Source: Business Law/Trade Secrets Practice in California/Contents

Contents

Preface

About the Authors

About the 2010 Update Authors

Acknowledgments

Selected Developments

Cutoff Dates and CEB Citation

1 Overview of California Trade Secrets Law

James H. Pooley
David J. Murphy
John Allcock
Donald J. Sullivan

2 Ownership of Trade Secrets

Bruce B. Brunda
Thomas A. Runk
Stephen M. Westbrook
Carol L. Smith

3 Idea Submissions

Bruce B. Brunda
Stephen M. Westbrook
Jack Russo
James C. Yang

4 Protecting a Company's Trade Secrets

Bruce B. Brunda
Stephen M. Westbrook
Carol L. Smith
James C. Yang

4A Trade Secret Audits and Protection Plans

Kurt A. Kappes
Robert B. Milligan
Timothy B. Nelson

5 Protecting Information Disclosed to Government Agencies

Nancy O. Dix
Sharon K. Sandeen

6 Form Protective Agreements and Provisions

Bruce B. Brunda
John D. Croll
Suzanne Springs

Geoffrey M. Creighton
James C. Yang

7 Exploiting Trade Secrets by Licensing

David N. Makous
Kevin D. DeBré

8 Form Licensing Agreements and Provisions

Peter C. Pang
Kevin D. DeBré

9 Security Interests in Trade Secrets

Ellen A. Friedman
Lawrence T. Woodlock
Lisa L. Ditora

10 Avoiding Misappropriation Claims

Michael J. Nader
Charles Tait Graves
Sharon K. Sandeen

11 Litigation Issues

Lowell Anderson
Robert B. Milligan

12 Remedies for Trade Secret Misappropriation

Lowell Anderson

13 Criminal Liability for Trade Secret Misappropriation

Perry J. Viscounty
James H. Pooley
David J. Murphy

14 Insurance Coverage for Misappropriation Claims

Daniel J. Callahan
Edward Susolik

15 Taxation of Trade Secrets

James G. Roberts
Walter R. Turner

16 Protecting Computer Technology

Louis J. Knobbe
Ronald J. Schoenbaum

17 Protecting Biotechnology

David J. Brezner

Diane J. Mason
Lisa E. Alexander
Peter C. Pang
Lynne M. Brennan

Appendix A: The Uniform Trade Secrets Act as Enacted in California (CC §§3426-3426.11)

Appendix B: The Uniform Trade Secrets Act (National Conference of Commissioners on Uniform State Laws)

Appendix C: Comparison of Trade Secrets, Patents, Copyrights, and Trademarks

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Appendix D: Civil Trade Secrets Statutes in Other Jurisdictions

Table of Statutes, Regulations, and Rules

Table of Cases

Table of References

Table of Forms

Index

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Preface

Virtually every company has trade secrets that enable it to compete in the marketplace, and every company needs to protect those secrets. As lawyers, we are often called on to assist our clients in dealing with this important information.

Trade secret issues arise in numerous contexts. Questions of ownership and use may arise when a company develops or otherwise obtains trade secret information. Clients may want assistance in protecting their trade secrets, whether from the peering eyes of competitors, from former employees who may inadvertently or intentionally disclose trade secrets, or from government agencies that may be asked to disclose trade secret information submitted to them. If a company believes it can profit from exploiting trade secrets by licensing, counsel can be invaluable in structuring and documenting the transaction. The client may also want to use trade secrets as collateral for financing. Tax treatment of trade secret acquisition and development costs may affect the client's trade secret decisions.

Clients need help in avoiding liability for misappropriation of another's secrets, and in obtaining relief when others have misappropriated their trade secrets. When misappropriation claims are made, trade secret owners may need advice in deciding what actions to take. Should they seek civil remedies, or is criminal liability more appropriate? Counsel must examine how specific litigation issues arise in trade secret misappropriation cases. The availability of insurance coverage may also affect litigation decisions.

New technologies in the information age are triggering new trade secret concerns. Specific problems can arise when trade secrets involve computer technology or biotechnology information. Because of our more global economy, counsel must recognize the problems that may arise from international licensing.

CEB first addressed these issues in its pioneering first edition of Attorney's Guide to Trade Secrets in 1971, which was quickly recognized as a leading text in the field. As demonstrated by the multitude of trade secrets concerns, the importance of this information has greatly increased over the years, leading more clients to seek out counsel on a wider variety of issues. The questions posed to counsel are answered in this revised and expanded edition of Trade Secrets Practice in California.

CEB gratefully acknowledges the work of the 22 attorneys who wrote one or more chapters for this book. Their names appear on the contents pages, on the first page of the chapter or chapters to which each contributed, and in the section "About the Authors."

Chapter manuscripts were reviewed by practicing attorneys throughout California, who contributed many helpful suggestions to the text. Their names are listed in the "Acknowledgments" section. We also wish to thank the consulting editors, James Pooley and Peter C. Pang, who reviewed all chapters in the book.

Cinda Ely was responsible for copyediting and production. Legal research analysis was provided by Jess R. Alvarado, Maria Borje-Bonkowski, Robert Denham, Maria Donohoe, Alan Flatt, Tom Hogan, Lucinda Igarashi, Ken Marr, Akilah Monifa, Ken Scudder, Kate Sheppard, Mindy Spatt, Mujahidun Sumchai, Martin Weis, and Tova L. Zeff. The index was prepared by Robert W. Burke, Jr., and composition was performed by CEB's Electronic Publishing staff. Cheryl Ventimiglia designed the book.

CEB plans to supplement this book on a regular basis. We solicit your suggestions and comments to help us keep it accurate and up to date.

October 2010 Update

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Selected Developments

October 2010 Update

Since last update:

If the trade secret exists in source code, possession of only the machine-readable code does constitute acquisition of the trade secret. *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27. See §§1.12, 4.25, 11.35.

A former employee could be enjoined from using trade secret information to identify and solicit former employer's customers, not because the employee's conduct fell within a "trade secret exception" to Bus & P C §16600, but rather because the employee's conduct was tortious and wrongful independent of any contractual undertaking. *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1238, 98 CR3d 585. See §§2.32B, 4.13, 10.16.

A joint survey of employees who had left or lost a job in 2008 found that 59 percent of former employees admitted to stealing confidential company information, including customer contact lists. See §4A.1.

Data about a client's needs and purchasing history were not trade secrets because information kept in agents' personal policyholder files was not adequately protected. *Nationwide Mut. Ins. Co. v Mortensen* (2d Cir 2010) 606 F3d 22. See §§4A.1, 4A.17.

If trade secrets are not marked confidential and are disclosed to others, such as customers, who are under no obligation to protect the confidentiality of the information, trade secret protection may be lost. *Southwest Stainless, LP v Sappington* (10th Cir 2009) 582 F3d 1176. See §4A.17.

In determining whether reasonable measures were taken to protect a trade secret, the focus is not on the omitted steps but on whether the steps taken to protect secrecy were reasonable. *Hertz v Luzenac Group* (10th Cir 2009) 576 F3d 1103. See §§4.4, 4.8.

An overly broad definition of a company's "confidential information" risks rendering the confidentiality agreement an invalid noncompete provision. *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 568, 102 CR3d 1. See §10.3.

In *Thomas Weisel Partners, LLC v BNP Paribas* (ND Cal, Mar. 31, 2010, No. C 07-6198) 2010 US Dist Lexis 11626, the court found that California law equates a "no hire" clause between a company and its customers with an unlawful noncompete provision. See §§10.4, 10.16.

Employing a competitor's former employee who entered into an employment agreement containing a noncompetition clause and a trade secrets clause could subject a defendant to jurisdiction in the state where the former employee and competitor entered into the agreement. *Astro-Med, Inc. v Nihon Kohden Am., Inc.* (1st Cir 2009) 591 F3d 1. See §11.6.

The broad definition of personal jurisdiction contained in the Racketeer Influenced and Corrupt Organizations Act (RICO) may provide a statutory basis for jurisdiction over related claims when a traditional due process analysis would not. See *Bray v Kendall* (ND Cal, Jan. 5, 2010, No. 08-0535 SC) 2010 US Dist Lexis 281, *10. See §11.6.

Some courts have permitted employers to sue former employees under the Computer Fraud and Abuse Act for e-mailing confidential information to their personal e-mail accounts. See *U.S. v John* (5th Cir 2010) 597 F3d 263. See §11.11.

Otherwise protected work product that is communicated to a testifying expert and considered in the formation of the expert's opinion is likely discoverable. *South Yuba River Citizens League v National Marine Fisheries Serv.* (ED Cal 2009) 257 FRD 607. See §11.20A.

The First Amendment interest in public dissemination of information obtained in discovery may tip the balance toward disclosure in appropriate cases. *Spindler v Baker & Daniels, LLP* (ND Ind, Mar. 12, 2010, No. 1:09-CV-5) 2010 US Dist Lexis 23343. See §11.20B.

In *Nycomed US, Inc. v Glenmark Generics, Inc.* (ED NY, Mar. 8, 2010, No. 08-CV-5023) 2010 US Dist Lexis 20788, a magistrate judge found that parties were "overdesignating" court filings as confidential. See §11.20B.

Parties are "not entitled to include broad, 'catch-all' language as a tactic to preserve an unrestricted, unilateral right to subsequently amend [a] trade secret statement." *Perlan Therapeutics, Inc. v Superior Court* (2009) 178 CA4th 1333, 1350, 101 CR3d 211. See §§11.21A, 11.23.

In *Hilderman v Enea Teksci, Inc.* (SD Cal, Jan. 8, 2010, No. 05cv1049 BTM) 2010 US Dist Lexis 1527, the court found that CCP

§2019.210 conflicts with Fed R Civ P 26. See §11.22.

A plaintiff that sold its rights to trade secrets in bankruptcy while reserving its rights of action for misappropriation commencing before the date of the transfer had standing to sue for misappropriation. *Jasmine Networks, Inc. v Superior Court (Marvell Semiconductor, Inc.)* (2009) 180 CA4th 980, 103 CR3d 426. See §§11.28, 12.1.

The Uniform Trade Secrets Act does not preempt a claim for misappropriation of non-trade secret business ideas because misappropriation of business ideas is a separate tort in California. *Interserve, Inc. v Fusion Garage PTE, Ltd.* (ND Cal, Apr. 9, 2010, No. C 09-05812 JW) 2010 WL 1445553. See §11.35.

A party may not be vicariously liable for conspiracy to breach a fiduciary duty. *Champlaie v BAC Home Loans Servicing, LP* (ED Cal, Oct. 22, 2009, No. CIV S-09-1316 LKK/DAD) 2009 US Dist Lexis 102285, *62 (citing *Applied Equip. v Litton Saudi Arabia* (1994) 7 C4th 503, 511, 514, 28 CR2d 475). See §11.41.

To show that a property right exists, a plaintiff must allege an interest that is "capable of precise definition" and may be exclusively possessed or controlled, and that the putative owner of the interest has "established a legitimate claim to exclusivity." *Tethys Bioscience, Inc. v Mintz, Levin, Cohn, Ferris, Glovsky & Popeo, PC* (ND Cal, Dec. 9, 2009, No. C 09-5115 CW) 2009 US Dist Lexis 114992. See §11.43.

To state a claim under civil RICO, the plaintiff is required to show that a RICO predicate offense was not only a "but for" cause of its injury, but was the proximate cause as well. *Hemi Group, LLC v City of New York* (2010) ___ US ___, 175 L Ed 2d 943, 130 S Ct 983. See §11.55.

If the accused misappropriator is not disseminating the trade secrets and has an incentive to keep the misappropriated information secret in order to maintain a competitive advantage, there may be no presumption of irreparable injury from the misappropriation. *Faiveley Transp. Malmo AB v Wabtec Corp.* (2d Cir 2009) 559 F3d 110. See §12.3.

In *Hyundai Motor Am. v National Union Fire Ins. Co.* (9th Cir 2010) 600 F3d 1092, the court held that third party patent infringement claims constituted allegations of "misappropriation of advertising ideas" when the advertising itself was the improper use of the patented method. See §14.2.

Asserting that the injunction was "narrow" and "applies only to users who purchase or license [the infringing software] after the date the injunction takes effect," the Federal Circuit upheld the permanent injunction granted to the plaintiff. *i4i v Microsoft Corp.* (Fed Cir 2010) 598 F3d 831. See §16.60.

In a long-awaited decision, the U.S. Supreme Court, by a 5-4 vote, ruled that business methods are not per se excluded by 35 USC §101 from patentability. *Bilski v Kappos* (2010) ___ US ___, 177 L Ed 2d 792, 130 S Ct 3218. See §16.63.

The court in *Association for Molecular Pathology v USPTO* (SD NY 2010) 94 USPQ2d 1683 held that mere extraction and purification of a naturally occurring chemical element or compound is not patentable. See §17.11.

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1

Overview of California Trade Secrets Law

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I. INTRODUCTION §1.1

II. SOURCES OF CALIFORNIA TRADE SECRET LAW §1.2

III. WHAT IS A TRADE SECRET?

A. UTSA Definition §1.3

B. Information Commonly Found to Be Trade Secret §1.4

1. Customer Lists §1.5

2. Negative Information §1.6

C. Independent Economic Value Requirement §1.7

D. "Not Generally Known" Requirement

1. Secrecy §1.8

2. Ready Ascertainability §1.8A

3. General Knowledge and Skill Versus Trade Secrets §1.9

E. Combination Trade Secrets §1.9A

F. Reasonable Efforts Requirement §1.10

IV. WHAT IS MISAPPROPRIATION?

A. UTSA Definition of Misappropriation §1.11

B. Common Types of Misappropriation §1.12

C. Disproving Misappropriation

1. Independent Development and Reverse Engineering §1.13

2. Ready Ascertainability §1.14

V. POSSIBLE REMEDIES §1.15

VI. ALTERNATIVE CLAIMS AND PREEMPTION §1.16

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§1.1 I. INTRODUCTION

We live in the "information age," when proprietary information can be more valuable to a business enterprise than physical assets. Sometimes the value of information depends on its being known only to its developer. If the information constitutes a trade secret, it may be protected by law. This chapter surveys the basics of California trade secret law—what the sources are for determining the law (see §1.2), what a trade secret is (see §§1.3-1.10), and what constitutes misappropriation of a trade secret (see §§1.11-1.14). It also identifies available remedies (see §1.15; see also chap 12) and alternative legal theories that bear on the protection of trade secret rights (see §1.16; see also chap 11). For discussion of the unique litigation issues that arise in trade secret disputes, see chap 11.

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Source: Business Law/Trade Secrets Practice in California/1 Overview of California Trade Secrets Law/§1.2 II. SOURCES OF CALIFORNIA TRADE SECRET LAW

§1.2 II. SOURCES OF CALIFORNIA TRADE SECRET LAW

In 1984, the California State Legislature adopted the Uniform Trade Secrets Act in large part as the California Uniform Trade Secrets Act (CC §§3426-3426.11). (The California Uniform Trade Secrets Act is referred to in this book as the "UTSA"; the Uniform Trade Secrets Act as proposed by the National Conference of Commissioners on Uniform State Laws in 1979 and amended in 1985 is referred to as the "Uniform Act." The UTSA and the Uniform Act are reprinted in Appendix A and Appendix B, respectively.) To date, 47 jurisdictions (including the District of Columbia) have adopted the Uniform Act in some form. See http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utsa.asp. See also App D. The UTSA applies to all alleged misappropriations of trade secrets occurring after January 1, 1985. To the extent earlier case law on trade secret issues conflicts with the UTSA, it is superseded. *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1324, 228 CR 713; *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034, 1043. Because the UTSA was meant to codify "better-reasoned cases," however, case law consistent with the UTSA but written before its adoption is persuasive. *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1324, 228 CR 713; *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1287, 272 CR 352.

The UTSA sets forth the general parameters of trade secret law in California, but there are some gaps in the case law interpreting the UTSA. Therefore, it is often necessary to refer to pre-UTSA California case law, the case law of other jurisdictions that have adopted the Uniform Act, legislative history, and general public policy to fill in those gaps. See, *e.g.,* Report of Senate Committee on Judiciary on Assembly Bill 501 (with the addition of one new comment, the comments to the UTSA reflect the Committee's intent). Further, case law from the jurisdictions that have adopted the Uniform Act in some form may be persuasive in California.

When considering California case law written before the adoption of the UTSA or trade secret case law from other jurisdictions, counsel should keep in mind the following points:

- Before adoption of the Uniform Act, most courts relied on the Restatement of Torts (1939) for trade secret law. States that have not adopted the Uniform Act may continue to rely on the Restatement of Torts (1939) or on the Restatement (Third) of Unfair Competition (1995), which replaced the prior discussion of unfair competition found in the original Restatement of Torts. California law differs from the Restatement of Torts in certain material respects (see Comment to CC §3426.1):

- Unlike the definition of "trade secret" in the Restatement of Torts, the UTSA definition covers information not "in use";

- Negative information (what not to do) (see §1.6) can be protected;

- Single events and other short-lived information, such as bids, can be protected; and

- A plaintiff must prove that it made reasonable efforts to maintain the secrecy of the information.

- The Uniform Act is not strictly uniform. Among the states that have adopted the Uniform Act, some (including California and Washington) have adopted the 1979 version, while others (including Colorado, the District of Columbia, Illinois, Michigan, Nevada, Oregon, Pennsylvania, and Utah) have adopted the 1985 version. For a current list of state-by-state adoptions, see http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-utsa.asp. See also App D. Some states have made changes to the version of the Uniform Act that they adopted. For example, the Uniform Act defines a trade secret as information that "derives independent economic value … from not being generally known to, and *not being readily ascertainable by proper means* by, other persons…." (Emphasis added.) Uniform Act §1. The California State Legislature deleted the language requiring that information be "not readily ascertainable" in order to remove ambiguity about what constitutes a trade secret. Under California law, the defendant has the burden of proving that the information was readily ascertainable as an affirmative defense, rather than having the plaintiff negate ready ascertainability as part of its case. See CC §3426.1; Comment to CC §3426.1; Pooley, The Uniform Trade Secrets Act: California Civil Code §3426, 1 Santa Clara Computer & High Tech LJ 193 (1985). See also §1.8.

- Much of California's trade secret law has been shaped by the state's public policy in favor of employee mobility—that is, the right of each employee to choose any lawful occupation. Bus & P C §16600 bars noncompetition agreements, and the statute figures in many published trade secret opinions. Because courts presume that the legislature enacts statutes with knowledge of existing statutes, California courts have interpreted the UTSA in a manner consistent with §16600, which was enacted in 1872 (former CC §1673). See, *e.g., Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084, 1090 (invalidating assignment clause that required all of former employee's inventions disclosed in patent applications or to any third party within 1 year after termination of employment to be

licensed to former employer); *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1238, 98 CR3d 585 (allowing injunction against former employee's misappropriation of secret customer list based on tort law rather than §16600). But see *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 946 n4, 81 CR3d 282 (reserving question whether trade secret exception to §16600 exists); *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881 (approving arbitration award that enforced noncompetition agreement based on other state's law). See also §§2.32-2.32D, 10.16, 11.41, 12.13 (discussing §16600).

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III. WHAT IS A TRADE SECRET?

§1.3 A. UTSA Definition

Under CC §3426.1(d), a trade secret is information that:

- Is not generally known in the industry, to the public, or to others who can realize economic value from its disclosure or use (see §§1.8-1.9);
- Has independent economic value, whether actual or potential, that derives from its secrecy (see §1.7); and
- Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy (see §1.10).

"Information" includes, among other things, formulas, patterns, compilations, programs, devices, methods, techniques, and processes. CC §3426.1(d); *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1322, 228 CR 713. See §§1.4-1.6.

NOTE: The UTSA breaks the definition into two categories, with (1) and (2) above combined, but the three elements are better understood if analyzed separately.

See §§2.13-2.21B for other statutory definitions of a trade secret, applicable in specific contexts.

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§1.4 B. Information Commonly Found to Be Trade Secret

"Information" has a broad meaning under the UTSA. In analyzing the Iowa version of the Uniform Act, the court in *Economy Roofing & Insulating Co. v Zumaris* (Iowa 1995) 538 NW2d 641, 647, broadly interpreted the term, stating that

[t]here is virtually no category of information that cannot, as long as the information is protected from disclosure to the public, constitute a trade secret. We believe that a broad range of business data and facts which, if kept secret, provide the holder with an economic advantage over competitors or others, qualify as trade secrets.

Determining the existence of a trade secret requires an objective analysis. A plaintiff's belief that information is secret or a contract describing information as secret may be a factor in the analysis but is not dispositive. See *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 1522, 66 CR2d 731 (plaintiff's belief); *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1325, 228 CR 713 (contract). Courts have recognized that the following types of information may constitute trade secrets in appropriate cases:

- **Customer and supplier lists.** *Morton v Rank Am., Inc.* (CD Cal 1993) 812 F Supp 1062, 1073; *ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 29, 286 CR 518; *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352. But see *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1240, 98 CR3d 585 (not trade secret if information is publicly available); *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1326, 228 CR 713 (not trade secret if information is generally known to public or is not sophisticated, difficult, or particularly time-consuming to acquire). See §1.5 for further discussion of customer lists as trade secrets.

- **Negative information (what not to do).** *Gates Rubber Co. v Bando Chem. Indus.* (10th Cir 1993) 9 F3d 823, 848; *Trandes Corp. v Guy F. Atkinson Co.* (4th Cir 1993) 996 F2d 655, 666; *Morton v Rank Am., Inc., supra; Courtesy Temp. Serv. v Camacho, supra*. See §1.6 for further discussion of negative information as a trade secret.

- **Manufacturing methods.** *Brescia v Angelin* (2009) 172 CA4th 133, 90 CR3d 842 (mixing, testing, and code marking of pudding); *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, 975 (specifications for material and manufacturing processes); *Christianson v Colt Indus. Operating Corp.* (7th Cir 1989) 870 F2d 1292, cert denied (1989) 493 US 822 (tolerances for mass-produced items, portions of which were patented).

- **Marketing and financing plans.** *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277 (marketing strategies); *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262 (market plans); *Alexander & Alexander Benefit Servs. v Benefit Brokers & Consultants, Inc.* (D Or 1991) 756 F Supp 1408 (financial information).

- **Computer software source code and related information.** *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169; *Rivendell Forest Prods. v Georgia-Pacific Corp.* (10th Cir 1994) 28 F3d 1042; *Aries Info. Sys. v Pacific Mgmt. Sys. Corp.* (Minn Ct App 1985) 366 NW2d 366.

- **The existence of licensing negotiations.** *Competitive Techs. v Fujitsu Ltd.* (ND Cal 2003) 286 F Supp 2d 1118.

One may also possess a trade secret in information obtained by reverse engineering another's trade secret. See Comment to CC §3426.1.

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Source: Business Law/Trade Secrets Practice in California/1 Overview of California Trade Secrets Law/§1.5 1. Customer Lists

§1.5 1. Customer Lists

Trade secret claims involving customer lists are frequently litigated. The central issue involves the boundary between the rights of former employees to compete for the same business and the rights of former employers to prevent the use of nonpublic information about customers in certain contexts. "Free competition prevails in the absence of a trade secret customer list." *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 633, 262 CR 92. Former employees cannot be required to "wipe clean the slate of [their] memories" to erase customers' names and addresses that are easily obtainable through normal resources such as the telephone directory. See *Moss, Adams & Co. v Shilling* (1986) 179 CA3d 124, 129, 224 CR 456. What, then, makes a customer list a trade secret? Courts look at customer list trade secret allegations on a case-by-case basis and evaluate them in light of the UTSA's requirements of value and secrecy. The most important questions are the following:

- Are the customers' identities common knowledge?
- What is the nature of the industry and of the customers? (Case law suggests that a trade secret will more likely be found where the industry is based on sales to customers whose desire for the goods or services at issue is not obvious, such as roof repair or laundry delivery.)
- What are typical customer buying habits in the industry? (There is less value in a list of customers who shift patronage based solely on price.)
- Was the plaintiff's customer list created through substantial effort and expense of locating customers from a universe of potential customers who do not advertise or make obvious their need for the goods or services at issue?
- Did the list include qualitative research (such as which were the best or most valuable customers)?
- Was the customer information sophisticated (such as billing information, key managerial contacts, and specific customer requirements)?
- Is the customer information obtainable via publically available sources?

Some courts also look to circumstantial evidence of the value of the customer list, such as whether the competitor who used the list or knowledge of the customers met with great success in a short period of time, thereby taking many of the plaintiff's customers.

Generally, the *identity* of customers is not protectable, but information about them can be. See *San Jose Constr., Inc. v S.B.C.C., Inc.* (2007) 155 CA4th 1528, 1538, 67 CR3d 54 (distinguishing between list of subcontractors and "compilation of the correspondence …; descriptions of the proposed scope of each project, measurements for each building, and detailed cost estimates").

Other cases finding that customer lists were trade secrets include the following:

- *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352: The customer list and other sophisticated customer information, such as billing rates, key contacts, specialized requirements, and mark-up rates, were of irrefutable commercial value and not readily ascertainable by other competitors. The information was developed by screening a large number of prospects at considerable time, effort, and expense.
- *Klamath-Orleans Lumber, Inc. v Miller* (1978) 87 CA3d 458, 461, 465, 151 CR 118: The plaintiff spent substantial time, energy, and money traveling around the country and developing a list of leading creditworthy customers. "Although the identity of some of plaintiff's customers may have been easily ascertainable by competitors, it cannot be said that the entire —or even a majority—of the customers scattered throughout the nation were readily accessible to defendants here."
- *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511, 521: The plaintiff's customer database had potential economic value "because it allows a competitor like [defendant] to direct its sales efforts to those potential customers that are already using the MAI computer system."

Cases finding that customer lists were *not* trade secrets include the following:

- *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1326, 228 CR 713: Customer names were generally known to the public, and the compilation process used by the plaintiff was "neither sophisticated nor difficult, nor

particularly time consuming."

- *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034, 1044: "[T]he typical customers of a [temporary personnel service] are large and small companies of all sorts, easily discoverable through public sources." In addition, the plaintiff had developed the lists through its own effort.

- *Moss, Adams & Co. v Shilling* (1986) 179 CA3d 124, 224 CR 456: The defendants, using a "safe harbor" procedure, sent announcements to the former employer's customers. But see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v Garcia* (CD Cal 2000) 127 F Supp 2d 1305 (sending account transfer forms to former employer's customer list was improper solicitation).

- *Liberty Mut. Ins. Co. v Gallagher & Co.* (ND Cal, Dec. 20, 1994, No. C94-3384 MHP) 1994 US Dist Lexis 18412, *14 (detailed discussion of California case law on customer lists and the circumstances under which customer lists can and cannot be deemed trade secrets—"Where only a small segment of a large group of potential purchasers of a good or service actually purchase that good or service, a customer list can indicate to competitors specifically which businesses have a predisposition to purchase that good or service.").

- *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 203, 246 P2d 11 (customers were not secret; defining "solicitation" with detailed discussion of rules for customer list cases).

- *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1240, 98 CR3d 585 (not trade secret if information is available through independent third party sources).

Trade secret lawsuits over customer lists also raise issues associated with Bus & P C §16600, which bars contracts that prohibit the solicitation of nonsecret customers. See §2.32 (collecting cases).

NOTE: By statute, employment agency customer lists less than 6 months old constitute trade secrets. Bus & P C §16607(a).

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§1.6 2. Negative Information

Negative information or secrets are developed during the course of research and development, when a researcher or developer learns *what not to do* or *what does not work optimally* in the industry or business. *SI Handling Sys., Inc. v Heisley* (3d Cir 1985) 753 F2d 1244, 1262. See also *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1287, 272 CR 352 (lengthy efforts that, from negative viewpoint, indicate what does not work or which potential customers are unlikely to become actual customers).

The principal guidance on negative secrets comes from the legislative comments to the UTSA (Comment to CC §3426.1):

The definition of "trade secret"… includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will *not* work could be of great value to a competitor.

California case law has only occasionally addressed the issue of negative secrets. See *Morton v Rank Am., Inc.* (CD Cal 1993) 812 F Supp 1062, 1073 (negative research results may be protectable as trade secret); *Courtesy Temp. Serv. v Camacho, supra* (citing Legislative Committee Comment and finding that negative information could constitute trade secret); *Leatt Corp. v Innovative Safety Technol., LLC* (SD Cal, Apr. 10, 2010, No. 09-CV-1301) 2010 US Dist Lexis 37382, *10 (unsuccessful test results of prototype were nevertheless "a step in the process of developing a new [product]"); *Self Directed Placement Corp. v Control Data Corp.* (9th Cir 1990) 908 F2d 462 (know-how and negative information not secret and therefore not trade secret); *Religious Technol. Ctr. v Wollersheim* (9th Cir 1986) 796 F2d 1076, 1090 (religious scripture lacked requisite economic value to be protectable trade secret under UTSA). Courts therefore look to case law from other jurisdictions to supplement and fill gaps in California law in know-how trade secret cases.

NOTE: The UTSA overrules *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, which held that negative information is not protectable.

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§1.7 C. Independent Economic Value Requirement

To qualify as a trade secret, information must derive value from the fact that it is a secret. See CC §3426.1(d)(1). This aspect of its value must be independent of its intrinsic value, for example, in helping the owner manufacture something. Thus, what matters is the value of the information at issue in comparison to information that is generally known. If the owner's customers buy its products for reasons that have nothing to do with the secret, it is difficult to assign any value to the secret. See *Buffets, Inc. v Klinke* (9th Cir 1996) 73 F3d 965, 968. In other words, the focus of this inquiry is on whether the information is generally known to, or readily ascertainable by, business competitors or others to whom the information would have some economic value. *Syngenta Crop Protection, Inc. v Helliker* (2006) 138 CA4th 1135, 1172, 42 CR3d 191; *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 251, 10 CR3d 185. The value of the information to a competitor must be substantial; it is insufficient to show only that it might have been helpful. *Yield Dynamics, Inc. v Tea Sys. Corp.* (2007) 154 CA4th 547, 567, 66 CR3d 1 (software routines only represented trivial value because they or their equivalents could be recreated).

The UTSA element of "independent economic value" is a codification of the common law requirement that a trade secret reflect a "competitive advantage." Restatement (Third) of Unfair Competition §39, Comment d, Reporters' Note (1995).

Slight variations on similar approaches used throughout an industry may not suffice; nor is it enough that the secret is merely different, or "unorthodox." See *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 271, aff'd (9th Cir 1960) 283 F2d 695. As long as the incremental value of the secret is not trivial, however, the value need not be great. Restatement (Third) of Unfair Competition §39, Comment e (1995). Proof of substantial development expense is relevant to value (see *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1282, 272 CR 352), but it is not necessary to show an enormous investment in research. Sufficient value can exist in a lucky discovery. See *A.O. Smith Corp. v Petroleum Iron Works Co.* (6th Cir 1934) 73 F2d 531, 538: "Facts of great value may, like the lost purse upon the highway, lie long unnoticed upon the public commons. Hundreds pass them by, till one more observant than the rest makes discovery. It is idle to say that, in the eyes of the law, interest may not in such case follow discernment." Conversely, a large investment in development does not by itself prove the existence of a trade secret. See *National Rejectors, Inc. v Trieman* (Mo 1966) 409 SW2d 1.

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D. "Not Generally Known" Requirement

§1.8 1. Secrecy

If information is to qualify as a trade secret, it must *not be generally known* in the industry, by the public, or by others who can realize economic value from its use. Thus, information disclosed, *e.g.,* in patents, on the Internet, in scholarly publications, by the plaintiff or by competitors, cannot be a trade secret. The Uniform Act generally adopts the "substantial secrecy" approach of prior case law.

The first published California case to reject a trade secret claim on grounds that the information was nonsecret was *Avocado Sales Co. v Wyse* (1932) 122 CA 627, 10 P2d 485, and the rule has been applied many times since. In one frequently cited Fifth Circuit case, the court explained that limited disclosures made to further the economic interests of the trade secret holder, *e.g.,* to interest others in the information during business negotiations, do not necessarily destroy trade secret status. *Metallurgical Indus. v Fourtek, Inc.* (5th Cir 1986) 790 F2d 1195, 1200.

A troubling consequence of modern communications technology is that property rights may be lost very quickly on the Internet. An anonymous posting on the Internet, even for a very brief period, may cause information to lose its status as a trade secret because the information is accessible by millions of people even though few may in fact have seen it. See *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 254, 10 CR3d 185 (vacating preliminary injunction on the grounds that "a preliminary injunction cannot be used to protect a secret if there is no secret left to protect"); see also *Religious Technol. Ctr. v Netcom On-Line Communication Servs.* (ND Cal 1995) 923 F Supp 1231, 1255 ("[o]nce trade secrets have been exposed to the public, they cannot later be recalled"). Due to the First Amendment and other constraints, a company whose secrets have been anonymously revealed on the Internet may have to rely on an internal investigation to discover the person responsible; courts are reluctant to force such information from publishers. See *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72.

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§1.8A 2. Ready Ascertainability

California's version of the Uniform Act allows a defendant to prove that the alleged information is not a trade secret by showing that it is readily ascertainable through proper means. If the plaintiff carries its burden of proving that the information was not generally known, the defendant may then present evidence to the contrary. See *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034; *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352; *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 228 CR 713; *Moss, Adams & Co. v Shilling* (1986) 179 CA3d 124, 224 CR 456. If the information, although not "generally known," could nevertheless be discovered with a very modest effort, it is said to be "readily ascertainable." Under the Comments to the California UTSA, a defendant may escape liability by proving ready ascertainability. This approach differs from that of the Uniform Act, which places on the plaintiff the burden of proving that the information is not readily ascertainable. Uniform Act §1(4)(i).

NOTE: Because the legislative history of the UTSA specifically designated ready ascertainability as an affirmative defense, the accused infringer has the burden of proving that defense. But other conduct that might be also considered an affirmative defense, such as reverse engineering, was not designated as such in the UTSA, so the burden of proof in regard to such other conduct does not shift. For example, in *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 1669, 3 CR3d 279, the trade secret owner requested a jury instruction shifting to the accused infringer the burden of proving independent creation or reverse engineering, once the trade secret owner proved that it had a trade secret and that the accused infringer had a system similar to the plaintiff's that used the trade secret. The court denied the jury instruction, holding that a trade secret owner has the burden of proving all elements entitling it to relief. The defendant does not have the burden of proving reverse engineering or independent creation, but the defendant acts at its peril if it does not present evidence rebutting the plaintiff's prima facie case. For further discussion of the concepts of independent creation and reverse engineering, see §1.13.

One California court stated in dicta that the ease of ascertainability is irrelevant to the definition of a trade secret under California law, but may be a defense to a misappropriation claim. *ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 21, 286 CR 518 ("information can be a trade secret even though it is readily ascertainable, so long as it has not yet been ascertained by others in the industry"). But see *Syngenta Crop Protection, Inc. v Helliker* (2006) 138 CA4th 1135, 1172, 42 CR3d 191 ("Information that is readily ascertainable by a business competitor derives no independent value from not being generally known.") See §1.14. Cases finding that the information at issue was not readily ascertainable and therefore satisfied the definition of a trade secret include *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034, 1043; *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1282, 272 CR 352; *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1326, 228 CR 713; and *Moss, Adams & Co. v Shilling* (1986) 179 CA3d 124, 130, 224 CR 456.

"Ready ascertainability" is defined by a spot on the continuum of reverse engineering difficulty. No law clearly establishes the location of that spot under California law. The Prefatory Note to the Uniform Act refers to *Wesley-Jessen, Inc. v Reynolds* (ND Ill 1974) 182 USPQ 135, 145, as an example of the common law principle that was codified as ready ascertainability. In that case, relief was denied because the claimed secret could be discovered from the marketed product (a camera) "by an engineer in a couple of days of study." Thus, secret information is protectable only if its discovery requires substantial (*i.e.,* nontrivial) effort. See also *San Jose Constr., Inc. v S.B.C.C., Inc.* (2007) 155 CA4th 1528, 1543, 67 CR3d 54 (triable issue of fact exists as to whether trade secret is readily ascertainable—that is, whether defendant could have "replicated" trade secret "within the short period it claimed to have needed").

The distinction between information that is generally known and information that is not readily ascertainable may appear to be of mere academic significance, but it can have a practical effect in litigation. Trade secret owners may argue that obscure publication of information (making the information only hypothetically ascertainable) does not negate the information's trade secret status or the plaintiff's right to relief if at the time of the misappropriation the defendants were not aware of—and therefore did not actually use—the obscure publication. Evidence of publication is relevant, however, even if the defendant did not learn of it. The defendant may challenge the plaintiff's assertion that the information is not generally known to the public (and thereby the assertion that the information is a trade secret) based on the mere availability of the information in publications such as directories, industry brochures, or pamphlets. Disclosure of the information in media available to the public or to persons who could obtain economic value from the information is relevant in determining whether the public knows of the alleged trade secret information. See *American Paper & Packaging Prods., Inc. v Kirgan, supra* (concerning "nonexclusive" information rather than publications).

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§1.9 3. General Knowledge and Skill Versus Trade Secrets

When misappropriation is based on trade secrets disclosed by former employees, the plaintiff must demonstrate to the trier of fact that the alleged trade secrets are not the same as the general knowledge or skills of the employee. In other words, an employee has a "tool kit" of skill and knowledge that he or she is privileged to take from job to job. See *AMP, Inc. v Fleischhacker* (7th Cir 1987) 823 F2d 1199, 1205, in which the court stated:

That is not to say that [a former employee] may not have derived some benefit from his access to the collective experience of [his employer] (experience to which [the employee] himself doubtless contributed significantly during the course of his employment). It is rather to say such information comprises general skills and knowledge acquired in the course of employment. Those are things an employee is free to take and to use in later pursuits, especially if they do not take the form of written records, compilations or analyses. Any other rule would force a departing employee to perform a prefrontal lobotomy on himself or herself. It would disserve the free market goal of maximizing available resources to foster competition. [I]t would not strike a proper balance between the purposes of trade secrets law and the strong policy in favor of fair and vigorous business competition.

See also *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 262, aff'd (9th Cir 1960) 283 F2d 695.

Neither matters of public knowledge nor matters of general knowledge in an industry can be trade secrets. CC §3426.1; Legislative Committee Comment to CC §3426.1. Therefore, if a plaintiff's methods, processes, or customer identities are matters of general knowledge in the industry, an employee can use such information for the benefit of a new employer even if the information was obtained during former employment. *National Welding Equip. Co. v Hammon Precision Equip. Co.* (ND Cal 1958) 165 F Supp 788, 795. Similarly, trade secret protection is not available for general engineering principles in the public domain (*Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 139) or for mathematical models based on public knowledge (*Ashland Mgmt. v Janien* (1993) 604 NYS2d 912, 624 NE2d 1007). The distinction between general knowledge available in the industry and specific information proprietary to the former employer is often hard to see. Thus, the analysis is often factual rather than legal. *Uniram Technol., Inc. v Taiwan Semiconductor Mfg. Co.* (ND Cal 2007) 617 F Supp 2d 938, 944. See chap 10 for further analysis of the trade secret status of information.

An employer cannot use trade secret law to unduly restrict employee mobility. "[O]wnership of a trade secret does not give the owner a monopoly in its use, but merely a proprietary right which equity protects against usurpation by unfair means." *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 283, 23 CR 198.

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§1.9A E. Combination Trade Secrets

A trade secret can exist even if its constituent elements are, in isolation, in the public domain. For example, the fact that one can purchase the individual components used to make an inventive device at a hardware store does not render the invention itself nonsecret. At the same time, a combination trade secret requires some showing that the individual elements are functionally interrelated such that they form a single, unique process that should properly be analyzed as a single trade secret. See generally *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142, 147 (under California law, a combination of elements, "each of which by itself is in the public domain," can be a trade secret when the "unified process" in combination is secret); *Winston Research Corp. v Minnesota Mining & Mfg. Co*. (9th Cir 1965) 350 F2d 134, 139 (under California law, even though components of recorder could be found in other recorders, "the specifications of these basic mechanical elements and their relationship to each other" in the machine made their combination a secret); *By-Buk Co. v Printed Cellophane Tape Co*. (1958) 163 CA2d 157, 166, 329 P2d 147 (fact that "component parts" of machine "were standard parts which could be procured by anyone in the open market" did not prevent finding that combination in machine was "unique or unusual").

The case law on combination trade secrets is not particularly clear on the requisite elements of such claims. See, *e.g., UniRAM Technol., Inc. v Taiwan Semiconductor Mfg. Co.* (ND Cal 2007) 617 F Supp 2d 938, 941 (observing that no published decision analyzed knowledge element of combination trade secret claim). In some cases, courts reject efforts to tie together individual items as a combination claim. See *Lawfinders Assocs., Inc. v Legal Research Ctr., Inc*. (ND Tex 1998) 65 F Supp 2d 414 (combination claim improper if individual elements should be analyzed separately). Transparent attempts to claim a combination trade secret when none exists can result in sharp language from the courts. See *American Airlines, Inc. v KLM Royal Dutch Airlines, Inc*. (8th Cir 1997) 114 F3d 108 (plaintiff used "sham" pleading of combination secret in effort to avoid summary judgment). On the other hand, a defendant cannot escape liability by showing that the specific combination was not identified as such by the plaintiff at the time of disclosure; if the defendant had access to the body of information, it is presumed to have had access to the valuable combination of elements. *UniRAM Technol., Inc.,* 617 F Supp 2d at 944 (issue of relative complexity of turning elements into secret combination should be decided by jury).

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§1.10 F. Reasonable Efforts Requirement

The efforts that the trade secret owner takes to keep the information secret must be reasonable under the circumstances. This rule requires a close evaluation of the industry in which the information is developed and who develops it. What may be a "reasonable effort" for a major manufacturer may not be reasonable for a garage shop inventor or a small company in its early stages of growth.

The Legislative Committee Comment to CC §3426.1 describes reasonable efforts:

[R]easonable efforts to maintain secrecy have been held to include advising employees of the existence of a trade secret, limiting access to a trade secret on "need to know basis," and controlling plant access. On the other hand, public disclosure of information through display, trade journal publications, advertising, or other carelessness can preclude protection.

Although "heroic measures" need not be taken to preserve the secrecy (*USM Corp. v Marson Fastener Corp.* (Mass 1979) 393 NE2d 895, 900), "a substantial element of secrecy must exist, so that, except by the use of improper means, there would be difficulty in acquiring the information" (*Clark v Bunker* (9th Cir 1972) 453 F2d 1006, 1009, quoting Restatement of Torts §757, Comment b (1939)). See also *Surgidev Corp. v Eye Technol., Inc.* (8th Cir 1987) 828 F2d 452, 455 (nondisclosure agreement provides evidentiary support for claim that reasonable precautions were taken); *Structural Dynamics Research Corp. v Engineering Mechanics Research Corp.* (ED Mich 1975) 401 F Supp 1102, 1117 (same); *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352 (information divulged only to branch office employees as needed for their specific duties and not to persons outside business; all employees advised of confidentiality); *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 630, 262 CR 92. But see *Gemisys Corp. v Phoenix Am., Inc.* (ND Cal 1999) 186 FRD 551, 558 (no trade secret because plaintiff failed to place confidentiality markings on materials containing and describing software), and *Motor City Bagels, L.L.C. v American Bagel Co.* (D Md 1999) 50 F Supp 2d 460, 480 (business plans carried an insufficiently prominent confidentiality notice).

Common steps a trade secret owner can take to meet the "reasonable efforts" requirement for a trade secret must deal with the problems of both inadvertent disclosure and intentional disclosure. Among the most persuasive measures are those that restrict access to the trade secret information (*e.g.,* disclosing information on a need-to-know basis only; implementing visitor access procedures), impose an obligation of confidentiality on persons having access to the information (*e.g.,* requiring nondisclosure agreements), and prevent others from obtaining the information through unintended means (*e.g.,* shredding discarded documents; sending information electronically, if at all, only in encrypted form). See chap 4 for full discussion of specific procedures a company may adopt to protect its trade secrets.

A corollary to the reasonable efforts requirement is the rule that information sold on the open market cannot constitute a trade secret. See *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 289, 23 CR 198 (plaintiff sold its allegedly secret valves to rocket manufacturers who incorporated them into products sold to the government). At the same time, however, information in a marketed product that would be impossible to reverse engineer can still be a trade secret. *Thermodyne Food Serv. Prods., Inc. v McDonald's Corp.* (ND Ill 1996) 940 F Supp 1300, 1307 (unrebutted testimony that specialty oven could not be reverse engineered).

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IV. WHAT IS MISAPPROPRIATION?

§1.11 A. UTSA Definition of Misappropriation

Under CC §3426.1(b), "misappropriation" is defined as:

1. 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

2. 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; or

(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 it had been acquired by accident or mistake.

To establish liability, a plaintiff must show that the defendant "knew or had reason to know" of the wrongful use or disclosure. The notion of "constructive knowledge" is most frequently applied to situations in which an employer disclaims knowledge of an employee's use of a previous employer's information. See, *e.g., Rohm & Haas Co. v Adco Chem. Co*. (3d Cir 1982) 689 F2d 424, 431 ("Defendants never asked where the 'Harvey Process' had come from [and] therefore were charged 'with whatever knowledge such inquiry would have led to.'"); *Data Gen. Corp. v Grumman Sys. Support Corp.* (D Mass 1993) 825 F Supp 340, 360 ("studious ignorance" is not a defense).

"Improper means" include theft, bribery, misrepresentation, espionage, or breach or inducement of a breach of a duty to maintain secrecy. Actions that are legal may nevertheless qualify as "improper means" if they are improper under the circumstances. Comment to CC §3426.1. Improper means generally encompass conduct that falls below an acceptable level of commercial ethics. See *Alcatel USA, Inc. v DGI Technol., Inc.* (5th Cir 1999) 166 F3d 772 (tricking customer to permit installation of electronic "snooper board" in secret equipment); *E.I. Du Pont de Nemours & Co. v Christopher* (5th Cir 1970) 431 F2d 1012, 1015, cert denied (1971) 400 US 1024 (aerial reconnaissance of construction site). Note that reverse engineering is specifically identified as a *proper* means of acquiring a trade secret. CC §3426.1(a). For a discussion of constructive knowledge, see *Ralph Andrews Prods. v Paramount Pictures Corp*. (1990) 222 CA3d 676, 271 CR 797.

NOTE: The UTSA protects against both actual misappropriation and threatened misappropriation. CC §3426.2. The doctrine of "inevitable disclosure" (*i.e.,* that circumstances of a defendant's new job make misappropriation so likely that restrictions can be imposed without proof of actual or threatened misuse) has been rejected by the Fourth District Court of Appeal in *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277 (reasoning that doctrine creates post-hoc covenant not to compete). See also *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 95 CR3d 307 (refusing to enter permanent injunction because California does not recognize inevitable disclosure doctrine and CC §3426.2(c) authorizes mandatory, not prohibitory, injunctions). But see *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 524, 75 CR3d 771 (CC §3426.2(a) expressly authorizes injunctions for "threatened misappropriation"). For further discussion of the doctrine of inevitable disclosure, see §12.13.

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Source: Business Law/Trade Secrets Practice in California/1 Overview of California Trade Secrets Law/§1.12 B. Common Types of Misappropriation

§1.12 B. Common Types of Misappropriation

Improper acquisition commonly involves copying and removing trade secret documents (see *Chicago Lock Co. v Fanberg* (9th Cir 1982) 676 F2d 400, 404; *By-Buk Co. v Printed Cellophane Tape Co.* (1958) 163 CA2d 157, 329 P2d 147), obtaining trade secret information from the owner's employee (*Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 116 CR 654), or improper conduct such as taking aerial photographs to discover another's trade secrets (*E.I. Du Pont de Nemours & Co. v Christopher* (5th Cir 1970) 431 F2d 1012, cert denied (1971) 400 US 1024). But see *Dow Chem. Co. v U.S.* (1986) 476 US 227, 90 L Ed 2d 226, 106 S Ct 1819 (no reasonable expectation of privacy from EPA aerial surveillance of chemical plant). Lawful acquisition of another's trade secrets, without more, is not actionable; improper means must have been used to acquire the trade secret to impose liability for this type of misappropriation. CC §3426.1(b)(1)-(2)(A). Thus, if the trade secret exists in source code, possession of only the machine-readable executable code does constitute acquisition of the trade secret. *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27.

NOTE: If no trade secret exists, the defendant is not liable under the UTSA, even if the information was improperly acquired. The plaintiff must pursue a different cause of action, such as a claim for breach of confidence, for relief. See §§11.35-11.54 for discussion of claims not based on UTSA.

Improper disclosure may be either intentional or inadvertent; both can result in liability because the UTSA does not require "intent" for civil liability. Inadvertent misappropriation can occur, for example, when the trade secret owner's employee has an interview with a new employer or when the employee is actually employed by a new employer and discusses the former employer's trade secret information. See *Loral Corp. v Moyes* (1985) 174 CA3d 268, 219 CR 836. A defendant may be liable for improper disclosure even if he or she did not directly or indirectly participate in acquisition of the trade secret. There need not be unauthorized use to trigger liability for misappropriation based on improper disclosure. *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1993) 822 F Supp 634.

Improper use is the most common, and most commonly misunderstood, type of misappropriation. A trade secret owner need not establish that the defendant's product is an element-for-element copy of the owner's trade secret product or process. Accordingly, proof of use is often based on circumstantial evidence. See *Greenberg v Croydon Plastics Co.* (ED Pa 1974) 378 F Supp 806, 814 ("Misappropriation and misuse can rarely be proved by convincing direct evidence. In most cases plaintiffs must construct a web of perhaps ambiguous circumstantial evidence from which the trier of fact may draw inferences which convince him that it is more probable than not that what plaintiffs allege happened did in fact take place. Against this often delicate construct of circumstantial evidence, there frequently must be balanced defendants and defendants' witnesses who directly deny everything."). Circumstantial evidence can be strong enough to overcome the direct evidence of a defendant's denial. *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 50, 37 CR3d 221. The plaintiff, however, must present real proof of misuse and cannot rely on speculation. See, *e.g., Wyatt Technol. Corp. v Malvern Instr., Inc.* (CD Cal, July 29, 2009, No. CV 07-08298 DDP) 2009 US Dist Lexis 66097 (summary judgment of no misappropriation of financial information granted when only "completely speculative" evidence submitted); *Electronic Planroom, Inc. v The McGraw-Hill Cos.* (ED Mich 2001) 135 F Supp 2d 805, 821 (summary judgment granted defendant despite evidence of theft of information and drop in plaintiff's business; "[o]nly rank speculation could forge the necessary link").

Often, a plaintiff establishes that the defendant had access to the trade secret information and thereafter successfully competed either in a short period of time or using a substantially similar manufacturing process or machine. Some cases support the proposition that a prima facie case by the plaintiff shifts the burden of persuasion to the defendant to prove it did not use the information. See, *e.g., Garter-Bare Co. v Munsingwear, Inc.* (9th Cir 1984) 723 F2d 707, 715. But more recently a California court has clarified that although the burden of *persuasion,* or of "coming forward" with evidence, may shift in this fashion, the burden of *proof* on misuse, as with all elements of trade secret misappropriation, stays with the plaintiff at all times. *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 1673, 3 CR3d 279. The Restatement (Third) of Unfair Competition §40, Comment c (1995), explains that "use" of a trade secret need not be direct and can be established, for example, when information is improperly used to "assist or accelerate research or development." The plaintiff, however, must show that the defendant's product or process was "substantially derived from the trade secret," and if the "contribution is so slight" that the result can be said to derive from other sources of information or from independent creation, there has been no actionable use. The Reporters' Notes to the same section also address proof of use by inference from substantial similarity, discussed above, and point out that any such comparison for similarities "must be evaluated in light of the scope of the trade secret and the content of the public domain," because similarities mean very little when they simply reflect technology that is generally known.

One court has found that indirect misuse occurred through "internal experimentation," even though no commercial product resulted. *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064, 1072. However, another court has pointed out that "use" must be substantial. *Yield Dynamics, Inc. v Tea Sys. Corp.* (2007) 154 CA4th 547, 570, 66 CR3d 1 ("A

defendant might steal the plaintiff's design for a distributor cap and use it in building his automobile. The entire automobile may be said to 'use' the distributor cap to accomplish its essential function, which is to move. This does not mean that the entire automobile is in any reasonable sense derived from or dependent upon the purloined design"). See also *JustMed, Inc. v Byce* (9th Cir 2010) 600 F3d 1118 (employee who converted employer's trade secret source code by deleting it from computers did not otherwise "use" source code so as to misappropriate it).

In the context of customer list trade secrets, soliciting a former employer's customers is improper use misappropriation. *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 262 CR 92. Although confidential customer lists may properly be used by departing employees to notify customers of the departure, when a notice implied that the employer went out of business and the customer list was used to directly solicit customers, there was misappropriation. *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289.

NOTE: A defendant may be liable for improper use even if he or she did not directly or indirectly participate in acquisition of the trade secret.

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C. Disproving Misappropriation

§1.13 1. Independent Development and Reverse Engineering

A person using information alleged to be a trade secret is not liable if he or she independently developed or reverse engineered the trade secret owner's product to discover the information through proper means. CC §3426.1(a); *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 476, 40 L Ed 2d 315, 94 S Ct 1879. The person must actually develop or reverse engineer the product; it is not sufficient that the information *could* have been so discovered (unless it is readily ascertainable; see §§1.8A, 1.14). See *Klamath-Orleans Lumber, Inc. v Miller* (1978) 87 CA3d 458, 151 CR 118, in which the court recognized that the defendants could have used their own resources to uncover the information in question, which they then could have exploited with impunity. "Instead, however, they chose simply to ride plaintiff's coattails." 87 CA3d at 465 n3.

The *Klamath-Orleans* case represents a common law view of trade secret protection that likely has been changed by the UTSA. Common law protected the confidential relationship under which a trade secret was often acquired, such that even if an accused misappropriator might have acquired the information through public sources, liability would be still found if the information was in fact acquired in breach of the confidential relationship. *Klamath-Orleans* was such a case. But under the UTSA, protection of the confidential relationship is impliedly rejected because the statutory requirements separate the defined acts of misappropriation from the requirements for evaluating if a trade secret even exists. No relief is granted if the information is generally known or readily ascertainable, no matter how egregious the evidence of misappropriation. See *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 254, 10 CR3d 185 ("a preliminary injunction cannot be used to protect a secret if there is no secret left to protect").

PRACTICE TIP: A claim of reverse engineering or independent development should be corroborated with sketches, notes, copies of publications, or other concrete evidence of how the information was developed. In *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1321, 228 CR 713, the defendants successfully refuted the plaintiff's contention that customer information had been misappropriated by showing that the customer lists were developed by defendants' own labor by (1) visiting industrial zone communities in their sales area, (2) compiling lists of manufacturing companies, and (3) making cold calls on companies and consulting telephone directories. All these efforts were documented by contemporaneous records—a must for a successful reverse engineering or independent derivation defense.

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§1.14 2. Ready Ascertainability

A defendant is not liable for trade secret misappropriation under the UTSA if the information at issue is readily ascertainable. If there is no secret, then in theory it is irrelevant how the defendant obtained it; there can be no actionable misappropriation. The defendant's conduct, however, may itself be evidence that the information was sufficiently difficult to acquire by proper means. Restatement (Third) of Unfair Competition §39, Comment f (1995) states:

When a defendant has engaged in egregious conduct in order to acquire the information, the inference that the information is sufficiently inaccessible to qualify for protection as a trade secret is particularly strong.

See also *Clark v Bunker* (9th Cir 1972) 453 F2d 1006, 1010.

For further discussion of ready ascertainability as a defense to disprove that the information at issue is a trade secret, see §1.8A.

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§1.15 V. POSSIBLE REMEDIES

A plaintiff who proves actual or threatened misappropriation of trade secrets has several potential remedies:

- Injunction. CC §3426.2.
- Compensatory damage for actual loss. CC §3426.3(a).
- Compensatory damage for defendant's unjust enrichment, to the extent not taken into account by plaintiff's actual loss. CC §3426.3(a).
- Payment of a reasonable royalty, if neither damages nor unjust enrichment is provable. CC §3426.3(b).
- Exemplary damages not exceeding twice the compensatory damages award if willful and malicious appropriation is found to exist. CC §3426.3(c).
- Attorney fees and costs for bad faith tactics in trade secret litigation or willful and malicious misappropriation. CC §3426.4. See *Computer Prepared Accounts, Inc. v Katz* (1991) 235 CA3d 428, 286 CR 556 (granting attorney fees under CC §3426.4 and CCP §128.5 against plaintiff who sued law firm for misappropriation of software programs and then submitted forged documents in support of its claims). See also *Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 1262, 116 CR2d 358 (bad faith established by claim that superficially may appear to have merit, while ultimately proving "specious," a less demanding standard than "frivolous").

For full discussion of available civil remedies, see chap 12.

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§1.16 VI. ALTERNATIVE CLAIMS AND PREEMPTION

Many other causes of action bear on the ability of a party to protect its information and may impact trade secret rights. See §§11.35-11.55. Does a plaintiff who alleges breach of confidence, interference with contract, or other tort have a remedy other than under the UTSA? This issue can be very important for several reasons. The UTSA limits exemplary damages to twice the compensatory award (CC §3426.3(c)), but other causes of action may not so limit such relief. In addition, procedural standards (*e.g.,* CCP §2019.210; see §§11.21-11.22) and substantive limitations (*e.g.,* whether the information qualifies as a trade secret) arguably may not apply in other types of claims. Moreover, given the evolution of this area of the law, it is increasingly likely that California courts confronted with the question of whether the UTSA preempts other claims premised on allegedly confidential information that does not rise to the level of a trade secret may hold that preemption applies and precludes such claims from going forward.

The UTSA discusses preemption in CC §3426.7, stating in pertinent part that it

does not affect (1) contractual remedies, whether or not based upon misappropriation of a trade secret, (2) other civil remedies that are not based upon misappropriation of a trade secret or (3) criminal remedies, whether or not based upon misappropriation of a trade secret.

Thus, although the UTSA governs noncontractual civil remedies that *are* based on misappropriation of a trade secret, it was not intended to be a comprehensive remedy. See Comment to Uniform Act §7. Specifically excluded in the Comments to Uniform Act §7 are contractual obligations (*e.g.,* covenants not to compete and nondisclosure obligations) and "duties imposed by law that are *not dependent upon the existence of competitively significant secret information*." (Emphasis added.)

The necessary corollary is that when an action is directed at "competitively significant secret information," the UTSA provides the exclusive noncontractual remedy. This is because the statute was intended "to occupy the field." *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 957, 90 CR3d 247. Therefore, noncontractual theories such as tortious interference with contract/prospective economic advantage, fraud, breach of confidential relationship, unfair competition, and unjust enrichment are displaced by the UTSA. See *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025. See also *Callaway Golf Co. v Dunlop Slazenger Group Am., Inc.* (D Del 2004) 318 F Supp 2d 205 (applying California law); *AccuImage Diagnostics Corp. v Terarecon, Inc.* (ND Cal 2003) 260 F Supp 2d 941, 953 (common law misappropriation); *Convolve, Inc. v Compaq Computer Corp.* (SD NY, Mar. 29, 2006, 00-CV-5141) 2006 US Dist Lexis 13848, cert denied (2008) 552 US 1230 (applying California law and holding preemption argument not waived by failure to assert as affirmative defense). A few state courts allow alternate claims for information that does not rise to the level of a trade secret. See, *e.g., Burbank Grease Servs., LLC v Sokolowski* (Wis 2006) 717 NW2d 781. However, California's version of the statute expresses preemption more broadly than these other states. *K.C. Multimedia, Inc.,* 171 CA4th at 955. Therefore, displaced claims may not be pled in the alternative. In addition to statutory preemption under the UTSA, a defendant might urge that trade secret law may be the exclusive means of state law protection of the substance of information that is patentable subject matter (*i.e.,* a "process, machine, manufacture, or composition of matter" (35 USC §101)). See *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 103 L Ed 2d 118, 109 S Ct 971 (invalidating Florida statute that prohibited "plug mold" copies of boat hulls).

For discussion of specific alternative civil claims, see §§11.35-11.55. For discussion of criminal liability, see chap 13.

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Source: Business Law/Trade Secrets Practice in California/2 Ownership of Trade Secrets/Chapter Outline

2

Ownership of Trade Secrets

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I. INTRODUCTION; SCOPE OF CHAPTER §2.1

II. COMMON LAW RULE: OWNERSHIP DEPENDS ON EQUITY AND FIDUCIARY OBLIGATIONS §2.2

A. Employer Versus Employee §2.3

1. When Is Employee "Hired to Invent"? §2.4

2. Determining Who Owns Certain Procedures, Methods, and Expertise §2.5

3. Resolving Concurrent Interests: Shop Rights Doctrine §2.5A

a. Employee Uses Employer's Time and Resources to Develop §2.6

b. Shop Right Arises by Estoppel §2.7

c. Possible Exception to Shop Rights Doctrine: Employee Breach of Confidentiality §2.8

d. Limited Transferability of Shop Rights §2.9

B. Alter Ego, Principal Shareholder, or Officer Versus Corporation: Corporate Opportunity Doctrine §2.10

C. Other Business Relationships §2.11

III. STATUTES AFFECTING OWNERSHIP §2.12

A. Statutory and Restatement Definitions of Trade Secrets §2.13

1. Uniform Trade Secrets Act (CC §3426.1(d)) §2.14

2. Penal Code §499c §2.15

3. Government Code §6254.7(d) §2.16

4. Business and Professions Code §§16606, 16607(a) §2.17

5. Evidence Code §§1060-1061 §2.18

5A. Right of Access §2.18A

6. Labor C §§2860, 2870-2872 §2.19

7. Revenue and Taxation Code §11342 §2.20

8. Title 18 United States Code §1905 §2.21

9. Economic Espionage Act of 1996 (18 USC §§1831-1839) §2.21A

10. Restatement of the Law (Third) on Unfair Competition §2.21B

B. Application of Multiple Definitions §2.22

1. Ownership Depends on Employment §2.23

2. Ownership Depends on Who Controls Tangibles §2.24

3. Ownership Depends on Who Made Effort to Protect §2.25

IV. CONTRACTUAL PROVISIONS AFFECTING OWNERSHIP §2.26

A. Need for Consideration §2.27

1. Consideration Sufficient §2.28

2. Consideration Not Sufficient §2.29

B. Contract of Adhesion and Other Contract Defenses §2.30

1. Employee Assignment Agreements §2.31

2. Noncompetition Agreements

a. Bus & P C §16600 and Statutory Exceptions §2.32

b. General Rule: Noncompetition Agreements Void §2.32A

c. Status of Trade Secret Exception §2.32B

d. Status of Narrow-Restraint Exception §2.32C

e. Other Potential Exceptions §2.32D

V. EFFECTS OF OTHER INTELLECTUAL PROPERTY ON OWNERSHIP §2.33

A. Confidentiality Agreements §2.33A

B. Copyright Protection §2.34

C. Patent Protection §2.35

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Source: Business Law/Trade Secrets Practice in California/2 Ownership of Trade Secrets/§2.1 I. INTRODUCTION; SCOPE OF CHAPTER

§2.1 I. INTRODUCTION; SCOPE OF CHAPTER

A key issue in any trade secret dispute, and in any matter in which a trade secret will be developed, is who owns or will own the trade secret. Many problems arise from a failure to consider or properly resolve this issue at an early stage.

Because trade secrets have the status of property under the law (see CC §§655, 980-985, and *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169), determining ownership is a foundational concern, as it is with any property right. The determination of ownership affects a great many issues, including naming parties in trade secret litigation, licensing trade secrets, and the acquisition or divestiture of trade secrets. In particular, the following questions arise: Who is the proper licensor? Who is freely entitled to use the trade secret? Who is the proper plaintiff or coplaintiff in an action for misappropriation? And, among other questions, who is the appropriate defendant or codefendant?

Indeed, ownership is one of the basic elements of a trade secret misappropriation claim. Failure to allege ownership may result in dismissal of the case at an early stage. See *California Police Activities League v California Police Youth Charities* (ND Cal, Mar. 3, 2009, No. C 08-1991 PJH) 2009 US Dist Lexis 20507. Failure to prove ownership may result in a jury verdict for the defendant. See *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 957, 90 CR3d 247.

Ownership, however, should not be confused with standing. The concept of standing requires that the plaintiff establish an entitlement to judicial action. Ownership is clearly sufficient to establish standing; however, it is not the only way. In fact, existing authority imposes no "current" ownership requirement on trade secret plaintiffs. For a detailed discussion of "standing," see *Jasmine Networks, Inc. v Superior Court (Marvell Semiconductor, Inc.)* (2009) 180 CA4th 980, 103 CR3d 426. See also *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27 (for general principles of standing under California's Unfair Competition Law); *Farhang v Indian Inst. of Technol., Kharagpur* (ND Cal, June 1, 2010, No. C-08-02658 RMW) 2010 US Dist Lexis 53975.

In preparation for the discussion of trade secret ownership that follows in this chapter, the characteristics of the trade secret property right are reviewed briefly below. Inherent in the nature of trade secrets is that the information (see CC §3426.1(d); §§1.3, 1.8-1.10, 2.14):

- Is not generally known to the public or anyone who could gain economic value from its disclosure;
- Confers some advantage to the owner; and
- Is the subject of reasonable efforts under the circumstances to maintain its secrecy.

As such, trade secrets are protected only against disclosure or use through improper means. *DTM Research, LLC v AT&T Corp.* (4th Cir 2001) 245 F3d 327; *Glasstech, Inc. v TGL Tempering Sys., Inc.* (ND Ohio 1999) 50 F Supp 2d 722. See §1.12. Under the California Uniform Trade Secrets Act (UTSA), an action for trade secret misappropriation must be brought within 3 years after the misappropriation is discovered or, by the exercise of reasonable diligence, should have been discovered. CC §3426.6; see *Glue-Fold, Inc. v Slautterback Corp.* (2000) 82 CA4th 1018, 98 CR2d 661. For purposes of the statute, a continuing misappropriation constitutes a single claim. *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169. For further discussion of the limitations period, see §§11.13-11.13C.

NOTE: A combination of characteristics and components, each of which is generally known, can constitute a trade secret if the unified process satisfies the requirements for a trade secret. *Integrated Cash Mgmt. Servs., Inc. v Digital Transactions, Inc.* (2d Cir 1990) 920 F2d 171, 174. See also *Mangren Research & Dev. Corp. v National Chem. Co.* (7th Cir 1996) 87 F3d 937 (stating that "if the trade secret law were not flexible enough to encompass modified or even new products that are substantially derived from the trade secret of another, the protections that the law provides would be hollow indeed"). For further discussion of combination trade secrets, see §1.9A.

For further discussion of the issue of what is a trade secret, see chap 1.

As a starting point for analysis of ownership, the general principle is that one who discovers, develops, or compiles a trade secret is the owner of the trade secret. *U.S. v Dubilier Condenser Corp.* (1933) 289 US 178, 77 L Ed 1114, 53 S Ct 554. Once that individual or those individuals are identified, however, other factors may then come into play, most of which involve a relationship of some type between the discoverer, developer, or compiler and another party.

Ownership of trade secrets may be defined by common law principles under which equity may establish the ownership of a trade secret based on the relationship of the parties involved (see §§2.2-2.11). Contract principles, which may or may not be limited by statute, may also define ownership rights of trade secrets (see §2.26). Moreover, as is the case in California, various statutes must be considered, especially in the largest area of trade secret disputes, *i.e.,* the employment area. See, *e.g.,* Lab C §§2860, 2870. See §2.19.

This chapter outlines the principal factors affecting the ownership of trade secrets, to provide guidance to the practitioner in analyzing this important issue. The chapter begins with a description of common law principles (see §§2.2-2.11), discusses

statutory principles under California law (see §§2.12-2.25), analyzes contractual principles (see §§2.26-2.32), and concludes with a discussion of the effects of other intellectual property on ownership of trade secrets (see §§2.33-2.35).

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§2.2 II. COMMON LAW RULE: OWNERSHIP DEPENDS ON EQUITY AND FIDUCIARY OBLIGATIONS

At common law, the courts apply general equitable principles to the specific relationship of the parties to determine ownership of the trade secrets at issue. This approach is used in analyzing California employer/employee relationships to the extent described in §§2.3-2.9. It is also important to note that California has adopted several statutes directed to the employer/employee relationship that may greatly affect ownership and, in some cases, expressly identify the owner. See, *e.g.,* Bus & P C §16606; see also §2.17. Because most reported trade secret disputes involve employees and employers, a large body of law has developed around this issue. See Milgrim on Trade Secrets §§5.02, 6.02 (1967).

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§2.3 A. Employer Versus Employee

In the absence of an express agreement specifying the ownership of trade secrets, information developed by an employee usually belongs to the employer. In particular, Lab C §2860 provides:

Everything which an employee acquires by virtue of his employment, except the compensation which is due to him from his employer, belongs to the employer, whether acquired lawfully or unlawfully, or during or after the expiration of the term of his employment.

See also *Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 67 CR 19. Rather than taking the position that Lab C §2860 makes anything an employee creates subject to ownership by his or her employer, the courts have used the phrase "by virtue of his or her employment" as a limit on employer rights in certain employee developments. The substance of this phrase has been an issue in many cases over the years in determining ownership and has often been resolved using common law principles. Thus, if an employee is hired to invent (see §2.4), the employee's developments belong to the employer. *Standard Parts Co. v Peck* (1924) 264 US 52, 68 L Ed 560, 44 S Ct 239; *Solomons v U.S.* (1890) 137 US 342, 34 L Ed 667, 11 S Ct 88 (one employed to invent has sold his rights in advance and is estopped from asserting ownership rights against employer). See also *Wireless Specialty Apparatus Co. v Mica Condenser Co.* (Mass 1921) 131 NE 307, which recognized that because the employer bore the cost of development, it should also reap the benefits:

The fruit of the labor of one who is hired to invent … belongs to the employer.… If the employee fails to reach his goal the loss falls upon the employer, but if he succeeds … then the invention belongs to the employer even though the terms of employment contain no express provision dealing with ownership of whatever inventions may be developed.

In the absence of a written employment agreement, however, it is often not clear whether the employee was hired to invent. In these cases, further analysis must be undertaken. See §2.4. For a discussion of ownership rights as between employer and employee under certain non-UTSA statutes, see §§2.17, 2.19.

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Source: Business Law/Trade Secrets Practice in California/2 Ownership of Trade Secrets/§2.4 1. When Is Employee 'Hired to Invent'?

§2.4 1. When Is Employee "Hired to Invent"?

The question of whether an employee was "hired to invent" so as to give ownership rights to the employer has led to enormous controversy and has been the subject of more than one case in which the decision was based on thin distinctions between one set of facts and another. Although most of these controversies could have been avoided by the presence of a written employment agreement that explicitly specified that the employee was hired to invent, the practitioner will nevertheless still encounter numerous instances when the employer has not had the foresight to put such a written agreement in place.

The U.S. Supreme Court has construed "invent" in this context fairly narrowly (*U.S. v Dubilier Condenser Corp.* (1933) 289 US 178, 188, 77 L Ed 1114, 1119, 53 S Ct 554):

In deciding whether an employee was hired to invent, the court must recognize the fundamental nature of an invention. This distinction between the idea and its practical application led to the rule that employment merely to design, construct, or devise methods of manufacture is not the same as employment to invent.

See also *B.F. Gladding & Co. v Scientific Anglers, Inc.* (6th Cir 1957) 248 F2d 483. See Restatement (Third) of Unfair Competition §42, Comment e (1995).

According to California case law, not being "hired to invent" may make inventions fall outside the qualifier, "by virtue of his or her employment" (see Lab C §2860), meaning that the employer has no claim to the invention or trade secret subject matter. For example, in *Banner Metals, Inc. v Lockwood* (1960) 178 CA2d 643, 3 CR 421, Lockwood was hired as a salesman, a noninventive employee, with no written employment agreement and no written obligation to assign any inventions to his employer. During his employment, Lockwood developed an invention based on his on-the-job observations of a deficiency in stackable bakery receptacles and patented that invention. He offered the invention to his employer multiple times, only to be told that the employer had no interest. When the employer finally found an interest and sued to have the patent assigned, the court found that Lockwood was not hired to invent and had no obligation to assign. Apparently, the court applied equitable principles to find that Lockwood's invention did not arise "by virtue of his employment," even though he developed the concept as a result of his employment activities.

Other courts, however, have generally broadened this classification by holding that any assignment to work on a problem is sufficient to invest the employer with the exclusive right of ownership and control of resulting information or solutions. In *Forberg v Servel, Inc.* (D NY 1949) 88 F Supp 503, the employee was originally hired as a "testing engineer, making performance and efficiency tests on all kinds of gas appliances." The court found that he was not initially hired to invent, but that when his employer ordered him to concentrate on a particular type of problem (dust created by refrigerator burners) he became, in essence, employed to make an invention, even though he had not been originally employed to do so. See also *Marshall v Colgate-Palmolive Peet Co.* (3d Cir 1949) 175 F2d 215, 217 ("if the employee … is assigned the duty of devoting his efforts to a particular problem, the resulting invention belongs to the employer"). Thus an employee relieved of other work and sent to a new location specifically to conduct experiments to make a certain product is not entitled to ownership of the resulting patent. The patent is the employer's. *Houghton v U.S.* (4th Cir 1928) 23 F2d 386, cert denied (1928) 277 US 592. But see *Banks v Unisys Corp.* (Fed Cir 2000) 228 F3d 1357 (issue of fact whether hired inventor's status created implied-in-fact contract to assign all inventions to employer when he specifically assigned certain inventions to employer but refused to execute general assignment).

A conflict in the case law exists with respect to employees who are not originally hired to invent, but who are later asked to invent. On the one hand, the U.S. Supreme Court has held that an employee who was not originally hired to invent did not "sell his rights in advance" to his employer. See *Solomons v U.S.* (1890) 137 US 342, 34 L Ed 667, 11 S Ct 88. The issue of consideration becomes apparent immediately in situations when an employee has been hired originally in a noninventing capacity and at a much lower wage than employees hired in an inventing capacity. The consideration issue comes into focus when an employee not originally hired to invent is later asked to "solve problems" by the employer. A court could decide that, without more, an invention produced after an employer asked an employee originally hired as "noninventing" to solve a problem is not subject to assignment to the employer given a lack of consideration, and therefore does not fall within the phrase "by virtue of his or her employment." See §§2.27-2.29 for further discussion of the issue of consideration.

Although common law rules of equity may allow the employer a shop right in the invention in some instances, as discussed in §§2.5A-2.9, the employer may have wanted the entire right, title, and interest in the employee's invention instead. To possibly avoid such a situation, the practitioner should consider advising the client-employer to give the employee some additional consideration before the employee commences inventing at the company. The consideration may take the form of a raise, a promotion, better benefits, a change in job description that may enable the employee to qualify for higher pay or larger bonuses, or other compensation of significant value. The change in job duties to an "inventing" status should be documented in the employee's file, with a notation that the employee is now "employed to invent," as should the actual payment to the employee of the additional consideration. The employer should then qualify under the *Solomons* and *Wireless Specialty* cases (see §2.3) because the risk of economic loss would fall on the employer if the employee is not successful in inventing.

One may well ask whether a "hired to invent" analysis is necessary if the employer has a written employment agreement clearly

specifying that the employer owns everything that an employee creates. The answer is a qualified "no." As discussed in §2.23, Lab C §2870 places limits on what "inventions" a written employment agreement can take away from the employee.

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§2.5 2. Determining Who Owns Certain Procedures, Methods, and Expertise

Two preliminary considerations apply to the ownership inquiry. First, it should be determined whether the information that is the subject of the inquiry will qualify as a trade secret. See chap 1. If not, trade secret ownership rights are not an issue. Second, California public policy favoring employee mobility (see §2.32) should be considered to determine whether the information is protectable. This inquiry involves balancing the employee's right to make a living against the material that is possibly a trade secret; an employee's own skill and knowledge should not be hastily branded a trade secret. *Rigging Int'l Maintenance Co. v Gwin* (1982) 128 CA3d 594, 606, 180 CR 451.

Know-how or general knowledge, skill, or experience acquired or developed by an employee (rather than supplied by the employer) is not owned by or assignable to the employer. See *Rohm & Haas Co. v Adco Chem. Co.* (3d Cir 1982) 689 F2d 424; *EarthWeb, Inc. v Schlack* (SD NY 1999) 71 F Supp 2d 299, aff'd (2d Cir 2000) 2000 US App Lexis 11446. For example, know-how consisting of an ability to resolve novel problems arising in materials-handling system applications and the experience necessary to avoid past mistakes and failures is not entitled to protection as a trade secret to the extent that it gives the employer property rights over former employees' problem-solving ability or knowledge of mistakes to avoid. *SI Handling Sys., Inc. v Heisley* (3d Cir 1985) 753 F2d 1244; *Syntex Ophthalmics, Inc. v Novicky* (ND Ill 1982) 214 USPQ 272, aff'd sub nom *Syntex Ophthalmics, Inc. v Tsuetaki* (7th Cir 1983) 701 F2d 677. See §2.3.

Of course, drawing the line between the employee's general knowledge and skill and the employer's trade secrets can be difficult. A distinction must be drawn between what is a trade secret and thus owned by the employer and what is employee knowledge and skill and thus owned by the employee. The courts examine whether the employee's particular knowledge was supplied by the employer or derived from the employee's own actions. In *Daniel Orifice Fitting Co. v Whalen* (1962) 198 CA2d 791, 18 CR 659, the former employee, Whalen, had been hired to review and develop new products and improve existing products. Whalen did not disclose certain findings to his employer, because he planned to use them later in competition with his employer. The court rejected the idea that the developments were made on the employee's own time. The court found that the findings belonged to the employer because their development was within the scope of the employee's employment. See also *Treu v Garrett Corp.* (1968) 264 CA2d 432, 70 CR 284. See §§10.29-10.48 for discussion of sources of information.

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§2.5A 3. Resolving Concurrent Interests: Shop Rights Doctrine

The shop rights doctrine is a common law doctrine long in existence. See *Gill v U.S.* (1896) 160 US 426, 40 L Ed 480, 16 S Ct 322; *Solomons v U.S.* (1890) 137 US 342, 34 L Ed 667, 11 S Ct 88; *McClurg v Kingsland* (1843) 42 US (1 How) 202, 11 L Ed 102. It is sometimes defined as a nonexclusive right of the employer to use an invention created by an employee, under certain conditions. While patents are often involved, the doctrine is equally applicable to trade secrets.

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§2.6 a. Employee Uses Employer's Time and Resources to Develop

Historically, any developments of an employee not hired or assigned to invent belong to the employee. *Lion Mfg. Corp. v Chicago Flexible Shaft Co.* (7th Cir 1939) 106 F2d 930 (middle manager not required to assign inventions made incident to duties); *Banner Metals, Inc. v Lockwood* (1960) 178 CA2d 643, 661, 3 CR 421. An employee is not hired to invent if the employment contract does not cover research, invention, discoveries, patents, or employee duties; no implied assignment is made for the employee's inventions beyond the scope of his or her assignments. *U.S. v Dubilier Condenser Corp.* (1933) 289 US 178, 77 L Ed 1114, 53 S Ct 554. However, if an employee not hired or assigned to invent used the employer's resources or time in making the development, the employer is deemed to have an implied nonexclusive and nontransferable license to use it in the employer's business:

[W]here a servant, during his hours of employment, working with his master's materials and appliances, conceives and perfects an invention …, he must accord his master a non-exclusive right to practice the invention.

289 US at 188, 77 L Ed at 1119. See also §2.19.

Thus, even if employee ownership is found, the employer is deemed to have a nonexclusive and nontransferable implied license to use the development in its business if the employee used the employer's resources or time in making the development. See *Aero Bolt & Screw Co. v Iaia* (1960) 180 CA2d 728, 5 CR 53. See also Restatement (Second) of Agency §397, Comments b-c (1958). The employer's license is referred to as a "shop right." It does not require reduction to practice using the employer's resources. *Consolidated Vultee Aircraft Corp. v Maurice A. Garbell, Inc.* (9th Cir 1953) 204 F2d 946.

The employer's contribution must be more than de minimis for the shop right to accrue. *Corrigan v Armstrong, Teasdale, et al.* (Mo App 1992) 824 SW2d 92; *Dewey v American Stair Glide Corp.* (Mo App 1977) 557 SW2d 643 (no shop right when welder worked during lunch to make development, using both scrap metal that employees had right to take and company welder). See also *Banner Metals, Inc.,* 178 CA2d at 650, in which the court, in denying the employer a shop right, held that Lockwood's use of his employer's equipment and goods was "negligible and unimportant and in no substantial way produced or contributed to the development of a receptacle of a commercially acceptable form."

A shop right may also arise in other than an employment relationship. See, *e.g., Francklyn v Guilford Packing Co.* (9th Cir 1983) 695 F2d 1158 (court awarded shop right, holding that it made no difference that inventor claimed to be independent contractor); *GateWay, Inc. v Hilgren* (SD Cal 1949) 82 F Supp 546, aff'd per curiam (9th Cir 1950) 181 F2d 1010 (shop right can be acquired through partnership relationship).

For further discussion of the application and effect of the shop rights doctrine, see Anno, 61 ALR2d 356 (1958).

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§2.7 b. Shop Right Arises by Estoppel

A "shop right" may also arise by estoppel if the employee suggests that the employer use the invention or development. *Gill v U.S.* (1896) 160 US 426, 40 L Ed 480, 16 S Ct 322 (inventor who *suggested* that employer adopt invention estopped to deny employer's right to use it); *Solomons v U.S.* (1890) 137 US 342, 34 L Ed 667, 11 S Ct 88 (government employee who *assented* to government use before taking out patent estopped to recover exclusive rights). See also *Wommack v Durham Pecan Co.* (5th Cir 1983) 715 F2d 962, in which a laborer developed a method of identifying wormy pecans, using yellow dye and ultraviolet light. The laborer *gave the employer permission* to use the idea, and the employer lent the employee testing equipment. The court held that the principal aspect of the shop right was not the employer's participation, but rather the employee's permission. The employee's later attempt to revoke permission after being fired was held not effective. In *Banner Metals, Inc. v Lockwood* (1960) 178 CA2d 643, 661, 3 CR 421, however, in which the employee offered a license to his invention to his employer multiple times, no estoppel was found. Although not clear, the court did not find estoppel possibly because the employer refused the invention multiple times, and the employee's offer was limited to a royalty-bearing license.

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§2.8 c. Possible Exception to Shop Rights Doctrine: Employee Breach of Confidentiality

One court has held that the shop right doctrine does not apply in a trade secret case if the employee breached a duty of faith and confidence; in such cases the development belongs to the employer outright. *United Centrifugal Pumps v Cusimano* (WD Ark 1988) 9 USPQ2d 1171. Although the court treated the facts in this case as an exception to the shop rights doctrine, and expressed doubt that the doctrine applies to trade secrets, it also found that the employee was hired to make the invention. Thus, this case may not really present an exception, because it could have been decided as a "hired to invent" case.

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§2.9 d. Limited Transferability of Shop Rights

Shop rights are normally not assignable. An infringer may not circumvent infringement liability by, *e.g.,* selling a machine to the shop right holder and then leasing it back. *Francklyn v Guilford Packing Co.* (9th Cir 1983) 695 F2d 1158. Shop rights may be assigned to the successor of a business (*Lane & Bradley Co. v Locke* (1893) 150 US 193, 37 L Ed 1049, 14 S Ct 78; *California Eastern Labs., Inc. v Gould* (9th Cir 1990) 896 F2d 400; *Neon Signal Devices, Inc. v Alpha-Claude Neon Corp.* (WD Pa 1931) 54 F2d 793), but they may not be licensed (*Pursche v Atlas Scraper & Eng'g Co.* (9th Cir 1961) 300 F2d 467 (shop right not captured by grant-back license)).

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§2.10 B. Alter Ego, Principal Shareholder, or Officer Versus Corporation: Corporate Opportunity Doctrine

Under the corporate opportunity doctrine, an officer of a corporation has a fiduciary duty to assign to the corporation any invention made by the officer. *Kennedy v Wright* (CD Ill 1988) 676 F Supp 888, 6 USPQ2d 1379, aff'd (Fed Cir 1989) 10 USPQ2d 1316 (inventor was president, treasurer, and chairman of board). See also *Grip Nut Co. v Sharp* (7th Cir 1945) 150 F2d 192 (inventor was president and general manager); *LeFiell v U.S.* (1963) 162 Ct Cl 865 (inventor, president, general manager, and principal shareholder of corporation and was also alter ego and constructive trustee); *North Branch Prods. v Fisher* (D DC 1961) 131 USPQ 135, aff'd (DC Cir 1962) 312 F2d 880, 136 USPQ 28 (inventor was principal shareholder, general manager, and director); *Huong Que, Inc. v Luu* (2007) 150 CA4th 400, 58 CR3d 527 (seller accepted position as managing agent for buyer with fiduciary duty not to compete with buyer).

Although the corporate opportunity doctrine may vary with state law, it generally applies only to officers, directors, major shareholders, or persons in a fiduciary relationship with the corporation. *DSC Communications Corp. v Next Level Communications* (5th Cir 1997) 107 F3d 322, 327 (Texas law); *Kelegian v Mgrdichian* (1995) 33 CA4th 982, 988, 39 CR2d 390. The plaintiff has the burden of proving that (1) the fiduciary received a benefit from the opportunity, (2) there was a reasonable expectancy that the corporation would obtain the opportunity, and (3) the corporation had the financial resources to take advantage of the opportunity. *Robinson, Leatham & Nelson, Inc. v Nelson* (9th Cir 1997) 109 F3d 1388. See *Robinson v Re3R Publishing, Inc.* (D DC 1996) 943 F Supp 18 (copyrighted work created by corporate vice president and director belonged to corporation). If the third party offering an alleged opportunity was unwilling to offer it to the company, there is no opportunity. See *Rankin v Frebank* (1975) 47 CA3d 75, 88 121 CR 348. If the fiduciary offers the opportunity to the company and the company declines it, the fiduciary may exploit it. See *BT-1 v Equitable Life Assurance Soc'y* (1999) 75 CA4th 1406, 1415, 89 CR2d 811. See also §§10.37, 11.45.

An important corollary to the corporate opportunity rule is the "preparing to compete" doctrine. All employees, including fiduciaries, have the right to take certain basic steps to prepare for starting a business or joining a competing company after resigning from the current employer. See *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 346, 49 CR 825. But see *Xum Speegle, Inc. v Fields* (1963) 216 CA2d 546, 31 CR 104 (director formed competing entity while still employed and diverted plaintiff's customers to it). See also *Fowler v Varian Assocs., Inc.* (1987) 196 CA3d 34, 241 CR 539 (manager breached "duty of loyalty" by meeting with startup company and refusing to reveal information to existing employer). Fiduciary duties end on resignation. Accordingly, fiduciaries have the same right as ordinary employees to use nonsecret information learned from a former employer in his or her next job. See *Caddy-Imler Creations, Inc. v Caddy* (9th Cir 1962) 299 F2d 79, 82 (no breach where former fiduciary created list of potential customers from public sources for employer and then re-created it from same sources when working on his own afterwards).

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§2.11 C. Other Business Relationships

In some cases, trade secrets developed by an independent contractor belong to the one who hired the independent contractor to develop the idea unless the terms of the independent contractor agreement provide otherwise. See *Natural Organics, Inc. v Proteins Plus, Inc.* (ED NY 1989) 724 F Supp 50 (customer rather than supplier owned formula developed in accordance with retailer's specifications); *Jones v Ulrich* (Ill App Ct 1950) 95 NE2d 113 (fabricator/engineer hired to develop inventor's idea). But see *Hobbs v U.S.* (5th Cir 1967) 376 F2d 488; *Reinforced Molding Corp. v General Elec. Co.* (WD Pa 1984) 592 F Supp 1083 (supplier owns trade secrets on products developed and manufactured at customer's request). See also Jager, Trade Secrets Law §8.01[1] (1985).

Ownership rights may also arise by estoppel. See, *e.g., Lukens Steel Co. v American Locomotive Co.* (ND NY 1951) 99 F Supp 442, aff'd (2d Cir 1952) 197 F2d 939 (customer rather than supplier owned formula developed in accordance with retailer's specifications). Under other circumstances only a license by estoppel is recognized. *Kurt H. Volk, Inc. v Foundation for Christian Living* (SD NY 1982) 534 F Supp 1059 (foundation asked its printer to develop booklet design).

Ownership issues may also arise through certain Defense Acquisition Regulations (DAR) clauses incorporated into contracts with the government. *HiRel Connectors, Inc. v U.S.* (CD Cal, Apr. 3, 2006, No. CV01-11069 DSF) 2006 US Dist Lexis 93331 (construing DAR Clause 7-104.9(a) to mean contractor does not have trade secrets in form, fit, and function of contracted product).

The U.S. government's acquisition of goods and services is controlled by the Federal Acquisition Regulation (FAR) (Title 48 of the Code of Federal Regulations). Some agencies of the government, for example, the Department of Defense, have their own policies and procedures that supplement the FAR (DFAR). Federal Acquisition Regulation subpart 27.4 (48 CFR §§27.400-27.409) sets forth "Rights in Data and Copyrights." FAR §27.404-1 (48 CFR §27.404-1), "Unlimited Rights Data," specifically provides for government ownership in certain data that may qualify as trade secret data. FAR §27.404-2 (48 CFR §27.404-1), "Limited Rights Data and Restricted Computer Software," specifically provides the means for protection of trade secret data in government contracts for data not owned by the government. Failure to follow FAR §27.404-2 and the relevant contract clause may result in the loss of ownership and trade secret protection. For further discussion and sample contract language, see Intellectual Property in Business Transactions §§8.28-8.30 (Cal CEB 2008).

For further discussion of other business relationships that may give rise to trade secret protection, see §§10.37-10.46.

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§2.12 III. STATUTES AFFECTING OWNERSHIP

California is one of the few states that have passed specific laws concerning trade secret ownership by employers. Under Lab C §2860, everything an employee acquires by virtue of employment belongs to the employer. This applies to trade secrets and other property. See CC §§654-655, 980-985, where "property" and "ownership of property" are defined. Under Lab C §2870, any employment agreement requiring an employee to assign inventions to the employer is unenforceable if the employee developed the invention entirely on his or her own time, without using the employer's equipment, supplies, facilities, or trade secret information, unless the employee's invention, at the time of conception, related to the employer's business or resulted from work that the employee performed for the employer.

Seven other states have similar statutes limiting the scope of employee invention assignment contracts to exclude such inventions: Delaware (Del Code Ann, Tit 19, §805); Illinois (765 ILCS 1060/2); Kansas (Kan Stat Ann §§44-130); Minnesota (Minn Stat Ann §181.78); North Carolina (NC Gen Stat §66-57.2); North Dakota (ND Cent Code §34-02-11 (providing that everything acquired by virtue of employment is the employer's)); Utah (Utah Code Ann §34-39-3); and Washington (Wash Rev Code §49.44.140). See also Anno, 66 ALR4th 1135 (1988).

In California, many statutes are potentially relevant to the issue of trade secret "ownership," although they fail to explicitly define "owner." See §§2.14-2.21B.

PRACTICE TIP: To comply with Lab C §2872, employment agreements affecting trade secret rights should recite Lab C §2870.

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§2.13 A. Statutory and Restatement Definitions of Trade Secrets

Except for the two express provisions in Bus & P C §§16606, 16607(a) (see §2.17) relating to telephone answering services and employment agencies, the California statutes fail to explicitly define who is the "owner" of the trade secrets. That question is left for case-by-case determination by a court if ownership is disputed. The definitions set forth in §§2.14-2.21B help to define ownership of trade secrets by establishing what a trade secret is.

NOTE: In any dispute regarding ownership of trade secrets, both parties typically make efforts to prevent disclosure to third parties.

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§2.14 1. Uniform Trade Secrets Act (CC §3426.1(d))

The California Uniform Trade Secrets Act (UTSA) defines "trade secrets" as follows (CC §3426.1(d)):

"Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process that:

(1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and

(2) Is the subject *of efforts that are reasonable* under the circumstances to maintain its secrecy. [Emphasis added.]

See Comment to CC §3426.1. The elements of this definition are discussed in §§1.3-1.10.

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§2.15 2. Penal Code §499c

Penal Code §499c(a)(9) defines a trade secret as follows:

"Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

(A) Derives independent economic value, actual or potential, from not being generally known to the public or other persons who can obtain economic value from its disclosure or use; and

(B) *Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.* [Emphasis added.]

For further discussion of Pen C §499c, see §13.3.

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§2.16 3. Government Code §6254.7(d)

Government Code §6254.7(d) defines trade secrets as follows:

"Trade secrets," as used in this section, may include, but are not limited to, any formula, plan, pattern, process, tool, mechanism, compound, procedure, production data, or compilation of information which is not patented, which is known only to certain individuals *within a commercial concern who are using it* to fabricate, produce, or compound an article of trade or a service having commercial value and which gives its user an opportunity to obtain a business advantage over competitors who do not know or use it. [Emphasis added.]

This statutory definition is intended to clarify that trade secrets are not subject to public disclosure in environmental impact statements or any other governmental report accessible by the general public. See generally *Uribe v Howie* (1971) 19 CA3d 194, 96 CR 493.

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§2.17 4. Business and Professions Code §§16606, 16607(a)

These Business and Professions Code sections specifically address the meaning of a trade secret and explicitly provide that the employer is the owner:

The customer list, including the names, addresses, and identity of customers, of a telephone answering service shall constitute a trade secret and confidential information of, *and shall belong to, the owner of the telephone answering service*. [Emphasis added.]

Bus & P C §16606.

[T]he customer list, including the names, addresses and identity of all employer customers … and including the names, addresses and identity of all applicant customers of the employment agency, shall constitute a trade secret and confidential information of, *and shall belong to, the employment agency*. [Emphasis added.]

Bus & P C §16607(a).

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§2.18 5. Evidence Code §§1060-1061

To protect a person's trade secret during litigation, the Evidence Code provides a nondisclosure privilege (Evid C §1060):

[T]he *owner of a trade secret* has a privilege to refuse to disclose the secret, and to prevent another from disclosing it, if the allowance of the privilege will not tend to conceal fraud or otherwise work injustice. [Emphasis added.]

In addition (Evid C §1061(b)):

[T]he following procedure shall apply whenever *the owner of a trade secret* wishes to assert his or her trade secret privilege, as provided in Section 1060, during a criminal proceeding:

(1) The owner of the trade secret shall file a motion for a protective order or the People may file the motion on the owner's behalf and with the owner's permission. [Emphasis added.]

Even if the trade secret owner is made to disclose its trade secret because nondisclosure may otherwise work injustice, the courts generally attempt to devise a mechanism to minimize the damage to the competitive advantage derived from the trade secret. See, *e.g.*, *Hypertouch, Inc. v Superior Court* (2005) 128 CA4th 1527, 1555, 27 CR3d 839 (in class action involving names listed in database which constituted trade secret, if there were no other means by which database could be disclosed to plaintiff without violating secrecy, court could order defendant to provide notice to persons listed in database by telephone facsimile).

NOTE: In *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72 (Apple Computer, Inc. was real party in interest), the court of appeal ruled that the identities of persons who furnished Apple's alleged trade secrets to an online news organization that, in turn, published the information online were protected by operation of the federal Stored Communications Act (18 USC §§2701-2712) as well as by Cal Const art I, §2(b) and Evid C §1070(a), the California reporter's shield law.

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§2.18A 5A. Right of Access

First Amendment right of access provides access to government documents unless it is necessary to preserve higher values such as trade secrets. *People v Connor* (2004) 115 CA4th 669, 9 CR3d 521. The common law right of access may be overcome by balancing "all relevant factors" including whether disclosure of the material at issue could result in improper use such as to enable infringement of a party's trade secrets. *California ex rel Lockyer v Safeway, Inc.* (CD Cal 2005) 355 F Supp 2d 1111.

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§2.19 6. Labor C §§2860, 2870-2872

The Labor Code specifically defines ownership of trade secrets and inventions that arise during the course of employment (Lab C §2860):

Everything which an employee acquires by virtue of his employment, except the compensation which is due to him from his employer, *belongs to the employer*, whether acquired lawfully or unlawfully, or during or after the expiration of the term of his employment. [Emphasis added.]

The Labor Code also limits the enforceability of assignments of employee inventions in employment agreements (Lab C §2870):

(a) Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time *without using the employer's equipment, supplies, facilities, or trade secret information* except for those inventions that either:

(1) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer; or (2) Result from any work performed by the employee for the employer. [Emphasis added.]

(b) To the extent a provision in an employment agreement purports to require an employee to assign an invention otherwise excluded from being required to be assigned under subdivision (a), the provision is against the public policy of this state and is unenforceable.

Further, the Labor Code provides that employers may not make unenforceable assignments a condition of employment, but permits the employer to require disclosure of inventions (Lab C §2871):

No employer shall require a provision made void and unenforceable by Section 2870 as a condition of employment or continued employment. Nothing in this article shall be construed to forbid or restrict the right of an employer to provide in contracts of employment for disclosure, provided that any such disclosures be received in confidence, of all of the employee's inventions, made solely or jointly with others during the term of his or her employment, a review process by the employer to determine such issues as may arise, and for full title to certain patents and inventions to be in the United States, as required by contracts between the employer and the United States or any of its agencies.

It is important to note that the Labor Code also requires employers to give written notice to the employee, at the time of the agreement, that the assignment agreement does not apply to inventions that qualify under Lab C §2870 (Lab C §2872):

If an employment agreement entered into after January 1, 1980, contains a provision requiring the employee to assign or offer to assign any of his or her rights in any invention to his or her employer, the employer must also, at the time the agreement is made, provide a written notification to the employee that the agreement does not apply to an invention which qualifies fully under the provisions of Section 2870. In any suit or action arising thereunder, the burden of proof shall be on the employee claiming the benefits of its provisions.

Shifting the burden of proof in this manner may give the employer a distinct advantage should a dispute develop.

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§2.20 7. Revenue and Taxation Code §11342

Protection from trade secret disclosure is provided in a hearing on tax issues (Rev & T C §11342):

A petitioner may request the board to close to the public a portion of the hearing by filing a declaration under penalty of perjury that evidence is to be presented which relates to trade secrets the disclosure of which will be detrimental *to the business interests of the owner of the trade secrets*. [Emphasis added.]

See also Health & S C §44346(b), which provides that "the district shall protect from disclosure any trade secret designated as such by the operator, if that trade secret is not a public record"; and Lab C §6322, which states that "such orders as may be appropriate to protect the confidentiality of trade secrets."

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§2.21 8. Title 18 United States Code §1905

The United States Code establishes guidelines for punishing government officials who divulge trade secrets:

Whoever, being an officer or employee of the United States or of any department or agency thereof, any person acting on behalf of the Office of Federal Housing Enterprise Oversight, or agent of the Department of Justice as defined in the Antitrust Civil Process Act (15 USC 1311-1314), publishes, divulges, discloses, or makes known in any manner or to any extent not authorized by law any information coming to him in the course of his employment or official duties or by reason of any examination or investigation made by, or return, report or record made or filed with, such department or agency or officer or employee thereof, which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus, or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation, or association; or permits any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; shall be fined not more than $1,000, or imprisoned not more than one year, or both; and shall be removed from office or employment.

Title 15 of United States Code §1905 is coextensive with the Freedom of Information Act (FOIA) (5 USC §552) so that information available under the FOIA is not protected under §1905, and vice versa. *Frazee v U.S. Forest Serv.* (9th Cir 1996) 97 F3d 367. See §§5.6-5.9.

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§2.21A 9. Economic Espionage Act of 1996 (18 USC §§1831-1839)

The Economic Espionage Act of 1996 (EEA) (18 USC §§1831-1839) establishes federal trade secret protection and uses a definition of trade secrets that is based on the Uniform Act. The EEA defines a trade secret and its owner as follows (18 USC §1839(3)):

The term "trade secret" means 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 if

(A) the owner thereof has taken reasonable measures to keep such information secret; and

(B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, the public.

In *U.S. v Chung* (CD Cal 2009) 622 F Supp 2d 971, 974, the court denied the defendant's motion to dismiss, which claimed that EEA's definition of "trade secret" was unconstitutionally vague, finding that §1839 "provides fair notice to defendants of the conduct that is prohibited by the statute."

The EEA defines the owner of a trade secret as follows (18 USC §1839(4)):

The term "owner", with respect to a trade secret, means the person or entity in whom or in which rightful legal or equitable title to, or license in, the trade secret is reposed.

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§2.21B 10. Restatement of the Law (Third) on Unfair Competition

The Restatement (Third) of Unfair Competition, §39, defines "trade secret" as follows:

A trade secret is any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.

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§2.22 B. Application of Multiple Definitions

When ownership is disputed, how should the various statutory definitions apply to help a court's determination of ownership? The principles discussed in §§2.23-2.25 follow from the language of the statutes cited and provide guidelines for determining ownership of trade secrets.

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§2.23 1. Ownership Depends on Employment

The California Labor Code embodies a general rule in favor of employers that an employer owns everything arising by virtue of the employment relationship, including all trade secrets generated by the employee (Lab C §2860):

Ownership of things acquired by virtue of employment. Everything which an employee acquires by virtue of his employment, except the compensation which is due to him from his employer, belongs to the employer, whether acquired lawfully or unlawfully, or during or after the expiration of the term of his employment.

See also *Zahler v Columbia Pictures Corp.* (1960) 180 CA2d 582, 4 CR 612.

In regard to "inventions" and any written employment agreements pertaining to the ownership of inventions, Lab C §2860 must be read in conjunction with Lab C §§2870-2872. An employer's right to ownership of an employee's inventions arising from his or her employment is balanced by the employee's right to ownership of inventions that are developed "entirely on his or her own time" and "without using the employer's equipment, supplies, facilities, or trade secret information." Lab C §2870. That employee right is qualified by the employer's right to own inventions (which presumably include trade secret information leading to an invention) that "relate to the employer's business," "relate to the employer's … actual or demonstrably anticipated research or development," or "result from any work performed by the employee for the employer." Lab C §2870(a). See *Cubic Corp. v Marty* (1986) 185 CA3d 438, 229 CR 828.

Individuals who truly are independent contractors rather than employees are not subject to Lab C §2860, §2870, §2871, or §2872. Therefore, in the absence of a written contract that includes an invention assignment or license back to the employer, an independent contractor will likely have some ownership rights in trade secrets or other intellectual property developed in the course of his or her engagement. See generally §§2.26, 6.16-6.39; Internet Law and Practice in California §4.18 (Cal CEB 2004). Labor Code §2860 would control ownership, however, if the relationship between the individual contractor and the employer were more analogous to an employer-employee relationship.

The title "independent contractor" should not be considered conclusive. In some instances, employers find that costs can be reduced by misclassifying personnel as independent contractors when for all intents and purposes, they are actually employees. Compare Lab C §§3351-3351.5 (defining "employee") with Lab C §3353 (defining "independent contractor"). See also Lab C §3357: "Any person rendering service for another other than as an independent contractor… is presumed to be an employee." For a discussion of factors relevant to determining whether an individual should be classified as an independent contractor or an employee, see Internet Law §§4.13-4.17.

PRACTICE TIP: An employer should put in writing the areas that the employer believes are within the scope of the employee's work, both specifically within the scope of the employer's research and development as well as generally within the scope of the employer's business. A written agreement and a written policy in an employee handbook should cover these topics in a manner that avoids disputes. The employer should enter into a similar written agreement with independent contractors. See chap 6 for a form of protective agreement.

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§2.24 2. Ownership Depends on Who Controls Tangibles

California statutes assume, although do not specifically state, that the party who has control over tangible items—such as customer lists, telephone records, or other physical items—is the party who has ownership of the trade secrets encompassed in those tangible items. This principle is most clearly inferred from the two statutes specifically providing trade secret ownership of customer lists to owners of telephone answering services (Bus & P C §16606) and owners of employment agencies (Bus & P C §16607(a)). Under these two statutes, even if an independent contractor generates the information, the ownership is in favor of the agency or service, at least for state law purposes. Whether federal law would preempt this conclusion to the extent the independent contractor claimed copyright in the list created in the course of independent contractor work for such a service or agency is an open question. However, copyrights do not protect the ideas or functional aspects embodied in trade secrets (see 17 USC §102(b)), and the secrecy required to establish a trade secret usually constitutes an extra element that is sufficient to avoid preemption of trade secrets under 17 USC §301. See §11.52.

These two statutes clearly indicate that the party who maintains control over information—indeed, the party that controls the entire information system on which the information is being compiled—has an implicit right to continue to control and maintain ownership over the compilation of information.

PRACTICE TIP: In light of this principle, a trade secret owner should secure all files, documents, and other tangible items that embody trade secrets. See §§4.16-4.23 for physical access restrictions and document control.

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§2.25 3. Ownership Depends on Who Made Effort to Protect

The third principle for establishing trade secret ownership under California law is that the party who engages in efforts to protect secrecy is presumed to be the owner. For example, CC §3426.1(d)(2) provides that to come within the definition of "trade secrets" information must be "the subject of efforts [by the owner] that are reasonable under the circumstances to maintain its secrecy."

Similarly, other California statutes provide that a trade secret owner is, at least implicitly, the person who "uses" the trade secret (Pen C §499c(a)(9)), who obtains "a business advantage over competitors who do not know or use it" (Govt C §6254.7), or who otherwise "derives independent economic value" from it (CC §3426.1(d)(1)). See §2.23.

The California statutes assume that it is the owner who will take steps judicially to protect the trade secrets. The owner has the right to assert the privilege against disclosure in judicial proceedings. Evid C §1060. The owner must submit a motion for a protective order, in criminal as well as civil proceedings, to protect the trade secrets. See Evid C §1061. On the nondisclosure privilege, see §2.18.

In short, California statutory law implicitly presumes that the party who takes steps to protect trade secrets is the owner of those secrets. See CC §3426.1(d)(2).

PRACTICE TIP: The trade secret owner should use written agreements and a written trade secret protection plan to demonstrate that it has taken steps to protect the information. See *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 6 CR2d 602. See also chaps 4 and 4A for discussion of measures to protect the secrecy of information.

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§2.26 IV. CONTRACTUAL PROVISIONS AFFECTING OWNERSHIP

Although the common law applies equitable principles to determine ownership and finds a duty to assign in most relationships in which a fiduciary duty is found, uncertainties in this area can be avoided by means of express contract provisions defining the parties' rights and obligations. Whenever an activity could give rise to a trade secret, a contract delineating the parties' rights and obligations is highly advisable. These agreements are generally referred to as "invention assignment agreements" in the context of the employer-employee relationship. In such agreements an employee assigns to the employer all rights in the employee's inventions developed while employed. Even though the common law or statutes provide certain rights for the employer, these contracts provide several advantages:

- They can be used to circumvent any question of whether the relationship will vest rights in the employer by clearly defining such an obligation; and
- They can be used to clarify or broaden the scope of such rights.

WARNING: Problems can arise with express contracts in the context of the employer-employee relationship. See §§2.3-2.9 and 2.19. See §§6.16-6.39 for full discussion of and form language for invention assignment agreements.

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§2.27 A. Need for Consideration

In the context of an employer-employee relationship, the issue often arises as to whether there is consideration for a contract expressly assigning rights in inventions to the employer if the employee was hired before being asked to sign the contract. Because California presumes consideration from a written agreement (CC §1614), the burden of proving insufficient consideration falls on the party seeking to invalidate the contract (CC §1615). Scrutiny of the facts in each case indicates that the courts usually attempt to reach an equitable result. See §§2.28-2.29 for analysis of cases addressing consideration. See also California Law of Contracts §§3.42-3.43 (Cal CEB 2007).

Consideration is sufficient for a new employee signing an assignment agreement or covenant not to disclose if the employer gives notice to the prospective employee that assignment of trade secrets developed is required. Sometimes employers ask existing employees to sign such agreements, either as part of a newly instituted program, or because the previous form agreement has been updated or modified. Whenever such an agreement is signed after the employee has begun employment, the issue of enforceability arises. For existing employees who are being asked to sign such an agreement, the prudent employer should provide some new consideration, such as a bonus or a promotion. See §2.4. See *Rivendell Forest Prods. v Georgia-Pacific Corp.* (D Colo 1993) 824 F Supp 961, rev'd on other grounds (10th Cir 1994) 28 F3d 1042. Less cautious employers may attempt to rely on consideration arising from forbearing to terminate at-will employees. *International Paper Co. v Suwyn* (SD NY 1997) 951 F Supp 445 (noncompetition covenant under New York law).

PRACTICE TIP: For discussion of the need for consideration when asking an existing employee to sign a covenant not to compete, an analogous situation, see Anno, 51 ALR3d 825 (1973).

No consideration is required to form a principal-agent relationship between the employer and the employee so that the employee is under a fiduciary duty of loyalty to his or her employer. *Huong Que, Inc. v Luu* (2007) 150 CA4th 400, 58 CR3d 527.

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§2.28 1. Consideration Sufficient

The following cases held the consideration to be sufficient:

- *Eaton Corp. v Giere* (8th Cir 1992) 971 F2d 136: Although the first confidentiality agreement, executed at initial employment, was never terminated or formally superseded and was thus enforceable under Minnesota's "blue pencil doctrine," the second confidentiality agreement was supported by adequate consideration because it expanded the employee's rights. The court also found that the employee had a fiduciary duty to assign.

- *Harsco Corp. v Zlotnicki* (3d Cir 1985) 779 F2d 906: An employee who was hired as staff engineer was asked to sign an agreement after he made an invention. He initially refused, but changed his mind when threatened with termination. The Third Circuit held that he had given additional consideration in promising to assign, and thus the employer had a duty to employ him for a reasonable time. This duty was sufficient consideration to uphold the assignment contract.

- *Fish v Air-O-Fan Prods. Corp.* (9th Cir 1960) 285 F2d 208: The inventor, although originally hired as a shop foreman, was hired to invent because he had previously made other inventions for which he received raises and bonuses; his compensation was adequate consideration for the contract.

- *Goodyear Tire & Rubber Co. v Miller* (9th Cir 1927) 22 F2d 353: Invention by employee assigned exclusively to department to develop new processes and devices belonged to employer regardless of special contract to that effect, although court found continued employment was sufficient consideration to support assignment agreement.

- *Faw, Casson & Co. v Cranston* (Del Ch 1977) 375 A2d 463: Agreement not to compete was part of a promotion agreement, and promotion was held to be sufficient consideration. See §2.24.

- *Fleming & Hall Ltd. v Cope* (D Del 1998) 30 F Supp 2d 459: Signing the confidentiality agreement was either mandatory or necessary for proper job performance and advancement; the employee received as consideration the opportunity to attend a meeting in which the employer's trade secrets would be disclosed to him.

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§2.29 2. Consideration Not Sufficient

In the following cases, the consideration was found not sufficient:

- *Educational Testing Serv. v Stanley H. Kaplan Educ. Ctr.* (D Md 1997) 965 F Supp 731: Breach of contract and fraud claims failed because they were based on a confidentiality agreement signed immediately before taking a test but after paying the fee to take the test; the agreement was not enforceable for lack of new consideration.

- *Mirafi, Inc. v Murphy* (WD NC 1989) 14 USPQ2d 1337, aff'd in part and rev'd in part (Fed Cir 1991) 18 USPQ2d 1087: The agreement to continue at-will employment was not sufficient consideration for a later nondisclosure and invention assignment agreement.

- *Jostens, Inc. v National Computer Sys.* (Minn 1982) 318 NW2d 691: The mere continuation of employment was not sufficient consideration.

- *Hewett v Samsonite Corp.* (Colo App 1973) 507 P2d 1119: An employee who was not hired to invent was required to sign an assignment with each invention. The assignments recited consideration of $1 and other valuable consideration, but he never received anything. The employee's mere continued employment was not sufficient consideration.

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§2.30 B. Contract of Adhesion and Other Contract Defenses

An adhesion contract is a standardized contract drafted and imposed by the party with superior bargaining strength, giving the other party only the opportunity to adhere to the contract or reject it. See, *e.g.*, *Ferguson v Countrywide Credit Indus., Inc.* (9th Cir 2002) 298 F3d 778 (arbitration agreement included in employment contract unenforceable when imposed on "take it or leave it" basis); *Martinez v Master Protection Corp.* (2004) 118 CA4th 107, 12 CR3d 663 (arbitration clause unenforceable because it required employees to arbitrate claims they were most likely to assert against employer, while simultaneously permitting employer to litigate claims it was likely to assert against employees, such as trade secret claims); *O'Hare v Municipal Resource Consultants* (2003) 107 CA4th 267, 132 CR2d 116 (arbitration clause unenforceable because employee required to arbitrate, yet employer not required to arbitrate claims). Procedural and substantive unconscionability must exist before a court refuses to enforce a contract on this ground. *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 415, 29 CR3d 881. Procedural unconscionability focuses on oppression or surprise due to unequal bargaining power, and usually takes the form of a contract of adhesion. Substantive unconscionability focuses on overly harsh or one-sided results. 130 CA4th at 415.

NOTE: For further discussion of adhesion contracts and the doctrine of unconscionability, see California Law of Contracts §§5.72-5.77 (Cal CEB 2007). See also CC §1670.5 (California statute concerning unconscionable contracts).

Some employees have argued that an invention assignment agreement that existing employees are required to sign is void as an adhesion contract. This argument, however, has usually failed. See *Harsco Corp. v Zlotnicki* (3d Cir 1985) 779 F2d 906 (no duress found even though employee was threatened, because situation giving rise to fears was of his own making in refusing to sign); *Goodyear Tire & Rubber Co. v Miller* (9th Cir 1927) 22 F2d 353 (contract assigning inventions made by employee to employer held not to lack consideration or mutuality and not to be unfair, although invention made by employee hired to make it belonged to employer regardless of contract to that effect); *Cubic Corp. v Marty* (1986) 185 CA3d 438, 229 CR 828 (adhesion contract found valid as to former employee because employee's employment encompassed invention-related duties; employee was adequately compensated in that he received substantial raise and promotion as partial consequence of his invention).

Even if the agreement is a contract of adhesion, it will be enforced unless it (1) does not fall within the adhering party's reasonable expectations or (2) is unconscionable. See *Armendariz v Found. Health Psychcare Servs., Inc.* (2000) 24 C4th 83, 113, 99 CR2d 745. These conditions do not exist if the employee is adequately compensated. *Davies & Davies Agency, Inc. v Davies* (Minn 1980) 298 NW2d 127 (consideration was adequate but trial court's modification of unreasonably broad noncompetition agreement upheld). But see *Roberts v Sears Roebuck & Co.* (7th Cir 1978) 573 F2d 976, in which an 18-year-old employee invented a quick release socket wrench and submitted it to Sears. Sears's attorney made material misrepresentations of the cost and patentability of the wrench. The court, finding fraud in the execution of the assignment contract as well as in the disparity in age, education, and experience, and the employee relationship, held that the contract was unenforceable. For additional contractual issues, see §§11.38-11.41.

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§2.31 1. Employee Assignment Agreements

Employee assignment agreements are agreements by which an employee assigns ownership of a trade secret, invention, or other intellectual property to an employer. Such agreements are used to implement the employer ownership right granted by Lab C §2860:

> Everything which an employee acquires by virtue of his employment, except the compensation which is due to him from his employer, belongs to the employer, whether acquired lawfully or unlawfully, or during *or after* the expiration of the term of his employment. [Emphasis added.]

Even though this statute provides for ownership by the employer of developments acquired by the employee *after* the expiration of employment, a contract assigning ownership rights in inventions and developments must be reasonably limited with regard to time.

This issue arises if the agreement attempts to cover inventions made after termination of employment (a "holdover clause"). A reasonable holdover clause is enforceable. See *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134 (employment agreement requiring employees to assign inventions made within 1 year after termination based on employer's confidential information was found reasonable although court found that some inventions were not based on employer's confidential information and thus were not assignable); *Goodyear Tire & Rubber Co. v Miller* (9th Cir 1927) 22 F2d 353 (agreement requiring employee to assign inventions, made within 1 year after termination, based on employer's confidential information, was found reasonable).

A holdover clause is unenforceable, however, if it is unreasonable as to time. See *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084 (clause that covered inventions conceived after termination was void); *GTI Corp. v Calhoon* (SD Ohio 1969) 309 F Supp 762 (requirement that employee disclose and assign to employer any ideas or improvements for 5 years after termination of employment was found unreasonable and void as against public policy). Similarly, the courts have not enforced contracts assigning ownership rights in inventions and developments if they are unreasonable in scope. See *Guth v Minnesota Mining & Mfg. Co.* (7th Cir 1934) 72 F2d 385 (agreement to assign all inventions for an unlimited time unenforceable, but contract found divisible and some assignment provisions enforceable); *Ingersoll-Rand Co. v Ciavatta* (NJ 1988) 542 A2d 879 (provision to assign all inventions made within 1 year after termination "if that invention is conceived as a result of and is attributable to work done during" employment too broad because not limited to trade secrets).

In *Armorlite Lens Co. v Campbell* (SD Cal 1972) 340 F Supp 273, the court held that an agreement to assign all ideas and concepts conceived within 1 year after the employee's termination was an unreasonable restraint of trade, in violation of Bus & P C §16600. The court did not accept the plaintiff's argument that a 1-year period was reasonable to prevent greed on the part of the employee, who on recognizing that he made a material improvement in the employer's field, resigned and after termination brought out his idea. See also *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co., supra* (requirement that inventions disclosed within 1 year after termination of employment be licensed to former employer was void as overly broad because it was not limited to employer's confidential information and trade secrets). Employee assignment contracts must also be limited to a reasonable length of time and with respect to the subject matter of the employee's activities. *Dorr-Oliver, Inc. v U.S.* (Ct Cl 1970) 432 F2d 447.

PRACTICE TIP: The cases discussed above illustrate why so many holdover clauses are written to expire after 6 months.

Assignment contracts may include terms giving them retroactive effect during employment (*Harsco Corp. v Zlotnicki* (3d Cir 1985) 779 F2d 906), but it is questionable whether they may be retroactive to a time before employment. See *Georgia-Pacific Corp. v Lieberam* (11th Cir 1992) 959 F2d 901 (ambiguous agreement not clearly retrospective).

See §§6.17-6.39 for a form of employee confidentiality agreement that includes an invention assignment.

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2. Noncompetition Agreements

§2.32 a. Bus & P C §16600 and Statutory Exceptions

California bars noncompetition agreements by statute. Business and Professional Code §16600 states that "every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void." That statute, enacted in 1872 (former CC §1673), is the basis of California's often-expressed public policy in favor of employee mobility and betterment. See *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 946, 81 CR3d 282; *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573 ("[T]his provision [is] an expression of public policy to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice"). See also §§1.2, 4.6, 10.16, 11.41, 12.13 (discussing §16600).

Two statutory exceptions permit noncompetition agreements associated with sales of the goodwill of a business or the dissolution of a partnership. See Bus & P C §§16601-16602; *Hill Med. Corp. v Wycoff* (2001) 86 CA4th 895, 103 CR2d 779 (Bus & P C §16601); *Monogram Indus., Inc. v Sar Indus., Inc.* (1976) 64 CA3d 692, 134 CR 714 (Bus & P C §16601); *Swenson v File* (1970) 3 C3d 389, 90 CR 580 (Bus & P C §16602).

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§2.32A b. General Rule: Noncompetition Agreements Void

Generally, all other types of noncompetition agreements are void. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 942, 81 CR3d 282; *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 1428, 7 CR3d 427. For example, contracts barring employees from forming or joining a competitive business after resignation are void. See *Fortna v Martin* (1958) 158 CA2d 634, 638, 323 P2d 146 (voiding noncompetition clause); *Hunter v Superior Court* (1939) 36 CA2d 100, 114, 97 P2d 492 (contract barring independent contractor from manufacturing machines developed jointly is void). Furthermore, employees can sue for wrongful termination if fired for refusing to sign a noncompetition agreement. See *D'Sa v Playhut, Inc.* (2000) 85 CA4th 927, 929, 102 CR2d 495 ("an employer's termination of an employee who refuses to sign such an agreement constitutes a wrongful termination in violation of public policy"). As a result, California employees are free to join a competitor immediately after resignation. See, *e.g.*, *Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 106, 148 P2d 9 (reversing injunction; former employee began work at newly formed company one day after resignation). Similarly, employers are free to hire from competitors, absent hiring through the use of unlawful means. See *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573 (stating rule). See also *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289 (using unlawful means to hire at-will employee is actionable tortious interference with prospective economic advantage).

Section 16600 also voids contracts that bar the use of nonsecret information by former employees, including the solicitation of nonsecret customers. California employees are thus free to use nonsecret information learned from former employers. See *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 1430, 7 CR3d 427; *Fortna v Martin* (1958) 158 CA2d 634, 638, 323 P2d 146. Along the same lines, the "announcement rule" provides that former employees can announce their change of employment to customers on a secret customer list, as long as they do not engage in solicitation. *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 203, 246 P2d 11 (informing clients of plans to start business is not solicitation); *Hilb, Rogal & Hamilton Ins. Servs. of Orange County, Inc. v Robb* (1995) 33 CA4th 1812, 1821, 39 CR2d 887; *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 636, 262 CR 92.

NOTE: Noncompetition agreements often include "holdover" clauses (see §2.31). Employers who hire employees directly from competitors should be advised to admonish new employees against breaching an employment agreement they had with a previous employer or disclosing any of the previous employer's confidential information.

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§2.32B c. Status of Trade Secret Exception

Even though a covenant may be void under §16600 and may not fall within the statutory exceptions, before the California Supreme Court's decision in *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, California courts did enforce covenants necessary to protect trade secrets. See, *e.g.*, *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 24 CR3d 720; *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427 (collecting cases and stating rule). However, in a footnote to its decision in *Edwards v Arthur Andersen LLP, supra,* the California Supreme Court expressly reserved the question of whether there was a trade secret exception to §16600. 44 C4th at 946 n4. The Court seemed to imply that there may be no exceptions to §16600 other than the statutory exceptions. See 44 C4th at 942. See also *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 102 CR3d 1 (declining to rule on question). Nonetheless, in *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1238, 98 CR3d 585, the court of appeal held that a former employee could be enjoined from using trade secret information to identify and solicit the former employer's customers, not because the employee's conduct fell within a common law exception to §16600, but rather because the employee's conduct was tortious and wrongful independent of any contractual undertaking.

NOTE: For practical steps an employer may take to protect trade secrets in light of the *Edwards* case, see Wilka, *How to Avoid Liability and Protect Trade Secrets When Hiring and Losing Employees*, 24 CEB Cal Bus L Prac 1 (Winter 2009). For further discussion of whether a trade secret exception to §16600 exists, see §11.41.

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§2.32C d. Status of Narrow-Restraint Exception

Over the years, California and federal courts applying California law issued inconsistent opinions regarding whether a noncompetition provision is a restraint of trade in violation of Bus & P C §16600. One line of cases, mostly in state court, held that even narrow noncompetition agreements, such as financial penalty clauses aimed at employees who join competitors, are void. See, *e.g.,* *Thompson v Impaxx, Inc*. (2003) 113 CA4th 1425, 7 CR3d 427 (voiding clause barring solicitation of customers: "This clause is less restrictive, and less anti-competitive, than the broad, traditional anti-competitive clauses.... It is nevertheless anti-competitive—why else would they ask employees to sign it?"); *Muggill v Reuben Donnelley Corp*. (1965) 62 C2d 239, 42 CR 107 (voiding contract that suspended pension payments if former employee joined competitor).

Another line of cases, in the federal courts, allowed narrow restraints. See *IBM Corp. v Bajorek* (9th Cir 1999) 191 F3d 1033 (allowing clause that requires employee who joins competitor to return stock option profits); *General Commercial Packaging, Inc. v TPS Package Eng'g, Inc*. (9th Cir 1997) 126 F3d 1131 (restraint barring subcontractor from accepting work from certain customers upheld).

The federal cases now appear inconsistent with California law. In *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, the California Supreme Court clarified the point as follows:

California courts have not embraced the Ninth Circuit's narrow-restraint exception. Indeed, no reported California state court decision has endorsed the Ninth Circuit's reasoning, and we are of the view that California courts "have been clear in their expression that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat." [Citation.] Section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect.

The California Supreme Court affirmed the court of appeal, holding that the Arthur Andersen noncompetition agreement was invalid under Bus & P C §16600.

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§2.32D e. Other Potential Exceptions

One narrow type of noncompetition agreement might be valid: contracts that bar former employees from soliciting coworkers after resignation. A California court of appeal in *Loral Corp. v Moyes* (1985) 174 CA3d 268, 275, 219 CR 836, upheld such a contract against a §16600 challenge, and a federal court followed the California decision (see *Robinson v Jardine Ins. Brokers Int'l Ltd.* (ND Cal 1994) 856 F Supp 554, 558). The status of the *Loral* decision after *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, is unclear, however. *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427, held that employers cannot bar postresignation solicitation of nonsecret customers. In *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1238, 98 CR3d 585, however, the court of appeal held that a former employee could be enjoined from using trade secret information to identify and solicit the former employer's customers, independent of §16600, if the employee's conduct was tortious as a misappropriation of trade secrets.

If the identities of co-workers and their general skills, knowledge, and experience are not trade secrets under California law, it is unclear whether a co-worker nonsolicitation clause would now be upheld, and if so on what basis. It remains for California courts to clarify the issue.

Another type of noncompetition agreement may be valid: an employment contract containing a choice of law provision designating a particular state with a pro-noncompetition clause policy. *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881. For further discussion of choice of law issues regarding noncompetition agreements, see §11.41.

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§2.33 V. EFFECTS OF OTHER INTELLECTUAL PROPERTY ON OWNERSHIP

In some cases, rights to a trade secret can inadvertently be put into place or otherwise can be affected by means of other intellectual property.

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§2.33A A. Confidentiality Agreements

In most cases, confidentiality or nondisclosure agreements are used simply to control access to and use of confidential information. However, when parties join together to create technology, the confidentiality agreement may contain a wide range of provisions, some of which pertain to joint ownership of the technology created. Such provisions, unless carefully drafted, can have wide-ranging effects on the ownership of future development of trade secrets as well as existing trade secrets and, in some cases, can operate as an actual assignment of trade secret rights.

Sometimes confidentiality, nondisclosure, or other similar types of agreements attempt to create or affect ownership of an alleged trade secret when no trade secret exists. Such agreements are ineffective in creating rights in information if, in fact, there is no trade secret. *Cambridge Filter Corp. v International Filter Co.* (D Nev 1982) 548 F Supp 1301; *Andrea Dumon, Inc. v Pittway Corp.* (Ill App Ct 1982) 442 NE2d 574; *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 265, aff'd (9th Cir 1960) 283 F2d 695 ("matters … generally known in the trade or readily discernible by those in the trade cannot be made secret by being so labeled in an agreement"). Moreover, trade secret ownership or other rights may be limited by other intellectual property rights such as copyright and patent protection. See §§2.34-2.35, 11.52-11.54.

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§2.34 B. Copyright Protection

Statutory copyright does not protect ideas, procedures, processes, systems, methods of operation, concepts, principles, or discoveries, any or all of which can form the basis of a trade secret. 17 USC §102(b). Nor does statutory copyright protect facts; it merely protects the expression of such ideas. 17 USC §102(b); *Worth v Selchow & Righter Co.* (9th Cir 1987) 827 F2d 569. This distinction between idea and expression is one of the most difficult areas of copyright law. 1-2, 4-13 Nimmer on Copyright §§2.03[D], 13.03[A] (1963). Thus, as a general rule, while a trade secret may be "expressed" in a work that is subject to copyright protection, the ownership of the copyright on that work does not indicate ownership of the trade secret. A common scenario is one in which a trade secret is developed by a first person and a second person is asked to document the trade secret. Even if that documentation of the trade secret qualifies for copyright protection and the ownership of the copyright is in the second person, this does not affect ownership of the trade secret, which remains in the first person.

Ownership of a copyright originally vests in the author of a work. 17 USC §201(a). When a work is prepared by an employee in the scope of employment, it is a work made for hire, and the employer is considered to be the author for purposes of the Copyright Revision Act of 1976. 17 USC §§101, 201(b); *Dumas v Gommerman* (9th Cir 1989) 865 F2d 1093, 1096; *Baltimore Orioles, Inc. v Major League Baseball Players Ass'n* (7th Cir 1986) 805 F2d 663, 667. A work prepared by one who is not a formal, salaried employee (*e.g.,* an independent contractor) can be a work made for hire only if the work falls within one of the specific categories named in 17 USC §101(2) and if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire. *Community for Creative Non-Violence v Reid* (1989) 490 US 730, 104 L Ed 2d 811, 109 S Ct 2166; *Dumas v Gommerman* (9th Cir 1989) 865 F2d 1093, 1102.

California employers should take note of the effect of Lab C §3351.5(c) on a work made for hire:

"Employee" includes:… (c) Any person while engaged by contract for the creation of a specially ordered or commissioned work of authorship in which the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire, as defined in [17 USC §101], and the ordering or commissioning party obtains ownership of all the rights comprised in the copyright in the work.

Independent contractors retain rights to their works of authorship absent a written assignment of such rights. Compare 17 USC §201(a) ("Copyright… vests initially in the author or authors of the work") with 17 USC §201(b) ("In the case of a work made for hire, the employer… is considered the author for purposes of this title, and unless the parties have expressly agreed otherwise in a written instrument signed by them, owns all rights comprised in the copyright"). See also 17 USC §204(a) ("A transfer of copyright ownership… is not valid unless an instrument of conveyance… is in writing and signed by the owner of the rights conveyed").

Federal copyright laws do not preempt state claims based on trade secret law. *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 267 CR 787. The Copyright Act (17 USC §§101-810) does not annul or limit state trade secret law in any way. 17 USC §301(b)(3). Accordingly, a party may claim both trade secret and copyright protection for a particular work in certain circumstances. For a more detailed discussion of copyright law, including the federal work-for-hire doctrine, see Internet Law and Practice in California, chap 1 (Cal CEB 2004); California Business Litigation, chap 7 (Cal CEB 2002). See also §11.52.

The general distinction between copyright ownership and trade secret ownership can become less clear when computer programs are involved. The source code of a computer program is subject to copyright protection. When that source code includes a trade secret, disputes may arise. For example, in *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442, the court held that an independent contractor, who held the copyright in software programs created for the plaintiff, impliedly granted the plaintiff an unlimited, nonexclusive license to use and modify the software. There was no written agreement signed by both parties in which they agreed about ownership of the program or any trade secrets. When a dispute arose, both parties claimed that the program included their own trade secrets. Because the license was nonexclusive, presumably Gagnon could provide it to others, rendering Asset's ownership of any trade secrets in the program of little value.

NOTE: The U.S. Copyright Office is a public entity, and the mere filing of a copyright registration application with that office constitutes a disclosure of the filed materials to the public. Filing may have the effect of destroying ownership of a trade secret because the information in the filed materials is no longer secret. However, copyright law does provide a means to protect trade secrets in a copyright registration of computer software. The applicant for copyright registration should follow 37 CFR §202.20(c)(2)(vii) closely to preserve trade secrets (see 37 CFR §202.20(c)(2)(vii)(A)(2), which mentions "trade secret material").

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§2.35 C. Patent Protection

Disclosure of a trade secret in a patent will destroy the existence and ownership of the trade secret on publication of the patent or patent application, if not sooner. One of the requirements of a trade secret is that it be "the subject of reasonable efforts under the circumstances to maintain its secrecy." CC §3426.1(d)(2). See §2.1. This can hardly be said to have been done if the trade secret is described or shown in writing in a patent that is made available for the public to read.

A patent is obtained by the inventor's disclosure to the public, in a successful patent application, of a "new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof" (35 USC §101) that could not "have been obvious at the time the invention was made" (35 USC §103). The subject matter of the patent is defined by the claims of the patent. *Aro Mfg. Co. v Convertible Top Replacement Co.* (1961) 365 US 336, 337, 5 L Ed 2d 592, 595, 81 S Ct 599; *Smith v Snow* (1935) 294 US 1, 79 L Ed 721, 55 S Ct 279. A patent entitles its holder to exclude others from making, using, or selling the subject matter of the patent; it does not entitle the patent holder to make, use, or sell the invention.

Patent protection and trade secret protection cannot exist simultaneously on a trade secret. However, only when they cross in this manner, *i.e.,* disclosure of the trade secret in a published patent document, does the patent process interfere with the trade secret laws of a state. *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039 (stating that Patent Act does not preempt state's trade secret law). For example, in *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, the plaintiff alleged that the defendant had misappropriated trade secret information on the technology of producing curly French fries through a "helical blade and water-feed system." The defendant argued that trade secret protection was lost when a patent on the process was issued. The court rejected this argument, noting that when the patent was issued, the specifications, materials, and manufacturing process for making the blade were still trade secrets because they had not been included in the patent application.

Trade secret owners cannot have it both ways: They cannot maintain a trade secret and at the same time obtain a valid patent on that trade secret by failing to disclose the substantive parts of the trade secret in the patent. Patent law requires the patent applicant to provide (35 USC §112)

a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same, and shall set forth the best mode contemplated by the inventor of carrying out his invention.

If the trade secret owner files the patent application without disclosing the "best mode" of the invention, which is coincidentally the trade secret part, the trade secret may not be lost but the patent will likely be invalid. As noted above, however, the "invention" is defined by the claims of the patent. If the claims are written so that they do not cover the trade secret, then there may not be any need to disclose the trade secret in the patent application. In such a case, the patent will not provide patent protection over the trade secret.

Ownership of a patent originally vests in the inventor (35 USC §101), and inventors may freely assign their ownership rights. 35 USC §261. A trade secret owner may be entitled to ownership of the patent obtained by a wrongdoer on a misappropriated trade secret, unless the patent contains significant inventive elements that were not misappropriated. *Whiteside Biomechanics, Inc. v Sofamor Danek Group, Inc.* (ED Mo 2000) 88 F Supp 2d 1009.

Since 1999, U.S. patent applications are published 18 months after their priority filing date, regardless of whether a patent ever issues from the application. 35 USC §122(b)(1). There is an exception by which the application will not be published before issuance of a patent, which requires that the applicant declare that the application will not be foreign-filed. 35 USC §122(b)(2)(B)(i). However, publication destroys any trade secret matter in the application.

NOTE: Although issuance of a patent terminates trade secret status for information contained in the patent, later-developed improvements to the patented invention can be trade secrets. *Hickory Specialties, Inc. v Forest Flavors Int'l, Inc.* (MD Tenn 1998) 12 F Supp 2d 760, aff'd (6th Cir 2000) 215 F3d 1326.

All information disclosed in a patent application or patent may not be characterized as a trade secret. Also, ideas that may be patentable may not rise to the level of being protectable as a trade secret. For example, in *QR Spex, Inc. v Motorola, Inc.* (CD Cal, Oct. 28, 2004, No. CV 03-6284-JFW) 2004 US Dist Lexis 27378, the plaintiff alleged that its trade secret was defined by a claim in its patent relating to embedding a Bluetooth (wireless computer) chip in an eyewear frame. The court held that plaintiff could not allege a trade secret in the general concept of Bluetooth-enabled eyewear.

Federal patent law does not conflict with state trade secret law. Trade secrets may be protected by state courts, regardless of their patentability, because the polices underlying trade secret protection are consistent with those of the patent laws. *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 493, 40 L Ed 2d 315, 332, 94 S Ct 1879. For a more detailed discussion of patents, see California Business Litigation, chap 8 (Cal CEB 2002). See also §11.54.

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3

Idea Submissions

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I. INTRODUCTION
- A. Scope of Chapter §3.1
- B. How the Issue Arises §3.2

II. STEP 1: SUBMITTER'S INITIAL CONTACT
- A. Submitter's Goals §3.3
- B. Method of Disclosure §3.4

III. STEP 2: RECIPIENT'S RECEIPT OF UNSOLICITED IDEAS §3.5
- A. No Review or Consideration Whatsoever
  - 1. Policy Procedures §3.6
  - 2. Form: Transmittal Letter Describing Policy §3.7
- B. No Review or Consideration Without Agreement
  - 1. Policy Procedures §3.8
  - 2. Form: Policy Statement §3.9
  - 3. Form: Transmittal Letter to Submitter Enclosing Company Policy §3.10
  - 4. Confidential Disclosure Waiver Agreement: Need for Clear Terms §3.11
    - a. Form: Confidential Disclosure Waiver Agreement §3.12
    - b. Form: Transmittal Letter to Submitter Enclosing Waiver Agreement §3.13
- C. No Distribution Pending Notice of Policy
  - 1. Policy Procedures §3.14
  - 2. Form: Notice of Policy Statement §3.15
- D. Using Outside Consultants §3.16
- E. Using In-House Committee §3.17

IV. STEP 3: SUBMITTER'S RESPONSE TO COMPANY POLICY §3.18
- A. No Disclosure Without First Securing Statutory Rights
  - 1. Policy Procedures §3.19
  - 2. Form: Agreement for Submission of Ideas §3.20
- B. No Delivery Without Agreement
  - 1. Policy Procedures §3.21
  - 2. Form: Agreement for Submission of Ideas §3.22
- C. Delivery With "Shrink-Wrap" Agreement §3.23
- D. Delivery With Confidentiality Notices and Other Proprietary Legends §3.24
- E. Delivery in Person Based on Implied Understanding §3.25

V. STEP 4: RECIPIENT'S FOLLOW-UP §3.26

VI. LITIGATION STRATEGIES
- A. By Recipient §3.27
- B. By Submitter §3.28

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I. INTRODUCTION

§3.1 A. Scope of Chapter

When are ideas "as free as the air"? When are they deemed to be protected by express, implied-in-fact, or implied-in-law contracts? And when are they deemed to be protected by a later-found fiduciary, confidential, or other actionable relationship? See, *e.g., Desny v Wilder* (1956) 46 C2d 715, 731, 299 P2d 257; *Gunther-Wahl Prods. v Mattel, Inc.* (2002) 104 CA4th 27, 128 CR2d 50. This chapter addresses these issues in the context of an inventor's unsolicited submissions of ideas and invention disclosures to others. See §§3.3-3.26. The chapter also identifies litigation strategies that each party may use if a negotiated written agreement is not first obtained and a dispute arises. See §§3.27-3.28.

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§3.2 B. How the Issue Arises

Individuals and small companies frequently have ideas or make developments that they feel have merit. Yet they often lack adequate capital, business experience, or market presence to successfully exploit these ideas. They may also lack the necessary funds to patent the development, or they may be reluctant to spend money on patenting efforts before others indicate an interest in its commercial use. Thus, individual inventors often try to interest larger companies in developing and exploiting their ideas in an arrangement that enables all parties to share equitably in any successes attributable to the idea. Contacts and communications between such an individual (the "submitter") and a company (the "recipient"), however, raise potential problems and serious risks for each party.

WARNING: These issues may become more prevalent with the increased use of electronic mail, facsimile, and other modern communications that make unsolicited submissions of ideas easier to make and somewhat harder to control.

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II. STEP 1: SUBMITTER'S INITIAL CONTACT

§3.3 A. Submitter's Goals

A submitter may have a potentially valuable invention or an idea that could be the kernel of a valuable invention. He or she wants to be adequately compensated for any use of the idea or invention. The submitter may have inchoate patent rights (if the one-year bar has not occurred; see 35 USC §102(b)) or copyright, trade secret, or other statutory rights but may also want additional protection for the idea. Submitters hoping to interest others in their ideas are faced with the problem of trying to disclose the idea without losing their trade secret rights. Typically, they contact one or more companies that they believe might be interested in their idea, often choosing a company that is a leader in the related market area. A submitter may endanger potential rights or decrease the consideration that may be received for the idea, however, because he or she is often not represented by counsel and may be unsophisticated in business matters. There is also a potential for conflict because the submitter may distrust large companies or have an unrealistic view of the idea's value.

Initially the company may only be willing to respect the patent and trade secret rights of the submitter. However, the goal of the submitter is to establish a confidential relationship with the company as negotiations progress and obtain promises that the company will protect more than just the submitter's patent and trade secret rights by, for example, not designing around the submitter's patent and negotiating exclusively with the submitter.

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.4 B. Method of Disclosure

§3.4 B. Method of Disclosure

If a submitter seeks legal assistance before approaching a potential purchaser or licensee, counsel should advise the submitter not to disclose the idea in the initial contact. The submitter should discuss only the general area to which the idea relates, express the desire to make a confidential disclosure of the idea, and inform the company in writing of the expectation of compensation in a manner to be negotiated if the recipient makes any use of the idea, including research or development efforts. Counsel should advise the submitter of the benefits of filing a patent application early, registering all copyrights (under appropriate special relief provisions for preserving trade secrets), registering all trademarks, and using proprietary legends (see §4.19 and forms 6.4-1 through 6.11-1). Counsel and client should also discuss the steps required to maintain trade secret rights.

Counsel should advise the submitter about the importance of obtaining a nondisclosure agreement before disclosing an idea to others. *Vanmoor v Wal-Mart Stores, Inc.* (Fed Cir 2000) 201 F3d 1363 (no trade secret misappropriation occurred because patent incorporated ideas that remained unchanged since before nondisclosure agreement); *Nora Beverages, Inc. v Perrier Group of Am., Inc.* (2d Cir 1998) 164 F3d 736 (no trade secret misappropriation occurred when submitter disclosed idea during course of negotiating contractual relationship without nondisclosure agreement). Even so, counsel should further caution the submitter that the idea is protectable only to the extent that it qualifies as a trade secret. *BP Chems. Ltd. v Jiangsu Sopo Corp.* (8th Cir 2002) 285 F3d 677, cert denied (2002) 537 US 942; *Computer Mgmt. Assistance Co. v Robert F. De Castro, Inc.* (5th Cir 2000) 220 F3d 396; *QR Spex, Inc. v Motorola, Inc.* (CD Cal, Oct. 28, 2004, No. CV 03-6284-JFW) 2004 US Dist Lexis 27378; *Hickory Specialties, Inc. v Forest Flavors Int'l, Inc.* (MD Tenn 1998) 12 F Supp 2d 760, aff'd (6th Cir 2000) 215 F3d 1326; *Magellan Int'l Corp. v Salzgitter Handel GmbH* (ND Ill 1999) 76 F Supp 2d 919; *Utah Med. Prods., Inc. v Clinical Innovations Assocs., Inc.* (D Utah 1999) 79 F Supp 2d 1290 (no trade secret misappropriation absent identification of what trade secrets had been detrimentally used).

PRACTICE TIP: Because a nonconfidential disclosure of an idea on which a patent has not yet been filed can destroy potential patent rights in non-U.S. countries, a submitter must carefully balance the potential benefits of a nonconfidential disclosure against the potential consequences. See §11.54. The desire to preserve foreign patent rights may be one reason to insist on a confidentiality agreement that may benefit both parties.

PRACTICE TIP: Assuming that the submitter has an application for patent on file with the United States Patent and Trademark Office, the submitter may want to seek early publication of the patent application if the submitter chooses to make a nonconfidential disclosure in an attempt to assert provisional patent rights against recipients under 35 USC §154(d).

Even if the submitter has not taken such precautions, the law may afford some protection by implying a confidential relationship if the recipient reasonably should have understood that the submission was made in confidence and that the submitter expected remuneration for use of the idea. *Phillips v Frey* (5th Cir 1994) 20 F3d 623; *Burten v Milton Bradley Co.* (1st Cir 1985) 763 F2d 461; *Pachmayr Gun Works, Inc. v Olin Mathieson Chem. Corp.* (9th Cir 1974) 502 F2d 802; *Reeves v Alyeska Pipeline Serv. Co.* (Alaska 1996) 926 P2d 1130 (agreement "between us"). *Kearns v Ford Motor Co.* (ED Mich 1978) 203 USPQ 884. However, the courts find no implied confidential relationship if there are no facts from which such a relationship can be inferred. See *Smith v Snap-On Tools Corp.* (5th Cir 1987) 833 F2d 578; *Cloud v Standard Packaging Corp.* (7th Cir 1967) 376 F2d 384. Moreover, failure to prove that the receiving party was aware of an obligation of confidentiality warrants reversing a judgment of liability. *Bateman v Mnemonics, Inc.* (11th Cir 1996) 79 F3d 1532 ($300,000 jury verdict reversed). But see *Gronholz v Sears, Roebuck & Co.* (8th Cir 1989) 869 F2d 390 (mere disclosure does not negate confidential relationship).

Ultimately, whether a confidential relationship exists is a question of fact to be decided at trial. Therefore, the submitter should take all steps necessary to create and document the obligation to compensate the submitter for use of the idea. For example, the submitter should ask the recipient to return the drawings after consideration, mark the drawings as confidential, and inform the recipient that the drawings are confidential. *Flotec, Inc. v Southern Research, Inc*. (SD Ind 1998) 16 F Supp 2d 992. See also *EarthWeb, Inc. v Schlack* (SD NY 1999) 71 F Supp 2d 299, aff'd (2d

Cir 2000) 2000 US App Lexis 11446 (trade secret owner must take reasonable measures to protect its secrecy); *Huffy Corp. v Superior Court* (2003) 112 CA4th 97, 4 CR3d 823 (maintaining secrecy under protective order requires showing of overriding interest); *In re Providian Credit Card Cases* (2002) 96 CA4th 292, 116 CR2d 833 (information not deemed to be trade secret because executive failed to take reasonable steps to maintain secrecy).

Counsel should prepare an express nondisclosure agreement to be presented to the company. If the submitter has already disclosed the idea to the company before seeking counsel's advice, the submitter's correspondence should be reviewed for any expression of an expectation of compensation, which is often reflected in such correspondence.

The disclosure may be made in writing to conform the disclosure to subject matter contained within a patent application. However, as the negotiation progresses, the recipient will want to verbally discuss the potential to incorporate the intellectual property rights of the submitter. In this situation, verbal discussions between the parties may lead to patentable improvements of the submitter's information. The parties should come to an agreement regarding ownership rights in these improvements. Until ownership is resolved, the verbal disclosures should track closely the subject matter of the patent application to mitigate inadvertent forfeiture of patentable subject matter. Additionally, any significant improvements should be discussed with a patent attorney to determine whether the expense of incorporating the improvements into the submitter's patent application is recommended.

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§3.5 III. STEP 2: RECIPIENT'S RECEIPT OF UNSOLICITED IDEAS

In view of the risk that a court may find an implied confidential relationship (see §3.4), a company's uncontrolled receipt of unsolicited disclosures has a high potential for future charges of misappropriation against the recipient company. The circumstances related to an unsolicited submission may raise an implied obligation of confidentiality and thus establish a key element of misappropriation. *Thermo Trim Inc. v Mobil Oil Corp.* (WD NY 1977) 194 USPQ 450. Neither the absence of an intention to misappropriate the inventions or ideas of others nor the absence of any misappropriation in fact dispels that risk. If a company develops or releases something similar to the disclosed idea, many courts put the burden on the company to show independent development. See *Droeger v Welsh Sporting Goods Corp.* (9th Cir 1976) 541 F2d 790; *Goldberg v Medtronic, Inc.* (7th Cir 1982) 686 F2d 1219; *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 3 CR3d 279 (placing burden of producing evidence of independent creation on defendant). But see *Microstrategy Inc. v Li* (Va App 2004) 601 SE2d 580 (establishing prima facie case of misappropriation does not shift burden of proof to defendant to prove independent development).

The company chosen by the submitter is probably active in the related field or market area and is probably working on developments in a similar area or will do so in the future. This situation, coupled with the fact that submitted ideas tend to be vaguely defined, may cause any of the recipient's developments related in any way to the submitted idea to provoke a charge of misappropriation from the submitter, even if work on the developments predates the submission. See *Droeger v Welsh Sporting Goods Corp., supra.* The company's cost of defending against such claims, even if unfounded, can be substantial. Further, the implied obligation of confidentiality preventing use in any way adverse to the interests of the submitter may last for a substantial period of time—as long as the trade secret. Thus, receipt of unsolicited disclosures tends to cut off the company's freedom to pursue and use its own research and development efforts. *Goldberg v Medtronic, Inc., supra.*

To minimize these risks, the recipient company should implement a well-reasoned policy and procedure for responding to unsolicited submissions. Such policies can take several forms. Some companies, viewing the risks related to consideration of unsolicited ideas as far outweighing any benefits that are likely to be derived from it, immediately return all unsolicited ideas. See §3.6. Other companies do receive and consider unsolicited ideas but only if any implied confidential relationships are disclaimed by an express written waiver of all obligations of confidentiality signed by the submitter. See §3.8. Such agreements are effective to destroy implied obligations. *Kearns v Ford Motor Co.* (ED Mich 1978) 203 USPQ 884; *Crown Indus. v Kawneer Co.* (ND Ill 1971) 335 F Supp 749. See also *FASA Corp. v Playmates Toys, Inc.* (ND Ill 1995) 892 F Supp 1061 (waiver of any and all claims, including future claims, held to be general release that was invalid as against public policy under California and federal law). Typically, such waiver agreements require a submitter to rely solely on any patent, copyright, or trademark rights they may have or subsequently acquire. An exception in a waiver agreement for any patent rights that the submitter may have is not inconsistent with an express waiver of any implied obligations of confidentiality. *Wanberg v Ocean Spray Cranberries, Inc.* (ND Ill 1977) 194 USPQ 350. Confidential disclosure waiver agreements also state that the recipient has no obligation to review the submission, to evaluate it, to give any reasons for not using it, or to return any materials to the submitter. See §§3.11-3.13 on confidential disclosure waiver agreements.

For any policy, only specific individuals in the company should be authorized to receive and handle such submissions, whether sent by postal or electronic mail, and all personnel in the company should be made aware of this restriction. This is important because the Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) imposes liability for misappropriation for intentional misconduct about which a person knew or had reason to know. *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169; *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 93 CR2d 663, modified at 79 CA4th 1144A; *PostX Corp. v Secure Data in Motion, Inc.* (ND Cal, Nov. 20, 2004, No. C 02-04483 SI) 2004 US Dist Lexis 24260 (UTSA preempts common law misappropriation of trade secrets claim but not common law unfair competition claim based on new facts); *Del Monte Fresh Produce Co. v Dole Food Co.* (SD Fla 2001) 148 F Supp 2d 1326. The designated individuals should be credible administrative staff whose work is unrelated to the company's research and marketing activities and who are not likely to have either the interest or the ability to evaluate,

communicate, or implement submitted ideas. Their sole functions with respect to such ideas should be logging in and retaining (in a restricted file) any disclosure material, sending out a response letter explaining the company's policy, and (for companies that accept only nonconfidential submissions) enclosing a form of express waiver of confidentiality.

Unsolicited submissions may come to companies in various forms and through various channels, from casual conversations to detailed written presentations sent by mail or electronic transmission. The company procedures supporting its policy should anticipate and address each form and channel in which a submission may be received.

See §§3.6-3.17 for description of various policies, summarized from most to least conservative, from the recipient's perspective.

PRACTICE TIP: The recipient company should ensure that all employees understand the policy by including it in the employee handbook, employee awareness programs, or otherwise. See §4.12. Failure to do so may result in an unintended disclosure of an unsolicited idea if it is received by an employee outside expected channels or even discussed by friends at an outside social event.

PRACTICE TIP: A recipient may choose to receive idea submissions over the Internet. The recipient's website may allow for uploading of information only if a submitter "clicks through" and agrees to the recipient's policy having limited confidentiality terms or an agreement that the submitted information will not be held in confidence.

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A. No Review or Consideration Whatsoever

§3.6 1. Policy Procedures

Some research and development organizations refuse to be "tainted" by unpublished third party information, even if the information is not protectable as a trade secret or may be protected only by copyright. Such organizations have a policy that a central person not involved in research or development for the company screen all unsolicited submissions and return them to the submitter. The organization's position then is that there was no effective corporate disclosure or receipt. In the most conservative version of this approach, the materials are returned by outside counsel who retains an archival copy of the material, but only to preserve a record of events. The central person can also evaluate unsolicited submissions to determine whether a confidentiality agreement is needed to preserve patent rights in foreign countries.

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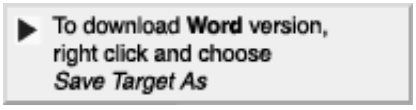
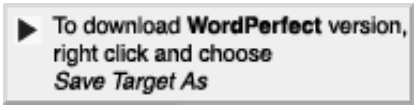
Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.7 2. Form: Transmittal Letter Describing Policy

§3.7 2. Form: Transmittal Letter Describing Policy





_ _[*Submitter's name and address*]_ _

Re: Your Submission of _ _[*date*]_ _

Dear _ _[*name of submitter*]_ _**:**

Your letter of _ _[*date*]_ _**, addressed to** _ _[*name and title of individual recipient*]_ _ **of** _ _[*name of recipient company*]_ _ **(the "Company") has been forwarded to me for response. It is the Company's policy not to accept any unsolicited submissions. Therefore, we are returning to you the materials you sent to the Company.**

Very truly yours,

_ _[*Name of recipient company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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B. No Review or Consideration Without Agreement

§3.8 1. Policy Procedures

A somewhat less conservative approach on receiving unsolicited ideas or invention submissions is to maintain corporate receipt for a period of time, *e.g.,* 30 days, pending receipt of an executed waiver agreement. Review or consideration of the idea would occur only if the submitter signs and delivers to the recipient a signed waiver agreement acknowledging that no confidential relationship exists between the submitter and the recipient and that there is no confidential information in the submission. Until the waiver agreement is signed, the submission is kept in the corporate offices but is not accessible to employees who are connected with the company's research and development activities or who could make use of the ideas or invention.

The waiver agreement, if properly drafted, should dispose of most issues of unwarranted use of unpatented ideas and greatly reduce the risk of charges of misappropriation of unsolicited ideas. See *Burten v Milton Bradley Co.* (1st Cir 1985) 763 F2d 461 for an example of an agreement that failed because it was deemed too ambiguous. See §3.11 on confidential disclosure waiver agreements. By limiting the company's obligation to respecting patent rights only, it reduces its risk/reward ratio because a patented development must be novel and not obvious (which is not required of a trade secret), described with particularity, and have some reasonable basis for a claim of ownership in the submitter. 35 USC §§101-103, 112. See California Business Litigation, chap 8 (Cal CEB 2002).

If a waiver agreement is signed, the idea disclosure should be forwarded to the appropriate department for evaluation. If it is not signed within a reasonable time, the matter should be terminated. Some companies return all materials to the submitter; others retain a copy as a record of what was submitted.

A recipient may want to preserve confidentiality of the submitter's information to preserve foreign patent rights in the event that the submitter's information has international potential, especially if the recipient currently has an international presence. The submitter should, in general terms, describe the area of invention and the reasons that the product might be successful in foreign jurisdictions.

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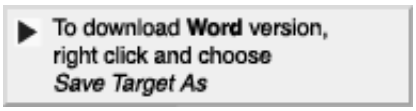
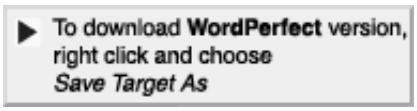
§3.9 2. Form: Policy Statement





POLICY ON HANDLING UNSOLICITED DISCLOSURES OF IDEAS

It is the policy of _ _[*name of company*]_ _ (the "Company") not to accept for consideration, and not to review, evaluate, or comment on, any unsolicited ideas that are submitted with expectation of compensation unless the submitting party agrees to the following conditions:

1. No confidential relationship is established by such submission or implied from consideration of the submitted material, and the material is not to be considered to be submitted "in confidence."

2. The Company shall have no obligation to keep secret or to refrain from using the idea or any material submitted in connection with it. The submitter should disclose only general aspects of the trade secret that the submitter considers nonconfidential for the purpose of evaluation.

3. The Company shall have no obligation to pay any compensation whatsoever for its use of ideas that have not been patented. If it is alleged that the Company has incurred liability to the submitter with respect to any unpatented ideas submitted to it, the submitter agrees that in no event shall any claim be asserted for equitable relief or for damages in excess of _ _[*e.g., $1000*]_ _, which the submitter agrees shall be the maximum damages for any and all liability of the Company for such unpatented idea, including but not limited to the Company's use or disclosure of the unpatented idea. If any such unpatented idea is subsequently covered by the claims of a patent granted to the submitter, this paragraph shall not apply to any rights under that patent.

4. The Company's receipt and consideration of any submitted idea shall not in any way impair the Company's right to contest the validity or infringement of any patent that may have been or may later be obtained on it. If the submitter believes that the Company is infringing such patent, the submitter's sole remedy shall be enforcement under the applicable patent laws of such exclusive rights as the submitter may possess by virtue of the patent.

5. The Company will give each submitted idea only such consideration as it merits, in the sole judgment of the Company.

6. The Company shall have no obligation to return any material submitted or to reveal its acts in connection with the submitted idea.

7. The Company shall have no obligation to reveal any information about its activities in either the general or specific field to which the submitted idea pertains.

8. If the Company decides not to use a submitted idea, it assumes no obligation to explain its decision or to do other than communicate its decision to the submitter.

9. Entering into negotiations for the purchase of patent rights in any idea submitted, or making an offer for such purchase, shall not in any way prejudice the Company, nor shall it be deemed an admission of the novelty of the idea or of priority or originality on the part of the person submitting it or of any other person.

10. Any and all prior negotiations or agreements by any agent or representative of the Company are merged into these conditions of submission, and no such prior representations, negotiations, or agreements shall be binding on the Company or be of any force or effect.

If you agree to the terms and conditions in this policy statement, please execute the enclosed copy of this policy and return it to the Company.

The undersigned has either sought the advice of counsel as to the meaning and significance of agreeing to and acknowledging the terms and conditions of this policy statement or has decided to forgo seeking the advice of counsel. The undersigned further agrees to and acknowledges the terms and conditions of this policy statement.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _

Comment: This policy statement is designed to discourage the submission of unsolicited ideas and makes no commitment to protect the rights of the submitter. It requires the submitter to forgo any common law rights under the law of trade secrets and to limit its rights to those available under the patent laws only, even if the idea might be best suited to trade secret protection. Because the submitter's trade secret information may be valuable to the company for purposes of acquisition and licensing, the trade secret status of the secret information should be maintained until the company can evaluate its usefulness. Even though most unsolicited ideas are worthless, less harsh language than that in this statement might protect a company without forcing it to abandon all possibility of negotiating an agreement with an inventor who might eventually submit a valuable unsolicited idea. Also, the policy statement sets the tone of the relationship to mitigate the risk of establishing a confidential relationship.

See §3.12 for confidential disclosure waiver agreement.

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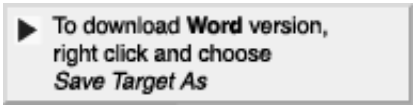
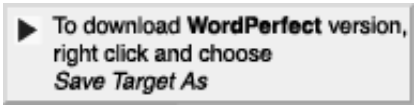
§3.10 3. Form: Transmittal Letter to Submitter Enclosing Company Policy





_ _[*Submitter's name and address*]_ _

Re: Your Submission of _ _[*date*]_ _

Dear _ _[*name of submitter*]_ _:

Your letter of _ _[*date*]_ _, addressed to _ _[*name and title of individual recipient*]_ _ of _ _[*name of recipient company*]_ _ (the "Company"), has been forwarded to me for response. Before the Company will consider new product ideas from others, we require acknowledgment of and agreement to the Company Policy on Handling Unsolicited Disclosures of Ideas (the "Policy"), two copies of which are enclosed. The Policy provides, among other things, that the Company has no confidentiality obligation regarding the ideas included in your letter and that you waive any rights you may have against the Company with respect to your disclosure of your ideas to the Company, except for any patent rights that you may have or subsequently obtain. We suggest that you review and discuss this Policy with your attorney, because acknowledging and agreeing to the Policy may result in loss of trade secret protection for your idea.

_ _[*name of recipient company*]_ _ maintains Research, Development, and Marketing departments where substantial efforts are devoted to the development of new products and processes and the creation of new merchandising and promotional ideas. It is, therefore, not unusual that a majority of the ideas submitted to us over the years fall into one of the four categories: (1) those that have been considered by us before; (2) those not within our fields of interest; (3) those that have already been developed by _ _[*name of recipient company*]_ _; or (4) those that are in the public domain. Because most of the ideas submitted to us fall in these categories and because review of the numerous ideas submitted to us requires a considerable expenditure of time and money by us, it is necessary that certain policies be followed in order for us to review such ideas in a business-like manner while maintaining _ _[*name of recipient company*]_ _'s freedom to pursue its own developments. As such, we have adopted the enclosed Policy. If you agree to our consideration of your ideas solely under the terms and conditions of the Policy, please execute one copy of the Policy and return it to me at your convenience. On receipt of the executed copy of the Policy, we would be happy to consider our interest in your idea.

Very truly yours,

_ _[*Name of recipient company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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§3.11 4. Confidential Disclosure Waiver Agreement: Need for Clear Terms

A confidential disclosure waiver agreement is adequate to disclaim any obligations of the recipient (*Kearns v Ford Motor Co.* (ED Mich 1978) 203 USPQ 884), but it is likely to be attacked on grounds that the submitter did not understand its significance. Such attacks have failed when the submitter clearly understood the agreement, as in *Kearns* (submitter was highly educated and experienced professional), but they have succeeded when the court found the language of the agreement to be ambiguous. See *Burten v Milton Bradley Co.* (1st Cir 1985) 763 F2d 461 (disclaimer of any implied relationship held not express disclaimer of confidential relationship). Therefore, an express disclaimer or waiver agreement must clearly dispel any express or implied confidential relationship in terms that are understandable to the most unsophisticated persons. See form in §3.12.

The specificity required for an enforceable waiver may vary with the type of claims waived. Generally, more specificity is required to waive tort claims than to waive contractual claims. In *Anderson v Century Prods. Co.* (D NH 1996) 943 F Supp 137 (applying New Hampshire law), a clause limiting the submitter to rights under patent laws lacked sufficient specificity to waive tort claims, and a clause stating that "no confidential relationship between the parties" was established lacked the specificity to waive claims for misappropriation of confidential information, trade secret misappropriation, breach of contract, and conversion.

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.12 a. Form: Confidential Disclosure Waiver Agreement

§3.12 a. Form: Confidential Disclosure Waiver Agreement

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

CONFIDENTIAL DISCLOSURE WAIVER AGREEMENT

I represent that I have certain suggestions, inventions, and ideas and may in the future have other suggestions, inventions, and ideas (collectively, "Suggestions") relating to _ _[*generally describe subject matter*]_ _, and I desire to interest _ _[*name of company*]_ _ (the "Company") in the merits of the Suggestions. I acknowledge that the Company cannot receive suggestions in confidence and that the Company consents to my disclosure of the Suggestions to the Company's representatives only under the following conditions:

1. All of my rights and remedies arising from the disclosure of the Suggestions to, or the use of the Suggestions by, the Company or any of its representatives shall be limited to any rights and remedies as may now or in the future be accorded to me under United States patent or copyright laws.

2. I waive all other claims of any nature whatsoever arising from any disclosure by me to the Company.

3. The Company shall obtain no right of any kind in the Suggestions by reason of this Agreement.

I fully understand the foregoing provisions. I have either sought the advice of counsel on the meaning and significance of this agreement or decided to forgo seeking such advice. I have not been coerced or induced by the Company to sign this agreement. The Company has not made any representations to me of any kind, either express or implied, and in consideration of the Company's receipt and review of my Information, I agree to all of the foregoing terms and provisions.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _
Address: _ _[*Address*]_ _

Witnessed:

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Date: _ _ _ _ _ _

Comment: See *Kearns v Ford Motor Co.* (ED Mich 1978) 203 USPQ 884, which upheld a confidential disclosure waiver similar to this one against claims relating to misappropriation of trade secrets and unjust enrichment. Note that a statement in the waiver that submission of an idea does not "establish or create by implication or otherwise any relationship" between the parties may too ambiguous to bar the submitter's action for misappropriation. See *Burten v Milton Bradley Co.* (1st Cir 1985) 763 F2d 461, 464 n3.

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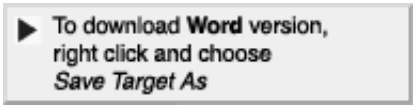
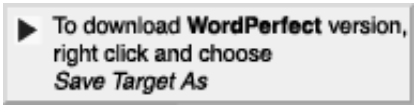
Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.13 b. Form: Transmittal Letter to Submitter Enclosing Waiver Agreement

§3.13 b. Form: Transmittal Letter to Submitter Enclosing Waiver Agreement





_ _[*Submitter's name and address*]_ _

Re: Your Submission of _ _[*date*]_ _

Dear _ _[*name of submitter*]_ _**:**

Your letter of _ _[*date*]_ _**, addressed to** _ _[*name and title of individual recipient*]_ _ **of** _ _[*name of recipient company*]_ _ **(the "Company") has been forwarded to me for response. Before the Company will consider new product ideas from others, we require the execution of our Confidential Disclosure Waiver Agreement (the "Agreement"), two copies of which are enclosed. The Agreement provides, among other things, that you waive any rights you may have against the Company concerning your disclosure of your ideas to the Company, except for any patent rights you may have or subsequently obtain. We suggest that you review and discuss this Agreement with your attorney, because signing the Agreement may result in loss of trade secret protection for your idea.**

It is necessary that the Company adhere to a policy of requiring the Agreement from persons who wish to disclose ideas to us because we cannot accept any disclosures from you under a confidential relationship. If you agree to our consideration of your ideas solely under the terms and conditions of the Agreement, please execute one copy of the Agreement and return it to me at your convenience. On receipt of the executed copy of the Agreement, we would be happy to consider our interest in your idea.

Very truly yours,

_ _[*Name of recipient company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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C. No Distribution Pending Notice of Policy

§3.14 1. Policy Procedures

A corporate recipient may also choose to prevent circulation or use of information (*e.g.,* by retaining the submission in the corporate secretary's office) until the corporation has given the submitter written notice of its position on unsolicited submissions and a reasonable period, *e.g.,* 30 days, has lapsed without objection from the submitter. See form in §3.15. The recipient is rejecting any confidential relationship, express or implied, and advising the submitter that its submission will be deemed an unlimited public disclosure unless it is promptly withdrawn. If it is withdrawn, however, the recipient's position is unclear. Therefore, it is unlikely that very many companies will want to adopt this policy.

WARNING: This policy is not recommended. The previous policies provide much broader protection for the recipient with much less exposure to risks. Whether the courts would view reliance on the submitter's failure to object as reasonable is an open question under California law. A company may claim statutory support for this treatment of unsolicited submissions under CC §983 (notice informs submitter that he or she is intentionally making the submission public), but there are no decisions on point; such a strategy would have a high risk of failure. See *Burten v Milton Bradley Co.* (1st Cir 1985) 763 F2d 461.

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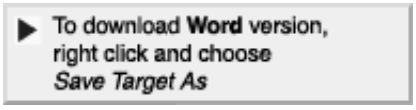
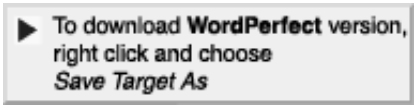
Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.15 2. Form: Notice of Policy Statement

§3.15 2. Form: Notice of Policy Statement





_ _[*Submitter's name and address*]_ _

Re: Your Submission of _ _[*date*]_ _

Dear _ _[*name of submitter*]_ _**:**

Your letter of _ _[*date*]_ _**, addressed to** _ _[*name and title of individual recipient*]_ _ **of** _ _[*name of recipient company*]_ _ **(the "Company") has been forwarded to me for response. The Company will only consider new product ideas from others in accordance with our Policy on Handling Unsolicited Disclosures of Ideas (the "Policy"). The Policy provides, among other things, that the Company has no confidentiality obligation concerning the ideas in your letter and that you waive any rights you may have against the Company regarding your disclosure of your ideas to the Company, except for any patent rights you may have or subsequently obtain. We suggest that you review and discuss this Policy with your attorney, because it may result in loss of trade secret protection for your idea.**

It is necessary that the Company adhere to this Policy because we cannot accept any disclosures from you under a confidential relationship. If you are not agreeable to our consideration of your ideas solely under the terms and conditions of the Policy, please contact us immediately to inform us of your objection and we will return your disclosures to you without review or consideration.

Very truly yours,

_ _[*Name of recipient company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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§3.16 D. Using Outside Consultants

A company, in using one or both of the policies discussed in §§3.8 and 3.14, may employ only outside expert consultants to evaluate the information. If the evaluation is negative, the information will be returned directly to the submitter by the consultant, together with a statement that the company never had access to the information and no further action is required. If the evaluation is positive, the consultant can send the submitter either a waiver agreement (see, *e.g.,* form in §3.12) or a statement of policy (see, *e.g.,* form in §3.9), as appropriate, and act as a clearinghouse for the company. In each transaction, the consultant should maintain all records and verify that declarations were signed as necessary to protect the company in any litigation. A consultant can also advise on whether it may be valuable to seek patent protection in foreign countries and, if such protection is desirable, advise on entering into a nondisclosure agreement.

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§3.17 E. Using In-House Committee

Probably the most aggressive and risky approach for a recipient is to receive and accept the submission and have it evaluated by an in-house committee. Evaluations are conducted in some form of "clean room," in which committee members are segregated from employees working on related areas. The committee will perform the same functions as those of outside consultants under the policy described in §3.16. This approach allows maximum freedom for the corporation but exposes it to the greatest risk. The risk factors arising from potential claims by submitters increase further depending on the precise steps taken by the committee and the degree of separation between its members and the research and development staff.

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§3.18 IV. STEP 3: SUBMITTER'S RESPONSE TO COMPANY POLICY

A submitter who receives notice of the recipient's policy has few options but, like the recipient, needs to implement a policy and procedures to protect his or her rights. Most recipient companies will not vary or waive their policy of either not considering submissions in any circumstance or considering them only after a waiver of confidentiality. Although the submitter can shop the idea to other potential recipients, they are unlikely to provide a more attractive arrangement. Faced with this dilemma, many submitters sign a waiver agreement. If the submitter has not previously sought counsel's advice, he or she may do so at this time.

The choices available to the submitter vary, depending on his or her goals and alternative opportunities available for the idea or invention. See §§3.19-3.25 for a summary of available approaches, listed from most to least conservative from the submitter's perspective.

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A. No Disclosure Without First Securing Statutory Rights

§3.19 1. Policy Procedures

Some ideas and inventions are so novel and important that a submitter should file patent applications in the United States (and perhaps abroad) before making any disclosure to a third party. The reason is that even a nondisclosure agreement may not be sufficient to protect the submitter's ideas and inventions because the submitter may be unable to carry the burden of proving that the submitter's ideas and inventions deserve trade secret status. See *QR Spex, Inc. v Motorola, Inc.* (CD Cal, Oct. 28, 2004, No. CV 03-6284-JFW) 2004 US Dist Lexis 27378. In this conservative approach, the submitter files patent applications before entering into a submission agreement. Should the submitter consider patent protection only in the United States, a nonpublication request may be submitted with the patent application to prevent the automatic publication of the patent application 18 months from the earliest priority date. The secret status of the information is maintained until the issuance of a patent. On issuance, the submitter loses secrecy of the information but can now assert the patent. Companies will generally consider a patent license as long as the submitter has waived all other rights to the information disclosed. See form in §3.20.

Submitters should also consider the length of time for a patent application to mature into an issued patent, which may take three or more years. Certain ideas may only be useful for a few years, such as software code, designs, etc. In these instances, a confidentiality agreement is necessary to protect the submitter's ideas. Otherwise, the recipient may freely use the submitter's idea during the pendency of proceedings in the Patent Office, with the hope that new technology will surpass the submitter's ideas before the issuance of a patent. The recipient can then implement the new technology.

For discussion of the requirements for a patent application, see California Business Litigation, chap 8 (Cal CEB 2002).

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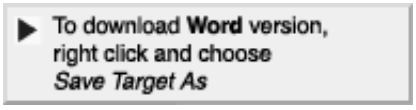
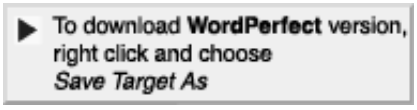
Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.20 2. Form: Agreement for Submission of Ideas

§3.20 2. Form: Agreement for Submission of Ideas





Date: _ _ _ _ _ _

_ _[*Name and address of recipient*]_ _

Att'n: Patent Department

Ladies and Gentlemen:

I request that _ _[*name of recipient*]_ _ (the "Company") consider my idea for _ _[*generally describe idea*]_ _. I retain all rights under any patents I now have or may obtain covering my idea. In consideration of the Company's examination of my _ _[*patent/patent application*]_ _, I release the Company from all liability not based on valid patents that I have or might obtain on the idea.

Yours very truly,

__[*Signature*]__
Name: _ _[*Typed name*]_ _

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B. No Delivery Without Agreement

§3.21 1. Policy Procedures

Sometimes, a submitter provides only a general description of the idea or invention and then seeks a signed agreement of confidentiality. The full invention or detailed elements of the confidential idea will be delivered only after the submitter receives the signed agreement. See form in §3.22. The disposition of the submitter's disclosure is expressly established by the precise terms and conditions of the mutually executed agreement. However, most counsel for recipients will advise the client not to accept the submission on these terms.

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.22 2. Form: Agreement for Submission of Ideas

§3.22 2. Form: Agreement for Submission of Ideas

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

AGREEMENT FOR SUBMISSION OF IDEAS

In submitting my ideas or suggestions (the "Suggestions") to _ _[*name of company*]_ _ (the "Company") and in requesting consideration of the Suggestions, I understand, warrant, represent, and agree as follows:

1. The Company is ready and willing, on request, to consider ideas and suggestions originated by persons outside its organization.

2. The Company is considering the Suggestions at my request.

3. I do not give the Company any rights or license under any patents or patent applications that I now have or that I may make or obtain in the future.

4. It is the Company's policy to recognize all contributions of persons outside its organization and to pay reasonable compensation for valuable ideas or suggestions submitted to it that it acts upon. However, such payment to me by the Company will be determined by, and only by, a written contract between me and the Company.

5. The Company, as a general practice, returns any drawings, written descriptions, models, or other technical information submitted for consideration by persons outside its organization. However, it has no obligation to return to me any such technical information that I am submitting or may submit to it in connection with the Suggestions.

6. I have the right to disclose the Suggestions and to make the present agreement. There are no outstanding agreements, whether written, oral, or implied, that are inconsistent with this agreement.

7. In consideration of the Company's examination of the Suggestions, I release the Company from any liability to me for any use of the Suggestions unless and until I obtain a patent on them.

8. The following is a brief description of the Suggestions: _ _[*Describe ideas or suggestions*]_ _.

Date: _ _ _ _ _ _ __[*Signature*]__
Name: _ _[*Typed name*]_ _
Address: _ _[*Address*]_ _

Agreed to and acknowledged:

_ _[*Name of recipient company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.23 C. Delivery With 'Shrink-Wrap' Agreement

§3.23 C. Delivery With "Shrink-Wrap" Agreement

A submitter may deliver information in a sealed envelope with a form of "acceptance upon opening" agreement attached to the envelope. The submitter can then argue that the recipient agreed to the express terms of confidentiality in the agreement. Not unlike the types of end-user software transactions that many software companies believe are reasonable, the submitter seek to enter into an agreement at an administratively low cost. Without any return of the materials in the same form in which they were received, the submitter relies on the position taken in the written shrink-wrap type of agreement.

WARNING: Because the enforceability of shrink-wrap licenses is questionable, submitters should not solely rely on this type of agreement. See §§16.30-16.40 for discussion of shrink-wrap licenses in connection with computer software and related case law and for form license.

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.24 D. Delivery With Confidentiality Notices and Other Proprietary Legends

§3.24 D. Delivery With Confidentiality Notices and Other Proprietary Legends

Using a more aggressive and less conservative approach, a submitter can provide information in a sealed envelope, with both the envelope and the enclosed material marked with confidentiality notices and other proprietary legends. The submitter then relies on a court's either shifting the burden to the recipient to return items that bear such notices or legends, or analyzing the parties' positions using a "battle of the forms" approach.

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§3.25 E. Delivery in Person Based on Implied Understanding

The most aggressive approach for a submitter is to meet with a recipient and to disclose an invention or other confidential idea under circumstances in which it is reasonable to infer that the information will be retained as confidential and will not be used unless the submitter enters into a written license agreement or other similar arrangement with the recipient. Such meetings are common in the business world, sometimes without either party realizing that they are about to occur. The submitter relies on an informal understanding based on verbal and nonverbal behavior, but years later this behavior may be evaluated quite differently by a judge or a jury. See *Editions Play Bac, S.A. v Western Publishing Co.* (SD NY 1993) 31 USPQ2d 1338. Risks exist for the recipient as well in these circumstances. Although this approach gives both parties maximum freedom, it also exposes both to substantial uncertainty and risks.

PRACTICE TIP: Personal discussions of confidential information often result in differing views of what was said and agreed on. A party to such a discussion should therefore consider:

- Recording the conversation electronically (with permission);
- Having a witness present;
- Taking contemporaneous notes that are supplemented immediately after the discussion;
- Sending follow-up letters outlining the party's understanding of any agreement on the important aspects of the discussion; or
- Any combination of the above.

Written submissions provide a more controlled environment for releasing information to the company; it is difficult to limit a verbal disclosure to the four corners of the patent document. Conversation may lead to patentable permutations of the invention for which the parties may want to seek patent protection. Without a prior written agreement of confidentiality, a submitter jeopardizes foreign patent protection. In the United States, the submitter or the company has 1 year to file a patent application. See 35 USC §102(b).

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§3.26 V. STEP 4: RECIPIENT'S FOLLOW-UP

If the company sent the submitter a waiver agreement, and the submitter signed and returned it, the idea may be forwarded to appropriate company departments for review and evaluation. If the company has no interest in pursuing the idea, it should inform the submitter. However, it should not give the submitter a statement of reasons for any lack of interest, because doing so could only lead to further complications. The company should photocopy all documents to keep a record of what was submitted and then return everything except the archival copy to the submitter, whether return was requested or not.

If the submitter does not sign a waiver agreement, the company should maintain the disclosure off-site in a restricted file as a record of what the company received. Only personnel administering the recipient's policy (and, in a dispute, attorneys handling such matters) should have access to the file, so that no disclosure of the materials is made to anyone in the company who could conceivably use them.

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VI. LITIGATION STRATEGIES

§3.27 A. By Recipient

The corporate recipient of an unsolicited disclosure wants to be able to prove that there was a binding and enforceable predisclosure agreement clearly acknowledging that:

- No confidential relationship exists between the parties;
- No confidential information exists in the submission;
- No rights exist other than patent or copyright rights;
- No assurance is given that review will occur at any level; and
- No return of the submission is required; *i.e.,* all submissions become the recipient's property to use (or not use) without limitation as long as the submitter's patent, copyright, or trademark rights are not infringed.

The recipient's aim is to use the agreement to establish that any legal claim by the submitter must be based on an issued patent, a copyright, or another statutory right. Without an unambiguous written agreement, the recipient must be prepared to affirmatively demonstrate that the submission was not used or that it was the subject of sufficient written notice to the submitter to negate any expectation of confidentiality. Counsel may need to obtain declarations from everyone who handled the submission for the recipient in order to support an early motion for summary judgment.

The recipient can consider including in any signed agreement a requirement that any submission dispute (or any other dispute including but not limited to any intellectual property ownership or infringement dispute) be decided in final and binding arbitration. See CCP §1281. Some advantages of arbitration are that the dispute is sometimes resolved faster and it is decided by experts with business experience; some disadvantages are that the dispute is not decided by a jury and the decision may not be based on law. For discussion of arbitration agreements and their advantages and disadvantages, see Drafting Business Contracts: Principles, Techniques & Forms §§16.17-16.41 (Cal CEB 1994).

Unless the recipient has sufficient bargaining power, a number of submitters may refuse to submit ideas to the recipient without a nondisclosure agreement. Accordingly, the recipient may forego potential lucrative ideas. The recipient should consider the level of confidentiality that it is willing to bear in order to receive more idea submissions in light of the risks. For example, a minimal nondisclosure agreement might provide for a 1- or 2-year period of confidentiality, with broad exceptions for independently derived subject matter and material distributed without a written nondisclosure agreement. These exceptions can be broadly drafted so that more information will fall within the exceptions to confidentiality.

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Source: Business Law/Trade Secrets Practice in California/3 Idea Submissions/§3.28 B. By Submitter

§3.28 B. By Submitter

A submitter who relies on state law rights (such as trade secret rights) at trial must raise a question of fact as to whether:

- A confidential relationship arose between the parties;
- The submission contained confidential information;
- State law trade secret rights exist in addition to patent and copyright rights and were not waived by agreement or conduct;
- The submission was provided for a limited purpose and did not constitute a general publication or dedication to the public domain; or
- The lack of return of the submission raises an inference that the information was valuable, useful, and used in furthering the design or development of a particular company product or service.

In addition, the submitter will want to establish that the recipient had reasonable notice that the invention or idea was viewed as novel and proprietary, was not to be exploited without consent, and was not intended to be disclosed for any purpose other than evaluation of a potential assignment, license, or other royalty-bearing arrangement between the parties.

Despite the resistance by a number of recipients to signing a nondisclosure agreement, some recipients are willing to enter into confidentiality agreements. Accordingly, submitters should initially attempt to enter into a confidentiality agreement with the recipient. Submitters should primarily seek to protect their ideas through patent, trademark, and copyright. If the idea can be protected by one of these intellectual property rights, then the submitter may choose to freely distribute the idea regardless of the existence of a confidentiality agreement. Alternatively, if the idea is not subject to protection by one of these intellectual property rights, then the submitter is strongly encouraged to enter into a confidentiality agreement with the recipient.

PRACTICE TIP: To encourage the recipient to enter into a confidentiality agreement, the submitter should stress the importance of patent protection in foreign countries.

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4

Protecting a Company's Trade Secrets

Bruce B. Brunda
Stephen M. Westbrook
Carol L. Smith
James C. Yang

I. INTRODUCTION §4.1

II. MAINTAINING SECRECY §4.2

A. Form of Obligation of Confidence

1. Implied Confidential Obligation §4.3

2. Contractual Confidential Obligation §4.4

B. Creating Contractual Confidentiality Obligations

1. Should the Contract Be Written or Oral? §4.5

2. Contracts With Employees §4.6

3. Contracts With Outsiders §4.7

III. REASONABLE EFFORTS TO MAINTAIN SECRECY

A. Reasonableness Requirement §4.8

1. Adequate Measures to Protect Trade Secrets §4.9

2. Inadequate Measures to Protect Trade Secrets §4.10

B. Procedures in Dealing With Employees

1. Interviewing Job Applicants §4.11

2. Employee Instruction and Employee Awareness Program §4.12

3. Employee Departures

a. Exit Interview §4.13

b. Documenting Departing Employees' Obligations §4.14

c. Notice to New Employer §4.15

C. Procedures Concerning Physical Access §4.16

1. Physical Restrictions Generally §4.17

2. Restricting Visitors' Access §4.18

D. Procedures Protecting Documents

1. Proprietary Legends §4.19

2. Copyright Notices §4.20

3. Access Limitations §4.21

4. Copying Limitations §4.22

5. Waste Disposal §4.23

E. Procedures for Information Dissemination §4.24

F. Procedures for Computer Data and Equipment; Other Advanced Technology §4.25

G. Procedures Concerning Product Sales §4.26

IV. GOVERNMENT SUBMISSIONS AND DISCLOSURES §4.27

V. COUNTERESPIONAGE §4.28

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§4.1 I. INTRODUCTION

A company's trade secrets are an integral and valuable part of its business assets. Use of a trade secret is not an inherent requirement for protection of the trade secret under the California Uniform Trade Secrets Act (CC §§3426-3426.11), but most companies either use their trade secrets or seek to do so. A company's activities typically require it to communicate trade secret information, both within and often outside the company, in carrying out the company's business activities. These activities, directed toward the company's business objectives, may require significant exposure of the trade secrets to both employees and outsiders. This exposure can jeopardize its trade secret unless the company employs adequate protective measures.

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Source: Business Law/Trade Secrets Practice in California/4 Protecting a Company's Trade Secrets/§4.2 II. MAINTAINING SECRECY

§4.2 II. MAINTAINING SECRECY

Trade secret information must derive its value "from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use." CC §3426.1(d)(1). (The second prong of the definition of a trade secret is that the information be "the subject of efforts that are reasonable under the circumstances to maintain its secrecy." CC §3426.1(d)(2). This issue is discussed in §§4.8-4.26.) Thus, the secrecy itself is at the core of the definition of a trade secret. Even inadvertent or unintentional disclosure of trade secrets to the public, whether generally or only to a limited external audience, destroys the "secret" status of the subject information and thus trade secret protection for such information.

NOTE: Information regarding a business's confidential future acquisition plans is generally not considered a trade secret. *EarthWeb, Inc. v Schlack* (SD NY 1999) 71 F Supp 2d 299, aff'd (2d Cir 2000) 2000 US App Lexis 11446.

The key to determining secrecy is the ease with which the information can be developed. To determine whether information deserves protection as a trade secret, the court examines whether the alleged trade secrets were "within the general skills and knowledge of the industry or were readily ascertainable without involving considerable time, effort or expense." *Pope v Alberto-Culver Co.* (Ill App 1998) 296 Ill App 3d 512, 516, 694 NE2d 615. See *Hoechst Diafoil Co. v Nan Ya Plastics Corp.* (4th Cir 1999) 174 F3d 411 (presence of information in unsealed court documents did not make information generally known); *AT&T Corp. v Microsoft Corp.* (ND Cal 2003) 2003 US Dist Lexis 8710. See also *C & F Packing Co. v IBP, Inc.* (Fed Cir 2000) 224 F3d 1296. Moreover, a showing of independent economic value may be necessary. *GAB Bus. Servs., Inc. v Lindsey & Newsom Claim Servs., Inc.* (2000) 83 CA4th 409, 99 CR2d 665, overruled on other grounds in *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289 (jury finding of no trade secret upheld because no showing that salary information had independent economic value). The court has broad latitude in determining the reliability of expert testimony used to argue whether alleged trade secrets were "generally known" in an industry. *Atmel Corp. v Information Storage* (ND Cal 1999) 189 FRD 410, rev'd on other grounds (Fed Cir 1999) 198 F3d 1374.

Absolute secrecy, however, is not required. It is sufficient that the information confer some competitive advantage on the one who possesses it. *Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 116 CR2d 358 (customer lists and related information may constitute protectable trade secrets); *Yeti by Molly, Ltd. v Deckers Outdoor Corp.* (9th Cir 2001) 259 F3d 1101 (identities of boot designer's suppliers may be deemed trade secrets); *Bohler-Uddeholm Am., Inc. v Ellwood Group, Inc.* (3d Cir 2001) 247 F3d 79 (information like client lists, client profiles, pricing information, and shipping information can be trade secret); *EFCO Corp. v Symons Corp.* (8th Cir 2000) 219 F3d 734 (manufacturer's research, development, pricing, cost, and marketing data constituted trade secrets as long as they had economic values); *C & F Packing Co. v IBP, Inc.*, *supra* (process for making and freezing precooked sausage is trade secret in light of time, expense, and effort expended to develop process); *Fireworks Spectacular, Inc. v Premier Pyrotechnics, Inc.* (D Kans 2000) 86 F Supp 2d 1102 (customer list containing public information afforded trade secret treatment because considerable amount of time, effort, and expense used in its development and in maintenance of its confidentiality); *Motor City Bagels, L.L.C. v American Bagel Co.* (D Md 1999) 50 F Supp 2d 460 (information available from marketplace afforded trade secret treatment because compiling and arranging such information was onerous task); *Meadox Medicals, Inc. v Life Sys., Inc.* (D NJ 1998) 3 F Supp 2d 549; *Enterprise Leasing Co. v Ehmke* (Ariz App 1999) 3 P3d 1064 (customer service worksheets and other financial documents provided only slight advantage over information generally known in trade, but still constituted protectable trade secrets). See also Restatement (Third) of Unfair Competition §39, Comment f (1995). The California Uniform Trade Secrets Act requires only that the information not be *generally known* to the public. CC §3426.1(d)(1). See *K-2 Ski Co. v Head Ski Co.* (9th Cir 1974) 506 F2d 471; *Cambridge Filter Corp. v International Filter Co.* (D Nev 1982) 548 F Supp 1301; *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, aff'd (9th Cir 1960) 283 F2d 695. See also Restatement §39, Comment f; Jager, Trade Secrets Law §5.05[1] (1985). But see *Western Forms, Inc. v Pickell* (8th Cir 2002) 308 F3d 930 (employer's customer identities and price information were not trade secrets even if they were not common knowledge, because they were obtainable without recourse to misappropriation from employer).

Trade secrets, which have their origins in the common law recognition of confidential relationships, are preserved even after disclosure if they are disclosed within the environment of a confidential relationship or otherwise disclosed under an *obligation of confidence. Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 40 L Ed 2d 315, 94 S Ct 1879. Therefore, it is critical that all trade secret disclosures be made under the umbrella of a confidential relationship. See §§4.3-4.7. Moreover, use of trade secrets in violation of a confidential relationship is not protected by the First Amendment. *Ford Motor Co. v Lane* (ED Mich 1999) 67 F Supp 2d 745. However, restrictions on the dissemination of computer codes (*i.e.,* proprietary information) are subject to the First Amendment. *DVD Copy Control Ass'n, Inc. v Bunner* (2003) 31 C4th 864, 4 CR3d 69. And in *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72 (Apple Computer, Inc. was real party in interest), the court of appeal ruled that the identities of persons who furnished Apple's alleged trade secrets to an online news organization that, in turn, published the information online were protected by operation of the federal Stored Communications Act (18 USC §§2701-2712) as well as by Cal Const art I, §2(b)

and Evid C §1070(a), the California reporter's shield law.

In settling a suit over breach of a confidentiality agreement, a release may bar a subsequent suit alleging that additional products were derived from misappropriation of the same trade secret involved in the first suit. *Security People, Inc. v Medeco Sec. Locks, Inc.* (ND Cal 1999) 59 F Supp 2d 1040. Parties to a release in a trade secret dispute remain free to fashion the release as broadly or narrowly as they choose. *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169. However, a release may not bar a claim that had not accrued at the date of its execution, or a claim that was not known to the party giving the release. See *Medtronic Ave, Inc. v Advanced Cardiovascular Sys., Inc.* (3d Cir 2001) 247 F3d 44 (release is provision that intends present abandonment of known right or claim). As such, a covenant not to sue may be an alternative approach. *Medtronic Ave, Inc. v Advanced Cardiovascular Sys., Inc., supra* (covenant not to sue applies to future claims and forms agreement to exercise forbearance from asserting any claim that either exists or that may accrue).

NOTE: An abandoned trade secret cannot be misappropriated. *Swartz v Schering-Plough Corp.* (D Mass 1999) 53 F Supp 2d 95.

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A. Form of Obligation of Confidence

§4.3 1. Implied Confidential Obligation

Obligations of confidentiality may be implied from the nature of the relationship of the parties or the nature of their communications with each other. These obligations are implied in many normal business relationships:

Negotiations for sale of business. *Phillips v Frey* (5th Cir 1994) 20 F3d 623; *Tri-Tron Int'l v Velto* (9th Cir 1975) 525 F2d 432; *Heyman v AR. Winarick, Inc.* (2d Cir 1963) 325 F2d 584. But see *Smith v Snap-On Tools Corp.* (5th Cir 1987) 833 F2d 578; *Walton v Morgan Stanley & Co*. (2d Cir 1980) 623 F2d 796.

License negotiations. *Speedry Chem. Prods. v Carter's Ink Co.* (2d Cir 1962) 306 F2d 328; *Trandes Corp. v Guy F. Atkinson Co.* (D Md 1992) 798 F Supp 284, aff'd in part, rev'd in part, and remanded (4th Cir 1993) 996 F2d 655; *Allis-Chalmers Mfg. Co. v Continental Aviation & Eng'g Corp.* (ED Mich 1966) 255 F Supp 645. But see *Daily Int'l Sales Corp. v Eastman Whipstock, Inc.* (Tex Ct App 1983) 662 SW2d 60.

Independent contractor relationships. *Hollywood Motion Picture Equip. Co. v Furer* (1940) 16 C2d 184, 105 P2d 299; *Crocan Corp. v Sheller-Globe Corp.* (ND Ill 1974) 385 F Supp 251. But see *VFD Consulting, Inc. v 21st Servs.* (ND Cal 2006) 425 F Supp 2d 1037.

Employment relationships. *Plant Indus. v Coleman* (CD Cal 1968) 287 F Supp 636; *Choisser Research Corp. v Electronic Vision Corp*. (San Diego Super Ct 1972) 173 USPQ 234. But see *E.I. Du Pont de Nemours Powder Co. v Masland* (1917) 244 US 100, 61 L Ed 1016, 37 S Ct 575; *Zoecon Indux v American Stockman Tag Co.* (5th Cir 1983) 713 F2d 1174; *McKay v Communispond, Inc.* (SD NY 1983) 581 F Supp 801; *Delta Filter Corp. v Morin* (App Div 1985) 485 NYS2d 143; *Union Pac. R.R. v Mower* (9th Cir 2000) 219 F3d 1069.

Relationship with vendors. *Riteoff, Inc. v Contact Indus.* (App Div 1973) 350 NYS2d 690.

Sales of products. *Laurie Visual Etudes, Inc. v Chesebrough-Pond's, Inc.* (Sup Ct 1980) 432 NYS2d 457, rev'd on other grounds (1981) 441 NYS2d 88.

Joint venture relationship. *Ewen v Gerofsky* (Sup Ct 1976) 382 NYS2d 651.

Relationship between manufacturer and supplier. *Space Aero Prods. Co. v R.E. Darling Co.* (Md 1965) 208 A2d 74.

Business negotiations. *Neothermia Corp. v Rubicor Med., Inc.* (ND Cal 2004) 345 F Supp 2d 1042.

Accordingly, to prevent future litigation, it may be prudent for both the disclosing party and the receiving party to enter into a written agreement specifying the extent of each party's obligation to not disclose the other party's confidential information or trade secret.

For further discussion of implied confidential obligation, see §3.4.

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§4.4 2. Contractual Confidential Obligation

Obligations of confidentiality can also be created contractually. Even though confidential relationships are implied in most business relationships, a trade secret owner should establish an express obligation of confidentiality by contractual agreement to confirm the existence of a confidential relationship and to serve as a notice and reminder to the recipient of the obligations of confidentiality.

NOTE: Confidential relationships may also be created through noncontractual means, because a contract may be void to the extent that it prevents an employee from seeking other employment under Bus & P C §16600. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282.

Confidentiality agreements make trade secret protection more probable and would support a finding that reasonable precautions were taken to protect trade secrets disclosed to employees (going to both the "maintaining secrecy" and the "reasonable efforts" prongs of the trade secret definition). *Cybertek Computer Prods. v Whitfield* (LA Super Ct 1977) 203 USPQ 1020; *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 262 CR 92; *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511. However, a written confidentiality agreement is not a requirement. *Hertz v Luzenac Group* (10th Cir 2009) 576 F3d 1103.

Other advantages of a contractual obligation are as follows:

- It defines the scope of the subject matter to be protected;
- It provides notification and confirmation of the confidential status of the information;
- It provides the owner of the trade secret with a possible opportunity to somewhat broaden protection by defining the scope of protected information beyond trade secrets so as to include proprietary information and the recipient's obligations;
- It creates a record of the subject matter, disclosure restrictions, and notice given;
- It can be evidence of efforts to protect the trade secret;
- It can provide for choice of law and arbitration if a dispute arises; and
- It changes a tort action to a contract action, with implications for the statute of limitations and available remedies (see chap 12 for discussion of remedies).

NOTE: Even though a contract may impose confidentiality obligations on the parties for information that does not qualify as a trade secret, the scope of a trade secret cannot be defined by contract. The information must satisfy the definition in CC §3426.1(d) to be a trade secret, regardless of attempts to define information as such by contract. See, *e.g.*, *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1325, 228 CR 713, citing *State Farm Mut. Auto. Ins. Co. v Dempster* (1959) 174 CA2d 418, 426, 344 P2d 821.

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B. Creating Contractual Confidentiality Obligations

§4.5 1. Should the Contract Be Written or Oral?

The Court of Appeals for the Seventh Circuit has held that parties may create an obligation of confidentiality if the prospective recipient is orally advised of the confidential nature of the information and orally agrees to hold it in confidence. *In re Innovative Constr. Sys.* (7th Cir 1986) 793 F2d 875. However, oral promises may not be enforceable in California. *Bayline Partners L.P. v Weyerhaeuser Co.* (ND Cal 1994) 31 USPQ2d 1051. As with most contracts, it is preferable to have the agreement in writing.

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Source: Business Law/Trade Secrets Practice in California/4 Protecting a Company's Trade Secrets/§4.6 2. Contracts With Employees

§4.6 2. Contracts With Employees

Many trade secret problems necessarily involve employees; at least some employees will know the employer's trade secrets. Therefore, it is particularly important to have nondisclosure or confidentiality agreements in place with all employees. The company should address employee confidentiality issues at all stages in the relationship between the employee and employer: during the interview process, during employment, from the time of hire until termination, and on termination.

PRACTICE TIP: A company should review an employee's file whenever a promotion is granted to ensure that a nondisclosure agreement is in place. An employee who was hired in a nonsensitive position may not have signed a nondisclosure agreement on initial hire. After a promotion, however, the employee may gain access to trade secrets. If the company does not review the employee's file, it may assume that a nondisclosure agreement was already in place or it could forget to obtain the agreement. In either situation, the employee would have access to trade secrets without any contractual obligation of confidentiality. Also, when the employee will have access to more sensitive or valuable information, the employee should execute a more specific agreement covering this information and agree specifically to maintain the information in confidence.

WARNING: Confidentiality agreements between employer and employee sometimes also include noncompetition clauses. Business and Professions Code §16600 renders noncompetition agreements void to the extent that they prevent an employee from seeking alternative employment. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282. Moreover, a contract between employer and employee that violates Bus & P C §16600 may constitute an unfair business practice under Bus & P C §17200. *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084, 1091. Thus, to better assure the enforceability of confidentiality agreements, companies should avoid including noncompetition clauses that are unenforceable under *Edwards*. For further discussion of noncompetition clauses, see §§2.32-2.32D.

To further protect itself, the company should require in any agreement assurances that the employee not use or disclose another's trade secrets. See chap 10 for procedures to help avoid inadvertent misappropriation of another's trade secrets.

NOTE: A confidentiality agreement between an employer and employee is enforceable only to the extent that it applies to protectable proprietary information. Information regarding alleged wrongdoing by an employer that is not privileged will not be covered by the agreement. *In re JDS Uniphase Corp. Secs. Litig.* (2002) 238 F Supp 2d 1127. Ideas that were already known at the time the agreement was signed will not be covered by the agreement. *Hickory Specialties, Inc. v Forest Flavors Int'l, Inc.* (MD Tenn 1998) 12 F Supp 2d 760, aff'd (6th Cir 2000) 215 F3d 1326; *Lanier Prof. Servs., Inc. v Ricci* (1st Cir 1999) 192 F3d 1; *Kublan v Hasbro Toy Div. of Hasbro & Tonka Corp.* (SD NY 1999) 1999 US Dist Lexis ¶3226, 50 USPQ2d 1539. Consequently, employees may not be restrained from using general techniques learned during their former employments. *EarthWeb, Inc. v Schlack* (SD NY 1999) 71 F Supp 2d 299, aff'd (2d Cir 2000) 2000 US App Lexis 11446; *Utah Med. Prods., Inc. v Clinical Innovations Assocs., Inc.* (D Utah 1999) 79 F Supp 2d 1290.

Employers commonly include in such agreements provisions for assignment of the employee's inventions. When drafting such provisions, however, counsel must consider Lab C §2870, which prohibits assignment of certain inventions in employment agreements. The employer must also give notice of §2870 if the employment agreement contains an inventions assignment. Lab C §2872. See §2.31 for further discussion of invention assignment agreements; see form in §6.23.

In many states, employers commonly include a covenant not to compete after termination of employment. However, California law makes such provisions unenforceable unless they are executed in connection with certain sales of the goodwill of a business, shares in a corporation, business assets, or interest in a partnership or limited liability company; or dissolution of a partnership or limited liability company. Bus & P C §§16600-16602.5. Because noncompetition provisions do not affect the validity of the rest of the agreement in which the covenant is included (*Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134), businesses with multistate operations and businesses anticipating operations in other states may wish to include the provisions in a universal form of agreement to provide additional protections in jurisdictions that enforce covenants not to compete. See 54A Am Jur 2d, Monopolies, Restraints of Trade, and Unfair Trade Practices §§840-986 (1996). Moreover, nonsolicitation clauses are enforceable only to the extent that they protect trade secrets or confidential proprietary information. *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427.

PRACTICE TIP: Multistate businesses should consult with local counsel to ascertain whether such a clause may be valid or desirable in other applicable jurisdictions. Counsel should also note that it is generally believed that noncompetition agreements may be enforced during the term of employment on a fiduciary duty theory.

Trade secrets disclosed to an employee may be protected, even in the absence of a nondisclosure agreement, by the employee's

fiduciary duty of loyalty to the employer as well as under the law of unfair competition. *Plant Indus. v Coleman* (CD Cal 1968) 287 F Supp 636. Any fiduciary duty of the employee should be reflected in writing in a separate agreement or else contained in the nondisclosure agreement. See *Huong Que, Inc. v Luu* (2007) 150 CA4th 400, 58 CR3d 527. Employee nondisclosure agreements are still advisable, however, because they make employees more aware of their obligation to protect the employer's trade secrets. See *Hollingsworth Solderless Terminal Co. v Turley* (9th Cir 1980) 622 F2d 1324, 1334 n7 (employer's requirement that employee sign confidentiality agreement relevant in determining whether information is protectable).

WARNING: If employees are asked to sign nondisclosure agreements after their employment has begun, an issue may arise in California concerning whether there is adequate consideration for the agreement. See §2.27. For companies with multistate or international operations, however, the employer should include notice of a nondisclosure agreement requirement as a condition of the employment offer. For discussion of consideration in the context of invention assignment agreements, see §§2.22-2.29.

For form of employee confidentiality agreement, see §§6.17-6.39.

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§4.7 3. Contracts With Outsiders

The trade secret owner should have nondisclosure agreements with third parties to whom it will disclose trade secrets in the course of its business or who will otherwise be exposed to the trade secrets. Such third parties typically include suppliers, consultants, prospective buyers of the business, visitors, collaborators of a joint effort, and customers.

Agreements with vendors and suppliers are often consummated using purchase orders or similar forms rather than full licensing or development agreements. In some transactions, the purchaser must disclose trade secrets or confidential information to enable the vendor or supplier to produce the necessary products or supplies. Before doing so, the vendor or supplier should sign a nondisclosure agreement. If trade secrets or other confidential information must be disclosed in the purchase orders or purchase agreements used, the trade secret owner or its counsel should add confidentiality provisions to the forms. Further, the confidentiality agreement should clarify ownership issues and the extent of the receiving party's ability to use the confidential information. *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442. For further discussion of confidentiality agreements with outsiders and related forms, see §§6.44-6.54.

WARNING: In a buy-sell agreement, the transfer of a general catch-all category of intellectual property rights will not transfer rights defined in a nondisclosure agreement between the transferor and a third party. The transferee will not have standing to sue the third party for a breach under the nondisclosure agreement. The rights under the nondisclosure agreement must be specifically identified in the buy-sell agreement. *Hoffman v Impact Confections, Inc.* (SD Cal 2008) 544 F Supp 2d 1121.

WARNING: A software license agreement should not grant an unlimited license to software that is embedded with trade secrets. An unlimited license may be construed to include a license to access any trade secret embodied in the software. *Asset Mktg. Sys., Inc. v Gagnon, supra*.

PRACTICE TIP: A trade secret owner should always ensure that any company to which it discloses trade secret information has written confidentiality agreements with its employees. The owner should also consider signing new agreements with the specific persons who will use the trade secrets, because a confidentiality or noncompetition agreement with another corporation to which the owner discloses trade secrets may not bind that corporation's employees (including the person signing the agreement on behalf of the corporation) to abide by the agreement after the employees leave that corporation. Alternatively, the confidentiality agreement may contain flow-down provisions that require the receiving party to obtain agreements from employees or third parties that they will disclose information in support of the purposes stated in the confidentiality agreement. *Composite Marine Propellers, Inc. v Van Der Woude* (7th Cir 1992) 962 F2d 1263 (Illinois version of Uniform Act). Additionally, confidentiality provisions with a receiving company and with the employees of the receiving company should be consistent with each other. Confidentiality provisions in an agreement with the receiving company should permit the trade secret owner to enter into separate confidentiality agreements with the receiving company's employees. *Patricia Adkins Ins. Agency, Inc. v State Farm Mut. Auto. Ins. Co.* (2007) 146 CA4th 526, 52 CR3d 882.

In certain instances, the trade secret owner may enter into a contract with a client with a no-hire provision under which the client is prevented from hiring the employees that actually perform work for the client. See §§6.57-6.58. The no-hire provision protects the trade secret owner by limiting the movement of employees such that employees cannot move to a new company regardless of California's rejection of the inevitable disclosure doctrine.

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III. REASONABLE EFFORTS TO MAINTAIN SECRECY

§4.8 A. Reasonableness Requirement

Trade secret protection is not triggered by merely showing that the secrecy of the information was maintained by disclosing it only within the framework of an obligation of confidentiality. See generally *Huffy Corp. v Superior Court* (2003) 112 CA4th 97, 4 CR3d 823 (placing information under protective order without showing of overriding interest is insufficient to maintain secrecy). A company must also show that it made reasonable efforts in the circumstances to prevent the inadvertent disclosure or unintended discovery of the trade secret. CC §3426.1(d)(2). Thus, not only does a trade secret cease to be protected if it is no longer secret, but this result is presumed absent a showing of reasonable efforts to keep the information a secret. See *Morton v Rank Am., Inc.* (CD Cal 1993) 812 F Supp 1062, 1075; *United States Surgical Corp. v Origin Medsys.* (ND Cal 1993) 27 USPQ2d 1526, 1530, aff'd without published opinion (Fed Cir 1993) 16 F3d 420; *In re Providian Credit Card Cases* (2002) 96 CA4th 292, 116 CR2d 833. Also, mere intention without any outward manifestation of that intention by making some effort to keep the information secret does not trigger trade secret protection. *VFD Consulting, Inc. v 21st Servs.* (ND Cal 2006) 425 F Supp 2d 1037, 1048.

NOTE: A similar requirement appears in the Restatement (Third) of Unfair Competition §39, Comment g (1995) (which also recognizes that a showing of reasonable efforts to maintain secrecy may be unnecessary in some cases) and the Restatement of Torts §757, Comment b (1939). See *Future Plastics, Inc. v Ware Shoals Plastics, Inc.* (D SC 1972) 340 F Supp 1376, 1382 (complaint dismissed because plaintiff "failed to take proper and reasonable steps to maintain secrecy"); *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1186 (plaintiff did not take reasonable steps to protect trade secrets).

PRACTICE TIP: Contracts requiring that information be kept secret are evidence of reasonable efforts, but counsel should ensure that the agreements are made with the correct entity. In one case, contractual noncompetition restrictions between an employee and "Margaret Miller, doing business as H&R Block," were held not binding on the employee when Miller began doing business under a name other than H&R Block. Because the contract was not binding, it did not constitute "reasonable efforts" to maintain a disclosed customer list as a secret. See *Miller v Hehlen* (Ariz App 2005) 104 P3d 193.

A company cannot expect a court to place any higher value on the information or give it greater protection (*e.g.,* grant injunctive relief) after the loss of the information's secrecy than the company did before the loss. See *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, aff'd (9th Cir 1960) 283 F2d 695 (manufacturing information in complex field failed to qualify as trade secret because it was not kept secret by company). The *Sarkes Tarzian* court, in denying relief, stated: "It is difficult to understand how Tarzian can claim as trade secrets against the defendants that which it, in substance, voluntarily discloses to whomever was willing to pay $1 for the handbook." 166 F Supp at 273 n71.

Measures to protect secrecy need not be absolute, but merely reasonable under the circumstances. CC §3426.1(d)(2). See *USM Corp. v Marson Fastener Corp.* (Mass 1979) 393 NE2d 895, 902 ("heroic measures not required"); *E.I. Du Pont de Nemours & Co. v Christopher* (5th Cir 1970) 431 F2d 1012, 1117, cert denied (1971) 400 US 1024 (business need not turn itself into "impenetrable fortress," or build tent over site to screen it from overflying aircraft); *Hickory Specialties, Inc. v B & L Labs.* (Tenn Ct App 1979) 592 SW2d 583 (absolute secrecy not required). The extent of such measures generally varies with the value of and the risk to the information. See, *e.g., Rockwell Graphic Sys. v DEV Indus.* (7th Cir 1991) 925 F2d 174. (A similar requirement appears in the Restatement (Third) of Unfair Competition §39, Comment g (1995) and the Restatement of Torts §757, Comment b (1939).) There must be a substantial element of secrecy, however, so that a third person would have difficulty acquiring the trade secret information without resorting to improper means. See §§4.2-4.7 for discussion of secrecy. Whether reasonable measures were taken by the trade secret owner is a question of fact, and the burden of proof is on the plaintiff. See *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 3 CR3d 279 (placing burden of producing evidence on claimant but shifting burden to defendant once claimant has made out prima facie case); *In re Providian Credit Card Cases, supra* (what constitutes reasonable efforts to maintain secrecy and whether information qualifies as trade secret are questions of fact).

Thus, a showing of reasonable efforts to maintain the secrecy of a trade secret is an important part of the trade secret owner's affirmative case in trade secret misappropriation litigation. *Morton v Rank Am., Inc.* (CD Cal 1993) 812 F Supp 1062. See also *Cypress Semiconductor Corp. v Superior Court (Silvaco Data Sys.)* (2008) 163 CA4th 575, 588, 77 CR3d 685 (as reasonable effort to protect trade secrets, trade secret owner should promptly inform third party, good faith acquirers that products they purchase may contain stolen trade secrets). The owner must plead and meet its burden of showing that the measures it took meet this requirement. See California Business Litigation, chap 4 (Cal CEB 2002). The focus is not on the omitted steps but on whether the steps taken to protect secrecy were reasonable. *Hertz v Luzenac Group* (10th Cir 2009) 576 F3d 1103. A defendant can be expected to attack such a showing and claim that any measures taken were inadequate and insufficient to meet this requirement. The extent

and adequacy of the measures taken to protect the trade secret in dispute are then key issues in litigation to protect a trade secret. Because doing business may require disclosure of trade secrets to employees and outside third parties, a business must balance the need to maintain the secrecy of its trade secrets with the level of protection from disclosure.

Most business environments and activities that threaten the secrecy of trade secrets are common to many companies and have been the subject of much litigation on the need for and degree of measures that should be taken to protect the trade secrets. For a list of cases identifying measures that have been found not to be reasonable to maintain the secrecy of trade secret information, see §4.9. For a list of cases identifying measures that have been found not to be reasonable to maintain secrecy, see §4.10. See also *Surgidev Corp. v Eye Technol., Inc.* (8th Cir 1987) 828 F2d 452; Bus Litigation, chap 4.

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§4.9 1. Adequate Measures to Protect Trade Secrets

The courts granted trade secret protection in the following cases:

- *A.H. Emery Co. v Marcan Prods. Corp.* (SD NY 1967) 268 F Supp 289, aff'd (2d Cir 1968) 389 F2d 11. Employees were made aware that certain documents were considered to be, and treated as, trade secrets by the company. The company also kept trade secret documents in a locked room.

- *Allis-Chalmers Mfg. Co. v Continental Aviation & Eng'g Corp.* (ED Mich 1966) 255 F Supp 645. The company placed proprietary notices on all trade secret documents, restricted physical access to the facility, imposed visitor restrictions, and kept drawings and copies of patent applications in locked files.

- *Anaconda Co. v Metric Tool & Die Co.* (ED Pa 1980) 485 F Supp 410. Even though the employees did not sign secrecy agreements, the company made them aware of the proprietary nature of trade secrets. The company also imposed visitor restrictions.

- *Cambridge Filter Corp. v International Filter Co.* (D Nev 1982) 548 F Supp 1301. Employees signed nondisclosure agreements.

- *Camp Creek Hospitality Inns v Sheraton Franchise Corp.* (11th Cir 1998) 139 F3d 1396. A franchisee supplied information under an agreement and on the mutual understanding that it would be kept confidential, presenting a question of fact regarding whether the franchisee's efforts to maintain confidentiality were reasonable under the circumstances.

- *CMAX/Cleveland, Inc. v UCR, Inc.* (MD Ga 1992) 804 F Supp 337. Employees signed confidentiality agreements and were aware of their obligations of secrecy. The company restricted access to the system, placed proprietary notices on software, included nondisclosure provisions in the licensing agreement, and shredded source code printouts.

- *Com-Share, Inc. v Computer Complex, Inc.* (ED Mich 1971) 338 F Supp 1229, aff'd (6th Cir 1972) 458 F2d 1341. The software was protected by notices. The company used passwords to prevent access and placed the information in restricted storage.

- *CPG Prods. Corp. v Mega Corp.* (SD Ohio 1981) 214 USPQ 206. The company restricted access to production processes and equipment area, had employees enter into nondisclosure agreements, restricted employee access, issued employee ID badges, restricted visitor access, and notified suppliers of trade secrets.

- *Data Gen. Corp. v Grumman Sys. Support Corp.* (D Mass 1993) 825 F Supp 340. Employees signed nondisclosure agreements. The company distributed its trade secret protection plan, hired security guards, restricted employee access to materials, followed employee termination procedures, restricted visitor access, had customers sign nondisclosure agreements, used copyright notices, and distributed software only in object code form (which is machine readable only).

- *Greenberg v Croydon Plastics Co.* (ED Pa 1974) 378 F Supp 806. The secret machine was segregated within the facility, operated by a small number of employees, and never run in the presence of outsiders.

- *In re Innovative Constr. Sys.* (7th Cir 1986) 793 F2d 875. Employees knew the secret formula was proprietary, and they orally pledged to keep it secret. The company segregated the secret operations within the facility, kept most information in the manager's office, and required others interested in acquiring the company to agree to maintain confidentiality.

- *J & K Computer Sys. v Parrish* (Utah 1982) 642 P2d 732. Employees signed nondisclosure agreements and knew of the product's secret nature. The company placed notices on the software that it was for use by authorized licensees only and was distributed to a limited number of customers.

- *Johns-Manville Corp. v Guardian Indus. Corp.* (ED Mich 1983) 586 F Supp 1034, 221 USPQ 319, amended at 223 USPQ 973, aff'd (Fed Cir 1985) 770 F2d 178. The company used employee warnings, vendor secrecy agreements, visitor controls, physical restrictions, and publications oversight.

- *Kelite Corp. v Khem Chems.* (ND Ill 1958) 162 F Supp 332. The company coded its chemical formulas in all written and oral communications, labeled raw materials in code, and used confidentiality agreements.

- *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511. Employees were required to sign confidentiality

agreements.

- *Mangren Research & Dev. Corp. v National Chem. Co.* (7th Cir 1996) 87 F3d 937. Employees signed confidentiality agreements. Access to secret formulas and to the laboratory that mixed chemical ingredients was limited. Ingredient containers had coded labels, and all financial and other records referring to the ingredients used the codes.

- *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 66 CR2d 731. The company limited circulation of its customer lists and advised employees, in employment agreements and the employee handbook, that it considered the lists to be confidential.

- *Plant Indus. v Coleman* (CD Cal 1968) 287 F Supp 636. The employee knew that the information was confidential and that he was subject to an implied confidentiality obligation. The company also restricted visitor access.

- *Q-Co Indus. v Hoffman* (SD NY 1985) 625 F Supp 608. The source code was not accessible to the public, and computer programs were copy protected. The court also inferred confidentiality obligations from the employment relationship.

- *Schalk v Texas* (Tex Crim App 1991) 823 SW2d 633. The company restricted access to software by a series of passwords and codes and used other security measures.

- *Stampede Tool Warehouse, Inc. v May* (Ill App Ct 1995) 651 NE2d 209. Computer copies of the customer list were accessible only by code, and hard copies were kept in a locked office. The salesmen worked in confined areas, they could not take customer cards out, and the cards were locked up at end of each shift. The company also checked its trash daily.

- *Surgidev Corp. v Eye Technol., Inc.* (8th Cir 1987) 828 F2d 452. Employees signed nondisclosure agreements. The company restricted visitor access, kept documents in locked files, and distributed information on a need-to-know basis only.

- *Thermodyne Food Serv. Prods., Inc. v McDonald's Corp.* (ND Ill 1996) 940 F Supp 1300. The combination of trade secrets and the interrelationship of component parts could not be discovered merely from looking at ovens embodying the trade secrets.

- *Trandes Corp. v Guy F. Atkinson Co.* (D Md 1992) 798 F Supp 284, aff'd in part, rev'd in part, and remanded (4th Cir 1993) 996 F2d 655. The company used a software licensing agreement that imposed nondisclosure obligations and used a password system for access to both in-house and licensed copies of the program.

- *United States Surgical Corp. v Origin Medsys.* (ND Cal 1993) 27 USPQ2d 1526, 1530, aff'd without published opinion (Fed Cir 1993) 16 F3d 420. Drawings were kept by the patent attorney and in the company chairman's locked cabinet.

- *USM Corp. v Marson Fastener Corp.* (Mass 1979) 393 NE2d 895. Employees signed nondisclosure agreements (which did not list trade secrets). The company carefully controlled drawings (but not all were marked), restricted visitor access, and segregated plant areas.

- *Valco Cincinnati, Inc. v N&D Machining Serv.* (Ohio 1986) 492 NE2d 814. Employees signed nondisclosure agreements. The company restricted access to parts drawings and visitor access, shredded computer printouts and old pricing sheets, and used proprietary markings on all drawings (even though drawings were given to outside suppliers without nondisclosure agreements).

- *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2006) 420 F Supp 2d 1070. Transformer board was not marked confidential but corresponding data sheet was marked confidential.

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§4.10 2. Inadequate Measures to Protect Trade Secrets

In the following cases, the courts denied trade secret protection:

- *Silicone Image, Inc. v Analogix Semiconductor, Inc.* (ND Cal, Jan. 17, 2008, No. C-07-00635 JCS) 2007 US Dist Lexis 96073. Nondisclosure agreements with a receiving party known to disregard, and to fail to respect, other nondisclosure agreements with third parties does not constitute reasonable efforts to maintain secrecy of information.

- *Arco Indus. Corp. v Chemcast Corp.* (6th Cir 1980) 633 F2d 435. The manufacturing process was shown to visitors, suppliers, and customers without restriction, and no notice of trade secrets was given to employees or visitors.

- *Bayline Partners L.P. v Weyerhaeuser Co.* (ND Cal 1994) 31 USPQ2d 1051. The company disclosed information to its supplier absent a need to know, and even though it required employees to sign a nondisclosure agreement, it did not require the supplier to sign one.

- *Baystate Tech. v Bentley Sys.* (D Mass 1996) 946 F Supp 1079. Reasonable steps to maintain secrecy were not taken because the computer program was readily ascertainable and a third party company had the program under a confidentiality agreement that expired at an earlier date, corporate employees were unaware of confidentiality restrictions (despite confidentiality notations on documents sent to an officer of the corporation), and a corporate officer had a policy of disclosing software on request.

- *Cadillac Gage Co. v Verne Eng'g Corp.* (Mich Cir Ct 1978) 203 USPQ 473. The company had no plant security, left drawings lying around, and permitted unrestricted tours. Defense counsel had freely entered the premises and taken pictures.

- *Capsonic Group, Inc. v Plas-Met Corp.* (Ill App 1977) 361 NE2d 41. The company failed to inform employees of the trade secret nature of the information, restrict plant access, use security guards, or lock up drawings.

- *Daily Int'l Sales Corp. v Eastman Whipstock, Inc.* (Tex Ct App 1983) 662 SW2d 60. The company did not place any warnings on documents and did not require the licensee to enter into a nondisclosure agreement.

- *Delta Filter Corp. v Morin* (App Div 1985) 485 NYS2d 143. The company did not require employees to sign nondisclosure agreements.

- *Eagle Comtronics, Inc. v Pico, Inc.* (App Div 1982) 453 NYS2d 470. The information was disclosed at trade show.

- *Electro-Craft Corp. v Controlled Motion, Inc.* (Minn 1983) 332 NW2d 890. The company did not lock the plant entrance, restrict access to the plant, mark drawings as confidential, keep drawings in a locked area, or conduct employee exit interviews.

- *Frazee v U.S. Forest Serv.* (9th Cir 1996) 97 F3d 367. Information was obtainable from the government under a FOIA request.

- *Glaxo Inc. v Novopharm Ltd.* (ED NC 1996) 931 F Supp 1280, 1300, aff'd (Fed Cir 1997) 110 F3d 1562. Information was disclosed in court testimony and exhibits, without objection to the nonconfidential introduction of information from the opposing party.

- *Hoffmann-La Roche Inc. v Yoder* (SD Ohio 1997) 950 F Supp 1348. There was no written confidentiality agreement, documents were only minimally marked as confidential, no internal controls were made on document distribution and access, no policy existed on retrieving distributed documents, a physician writing an article on the tests was not warned against publication, and information was distributed to numerous people.

- *Huffy Corp. v Superior Court* (2003) 112 CA4th 97, 4 CR3d 823. Information placed under a protective order without showing an overriding interest was unsealed.

- *In re Providian Credit Card Cases* (2002) 96 CA4th 292, 116 CR2d 833. Credit card issuer's telemarketing scripts were not deemed trade secrets because they had been disclosed to the public and no reasonable steps had been taken to maintain their secrecy.

- *J.T. Healy & Son v James A. Murphy & Son* (Mass 1970) 260 NE2d 723. The company did not require employees to sign nondisclosure agreements, did not admonish employees regarding information, and did not identify alleged trade secrets for employees.

- *MLB Corp. v Diekman* (Ill App 1983) 445 NE2d 418. Only some employees signed nondisclosure agreements. The company did not notify employees of specific confidential information, did not mark or lock up documents, and showed formulas and machines without restriction.

- *Metal Lubricants Co. v Engineered Lubricants Co.* (ED Mo 1968) 284 F Supp 483. Materials sent to the sales office were not claimed to be confidential. The product information could have been obtained by proper means if not general gleanings from the trade.

- *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173. The company did not identify trade secrets or provide employees with a list of trade secrets either at execution of employee nondisclosure agreements or at termination of employment. The company revealed information in marketed products and patents, failed to post signs or give warnings of the proprietary nature of the information, and allowed the release of photographs and movies showing trade secrets.

- *National Rejectors, Inc. v Trieman* (Mo 1966) 409 SW2d 1. The company failed to track and recover documents after they were no longer needed, failed to ask employees to sign nondisclosure agreements, and failed to give employees notice of trade secrets.

- *Northeast Coating Technol., Inc. v Vacuum Metallurgical Co.* (Me Ct 1996) 684 A2d 1322. Although marked with a confidentiality notice, the prospectus was distributed unsolicited to persons with no duty to maintain confidentiality.

- *Pressure Science, Inc. v Kramer* (D Conn 1976) 413 F Supp 618. The company conducted tours in plant areas in which trade secrets were visible and did not advise employees of the confidential nature of the trade secrets or of the employees' nondisclosure obligations.

- *Shatterproof Glass Corp. v Guardian Glass Co.* (ED Mich 1970) 322 F Supp 854. The company conducted public tours of plant operations without requiring secrecy agreements and failed to tell employees that the information was a trade secret.

- *VFD Consulting, Inc. v 21st Servs.* (ND Cal 2006) 425 F Supp 2d 1037. The independent contractor made absolutely no effort to inform defendant that contributions were to be considered trade secrets. The title of the manual produced by the independent contractor claiming trade secret protection was "Property of: Paul Kirkman 21st Services." Also, the court found no expectation of confidentiality based on the collaborative process between the independent contractor and the client.

- *Water Mgmt., Inc. v Stayanchi* (Ohio 1984) 472 NE2d 715. The company did not ask employees to sign nondisclosure agreements. The information at issue was otherwise public.

- *Weins v Sporleder* (SD Sup Ct 1997) 569 NW2d 16. The plaintiff discussed the product with people from other companies, allowed the product to be visible to others, tested it at various locations, and did not have confidentiality agreements signed.

- *Weygand v CBS, Inc.* (CD Cal 1997) 43 USPQ2d 1120. A script was deposited with the Copyright Office.

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B. Procedures in Dealing With Employees

§4.11 1. Interviewing Job Applicants

When interviewing prospective employees, a company often must disclose some confidential information in order to assess the applicant's qualifications, interest, and potential. In this situation, the employer should require that the applicant agree in writing (after having an opportunity to consult with counsel) to protect any information disclosed during the interview. The employer should review the confidentiality agreement with the applicant to ensure that he or she understands it. This interview provides an excellent opportunity to begin the potential employee's education on the importance the company places on its confidential information, strict adherence to protective policies, and protecting third party confidential information. The employer may also be able to discern an applicant's attitude about the former employer's confidential information; it may be the same attitude that the applicant will express toward the new employer's confidential information. If the employee appears to be willing to disclose confidential information about the former employer, any nondisclosure agreement with that employee may be operative to destroy the employer's trade secret status of information disclosed to that employee. *Silicone Image, Inc. v Analogix Semiconductor, Inc.* (ND Cal, Jan. 17, 2008, No. C-07-00635 JCS) 2007 US Dist Lexis 96073. For form of confidentiality agreement for prospective employee, see §§6.13-6.14.

Also important when interviewing prospective employees is for the company to take steps to avoid misappropriating the trade secrets of another. Generally, an employer should at least ascertain whether the interviewee entered into any agreements to protect the trade secrets of others. The company should instruct the employee not to reveal such trade secrets during the interview process or thereafter. See §§6.28-6.35 for discussion of the measures that employers should take during the interview process to avoid misappropriating the trade secrets of another.

In California, the inevitable disclosure doctrine has been rejected. *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277. See §12.13 for discussion of the inevitable disclosure doctrine. However, courts that have accepted the doctrine are enjoining, at least temporarily, newly hired management employees from undertaking positions that require the inevitable disclosure of trade secrets acquired from prior employers. Additionally, if during the interview or thereafter, an employee demonstrates an intention to disclose the trade secrets of a former employer, then the former employer may enjoin the hiring by the new employer regardless of the rejection of the inevitable disclosure doctrine in California because such an intention may be characterized as the threatened misappropriation of trade secrets. See *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 75 CR3d 771. However, merely possessing (*e.g.,* downloading electronic files containing) trade secret information, but then destroying it and raising objections to a patent application, do not constitute threatened misappropriation. *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 95 CR3d 307. Courts often impose a short duration injunction that lasts until the value of the information possessed by the employee dissipates. *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262; *Novell, Inc. v Timpanogos Research Group, Inc.* (D Utah 1998) 46 USPQ2d 1197 (Utah version of the Uniform Act). The doctrine of inevitable disclosure negates any requirement to find actual or threatened disclosure. See *Merck & Co. v Lyon* (MD NC 1996) 941 F Supp 1443 (1-year injunction for specific product under North Carolina version of Uniform Act) and *Novell, Inc. v Timpanogos Research Group, Inc., supra* (9-month injunction for use of confidential information acquired by former employee). The doctrine has been rejected in California based on incompatibility with Bus & P C §16600. See *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277. For further discussion of the inevitable disclosure doctrine, see §12.13.

WARNING: When hiring new employees, the employer should investigate and evaluate whether the new employee's job might require the inevitable disclosure of trade secrets and, if so, should consider placing such employees at least temporarily in a position not requiring such disclosure.

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§4.12 2. Employee Instruction and Employee Awareness Program

Many trade secret disputes involve a company's employees or former employees. During their employment, they are exposed to and use a number of the company's trade secrets as an integral part of their duties. To avoid possible inadvertent disclosure of trade secrets, employees should be well versed in the *identification, classification, labeling, and handling* of confidential materials. Even if materials are improvidently released, the employer has a stronger position in litigation if the release was a breach of fully implemented security policies. *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352 (company divulged information only to employees and only on as-needed basis, and informed employees of confidential and proprietary nature of information given).

The company should implement an employee awareness program that periodically reminds employees, either in writing or in presentations by management, that (1) the company's trade secrets are valuable company assets and (2) certain measures must be taken to protect those secrets. Employees should be reminded of specific acts that may constitute misappropriation of the company's trade secrets such as, *e.g.*, accessing a password-protected computer database to obtain customer lists and solicit customers. See *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289. Injunctive relief has been denied because of lack of employee admonishment on protecting trade secrets. *Lowndes Prods. v Brower* (SC 1972) 191 SE2d 761. Such programs, when feasible for the company, may include the following:

- Nondisclosure agreements for all employees, specifying the employees' confidentiality obligations;
- Notices and posters reminding employees that their work involves access to the trade secrets of the company and listing ways to ensure the protection of trade secret information;
- Periodic communications (*e.g.,* company memorandums and newsletters) emphasizing the importance of maintaining confidentiality of company documents and reminding employees of their confidentiality obligations;
- Color-coding documents to remind and inform employees of their confidential nature;
- Updating lists of trade secret information as appropriate, indicating additions to and deletions from the list (this procedure is controversial, however; failure to list all trade secrets may endanger trade secret protection for unlisted information);
- Presentations describing the company's protection plan and a written description of the plan for inclusion in an employment manual; and
- Requiring the employees to read the employee manual and sign an agreement to be bound by its terms. The manual may state, for example, that the employee agrees not to disclose or use for his or her own benefit any confidential information and trade secrets of the company.

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3. Employee Departures

§4.13 a. Exit Interview

Every employee who has been exposed to trade secrets poses a high risk of possible future misappropriation of the trade secrets on departure from the company. Most employees do not intend to misappropriate their former employers' trade secrets, but they need reminders, instruction, or both to help them understand and meet their legal obligations in this regard. Therefore, thorough employee exit interviews should be held. *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142, 150 (two exit interviews with copy of cease and desist letter; applying California law). See also *Rohm & Haas Co. v Adco Chem. Co.* (3d Cir 1982) 689 F2d 424, 427; *Jostens, Inc. v National Computer Sys.* (Minn 1982) 318 NW2d 691; *Dynamics Research Corp. v Analytic Sciences Corp.* (Mass App Ct 1980) 400 NE2d 1274.

NOTE: The courts have repeatedly upheld an employer's right to require preservation of confidential information by former employees after termination of employment for as long as it is a protectable trade secret. See, *e.g., E.I. Du Pont de Nemours & Co. v American Potash & Chem. Corp.* (Del Ch 1964) 200 A2d 428.

Employees with sensitive positions in a company are often escorted out of the building immediately after they are terminated or give notice of termination. Therefore, the company may be required to conduct the exit interview without time to prepare. Having a standard checklist for an exit interview is invaluable in this situation. See §6.40 for further discussion of exit interview; see §6.41 for exit interview checklist.

The exit interview should be conducted by a supervisor or an employee trained to conduct such interviews, who should explain to the departing employee that he or she

- was exposed to and has knowledge of the company's trade secrets;
- has a continuing legal obligation under the nondisclosure agreement previously signed to hold the information in confidence and not use it in any new employment; and
- is free to use general skills and know-how acquired while employed with the company but may not use the company's trade secrets.

Soliciting a former employer's clients is not prohibited, but the use of the former employer's trade secrets (*e.g.,* customer lists) to solicit the former employer's clients is. *The Retirement Group v Galante* (2009) 176 CA4th 1226, 98 CR3d 585.

The interviewer should identify the nature of trade secrets in general and review with the employee the various areas or classes of the company's trade secrets. See *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173. The interviewer can inventory the various trade secrets in the departing employee's possession and reduce that information to a list that the employee acknowledges in writing (although the trade secrets need not be listed unless necessary under the circumstances). Any inventory should include a list of the documents, notebooks, files, and other tangible items containing trade secret information. These items should be recovered before the employee leaves. The employee should be questioned to ensure that no proprietary information is stored on personal computers or computer disks in the possession or under the control of the employee. See *Telex Corp. v IBM, supra,* for a discussion of IBM's procedures to place a departing employee on notice of what constitutes confidential information. In some situations, the employer may want to preserve evidence in the departing employee's office and to check that the employee no longer has access to on- or off-site computer systems. For example, the employer may request an image copy of the departing employee's personal laptop if it was used at the employer's place of business.

The interviewer should also ask the employee what his or her new job duties entail to help evaluate whether the new job will require the employee to inevitably disclose trade secrets. See §4.7.

PRACTICE TIP: Not all trade secrets need be specifically listed in the exit interview. *Schalk v Texas* (Tex Crim App 1991) 823 SW2d 633.

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§4.14 b. Documenting Departing Employees' Obligations

At the exit interview, the company should have the employee sign a termination certificate or agreement. See form in §6.39. The employment agreement that the employee may have signed when hired may require execution of such an agreement.

If the employee does not sign a termination certificate, the company should require the employee to sign a separation agreement addressing the same issues. This agreement should state that the employee had access to and in fact received confidential information. It should remind the employee that trade secrets include memorized information and not just documents containing the information. *Ed Nowogroski Ins., Inc. v Rucker* (Wash 1999) 971 P2d 936 (use of former employer's confidential client information, which had been both written and memorized by former employee, constituted trade secret misappropriation; applying Washington version of Uniform Act). If litigation arises between the employer and the former employee regarding confidential information, the employer could produce the signed agreement as evidence that the former employee did have confidential information. If the employee refuses to execute a termination certificate or a separation agreement, the employer should try to learn whether the employee intends to adhere to the terms of the original employment agreement. The company should consider sending the former employee a letter, stating the company's position on its trade secrets (see §6.42), and a letter notifying the new employer of the employee's obligations regarding trade secrets (see §6.43). Counsel may also follow up on the termination process by asking the employer to state specifically what confidential information it believes the former employee had access to and possesses.

NOTE: Personal or subjective knowledge or other skills acquired by an employee while working for an employer do not come under the Trade Secrets Act. The use of such knowledge or skills may be prohibited through restrictive covenants in an employment contract. *Kitfield v Henderson* (Ga App 1998) 498 SE2d 537.

WARNING: The employer must take great care in drafting letters to the departing employee so as not to unlawfully threaten him or her. See, *e.g., Herzog v "A" Co.* (1982) 138 CA3d 656, 188 CR 155, in which an employer sent a letter reminding the former employee of the confidentiality agreement and stating that the employer considered the possibility of the former employee's being employed by a competitor as a serious threat to its own trade secrets. The letter stated that if the employer became aware that the former employee had been hired by a competitor, it would immediately consider bringing legal proceedings against the former employee and the new employer. The court found that this letter exceeded any legitimate purpose by threatening litigation based merely on possible subsequent employment. But see CC §47(c) (granting privilege for certain communications made, without malice, to parties reasonably believed to be interested, including statements by current or former employer about job performance of applicant for employment). On privileged statements, see §11.27.

WARNING: Any misrepresentations by a departing employee involving the new employer can help the former employer obtain preliminary relief; thus, the employer should obtain complete information and document it well. Further, if the governing jurisdiction allows noncompetition agreements, failure to obtain such an agreement can weigh against an injunction barring the "inevitable disclosure" of trade secrets. *Merck & Co. v Lyon* (MD NC 1996) 941 F Supp 1443.

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§4.15 c. Notice to New Employer

The company should notify a departing employee's new employer that the employee possesses company trade secrets. The company should indicate the general nature of the trade secrets and request the new employer's assurance that the employee will not be asked to use or disclose any proprietary information of the company. *Surgidev Corp. v Eye Technol., Inc.* (8th Cir 1987) 828 F2d 452. A new employer should clarify with the new employee or interviewee that none of the former employer's trade secrets can be used for the benefit of the new employer, even if there is a gap in employment longer than the period of the statute of limitations. See *Cypress Semiconductor Corp. v Superior Court (Silvaco Data Sys.)* (2008) 163 CA4th 575, 77 CR3d 685. Otherwise, the former employer may have a claim against the new employer for indirect trade secret misappropriation. *Hanger Prosthetics & Orthotics, Inc. v Capstone Orthopedic, Inc.* (ED Cal 2008) 556 F Supp 2d 1122.

WARNING: A letter implying that trade secret misappropriation is suspected or actually occurring may trigger the statute of limitations, which starts running when one knows or should have known that misappropriation is occurring. See, *e.g., Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 127 CR2d 169. What one knows or should have known can depend on whether there is a duty to inquire that gives rise to a constructive knowledge of trade secret information. *Ralph Andrews Prods. v Paramount Pictures Corp.* (1990) 222 CA3d 676, 271 CR 797. Failure to take protective action despite strong suspicions of misappropriation shows a failure to take reasonable steps to maintain secrecy, which may negate the existence of a trade secret. *Alamar Biosciences, Inc. v Difco Labs., Inc.* (ED Cal 1995) 40 USPQ2d 1437.

WARNING: If the employer prevents or attempts to prevent the former employee from obtaining employment by misrepresentation, the employer could be subject to misdemeanor penalties under Lab C §1050 and to civil liability for treble damages under Lab C §1054. The letter must also avoid derogatory statements that could give rise to a defamation claim by the former employee. See §6.43 for form of letter to the new employer.

In some instances, the new employment may be so close to the employee's previous employment that arguably it would be impossible for the employee to do the job without using the prior company's trade secrets. Some courts have granted injunctions based on this theory of "inevitable disclosure." See *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262. This theory has been rejected in California. *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277 (inevitable disclosure doctrine incompatible with Bus & P C §16600 and amounts to after-the-fact covenant not to compete, restricting employee mobility). However, it is being applied in an increasing number of other jurisdictions. See, *e.g., Novell, Inc. v Timpanogos Research Group, Inc.* (D Utah 1998) 46 USPQ2d 1197 (applying Utah version of Uniform Act). Regardless of the rejection of the inevitable disclosure doctrine in California, the threatened misappropriation of trade secrets may be enjoined. *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 75 CR3d 771.

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§4.16 C. Procedures Concerning Physical Access

The list of potential physical security measures is staggeringly long. While not all precautions can be identified, the measures listed in §§4.17-4.18 can provide guidance for the company.

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§4.17 1. Physical Restrictions Generally

Reasonable measures required to protect trade secrets include provisions for the physical security of all premises where trade secrets are located. Examples include building fences around buildings; installing locks on gates, doors, and windows; posting guards at the entrances; and having guards patrol other areas to guard against unauthorized entry. Only employees on a need-to-know basis should be permitted access to codes, combinations, or keys allowing access to trade secret information.

A company should consider special restrictions for highly sensitive areas in a plant or research facility where highly secret equipment or processes are located. These areas can be separated or screened from view of more public areas so that trade secret information cannot be seen by employees or visitors who do not need to see it. See *By-Buk Co. v Printed Cellophane Tape Co.* (1958) 163 CA2d 157, 329 P2d 147. Anyone entering and leaving these areas may be required to sign in and out of the area in a logbook with bound, numbered pages. Signs may be posted throughout the highly sensitive areas notifying employees and visitors that the area is restricted. Briefcases and packages may be searched to verify that no documents are removed.

The company can use code names for key ingredients, components, or processes to minimize their potential for disclosure. See *Kelite Corp. v Khem Chems.* (ND Ill 1958) 162 F Supp 332 (procedure successful for protecting trade secret); *Carter Prods. v Colgate-Palmolive Co.* (D Md 1955) 130 F Supp 557 (same). Similarly, the company can ask vendors to deliver components or ingredients in coded containers so that onlookers cannot discern the contents. Additionally, the company may request vendors to implement procedures to ensure that the company's confidential information or trade secret disclosed to the vendor is not visible to the vendor's other customers or suppliers. See *Karoun Dairies, Inc. v Los Altos Food Prods.* (9th Cir 2004) 107 Fed Appx 785 (unpublished opinion).

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§4.18 2. Restricting Visitors' Access

All visitors to a company's facilities pose a risk for loss of trade secrets. Insufficient visitor security can erode trade secret protections. In addition to requiring secrecy agreements from visitors who will be exposed to the company's trade secrets (see forms in §§6.45-6.46), the company should implement procedures to restrict and control the visitors' access to and movement in company facilities. Adequate security can prevent visitors from having access to all but the reception area of the company without the company's knowledge or permission. The company should require visitors to identify themselves and sign in with a guard or receptionist, wear a prominent identification badge, and have an escort at all times while on the premises. *Wilson Certified Foods, Inc. v Fairbury Food Prods.* (D Neb 1974) 370 F Supp 1081. See also *Cadillac Gage Co. v Verne Eng'g Corp.* (Mich Cir Ct 1978) 203 USPQ 473; *Arco Indus. Corp. v Chemcast Corp.* (6th Cir 1980) 633 F2d 435, 443. But see *K-2 Ski Co. v Head Ski Co.* (9th Cir 1974) 506 F2d 471; *In re Innovative Constr. Sys.* (7th Cir 1986) 793 F2d 875 (jury could have inferred that plaintiff took reasonable precautions to limit knowledge of trade secrets even though many standard security procedures not followed).

These procedures can apply to employees as well as to third party visitors, depending to some extent on the value of the trade secrets involved. Employees should have already signed a confidentiality agreement when hired. They should also wear badges to gain access to company facilities housing trade secrets. They should not be allowed in areas where they will be exposed to trade secrets unless there is a need for them to know such trade secrets.

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D. Procedures Protecting Documents

§4.19 1. Proprietary Legends

It is good practice to prominently mark all documents containing trade secret information. The documents can be marked on each page, or a legend can be superimposed over the text to ensure that employees and third parties who have copies of the document are aware of its nature and the need to give it special treatment. See *Thermotics, Inc. v Bat-Jac Tool Co.* (Tex Civ App 1976) 541 SW2d 255 and *Data Gen. Corp. v Digital Computer Controls, Inc.* (Del Ch 1975) 357 A2d 105 for forms of legends. Documents downloadable via the Internet that contain trade secret information should be accessible only with a password. Often, secrecy agreements with third parties require that trade secret documents be so marked. Even if an agreement does not require it, failure to mark the documents is a factor that courts consider in evaluating whether the owner of trade secrets took reasonable precautions to protect them. *Pixion, Inc. v Placeware Inc*. (ND Cal 2005) 421 F Supp 2d 1233, 1242. *Digital Dev. Corp. v International Memory Sys.* (SD Cal 1973) 185 USPQ 136; *Data Gen. Corp. v Digital Computer Controls, Inc., supra; SmokEnders, Inc. v Smoke No More, Inc.* (SD Fla 1974) 184 USPQ 309. However, the lack of a legend is not a barrier to protection if in the circumstances the defendant knows that the information is confidential. See *A.H. Emery Co. v Marcan Prods. Corp.* (SD NY 1967) 268 F Supp 289, aff'd (2d Cir 1968) 389 F2d 11 (failure to mark not fatal if document otherwise treated as trade secret); *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc*. (ND Cal 2006) 420 F Supp 2d 1070 (failure to mark transformer board not fatal to trade secret status because associated data sheet marked confidential).

The company should take care in selecting documents to be marked as containing trade secrets. Marking some documents but not all can lead to an inference that other documents do not contain trade secrets. In the United States Court of Appeals for the Seventh Circuit, marking documents as secret that in fact are not trade secret documents has been held harmless and immaterial. *Rockwell Graphic Sys. v DEV Indus.* (7th Cir 1991) 925 F2d 174, 176 (reversing lower court). Even if over marking does not *negate* trade secret protection, it may eliminate the difference that might otherwise be given to a "Confidential" stamp by failing to distinguish between truly confidential and nonconfidential material, or it may render suspect all documents so marked.

For proprietary legends, see forms 6.4-1 through 6.11-1.

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§4.20 2. Copyright Notices

Copyright notices pertain chiefly to published materials—something of an oxymoron in the context of trade secrets. "Copyright" may seem to imply "publication," and publication is ordinarily inconsistent with maintaining trade secrets. But reproduction may occur for internal use or other limited circulation. Because of the requirements of the United States Copyright Office for software registration, computer program source code routinely includes copyright notices. See chap 16 on computer technology. In *Technicon Med. Info. Sys. Corp. v Green Bay Packaging, Inc.* (7th Cir 1982) 687 F2d 1032, 1039, the court held that affixing a statutory copyright notice pursuant to the 1909 Copyright Act did not "estop the party who affixed the notice and published the documents from subsequently asserting that such documents have not been generally published, but instead contain subject matter which is 'trade secret.'" See ABA Section of Patent, Trademark and Copyright Law, 1980 Committee Reports at 219. A pending case that some court observers believe will raise related issues on appeal is *Religious Technol. Ctr. v Netcom On-Line Communication Servs.* (ND Cal 1995) 907 F Supp 1361.

Effective March 1, 1989, the United States became a member of the Berne Convention. Although the Convention requires generally that the author's name appear on the work, the use of the "©" symbol or other copyright legend is not required in Berne Convention signatory countries in order to have a valid copyright. See Berne Convention as Revised July 24, 1971, Article 15. (The Berne Convention is available at http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html.) A copyright legend is nonetheless useful to provide (1) unambiguous notice to potential infringers, (2) evidence of willful misappropriation if need be, and (3) protection in non-Berne-signatory countries. Note also that the Convention recognizes copyright interests in unpublished works. Berne Convention as Revised July 24, 1971, Article 3(1)(a).

For copyright notices, see forms 6.8-1 through 6.8-3, 16.3-1.

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§4.21 3. Access Limitations

Reasonable measures to protect trade secret documents include limiting access to the documents on a need-to-know basis. See *Intel Corp. v VIA Technols., Inc.* (ND Cal 2000) 198 FRD 525. *People v Laiwala* (2006) 143 CA4th 1065, 49 CR3d 639 (source code for software program widely disseminated among employees). The company can keep trade secret documents in locked files in a restricted area and can require anyone using confidential documents to log in and log out serially numbered documents. The company can also password-protect computer files containing trade secrets. See, *e.g., Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289. In extremely sensitive situations, the company could hire a custodian to log or register all copies of the documents. Any logbook should be bound with numbered pages to prevent their removal.

See §§4.16-4.18 for discussion of physical access limitations.

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§4.22 4. Copying Limitations

To minimize the number of copies of sensitive documents in existence, a company can permit copying of trade secret documents only when needed. For further protection, a document's proprietary legend can be stamped on or embedded in the document, rather than in the margins or on a cover sheet, so that photocopying would necessarily reproduce the legend. The documents could also be printed on dark, low-contrast paper, which photocopies poorly, to prevent unauthorized copying.

Photocopying equipment can be segregated from the area in which confidential information is stored to make copying more difficult. A company can also modify photocopy equipment so that it cannot be used without a personal key code. With such a system:

- A company could track all photocopy use;
- Outsiders would have difficulty copying proprietary documents; and
- Excessive copying could alert the company that someone was copying material for other than normal and legitimate use.

Flash memory should not be allowed on premises unless required. Other means of transporting electronic information should be provided to the employees, such as burning compact discs with the necessary information. The compact disc cover should state that the compact disc may contain trade secret information and should be destroyed (*e.g.,* broken) after use or returned to the company. Employees should not be permitted to use personal e-mail accounts, which may be used to attach files containing trade secret information and to e-mail the trade secret information to personal e-mail accounts. Companies should consider changing computer networks to track attachments in e-mails or copying of files. Such tracking should be disclosed to employees so that they will know that the company is tracking their electronic movements.

A trade secret owner should not copy information onto other media unless effective anticopying steps can be taken. Information on computer disks or networks in encrypted form cannot be readily copied onto other computer disks or files. Because of the potential for widespread replication and distribution, the company may want to prohibit transmission of unencrypted proprietary information by electronic mail. The employer may also wish to consider prohibiting electronic transmission of encrypted proprietary information because of the potential for massive replication of the information once it is decoded by the intended recipient.

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§4.23 5. Waste Disposal

One method of obtaining another's trade secrets is to hire "investigators" for "dumpster diving," or inspection of a company's wastepaper, either in public area trash containers or after interdiction along the disposal route. See *Soap Co. v Ecolab, Inc.* (Ala 1994) 646 So2d 1366; *Cadillac Gage Co. v Verne Eng'g Corp.* (Mich Cir Ct 1978) 203 USPQ 473. A person does not have a reasonable expectation of privacy in trash left for collection in a public place. *California v Greenwood* (1988) 486 US 35, 100 L Ed 2d 30, 108 S Ct 1625. A trade secret owner therefore fails to take reasonable precautions to maintain the secrecy of information left in trash containers accessible to the public. See *Soap Co. v Ecolab, Inc., supra*; *Cadillac Gage Co. v Verne Eng'g Corp., supra*. To protect discarded information, the company should consider shredding trade secret documents before discarding them in normal channels.

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§4.24 E. Procedures for Information Dissemination

Most companies disseminate information to the public from time to time, either formally as a company release, or informally as employee presentations, papers, and reports. The lack of effective controls on such dissemination may result in the loss of trade secrets and patent protection, may violate secrecy obligations to others, and may cause a court to refuse to protect such information. *Servomation Mathis, Inc. v Englert* (MD Pa 1971) 333 F Supp 9.

The company should implement procedures to routinely review all information planned for release—including advertisements and marketing brochures—by someone familiar with the status of the company's information to ensure that trade secret information is not inadvertently or intentionally disclosed. For example, any details on drawings that are not necessary for the information dissemination should be deleted from documents released to the public.

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§4.25 F. Procedures for Computer Data and Equipment; Other Advanced Technology

Security of computers and computer networks is vital for the protection of a company's trade secrets. Virtually all company documents, financial information, and even research reports reside on company computer systems. The rapid growth of networked computer systems necessitates reanalysis of a company's guidelines for electronic transmission and storage of confidential information. The company should use passwords, "firewalls," and other electronic measures to ensure against unauthorized access to the computer network and should provide employees with passwords on a need-to-know basis. The passwords should be periodically changed for increased protection. See *Trandes Corp. v Guy F. Atkinson Co.* (D Md 1992) 798 F Supp 284, aff'd in part, rev'd in part, and remanded (4th Cir 1993) 996 F2d 655; *Com-Share, Inc. v Computer Complex, Inc.* (ED Mich 1971) 338 F Supp 1229, aff'd (6th Cir 1972) 458 F2d 1341. Sensitive information should be encrypted to prevent wrongful access.

Computer software is generally licensed in executable or object code form rather than source code form to protect the trade secrets that may be embodied in the design and operation of the human perceivable code. *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27 (distribution of machine-readable code does not destroy trade secret status of human-readable source code embodied in underlying machine-readable code). Licensees often require licensers to deposit the source code with a third party escrow agent under a contract that will result in the release of the code to the licensee if the licensor fails to maintain (*i.e.,* correct "bugs" in) the software. If the licensor stores the code on the licensee's hardware, then the licensor should make its intentions clear through a written contract. For example, the terms of the contract should make clear whether the licensor retains the trade secret or copyright and the extent of the licensee's right to use the code. *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442. Such contracts should provide that the source code remains the licensor's trade secret and that the licensee will not disclose the code to third parties except to maintain the software for the licensee's internal business purposes.

A vendor may store source codes on client computer networks when the vendor is designing custom software for the client. The vendor should store only those portions of the source code necessary for completion of the project or the next steps in programming in the foreseeable future to mitigate against inference of an unlimited license. *Asset Mktg. Sys., Inc. v Gagnon, supra.*

PRACTICE TIP: The trade secret owner must take care in disposing of computer hardware that may have contained trade secret information. Data left in a computer's memory is not reasonably protected, and therefore trade secret status may be lost for that data. *Defiance Button Mach. Co. v C & C Metal Prods.* (2d Cir 1985) 759 F2d 1053, 1063.

For further discussion of electronic security measures and computer technology, see §4A.18; chap 16.

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§4.26 G. Procedures Concerning Product Sales

Unintended release of information in the sale of a product in which trade secret information is embodied can result in loss of the information. See *Secure Servs. Technol., Inc. v Time & Space Processing, Inc.* (ED Va 1989) 722 F Supp 1354. In this case, the plaintiff failed to protect its protocol information used in the facsimile machines it sold to the United States government. Applying the California Uniform Trade Secrets Act (CC §§3426-3426.11), the court found no indication that the machines contained proprietary information. Therefore, the protocol information was not eligible for trade secret protection. See *Sanford Redmond, Inc. v Mid-America Dairymen, Inc.* (SD NY 1992) 29 USPQ2d 1222, aff'd without published opinion (2d Cir 1993) 993 F2d 1534 (lease of machine with "no copying" provision in lease did not preserve secrecy of machine; there were also unrestricted sales of the machine); *Pioneer Hi-Bred Int'l v Holden Found. Seeds* (8th Cir 1994) 35 F3d 1226 (sale of seed corn to Soviet Union under contract containing confidentiality and restricted use provisions did not put genetic code of seed corn in public domain). Apparently, any sale of a device embodying an easily observable trade secret will likely be held to thrust the trade secret into the public domain. If the trade secret is difficult to reverse engineer, a sale under an agreement restricting disclosure might preserve the secret status of the information, but this is in some doubt.

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§4.27 IV. GOVERNMENT SUBMISSIONS AND DISCLOSURES

Regulatory compliance may require a company to disclose trade secret information to various regulatory agencies. This situation presents a threat for possible loss of trade secrets. The Freedom of Information Act (FOIA) (5 USC §552) allows information held by the federal government to be disclosed on request unless by statute the information may not be disclosed (see §5.8) or the information is a trade secret, privileged, or confidential (see §5.9). The FOIA is generally addressed to disclosure of government documents, and therefore public access, rather than secrecy, is its main purpose. *Center for Auto Safety v National Highway Traffic Safety Admin.* (DC Cir 2001) 244 F3d 144.

NOTE: A regulatory agency may be required to purge administrative records of trade secrets before disclosure. *Serono Labs., Inc. v Shalala* (D DC 1999) 35 F Supp 2d 1.

The California Public Records Act (CPRA) (Govt C §§6250-6270) mandates disclosure of information submitted to state agencies in certain situations. See, *e.g.,* *State Farm Mut. Auto. Ins. Co. v Garamendi* (2004) 32 C4th 1029, 12 CR3d 343 (Ins C §1861.07 allowed disclosure of trade secret because it contained no trade secret exemption). As a result, FOIA and CPRA requests are common methods of conducting industrial espionage. However, trade secrets, as defined under federal law, and privileged or confidential "commercial or financial information" are exempt from disclosure under the FOIA. 5 USC §552(b)(4); *Lion Raisins, Inc. v USDA* (9th Cir 2004) 354 F3d 1072; *Starkey v Department of Interior* (SD Cal 2002) 238 F Supp 2d 1188; *MCI Worldcom, Inc. v General Servs. Admin.* (D DC 2001) 163 F Supp 2d 28; *McDonnell Douglas Corp. v NASA* (DC Cir 1999) 180 F3d 303. Case law interpreting the FOIA has defined a trade secret as a secret, commercially viable plan, formula, process, or device that is used for making, preparing, compounding, or processing trade commodities and that can be said to be the product of either innovation or substantial effort. *Center for Auto Safety v National Highway Traffic Safety Admin.* (DC Cir 2001) 244 F3d 144, 151. Absolute secrecy is not essential for a document to be exempt from disclosure as a trade secret under the FOIA. *Department of Public Utils. of City of Norwich v Freedom of Info. Comm'n* (Conn App 1999) 739 A2d 328; *Department of Public Utils. v Freedom of Info. Comm'n* (Conn, Jan. 12, 2001, No. CV990498510S) 2001 Conn Super Lexis 84 (unpublished). Furthermore, confidential information may be exempt from disclosure if (1) it is voluntarily submitted to a government agency and is of a type not customarily disclosed to the public, or (2) it is mandatorily provided and disclosure will impair either the government's future attempts at gathering such information or the submitter's competitive position in the industry. *Center for Auto Safety v National Highway Traffic Safety Admin.* (D DC 2000) 93 F Supp 2d 1; *Trans-Pacific Policing Agreement v United States Customs Serv.* (DC Cir 1999) 177 F3d 1022. In this respect, an agency may withhold documents falling within one of the enumerated exemptions, but bears the burden of justifying such action. *OSHA Data/CIH, Inc. v U.S. Dep't of Labor* (3d Cir 2000) 220 F3d 153, 160. However, fundamental fairness requires all privileged information, including that exempt under FOIA, to be disclosed during litigation if the privileged information goes to the heart of a party's claim. *Steiny & Co. v California Electric Supply Co.* (2000) 79 CA4th 285, 93 CR2d 920.

Similar exemptions exist under the CPRA, which also includes exemptions for documents assessing vulnerability to terrorist attacks and criminal acts intended to disrupt the public agency's operations. See Govt C §6254. For a list of CPRA exemptions, see §5.13. Other jurisdictions have similar disclosure policies. See *Plain Dealer v Ohio Dep't of Ins.* (Oh 1997) 687 NE2d 661 (public documents must be disclosed by state agency, but trade secret information exempted).

NOTE: Title 18 USC §1905 criminalizes the unauthorized disclosure of trade secrets or confidential statistical data. This includes employees of a private sector organization who are or were assigned to an agency under 5 USC §§3701-3707. See §5.6.

For discussion of the application of disclosure laws, exemptions, and procedures for protecting information disclosed to government agencies, see chap 5.

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§4.28 V. COUNTERESPIONAGE

Companies should inform employees of some of the common techniques used in industrial espionage so that they can be alert to the possibility of such activities masquerading as legitimate. These techniques include sham telephone interviews, job applicants, recruitment of the company's employees, acquisition prebidding reviews, and joint venture discussions. Individuals may pose as service employees, government inspectors, and other visitors on any pretext. See *U.S. v Martin* (1st Cir 2000) 228 F3d 1 (CEO of competitor befriended disgruntled employee and convinced her to steal employer's veterinary products trade secrets). Computer "hackers" also use employees on the pretext of being with the company's information systems department and request the employee to log out and log in again to the computer network, thus giving the hacker the ability to observe and later use the employee's password.

NOTE: Computer hacking violates several civil and penal laws. *Thrifty-Tel, Inc. v Bezenek* (1996) 46 CA4th 1559, 54 CR2d 468. See Economic Espionage Act of 1996 (18 USC §1831) and §13.9A for further discussion. Generally, statutes that criminalize the knowing theft of trade secrets were not designed to punish competition, but rather to prevent unfair and wrongful usages of confidential information gained, discovered, copied, or taken. See generally *U.S. v Martin, supra*.

Companies should also be aware of less common techniques used in industrial espionage. For example, a company may use its customer's user name and password database to gain entry into a competitor's website to view proprietary information, because users typically use the same user name and password for multiple websites. See *Creative Computing v Getloaded.com, LLC* (9th Cir 2004) 386 F3d 930. A distributor may conduct an "abusive" audit of a retailer to gain customer information. See *Richmond Pharmacy & Surgical, Inc. v Therasense, Inc.* (ND Cal, Oct. 28, 2004, No. C-04-2070 C) 2004 US Dist Lexis 22152. Further, a company may enter into a short-term nondisclosure agreement with the goal of holding onto the information obtained during the term of the nondisclosure agreement and then exploiting the information after expiration of the agreement. See *Ali v Fasteners for Retail, Inc.* (CD Cal 2008) 544 F Supp 2d 1064.

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4A

Trade Secret Audits and Protection Plans

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I. INTRODUCTION §4A.1

II. TRADE SECRET THEFT §4A.1A

III. TRADE SECRET AUDITS §4A.2
- A. Audit Team §4A.3
- B. Scope of Audit §4A.4
- C. Identify Potential Trade Secrets §4A.5
- D. Review Current Policies and Procedures §4A.6
- E. Review Current Physical and Electronic Security Measures §4A.7
- F. Account for Technological Advances §4A.8
- G. Review Current Protective Agreements §4A.9

IV. TRADE SECRET PROTECTION PLANS §4A.10
- A. Benefits of Formal Procedures §4A.11
- B. Elements of Effective Trade Secret Protection Plans §4A.12
- C. Employee Relationships §4A.13
- D. Government and Third Party Relationships §4A.14
- E. Precautions With Visitors §4A.15
- F. Facilities Protection §4A.16
- G. Document Security §4A.17
- H. Electronic Security §4A.18
- I. Unsolicited Inventions and Ideas §4A.19

IV. CONCLUSION §4A.20

V. SAMPLE TRADE SECRET AUDIT CHECKLIST
- A. Introduction §4A.21
- B. Sample Trade Secret Audit Checklist §4A.22

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§4A.1 I. INTRODUCTION

As noted in §1.3, a trade secret is defined as information that "derives independent economic value, actual or potential, *from not being generally known*" and that is subject to *reasonable efforts "under the circumstances to maintain its secrecy*." (Emphasis added.) CC §3426.1(d). See §§1.3-1.10.

Trade secrets come in all shapes, sizes, and varieties. For example, trade secrets include such high-profile secrets as the recipes for Coca Cola, WD-40, and KFC. Trade secrets also include customer lists, designs or drawings, business strategies, confidential marketing plans, research, development activities, "negative know-how" (*i.e.,* information that something does not work), pricing information, sales forecasts, manuals, prototypes, and formulas. Trade secrets can be maintained in different formats, including computer files, formal or draft documents, working papers, scrap papers, appointment calendars, internal correspondence, newsletters, policy documents, minutes of meetings, and other records. Documents that are provided to public entities (*e.g.,* sealed bids, requests for proposal (RFPs), or responses to public entities) may also contain confidential trade secret information.

One key factor used to determine whether proprietary information constitutes a trade secret is the extent and nature of the precautions taken to preserve the information's secrecy. See generally chap 4. See also *Nationwide Mut. Ins. Co. v Mortensen* (2d Cir 2010) 606 F3d 22 (personal client information and data about client's needs and purchasing history were not trade secrets because information, kept in agents' personal policyholder files, was not adequately protected). Although absolute secrecy is not required, if a trade secret is leaked, its value to the company in some cases may be severely compromised or lost forever. There must be a substantial element of secrecy so that a third person would have difficulty acquiring the information without resorting to improper means. To maintain a claim for trade secret misappropriation, a company's efforts to maintain the confidentiality of its trade secrets need to be reasonable under the circumstances, depending on the value of the information and the risk of loss of the information. See §§4.8-4.10. A trade secret misappropriation lawsuit, however, may be too little, too late for a company whose trade secrets are its lifeblood. Accordingly, companies should ensure that they have adequate trade secret protections in place by conducting a thorough analysis of their protections through a formal trade secret audit.

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§4A.1A II. TRADE SECRET THEFT

Trade secret theft continues to be a large and growing problem. In 2009, Symantec Corporation and the Ponemon Institute announced the findings of a joint survey of employees who had left or lost a job in 2008. This survey found that 59 percent of former employees admitted to stealing confidential company information, including customer contact lists. The most commonly identified kinds of records taken included e-mail lists, employee records, and customer information, including contact lists. Among the additional findings of the Symantec/Ponemon study:

- 79 percent of respondents took data without the permission of their employer;
- 82 percent of respondents reported that their employers did not perform an audit or review of paper or electronic documents before respondent left his/her job;
- 53 percent of respondents reported that they had downloaded information onto a CD or DVD, 42 percent had downloaded information onto a USB drive, and 38 percent had sent attachments to a personal e-mail account;
- 24 percent of respondents reported that they had access to their employers computer system or network after they left or were terminated from the company.

The Symantec/Ponemon survey is available at http://www.symantec.com/about/news/release/article.jsp?prid=20090223_01.

A recent study of trade secret litigation in federal court reports that the number of cases involving alleged trade secret misappropriation is growing exponentially, doubling in the 7 years from 1988 to 1995, and doubling again in the 9 years from 1995 to 2004. Almeling, Snyder, Sapoznikow, McCollum, & Weader, *A Statistical Analysis of Trade Secret Litigation in Federal Courts,* 45 Gonzaga L Rev 292 (2010). This study also found that in over 85 percent of trade secret cases, the alleged misappropriator was someone the trade secret owner knew, including employees and business partners.

Another study of data security practices of North American, European, and Australian enterprises revealed that the enterprises tended to overestimate the effectiveness of their trade secret protections and underestimate the value of their trade secrets. Forrester Research, "The Value of Corporate Secrets," March 2010, available online at http://www.rsa.com/products/DLP/ar/10844_5415_The_Value_of_Corporate_Secrets.pdf. The study concluded that most enterprises did not actually know whether their data security programs functioned properly, and also concluded that companies were not investing enough in programs to protect trade secrets.

In addition to loss of trade secrets, companies that do not ensure that they have adequate protections for their trade secret and other confidential information can put management at risk of shareholder lawsuits and other litigation, including Sarbanes-Oxley violations.

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§4A.2 III. TRADE SECRET AUDITS

The best way to analyze a company's trade secrets and how well protected they are is through a formal audit. A trade secret audit is a proactive, dynamic analysis of a company's proprietary assets and how those assets are protected. A trade secret audit, and the resulting trade secret protection plan, should have three primary goals:

(1) The audit and the protection plan should be designed to ensure that a company's trade secrets are adequately protected from disclosure and should reduce the risk that trade secrets will be improperly disclosed.

(2) The audit and the plan should seek to ensure that if a trade secret is ultimately misappropriated, the company has taken adequate steps to protect itself in litigation resulting from the misappropriated trade secrets and should provide evidentiary support for any action brought for misappropriation of the company's trade secrets.

(3) The audit and the plan should limit the risk of exposure to other companies' claims of trade secret misappropriation.

The importance of a trade secret audit to ensure that trade secrets are adequately protected cannot be overemphasized, as high-profile cases of alleged trade secret theft continue to be reported on a regular basis. See, *e.g.,* Jones, *Trade Not-so-Secrets: Alleged Corporate Espionage Hits Goldman,* Wall Street Journal Law Blog (July 7, 2009), available at http://blogs.wsj.com/law/2009/07/07/trade-not-so-secrets-alleged-corporate-espionage-hits-goldman/; *Ex-Boeing Engineer Guilty of Stealing Trade Secrets for China,* Wall Street Journal (July 16, 2009), available at http://online.wsj.com/article/BT-CO-20090716-715219.html (first conviction under Economic Espionage Act); Drummond, "A new approach to China," *The Official Google Blog*, Jan. 12, 2010, available at http://googleblog.blogspot.com/2010/01/new-approach-to-china.html.

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.3 A. Audit Team

§4A.3 A. Audit Team

The core of any trade secret audit is an audit team. The audit team should consist of outside or inside counsel and appropriate business teams. Sometimes patent or other intellectual property attorneys are involved to tailor the most appropriate kind of protection for the particular intellectual property asset. Audits should be assisted by someone who is experienced with computer fraud, network security issues, and computer forensics, including managing and protecting electronically stored data.

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§4A.4 B. Scope of Audit

The scope of the trade secret audit should be determined at the outset of the audit. To do this, the audit team must be completely familiar with the company and how it operates, the company's assets that are valuable and worthy of protecting, the existing security protections, and any past trade secret issues that the company has experienced. The team must also identify the company's overall objectives related to its trade secrets and what levels of protection the company seeks. The audit team should further determine whether patent or other intellectual property attorneys should be consulted to tailor the most appropriate kind of protection for the company's particular intellectual property assets. A clear plan addressing the issues identified by the company should be created on the basis of the intended scope of the audit.

A sample trade secret audit checklist, which can be used as a starting point for determining the scope of the audit, is provided in §§4A.21-4A.22.

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§4A.5 C. Identify Potential Trade Secrets

The audit team should identify the company's intellectual property assets that are valuable and worth protecting, as well as any existing security protections in place to protect those assets. The team should review all technical information, financial information, marketing information, compensation information, and organizational information. The audit team should also help identify and classify the relative importance of the assets and the security precautions in place to protect them, and it should evaluate the adequacy of the existing security precautions. See §§4.9-4.10. This process should include identifying risk areas where information assets may be susceptible to loss. Any trade secret protection plan must be tailored to provide the most appropriate kind of protection for particular types of intellectual property assets, whether copyrights, trademarks, patents, or trade secrets.

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§4A.6 D. Review Current Policies and Procedures

Companies often have some policies or procedures in place to help protect their trade secrets. However, these policies are often inadequate, difficult to implement or understand, or ineffective. Sections 4.9-4.10 review case decisions regarding whether particular company measures taken to protect trade secrets were legally adequate or inadequate.

One survey revealed that some policies may even be counterproductive and may lead to more confidential information being divulged. See Hannah, *Keeping Trade Secrets Secret,* MIT Sloan Mgmt Rev (Apr. 1, 2006). Hannah identified eight mistakes that companies often make that hinder their ability to protect their trade secrets: (1) company policies signal to employees that the employees are not trusted; (2) the policies punish employees instead of helping them protect trade secrets; (3) managers fail to follow the policies; (4) management does not give appropriate attention to new employee orientation; (5) management fails to communicate with employees regularly; (6) companies forget to clarify ownership issues; (7) companies define the scope of their business too narrowly; and (8) companies fail to adequately address departing employees. Through a comprehensive trade secret audit, a company can develop effective policies that fit the particular business and organizational culture. The resulting policies and procedures should be useful and easy to administer and should adequately protect the company's trade secrets.

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§4A.7 E. Review Current Physical and Electronic Security Measures

The audit team should review the company's physical and computer data security practices and make recommendations to help ensure adequate security and prevent theft. This often involves making recommendations concerning facility access, security layout, computer access, network system layout, and protection of electronic data. Special attention should be given to developing the best practices for managing and protecting electronically stored data. See §4A.18. Most businesses keep their confidential data on computer networks, making this aspect of the audit especially critical.

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§4A.8 F. Account for Technological Advances

An effective trade secret audit needs to take into account advances in technology. Technology changes rapidly, and companies need to keep up with the latest developments. For example, several years ago, many company computers were protected only by corporate firewalls. With advances in technology, however, there are multiple points of entry and therefore numerous ways that persons can steal or corrupt the accuracy of data. Cutting-edge forensic computer analysis can detect any copying or deleting of proprietary information. Computer software can identify when USB mass-storage devices are used so that companies are alerted to unauthorized use and may even completely disable a mass-storage device. New software is also being developed that uses data mining and social networking techniques to spot and stop insider security threats and industrial espionage. Using computer forensics to recover departing employees' personal e-mails that were sent from company computers can uncover and alert companies to employee misconduct. See also §4A.18.

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§4A.9 G. Review Current Protective Agreements

Any trade secret audit must include a thorough review of the company's current protective agreements. See generally chap 6. Companies must monitor their standard form agreements regularly to keep them up to date on current technologies and the law. The audit team should review the company's various protective agreements—including employee confidentiality agreements, employment agreements, noncompetition and nonsolicitation agreements, blogging policies, anti-piracy agreements, technology use agreements, and invention assignment agreements, as well as third party nondisclosure agreements (*e.g.,* customer and vendor agreements)—to ensure that they safeguard the company's trade secrets appropriately.

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§4A.10 IV. TRADE SECRET PROTECTION PLANS

After identifying and classifying the company's proprietary information and reviewing the company's existing policies and procedures, the audit team should develop and implement new procedures as necessary to achieve the goals discussed in §4A.2. According to James Pooley, a trade secret protection plan should be based on four principles: inventory, simplicity, responsibility, and review. "Inventory" means "knowing what the company wants to protect" in sufficient detail so that the company can appreciate its value and determine whether there are any threats to its secrecy. "Simplicity" is important to a trade secret protection plan because overly complicated or burdensome plans are likely to be ignored by employees. "Responsibility" means that there is an individual or individuals who are responsible for implementing every part of the trade secret protection program. "Review" means that the trade secret protection plan must be reviewed periodically to ensure that trade secrets are being protected and that policies are being enforced. If all of these principles are followed, the company should have an effective trade secret protection plan in place and will have solid arguments that reasonable steps were taken to prevent disclosure of trade secrets. Pooley, Trade Secrets §9.02[2][b] (1997). See also §10.5; Quinto & Singer, Trade Secrets: Law and Practice (2009).

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§4A.11 A. Benefits of Formal Procedures

There are several benefits to having formal policies and procedures in place to protect trade secrets and other confidential information. Formal procedures can help protect valuable trade secrets and prevent unnecessary loss. In doing so, formal procedures can also help a company maintain a competitive edge in the marketplace. Further, the procedures help to inform employees and interested third parties of the company's commitment to protect its proprietary information. Finally, the procedures educate employees on what constitutes a trade secret, how to protect it, and the consequences of failing to do so. An effective trade secret protection plan should foster a workplace culture in which employees understand and appreciate the need to protect all of the company's trade secrets for the betterment of the company.

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.12 B. Elements of Effective Trade Secret Protection Plans

§4A.12 B. Elements of Effective Trade Secret Protection Plans

An effective trade secret protection plan should include the following components:

- An individual or committee responsible for overseeing the trade secret protection plan.
- Effective overall policies and procedures restricting access to, and prohibiting disclosure of, company trade secrets.
- Procedures for maintaining confidentiality by implementing appropriate protective agreements. See §4A.13; chap 6.
- An employee education program designed to educate the workforce about the importance of protecting trade secrets and the company's protection plan and to train employees to follow security procedures. See §4A.13.
- Effective employee and visitor intake and outtake procedures related to trade secrets and confidential information. See §4A.15.
- Effective security measures covering company facilities, documents, electronic data and other information, and manufacturing processes. See §§4A.16-4A.18.
- Effective procedures for dealing with unsolicited inventions and ideas. See §4A.19. See also chap 3.
- Guidelines for determining when certain information is not a trade secret and therefore available for use by the company. See §§10.23-10.48.
- Periodic audits of trade secret protection policies and practices that have been instituted, to ensure that they are being followed and to adjust them as necessary so that they remain effective. See §§4A.2-4A.9, 4A.21-4A.22.

See Quinto & Singer, Trade Secrets: Law and Practice 204 (2009); Cundiff, *Reasonable Measures to Protect Trade Secrets in a Digital Environment,* 49 IDEA: The Intellectual Property Law Rev 359, 363 (2009); Sands, *Preserving Trade Secrets in California: Best Practices,* Bus Law News, The State Bar of California (Issue 2, 2009).

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.13 C. Employee Relationships

§4A.13 C. Employee Relationships

New employees. The audit team should ensure that the company has appropriate procedures to properly screen job applicants. For a description of the measures a company should take in interviewing job applicants, see §4.11. See also §§10.7-10.19.

Employee confidentiality agreements. Companies should have effective confidentiality agreements in place with employees to ensure protection of trade secrets. Confidentiality agreements significantly increase the likelihood that a court will find that a trade secret owner took reasonable measures to protect its purported trade secrets. Almeling, Snyder, Sapoznikow, McCollum, & Weader, *A Statistical Analysis of Trade Secret Litigation in Federal Courts,* 45 Gonzaga L Rev 291, 294 (2010). Sample forms of employee confidentiality agreements are set forth in §§6.12-6.39. The confidentiality agreement should acknowledge that the employee will have access to confidential proprietary information and should identify the confidential and trade secret information, although specific trade secrets, such as precise formulas, need not be described in detail. The agreement should make clear that the employee is prohibited from disclosing any confidential or trade secret information and should require the employee to return all such information when the employee terminates employment with the company. For additional discussion of employee agreements, see §4.6.

Training programs. The company should develop and implement a comprehensive educational program to train both management and staff employees on what constitutes a trade secret and all aspects of the company's policies and procedures for protecting trade secrets. Employees need to understand the value of trade secrets and their ultimate responsibility to protect them. The company should make clear that protection of trade secrets is taken seriously and that specific consequences will result from any employees' failures in this regard. A formal education program will ensure that all employees receive the same information. The training should be tailored to the company's particular business, and the company's policies and procedures should be made available to employees in a written handbook. Training for new hires is especially important so that the company's protection policies are ingrained with a unified message. Companies should consider having formal training sessions delivered by their human resources or legal departments either in person or by video.

Companies may also provide more specialized training to managers, who can then monitor other employees and provide guidance with respect to protecting trade secrets as the need arises. See State Bar of California, Trade Secret Litigation and Protection in California §3.03(B) (2005); Quinto & Singer, Trade Secrets: Law and Practice 205 (2009). Management training can include particular warning signs and employee behaviors to watch for, such as an employee living beyond his or her means. See *10 Tips for Protecting Yourself From Employee Theft,* Law360 (Aug. 5, 2008).

The company should provide continuing education to employees with respect to trade secret protection. Regular reminders not only sensitize employees to the importance of protecting the company's proprietary information but also reinforce the employees' understanding of particular elements of the company's trade secret protection plan.

Companies should, however, strike a proper balance between giving employees too many cautions regarding trade secret protection and not giving enough attention to the issue. Admonishing employees too many times can backfire if as a result employees do not feel trusted; morale and company loyalty can be hurt. The goal of trade secret protection should be to keep the trade secrets confidential, not to punish employees. Most importantly, companies must make sure that management is setting a good example. For further discussion of employee training programs, see §4.12.

Departing employees. Many trade secret thefts occur from within. It is therefore imperative that companies develop effective methods for handling departing employees by requiring the return of all company property and conducting exit interviews with explicit instructions concerning departing employees' continuing obligation to protect the company's trade secrets. Issues concerning employee departures are discussed in detail in §§4.13-4.15. See also §6.39. Departing IT personnel should be asked to sign separate agreements acknowledging that company domain names, passwords, and user data are company property. Employers often image the computer devices of key employees who join competitors to examine whether trade secret information is going out the door with the employees. See Cundiff, *Reasonable Measures to Protect Trade Secrets in a Digital Environment,* 49 IDEA: The Intellectual Property Law Rev 359, 377

(2009); Sands, *Preserving Trade Secrets in California: Best Practices,* Bus Law News, The State Bar of California 32-34, 36 (Issue 2, 2009).

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§4A.14 D. Government and Third Party Relationships

Government relationships involving trade secrets present a unique set of issues. For example, trade secrets may be disclosed when a company is seeking a government contract, and the secrets could become public through the Freedom of Information Act (FOIA) (5 USC §552). See §§5.12-5.14. Chapter 5 addresses in detail how to protect proprietary information when dealing with federal, state, and local governments and their agencies. See also §4.27. Relationships with third parties such as independent contractors, consultants, visitors, vendors, suppliers, and other outsiders must also be considered. See §§4.7, 4A.15. Sections 6.44-6.58 include a series of form protective agreements intended for use in dealings with third parties. Companies should ensure that they have effective processes and agreements in place to protect the company's intellectual property assets in these specific contexts.

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§4A.15 E. Precautions With Visitors

Trade secrets must be protected from the risk of loss to third persons visiting the company's premises, such as family members of employees, competitors, vendors, or utility company employees. The company should take precautions that may include requiring visitors to sign nondisclosure agreements, requiring visitors to wear name tags or other identification to indicate that they are visitors, assigning escorts to visitors as they travel to their destinations, and restricting visitors from entering any area of the premises where trade secrets are accessible. Visitors should be closely monitored so that they are not able to surreptitiously gain access to areas where trade secrets are located. See Quinto & Singer, Trade Secrets: Law and Practice 207 (2009). For further discussion of issues concerning visitor access, see §4.18.

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.16 F. Facilities Protection

§4A.16 F. Facilities Protection

Facilities protection refers to efforts taken by a company to ensure that its physical premises are secured and that physical access to trade secrets and confidential information is restricted. To protect trade secrets, access should be provided only to employees and others who have a clear need for access. A company can limit access to trade secrets and proprietary information in many ways, including the steps listed below. Procedures to restrict physical access to trade secrets are also discussed in §§4.16-4.18.

- Limit physical access to computer servers, computer routers, and other computer network technology. See §4A.18 for discussion of electronic security.
- Keep areas with sensitive equipment, such as server rooms and phone closets, locked at all times.
- Maintain an inventory of sensitive equipment and check the inventory often for missing equipment.
- Lock file cabinets and offices that store sensitive information.
- Internally designate all documents with trade secret information or other confidential information as "confidential," and design and implement procedures to help ensure that all confidential documents are marked appropriately. For further discussion of document security, see §4A.17.
- Shred all documents marked "confidential" before they are discarded.
- Make sure all trash receptacles are secured, and post "No Trespassing" signs where appropriate.
- Make sure all magnetic media, including server tapes, are erased before discarding.

See Implementing a Trade Secret Protection Program (July 21, 2008), available at http://www.Law360.com. See also Sands, *Preserving Trade Secrets in California: Best Practices,* Bus Law News, The State Bar of California 35 (Issue 2, 2009).

The company's physical premises can be protected in the following ways (Quinto & Singer, Trade Secrets: Law and Practice 206 (2009)):

- Maintain adequate fencing with "No Trespassing" signs to keep unwanted individuals off the premises.
- Use security guards and guard facilities to restrict access to the premises and the parking lot.
- Use video surveillance to monitor the premises.
- Require key cards and name badges for employees in order to enter the premises and for employees and other individuals in order to restrict access to certain areas of the premises to individuals with designated key cards or badges.

Facilities protection extends beyond security and fencing. Employees should be counseled not to discuss confidential information in nonsecure locations that are open to the public, including hallways, elevators, parking garages, and other public locations. Employees should not discuss confidential information on cell phones in areas where they can be overheard by others. If company visitors have access to workspaces, employees should be counseled not to post or display confidential information in their workspaces. A clean desk policy may be appropriate for certain areas of the company, and restrictions should be established regarding materials that employees might take home. Locked storage space should be provided. Photocopiers should be located away from areas with sensitive information, and a tracking system should be established to determine which employees use the copiers. Whiteboards should be erased after meetings are concluded. Finally, the company should have tracking systems in place to track disclosure of a company's confidential information when necessary to third parties. See State Bar of California, Trade Secret Litigation and Protection in California §3.03(D)(2005). See also §4.12.

When all or part of a manufacturing process includes trade secrets, concrete steps must be taken to protect the manufacturing process from disclosure. Secret formulas and recipes should be stored in vaults. Employees without a need to know should not have access to manufacturing areas. Third parties with knowledge of the company's manufacturing process or equipment should sign nondisclosure agreements. If possible, the company should perform different parts of the manufacturing process at different locations. See Quinto & Singer, Trade Secrets: Law and

Practice 212.

In trade secret litigation, all of the steps discussed above may be shown to a jury to demonstrate that reasonable steps were taken to protect trade secrets. See §4.17 for additional discussion of physical plant security. See generally §§4.8-4.26.

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§4A.17 G. Document Security

Document security is another important aspect of an effective trade secret protection program. The steps that a company can take to help ensure document security are discussed in §§4.19-4.23. See also Quinto & Singer, Trade Secrets: Law and Practice 209 (2009). Among other things, documents containing proprietary information should be marked to indicate that they are confidential. See §4.19. Properly marking confidential documents may be viewed by courts as evidence that the company has made a reasonable effort to maintain their secrecy. See Nev Rev Stat §600A.032; *Pixion, Inc. v Placeware Inc*. (ND Cal 2005) 421 F Supp 2d 1233, 1242. *Digital Dev. Corp. v International Memory Sys.* (SD Cal 1973) 185 USPQ 136; *Ecolaire, Inc. v Crissman* (ED Pa 1982) 542 F Supp 196, 209. If trade secrets are not marked confidential and are disclosed to others, such as customers, who are under no obligation to protect the confidentiality of the information, trade secret protection may be lost. *Southwest Stainless, LP v Sappington* (10th Cir 2009) 582 F3d 1176, 1189. As discussed in §4.19, however, companies must be judicious in marking documents, not only to avoid the risk of an inference that unmarked documents do not contain trade secrets but also to avoid diluting the designation through overuse.

In addition, documents containing proprietary information should not be left where others may have access to them. A recent decision found that documents contained in a cardboard box in a company vehicle were not entitled to trade secret protection because the company had not taken reasonable steps to ensure the secrecy of the information contained in the documents. *Jones v Hamilton* (Ala App, Jan 22, 2010, No. 2081077) 2010 Ala Civ App Lexis 23. Even documents marked confidential may lose trade secret protection if they are left in a location where others can gain access to them.

Furthermore, companies must ensure that documents are protected at all company levels. In *Nationwide Mut. Ins. Co. v Mortensen* (2d Cir 2010) 606 F3d 22, insurance agents left their employer to work for a competitor and took with them confidential information about the employer's policyholders. The confidential client information included personal client information and data about the client's needs and purchasing history. This information was kept in two places: the employer's protected computer system and the agent's personal policyholder file. The U.S. Court of Appeals for the Second Circuit found that given the lack of adequate safeguards to prevent disclosure of the information kept in the agent's personal policyholder files, the confidential information was not entitled to trade secret protection. The fact that the confidential client information was properly protected in a secure computer system was irrelevant because, to qualify for trade secret protection, information must be adequately protected at all company levels.

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.18 H. Electronic Security

§4A.18 H. Electronic Security

Companies must be vigilant to protect documents and information that are stored electronically. In today's digital age, it is extremely easy for employees and others to access and transmit trade secrets electronically. Because of the significant role computers usually play in trade secret thefts, a knowledge of computer forensics is essential. Flash drives provide employees and others with a small, discrete electronic device that can be used to save and transport large quantities of confidential information. Employees may also use personal e-mail accounts to electronically transmit important documents containing trade secrets. Personal devices such as cell phone cameras, iPhones, and portable music players can all be used to store data or capture images. Online social networking sites, such as Facebook®, MySpace®, LinkedIn®, and Twitter®, as well as other Internet forums such as listservs, chat rooms, and blogs, provide numerous opportunities for employees to leak proprietary information—either intentionally or inadvertently.

To protect sensitive electronic information, a company can take many steps, including the measures listed below. See Cundiff, *Reasonable Measures to Protect Trade Secrets in a Digital Environment,* 49 IDEA: The Intellectual Property Law Rev 359 (2009); Quinto & Singer, Trade Secrets: Law and Practice 210 (2009). These measures should be incorporated in the company's trade secret protection program.

- Ensure that company computers are password-protected and that strong firewalls are in place to prevent outsiders from gaining access to the company's computer networks.
- Require the use of separate (multi-level) passwords to access individual documents after an initial password is entered to log on to the computer.
- Change passwords frequently.
- Install keystroke surveillance software to allow the company to monitor and track employee usage of company network and e-mail servers and individual computers.
- Utilize early detection capabilities in computer networks to advise the company of trade secret thefts when they occur, before the company is damaged by disclosure.
- Use other digital tools to restrict access to trade secrets, such as electronically programmable access cards, digital watermarks, and secure intranets.
- Ensure that employees keep their passwords secure and do not share them with other employees.
- Mark electronic information as confidential in the same manner that paper documents are designated.
- Limit the amount of data that employees can transfer using company servers.
- Block access to employee personal e-mail accounts, such as gmail, AOL, and Yahoo!.
- Disable USB ports on company computers to prevent employees from using portable storage devices to transfer data.
- Selectively monitor employees' use of social networking sites.
- Ensure that any computers that are no longer used or are discarded have their hard drives erased.
- Do not allow third parties to use company computers for any purpose.
- Do not allow portable electronic devices into areas such as manufacturing facilities with highly sensitive material.
- Do not grant access to trade secrets to third parties, or else allow access only on a secure intranet through the use of passwords that the company controls and only if the third party enters into a nondisclosure agreement.
- Perform periodic Internet searches to detect trade secret information that may be posted on the Internet, and take swift action if any such information is discovered.

As electronic tools have developed, it has become increasingly easy and affordable for companies to implement electronic security measures. Failure to install extra levels of electronic security may be used by courts as an indication of a company's failure to take reasonable measures to maintain secrecy. See, *e.g., Boston Laser, Inc. v Zu* (ND NY Sept. 21, 2007, No. 3:07-CV-0791) 2007 WL 2973663, *10, *12 (finding that plaintiff had not taken reasonable steps to maintain secrecy when "computer network on which such matters are digitally stored is generally not even password protected beyond the log-in process").

For further discussion of electronic security issues, see §4.25; chap 17. See also 49 IDEA: The Intellectual Property Law Review 359.

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§4A.19 I. Unsolicited Inventions and Ideas

To minimize the risk of potential misappropriation claims, it is important for a company to have established policies and procedures for handling unsolicited submissions of inventions and ideas. Companies can approach unsolicited inventions and ideas in several ways. One extreme is to refuse to consider any unsolicited ideas or inventions. Another approach is to consider unsolicited submissions only if the individual submitter enters into an agreement waiving confidentiality claims. The issues presented by unsolicited submissions are discussed in depth in chapter 3. Sections 3.5-3.17 and 3.26 address different procedures that a company may adopt and include sample forms of a company policy statement and a waiver letter. See also Quinto & Singer, Trade Secrets: Law and Practice 213 (2009).

Sections 10.21-10.46 address a related issue: how a company can determine that certain information is *not* a trade secret and is therefore available for use and exploitation by the company.

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§4A.20 IV. CONCLUSION

Too often trade secret issues are overlooked before a company's trade secrets and other confidential information have been compromised. As companies face increasing competitive and financial pressures, management is understandably consumed with running the day-to-day operations of the business—working to achieve business objectives and to maximize the bottom line. As a result, companies commonly find themselves in situations where important intellectual property assets are taken for granted. Those assets can be lost or compromised through what is often benign neglect. Companies may also find themselves exposed when, through poor controls, they inadvertently obtain others' trade secrets. Experience has shown that companies gain tremendous value by taking a proactive, systematic approach to assessing and protecting their trade secret portfolios through regular trade secret audits.

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V. SAMPLE TRADE SECRET AUDIT CHECKLIST

§4A.21 A. Introduction

The following sample trade secret audit checklist has been developed from the checklist used by the U.S. Department of Justice (DOJ), Computer Crime and Intellectual Property Section, in their investigations of criminal trade secret thefts. The DOJ's checklist (available at http://www.usdoj.gov/criminal/cybercrime/ipmanual/appxh.pdf) is a useful reference because it highlights some of the key considerations that the DOJ believes are important for maintaining the secrecy of trade secrets. See also §§4.9-4.10. The DOJ checklist is an appendix to the DOJ manual U.S. Department of Justice, Computer Crime and Intellectual Property Section, Prosecuting Intellectual Property Crimes (3d ed Sept. 2006), available at http://www.usdoj.gov/criminal/cybercrime/ipmanual/index.html.

NOTE: The checklist below is only a sample and should be viewed merely as a starting point for development of a more focused checklist that will be appropriate for the particular company that is the subject of the trade secret audit. Note that the form below contemplates only one trade secret. Multiple copies of relevant parts of the form must be made to capture relevant information for each trade secret inventoried in the audit.

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Source: Business Law/Trade Secrets Practice in California/4A Trade Secret Audits and Protection Plans/§4A.22 B. Sample Trade Secret Audit Checklist

§4A.22 B. Sample Trade Secret Audit Checklist

▶ To download **Word** version, right click and choose *Save Target As*

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Audit Team Contact Information

1. Name:

2. Address:

3. Phone:

4. E-mail:

Description of Trade Secret

5. Generally describe the trade secret (*e.g.,* source code, formula, technology, device).

6. Provide an estimated value of the trade secret according to one of the methods listed below:

Estimated Value	*Method*
$_____	Cost to develop the trade secret
$_____	Acquisition cost (identify date and source of acquisition)
$_____	Fair market value if sold

7. Identify a person knowledgeable about valuation of the trade secret, including that person's contact information.

General Physical Measures Taken to Protect Trade Secret

8. Describe the general physical security precautions taken by the company, such as fencing the perimeter of the premises, using visitor control systems, using alarming or self-locking doors or security personnel.

9. Has the company established physical barriers to prevent unauthorized viewing or access to the trade secret, such as locked storage facilities or "Authorized Personnel Only" signs at access points? (See below if computer-stored trade secret.)

___YES ___NO

10. Does the company require sign-in/sign-out procedures for access to and return of trade secret materials?

___YES ___NO

11. Are employees required to wear identification badges?

___YES ___ NO

12. Does the company have a written security policy? If so, attach a copy.

___YES ___NO

a. How are employees advised of the security policy?

b. Are employees required to sign a written acknowledgment of the security policy?

___YES ___NO

c. Identify the person most knowledgeable about matters relating to the security policy, including title and contact

information.

13. How many employees have access to the trade secret?

14. Is access to the trade secret limited to a "need to know" basis?

___YES ___NO

If so, describe how "need to know" was maintained in any ways not identified elsewhere (*e.g.,* closed meetings, splitting tasks between employees or vendors to restrict knowledge).

Confidentiality and Nondisclosure Agreements

15. Does the company enter into confidentiality and nondisclosure agreements with employees and third parties concerning the trade secret? If so, attach copies.

___YES ___NO

16. Has the company established and distributed written confidentiality policies to all employees? If so, attach copies.

___YES ___NO

17. Does the company have a policy for advising company employees regarding the company's trade secrets? If so, attach a copy.

___YES ___NO

Computer-Stored Trade Secrets

18. If the trade secret is computer source code or other computer-stored information, how is access regulated (*e.g.,* are employees given unique user names, passwords, and computer storage space, and was the information encrypted)?

19. If the company stores the trade secret on a computer network, is the network protected by a firewall?

___YES ___NO

20. Is remote access permitted into the computer network?

___YES ___NO

21. Is the trade secret maintained on a separate computer server?

___YES ___NO

22. Does the company prohibit employees from bringing outside computer programs or storage media to the premises?

___YES ___NO

23. Does the company maintain electronic access records such as computer logs?

___YES ___NO

Document Control

24. If the trade secret consists of documents, are they clearly marked "CONFIDENTIAL" or "PROPRIETARY"?

___YES ___NO

25. Describe the document control procedures employed by the company, such as limiting access and sign-in/sign-out policies.

26. Is there a written policy concerning document control procedures? If so, attach a copy.

___YES ___NO

If so, how are employees advised of it?

27. Identify the person most knowledgeable about the document control procedures, including title and contact information.

Employee Controls

28. Are new employees subject to a background investigation?

___YES ___NO

29. Does the company hold "exit interviews" to remind departing employees of their obligation not to disclose trade secrets?

___YES ___NO

Description of Any Suspected Incidents of Trade Secret Theft

30. Identify the name(s) and location(s) of possible suspects, including the following information:

Name:

Phone number:

E-mail address:

Physical address:

Employer:

Reason for suspicion:

31. Would the trade secret theft benefit a third party, such as a competitor, another business, or a foreign government (or agency of a foreign government)?

___YES ___NO

If so, identify that third party and its location.

32. If the suspect is a current or former employee, describe any confidentiality and nondisclosure agreements in effect and attach copies.

33. Identify any physical locations associated with the theft, such as where the trade secret may be currently stored or used.

34. Describe any evidence acquired, and provide copies of any investigative reports prepared.

Other Documents or Information

35. Provide any other documents or information not described above that might be relevant to this trade secret audit.

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5

Protecting Information Disclosed to Government Agencies

Nancy O. Dix
Sharon K. Sandeen

I. INTRODUCTION
- A. Scope of Chapter §5.1
- B. Applicable Laws §5.2

II. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH FEDERAL GOVERNMENT
- A. Who Owns the Rights to Data When Contracting With the Government: Federal Acquistion Regulations System
  - 1. Overview §5.3
  - 2. Determining the Scope of the Government's License Under the FAR §5.4
  - 3. Source of Funding as a Basis for the Government's Rights Under DFARS §5.5
    - a. Government Funding §5.6
    - b. Private Funding
      - i. Commercial Data §5.7
      - ii. Noncommercial Data §5.8
    - c. Mixed Funding §5.9
  - 4. Other Types of Government Rights §5.10
  - 5. Requirements for Limiting Government Rights §5.11
- B. Who Can Access Your Proprietary Information: Freedom of Information Act
  - 1. Overview §5.12
  - 2. Exemption 3 of FOIA §5.13
  - 3. Exemption 4 of FOIA §5.14
- C. Challenging Government Release of Your Proprietary Information
  - 1. Executive Order 12600 §5.15
  - 2. Objecting to Disclosure of Records Under FOIA Request §5.16
  - 3. "Reverse FOIA"—Administrative Procedure Act §5.17
- D. Federal Trade Secrets Act §5.18
- E. Privacy Act of 1974 §5.19

III. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH STATE OF CALIFORNIA
- A. Sources of Protection §5.20
- B. California Public Records Act
  - 1. Overview §5.21
  - 2. Trade Secret Exemption §5.22
  - 3. "Catchall" Exemption §5.23
  - 4. Recent Developments Under CPRA §5.23A
- C. California Information Practices Act §5.24

IV. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH LOCAL GOVERNMENT §5.25

V. LIABILITY OF GOVERNMENT AGENCIES OR EMPLOYEES FOR IMPROPER DISCLOSURE OF TRADE SECRET INFORMATION §5.26

VI. SUMMARY §5.27

VII. CHECKLIST: PRACTICAL POINTERS FOR PROTECTING TRADE SECRETS WHEN DEALING WITH GOVERNMENT §5.28

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I. INTRODUCTION

§5.1 A. Scope of Chapter

Protecting trade secrets and other proprietary information is a crucial part of doing business and can often determine the success of a company. When a company chooses to disclose such information to an outside party in the normal course of business, the company can adequately protect this information through contract, such as a nondisclosure agreement (NDA), thus providing legal redress in the case of misappropriation or unauthorized disclosure. When the outside party is a government agency, protecting this information becomes more complicated.

There are two situations in which companies share proprietary information with the government. Mandatory disclosure occurs when a company's activities fall under the purview of a regulatory agency and the company is required to submit data to that agency. In addition, a company may voluntarily disclose proprietary information to the government in order to obtain, or as part of, a government contract. In the latter case, a company may be in a stronger position to bargain for protective agreements and always has the option not to contract if it feels the risk of government release of that information outweighs the benefits of the government contract, as unpleasant as this option may be.

Once the government has a company's proprietary information, there are a number of ways in which that information can be released to third parties. First, the government agency may intentionally disclose the information to other government agencies or other contractors in furtherance of the agency's overall objective. Second, the government may be required to release the information to a third party via a request under the Freedom of Information Act (5 USC §552), for federal agencies (see §§5.12-5.14), or the California Public Records Act (Govt C §§6250-6276.48), for state agencies (see §§5.21-5.23). Third, the information may be subpoenaed through a court of competent jurisdiction. Finally, proprietary information may be improperly disclosed to third parties. Each situation presents a different set of challenges for a company and its counsel to prevent such disclosure.

This chapter explores the legal landscape surrounding government release of proprietary information and discusses practical ways for companies to protect that information.

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§5.2 B. Applicable Laws

Numerous statutes and regulations impose on government entities the duty to maintain the confidentiality of certain information. When attempting to protect information submitted to the government, companies and their counsel must understand the applicable statutes and regulations in order to protect the information in question. These include general laws such as the Federal Trade Secrets Act (18 USC §1905) (see §5.18), the Freedom of Information Act (5 USC §552) (see §§5.12-5.14), the Privacy Act of 1974 (5 USC §552a) (see §5.19), the California Public Records Act (Govt C §§6250-6276.48) (see §§5.21-5.23), the California Information Practices Act (CC §§1798-1798.78) (see §5.24), and applicable regulations such as the Federal Acquisition Regulations System (Title 48 of the Code of Federal Regulations) (see §§5.3-5.11). In addition to special statutes and general statutes such as the Freedom of Information Act and the California Public Records Act, government entities are bound by general principles of trade secret law and can be sued for trade secret misappropriation. Government entities that enter into contracts requiring confidentiality can also be sued for breach of contract if they improperly disclose proprietary information. See §5.26.

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II. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH FEDERAL GOVERNMENT

A. Who Owns the Rights to Data When Contracting With the Government: Federal Acquisition Regulations System

§5.3 1. Overview

To protect trade secrets when contracting with the federal government, companies must comply with the requirements of the applicable statutes and regulations. With minimal exception, these regulations are found in the Federal Acquisition Regulations (FAR), for civilian agency contracts, and the Department of Defense FAR Supplement (DFAR), for military agency contracts. These "data rights" regulations apply to trade secret or copyrightable material provided to government agencies in connection with a government contract.

When performing government contracts, companies generally own the material created by their employees, including both technical data and computer software. 17 USC §201(b). See 17 USC §101 (definition of "work made for hire"). When technology is developed under a government contract, the government automatically receives a license to use or disclose that technology. Under the FAR, the scope of this license is determined by several factors, including the source of funding for the technical data, the classification of the data as trade secret or confidential, and the restrictive legend placed on the data when submitted to the government. See §5.4. Under the DFARS, the scope of that license is primarily determined by the source of the funding for the technology as set forth in the regulations. See §§5.5, 5.11.

NOTE: "Technical data" is defined as "recorded information, regardless of the form or method of the recording, of a scientific or technical nature (including computer software documentation). The term does not include computer software or data incidental to contract administration," such as financial, administrative, cost or pricing, or management information. 48 CFR §§252.227-7013(a)(14) (DFAR); 48 CFR §52.227-14(a) (FAR).

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§5.4 2. Determining the Scope of the Government's License Under the FAR

When submitting data to civilian agencies, the FAR governs the limitations a contractor can place on its proprietary information. Excluding copyrighted material, the government automatically receives "unlimited rights" in data submitted under a government contract. 48 CFR §52.227-14(b)(1), (c). This means that the government has the right to "use, disclose, reproduce, prepare derivative works, distribute copies to the public, and perform publicly and display publicly, in any manner and for any purpose, and to have or permit others to do so." 48 CFR §52.227-14(a). However, for some data, a contractor may place restrictions on the government's license to use or disclose that information. See, *e.g.,* 48 CFR §52.227-14(b)(2)(ii).

Under certain circumstances the FAR allows contractors to impose "limited rights" on technical data and "restricted rights" on computer software submitted to the government. See 48 CFR §52.227-14(b)(2)(ii), (g), (i). "Limited rights" prevent the government from using the data for purposes of manufacture and from disclosing the information outside the government. For technical data to qualify for "limited rights" protection, the data must be developed at private expense and must either embody a trade secret, or be commercial or financial and confidential or privileged. 48 CFR §52.227-14(a). Unfortunately, the regulations provide no definition for "trade secret" or "developed at private expense," and these terms have been subject to a wide variety of judicial interpretation.

"Restricted rights" place greater limitations on the government's use of computer software. The government agency may only use "restricted rights" software on the computer(s) for which it was acquired and a backup computer. In addition, the government may archive the software and may modify or adapt the software, but only to the extent that the derivative software is subject to the same restrictions. 48 CFR §52.227-14(g)(4)(i)(b). Finally, the government may disclose the software to "support service [c]ontractors," again subject to the same restrictions listed above. 48 CFR §52.227-14(g)(4)(i)(b)(5). For computer software to qualify for "restricted rights," it must be a trade secret and developed at private expense; commercial or financial and confidential or privileged; or published copyrighted. 48 CFR §52.227-14(a). Again, these terms are not defined within the FAR and are open to judicial interpretation.

Even if technical data or software would otherwise qualify for "limited" or "restricted" rights, the contractor must use the specific legends listed in the FAR (48 CFR §52.227-14(g)) to obtain these rights. For further discussion of these notice requirements, see §5.11.

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§5.5 3. Source of Funding as a Basis for the Government's Rights Under DFARS

Unlike the FAR, the DFARS provides a broader array of licensing options and more detailed guidance for regulatory compliance. Furthermore, the scope of the government's license in data is generally determined by the source of funding for that data. Technology developed under a government contract is funded through one of three sources: the government, private funds, or mixed government and private funds. 48 CFR §227.7103-5. The source of the funding determines the level of protection, if any, the data receives. See §§5.6-5.11. As one would intuitively expect, funding technology entirely with government money provides the government with broader rights in that technology while using exclusively private funds limits the extent of the government's rights. The determination of whether information was "developed at private expense" is often complicated, and relates to the allocation of development costs in the contractor's accounting system. See §5.11.

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§5.6 a. Government Funding

When technology is considered to be developed exclusively with government funds, the government receives "unlimited rights" in that technology. 48 CFR §§227.7103-5(a), 227.7203-5(a). As the name implies, unlimited rights affords the government a very broad scope of rights allowing it to "use, modify, reproduce, release, perform, display, or disclose … for any purpose whatsoever." 48 CFR §252.227-7014(a)(15). As a result, these rights potentially allow the government to provide a company's technical data or computer software to a competitor who could then use this information to compete against the company for future government contracts or in the commercial marketplace. Because of this possibility, it is crucial for companies seeking to protect valuable technological developments to provide the government with less than unlimited rights where it is appropriate to do so.

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b. Private Funding

§5.7 i. Commercial Data

The DFARS makes a distinction between commercial and noncommercial data, and the scope of the government's rights in each varies based on this distinction. The relevant statute associated with the DFARS establishes a presumption that commercial items are developed at private expense. 10 USC §2320(b)(1). Therefore, a contractor need not prove the source of funding unless this point is directly challenged by the government.

For commercial technical data, the government receives an unrestricted license in data that (1) has been submitted without restrictions on use; (2) are form, fit, and function data; (3) are a correction or change to previously submitted data; (4) constitute data that is "necessary for operation, maintenance, installation, or training (other than detailed manufacturing or process data); or (5) constitute data submitted under a prior contract in which the government had unlimited rights. 48 CFR §252.227-7015(b)(1). For all other data, the government receives a limited rights license similar to that described in §5.8. 48 CFR §252.227-7015(b)(2). If the government determines that additional license rights are needed, the parties are free to negotiate a more specific license. 48 CFR §252.227-7015(c).

The DFARS has no clause for commercial computer software. 48 CFR §227.7202-4. Instead, the regulations provide that "[c]ommercial computer software or commercial computer software documentation shall be acquired under the licenses customarily provided to the public unless such licenses are inconsistent with Federal procurement law." 48 CFR §227.7202-1(a). Thus, the government receives "only the rights specified in the license under which the commercial computer software or commercial computer software documentation was obtained." 48 CFR §227.7202-3(a). As with commercial technical data, if the government needs broader rights than those conveyed under the license customarily provided to the public, the government and the contractor may negotiate a more specific license. 48 CFR §227.7202-3(b).

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§5.8 ii. Noncommercial Data

When the development costs of noncommercial technology are not allocated directly to a government contract within a contractor's accounting system, the technology is considered to have been developed at "private expense," even though the expense may be reimbursed by the government as an indirect cost. See 48 CFR §252.227-7013(a)(7). Note, however, that while this definition applies under the DFARS, this distinction is not set forth in the FAR. Where development is privately funded, the government receives a more limited license. For noncommercial technical data, the government receives "limited rights," meaning that the government has the right to "use, modify, reproduce, release, perform, display, or disclose technical data, in whole or in part, [but only] within the government." 48 CFR §252.227-7013(a)(13). For noncommercial computer software, the government receives "restricted rights" that allow it to "[u]se a computer program with [only] one computer at one time. The program may not be accessed by more than one terminal or central processing unit or time shared." 48 CFR §252.227-7014(a)(14)(i). A company has the right to protect "limited rights" data and "restricted rights" computer software from unauthorized disclosure and use. In some instances, companies may withhold such data from the government and instead provide "form, fit and function data." 48 CFR §52.227-14(b)(1)(ii), (g)(1)(ii).

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§5.9 c. Mixed Funding

When a company uses a combination of government and private funding to develop technology, the government receives "government purpose rights" in that technology. "Government purpose rights" allow the government to use or disclose the technology, either within the government or outside the government, but only for government purposes (*i.e.,* not for commercial purposes). 48 CFR §227.7103-5(b)(4). Data in which the government holds government purpose rights may be disclosed to persons other than government contractors only when the intended recipient is subject to use and nondisclosure restrictions. 48 CFR §227.7103-5(b)(4)(i).

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§5.10 4. Other Types of Government Rights

In addition to those rights discussed above, the government's rights in technology can be limited through "specifically negotiated license rights" and through "Small Business Innovation and Research (SBIR) data rights." See 48 CFR §§227.7103-5(d), 227.7104, 227.7203-5(d), 227.7204.

Specifically negotiated license rights allow the government and the contractor to enter into a license agreement under which the rights are negotiated to fit the particular circumstances. 48 CFR §§227.7103-5(d), 227.7203-5(d). This option is limited in that the government cannot receive less than limited or restricted rights, depending on whether technical data or software is at issue, but it does provide greater flexibility than the standard clauses. See 48 CFR §§227.7103-5(d)(1), 227.7203-5(d). For example, the parties may negotiate specifically negotiated rights amounting to either "limited" or "restrictive" rights in circumstances that might otherwise call for "government purpose" rights.

NOTE: When the government needs rights in data acquired with government purpose or limited rights, the contracting officer must negotiate with the contractor to determine whether acceptable terms exist for transferring additional rights. The regulations suggest alternatives to consider before negotiating for additional rights, and counsel that negotiations should be conducted only when the government needs to disclose the data outside the government, or when additional rights are required for competitive procurement and anticipated savings expected through competition are estimated to exceed the acquisition cost of the additional rights. 48 CFR §227.7103-5(d)(2).

SBIR Data Rights apply only to contracts awarded under the SBIR Program. 48 CFR §§52.227-20, 252.227-7018(b)(4), 227.7104, 227.7204. Under this program, small businesses are allowed to impose restrictions for a period of 5 years on defense agencies (4 years on civilian agencies under the FAR), even when the technology is funded exclusively with government funds. During this period, the government is restricted in roughly the same manner as the government purpose restriction imposed on mixed funding technology. See §5.9. After the 4- or 5-year period, depending on whether the FAR or DFARS governs the contract, the government receives unlimited rights to the data or software. 48 CFR §§52.227-20(d)(1), 227.7104(b).

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§5.11 5. Requirements for Limiting Government Rights

For a company to impose anything short of unlimited rights on the government, it must be able to prove that the technical data or software was developed exclusively at private expense. It can do this by segregating and tracking the development costs from those of other projects funded by the government. Thus, it is essential that the company maintain and use a configuration management and accounting system that accurately tracks the development and funding of technology.

In addition, under the DFARS, the company must provide notice to the government, in advance of entering into the contract, that the government will receive less than unlimited rights. 48 CFR §252.227-7013(e)(2). See 48 CFR §252.227-7013(e)(1) (requirement inapplicable to restrictions based solely on copyright). This information must specifically be laid out in one of the restrictive legends found in FAR and DFARS (or the contractor may withhold the data after identifying it and furnishing form, fit, and function data). Failure to strictly adhere to the notice requirements in FAR or DFARS could result in a grant of unlimited rights to the government. *Ervin & Assocs., Inc. v U.S.* (2004) 59 Fed Cl 267, 297; see also *KSD, Inc. v U.S.* (2006) 72 Fed Cl 236, 258. In *Ervin,* a government contractor claimed that oral statements, letters, and e-mails to agency officials provided sufficient "limited rights" notice. The court ruled that, because these communications did not comply with the notice requirements of FAR, "even if the Government did not already have unlimited rights and even if Ervin's data … [was] developed at private expense, the Government nonetheless acquired 'unlimited rights' in all technical data and computer software delivered under the terms of the … [c]ontract." 59 Fed Cl at 297. This decision highlights the necessity of strict compliance with FAR requirements.

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B. Who Can Access Your Proprietary Information: Freedom of Information Act

§5.12 1. Overview

The Freedom of Information Act (FOIA) (5 USC §552) is a disclosure statute. *Cal-Almond, Inc. v Department of Agric.* (9th Cir 1992) 960 F2d 105, 107 ("disclosure, not secrecy, is the dominant objective of the Act"; exemptions are narrowly construed), citing *Department of Air Force v Rose* (1976) 425 US 352, 361, 48 L Ed 2d 11, 96 S Ct 1592. Under the FOIA, each federal agency must make government information available to the public, specifically the "person" requesting the information. 5 USC §552(a)(3)(A); *Taylor v Sturgell* (2008) 553 US 880, 171 L Ed 2d 155, 162, 128 S Ct 2161 ("[A] successful FOIA action results in a grant of relief to the individual plaintiff, not a decree benefiting the public at large."). However, statutory exemptions to the FOIA provide a basis for arguing that certain information should not be disclosed. The two exemptions that might apply to trade secret information are Exemption 3 (5 USC §552(b)(3)) (see §5.13) and Exemption 4 (5 USC §552(b)(4)) (see §5.14).

Although the FOIA can protect the confidentiality of certain information in the government's possession, it has its limits:

- The exemptions are permissive rather than mandatory; *i.e.,* they provide a government agency with a basis not to disclose, but the agency can still choose to do so. *Avondale Indus. v NLRB* (5th Cir 1996) 90 F3d 955, 958. Therefore, even confidential information may be disclosed at the agency's discretion. However, the party submitting the information to the government agency may bring an action to enjoin disclosure. See *McDonnell Douglas Corp. v EEOC* (ED Mo 1996) 922 F Supp 235, 237. When disclosure serves no legitimate purpose in informing members of the public about the activities of their government, the court may prohibit disclosure. *Avondale Indus.,* 90 F3d at 959.
- The FOIA makes no distinction between records created by a government agency and business documents submitted to the agency. But see Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23781, discussed in §5.15. Nor does the FOIA distinguish among the class of people who request information. The same standards are applied whether the information request is made by the media, the academic community, inquisitive citizens, or business competitors.
- Any record disclosed in an authorized manner to any member of the public is available for disclosure to all members of the public. 5 USC §552(a)(3)(A). There are various exceptions to this rule, however. See, *e.g.,* 9 CFR §390.9 (administrator of Food Safety Information Services may make distribution lists from firms recalling meat products available to other government agencies without being required to make them available to public).
- The term "trade secrets" is not defined by federal statute and is therefore subject to judicial interpretation based on secondary sources. This can lead to the application of differing definitions, which may or may not be broad enough to protect what an individual or a business considers to be its trade secrets. See *Anderson v Department of Health & Human Servs.* (10th Cir 1990) 907 F2d 936, 943.

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§5.13 2. Exemption 3 of FOIA

Exemption 3 (5 USC §552(b)(3)) of the Freedom of Information Act (FOIA) (5 USC §552) prohibits an agency from disclosing information that is specifically exempt from disclosure by statute. This exemption applies only if the statute:

> (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld.

The 1976 amendment to Exemption 3 and its legislative history added conditions for exemption to "make clear that Congress did not want the exemption to be triggered by every statute that in any way gives administrators discretion to withhold documents from the public." *Church of Scientology v U.S. Postal Serv.* (9th Cir 1980) 633 F2d 1327, 1329, quoting *Irons & Sears v Dann* (DC Cir 1979) 606 F2d 1215, 1220. Thus, the Supreme Court has promulgated a two-part test for determining whether information is exempt from disclosure under Exemption 3 (see *CIA v Sims* (1985) 471 US 159, 167, 85 L Ed 2d 173, 182, 105 S Ct 1881):

(1) The statute being invoked must qualify as an exemption statute; and

(2) The information requested must fall within the statute.

Subsection (A) of the exemption relates only to "statutes incorporating a congressional mandate of confidentiality that, however general, is 'absolute and without exception.'" *CNA Fin. Corp. v Donovan* (DC Cir 1987) 830 F2d 1132, 1138. Subsection (B) requires that the statute "incorporate a formula whereby the administrator may determine precisely whether disclosure in any instance would pose the hazards that Congress foresaw." 830 F2d at 1139. See, *e.g., Starkey v Department of Interior* (SD Cal 2002) 238 F Supp 2d 1188, 1192 (statute in Archeological Resources Protection Act (16 USC §§470aa-470mm) that prevented disclosure sufficiently complied with subsection (B) because it defined particular matters to be withheld from disclosure).

The many statutes that allow a department administrator to withhold data in the public interest are narrowly construed to prohibit disclosure under Exemption 3 only to the extent that the statutes specifically exempt information from disclosure. *Aguiree v SEC* (DC Cir 2008) 551 F Supp 2d 33, 50 (Exemption 3 does not apply to statute that gives agency wide latitude in determining which materials may be disclosed); *Irons v Gottschalk* (DC Cir 1976) 548 F2d 992, 995. The Federal Trade Secrets Act (18 USC §1905) (see §5.18) is not a statute of the type referred to in Exemption 3, because it does not guide the agency in deciding when disclosure would be harmful. *CNA Fin. Corp. v Donovan* (DC Cir 1987) 830 F2d 1132, 1141; *National Parks & Conserv. Ass'n v Kleppe* (DC Cir 1976) 547 F2d 673, 686.

Statutes that trigger application of Exemption 3 include:

- 35 USC §122, which provides that pending and abandoned patent applications must be kept secret (*Irons & Sears v Dann* (DC Cir 1979) 606 F2d 1215, 1220); and
- 15 USC §2055(b)(1), which regulates the public disclosure of information by the Consumer Products Safety Commission (*Consumer Prods. Safety Comm'n v GTE Sylvania, Inc.* (1980) 447 US 102, 64 L Ed 2d 766, 100 S Ct 2051) and is part of the Consumer Product Safety Act (15 USC §§2051-2085).

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§5.14 3. Exemption 4 of FOIA

Exemption 4 (5 USC §552(b)(4)) of the Freedom of Information Act (FOIA) (5 USC §552) provides that the FOIA does not apply to either trade secrets or "commercial or financial information obtained from a person and privileged or confidential." 5 USC §552(b)(4). The government need not show that releasing the documents would cause "actual competitive harm." *GC Micro Corp. v Defense Logistics Agency* (9th Cir 1994) 33 F3d 1109, 1113. Rather, the government need only show that there is (a) actual competition in the relevant market, and (b) a likelihood of substantial competitive injury if the information were released. *Lion Raisins, Inc. v USDA* (9th Cir 2004) 354 F3d 1072, 1079. But see *R&W Flammann GmbH v U.S.* (Fed Cir 2003) 339 F3d 1320, 1323 (Army's release of losing bidder's pricing information to public did not violate Exemption 4 of FOIA, because sealed bid had entered public domain when opened and therefore was not confidential within meaning of Exemption 4).

"Trade secret" is not defined in the statute, however, so the courts look to various secondary sources for an appropriate definition. In *Anderson v Department of Health & Human Servs.* (10th Cir 1990) 907 F2d 936, 943, the Tenth Circuit examined three possible definitions of "trade secret." It rejected the broad definition in Restatement (First) of Torts §757, Comment b (1939) and the definition in 21 CFR §20.61(a) (regulation of the Food and Drug Administration, Department of Health and Human Services). The court then adopted the narrower common law definition (907 F2d at 944, citing *Public Citizen Health Research Group v FDA* (DC Cir 1983) 704 F2d 1280, 1288) that a trade secret is

> a secret, commercially valuable plan, formula, process, or device that is used for the making, preparing, compounding, or processing of trade commodities and that can be said to be the end product of either innovation or substantial effort.

The Tenth Circuit noted that if the broader Restatement definition were adopted, it would make the remaining category of Exemption 4 information (*i.e.,* "commercial or financial" information) needless because there would be no information within this remaining category that would be outside the reach of the trade secret category. 907 F2d at 944. The court did not examine the definition in Uniform Act §1.

In contrast, the Ninth Circuit has relied on the Restatement of Torts definition of trade secrets in applying Exemption 4. *Union Oil Co. v Federal Power Comm'n* (9th Cir 1976) 542 F2d 1036, 1044 (withholding disclosure of information); *Chevron Chem. Co. v Costle* (ND Cal 1978) 443 F Supp 1024, 1032 (adopting Restatement definition and enjoining disclosure of data submitted to EPA). Note that cases previously referring to Restatement (First) of Torts §757, Comment b (1939) may now refer to Restatement (Third) of Unfair Competition §39 (1995), which defines trade secrets more broadly.

If information does not qualify as a trade secret for purposes of this exemption, the party seeking to avoid disclosure can attempt to qualify it under the second alternative of Exemption 4. To do so, the information must be (1) commercial or financial, (2) obtained from a person, and (3) privileged or confidential. *National Parks & Conserv. Ass'n v Morton* (DC Cir 1974) 498 F2d 765, 766. Information generated by the federal government is not included. See 5 USC 551(2); *O'Connor v Department of Treasury* (ED Pa 2008) 570 F Supp 2d 749, 777. Again, "commercial" and "financial" are not defined by statute, and the courts interpret them based on their own experience and understanding. For example, in *Public Citizen Health Research Group v FDA, supra,* the court held that the terms should be given their ordinary meaning, and accordingly, records are deemed commercial if they are of commercial interest. 704 F2d at 1290. See also *Carlson v USPS* (9th Cir 2007) 504 F3d 1123, 1128 (information is commercial if it relates to commerce, trade, or profit); *American Airlines, Inc. v National Mediation Bd.* (2d Cir 1978) 588 F2d 863, 870 (defining "commercial" as pertaining or relating to or dealing with commerce); *Burnside-Ott Aviation Training Ctr., Inc. v U.S.* (D Fla 1985) 617 F Supp 279, 285.

The definition of "person" in Exemption 4 refers to a wide range of entities, and may include individuals, partnerships, corporations, associations, or public or private organizations. See 5 USC §551(2); *Nadler v FDIC* (2d Cir 1996) 92 F3d 93, 95. Courts have also found the following entities to be "persons": a foreign government agency (*Stone v Export-Import Bank* (5th Cir 1977) 552 F2d 132, 136); a Native American tribe (*Indian Law Reservation Ctr. v*

Department of Interior (D DC 1979) 477 F Supp 144, 146); and a foreign government (*Neal-Cooper Grain Co. v Kissinger* (D DC 1974) 385 F Supp 769, 776).

Mandatory disclosures. Information contained in mandatory disclosures to a government agency qualifies as "confidential" under Exemption 4 if its disclosure is likely to have either of the following effects (*National Parks & Conserv. Ass'n v Morton* (DC Cir 1974) 498 F2d 765, 770):

- Impairing the government's ability to obtain necessary information in the future; or
- Causing substantial harm to the competitive position of the person or business from whom the information was obtained.

The first part of the test—impairment of the government's ability to obtain information—will not be satisfied if the government agency is willing to disclose the information. *Burroughs Corp. v Schlesinger* (ED Va 1975) 403 F Supp 633, 637. Moreover, the agency's ability to protect information is impaired if disclosure would affect the quality or reliability of future submissions. *O'Connor v Department of Treasury* (ED Pa 2008) 570 F Supp 2d 749, 772. Thus, the submitter should try to obtain in advance agency support for protection of any submitted confidential information.

The second part of the test, likelihood of causing substantial harm to a competitive position, was the subject of *National Parks & Conserv. Ass'n v Kleppe* (DC Cir 1976) 547 F2d 673. In this case, the submitting company was a park concessionaire with a monopoly. The company seeking financial information was its competitor. The appellate court directed the trial court to decide whether public disclosure of the information posed a likelihood of substantial harm to the submitter's competitive position, either as a park concessionaire or in some other business. The court pointed out that it would consider not only the value of the information to the competitor and the damage to the submitting party if the competitor obtained the information, but also whether government disclosure was the only means by which the competitor could obtain the information and the cost of acquiring it by other means. Under this test, a court is empowered to release only part of the information sought in order to diminish the competitive harm. *Continental Oil Co. v Federal Power Comm'n* (5th Cir 1975) 519 F2d 31, 36. See *Worthington Compressors, Inc. v Costle* (DC Cir 1981) 662 F2d 45, 51, for discussion of standards applied to establish substantial competitive harm.

To bring mandatory disclosure information under this exemption, the owner of the information should produce evidence showing actual competition and a likelihood of substantial competitive injury. *GC Micro Corp. v Defense Logistics Agency* (9th Cir 1994) 33 F3d 1109, 1113 (citing *Public Citizen Health Research Group v FDA* (DC Cir 1983) 704 F2d 1280, 1290). "'If the information is freely or cheaply available from other sources …, it can hardly be called confidential' and government agency disclosure is unlikely to competitively harm the submitter." *Frazee v Forest Serv.* (9th Cir 1996) 97 F3d 367, 371 (citing *GC Micro Corp. v Defense Logistics Agency* (9th Cir 1994) 33 F3d 1109, 1112 n3).

Voluntary disclosures. Information voluntarily disclosed to a government agency may be treated differently from mandatory disclosures. *Critical Mass Energy Project v Nuclear Regulatory Comm'n* (DC Cir 1992) 975 F2d 871, 872. In *Critical Mass,* the circuit court recognized that the governmental interests at stake differed: For voluntary disclosures, the government has an interest in the continued *availability* of the disclosed information. By definition, mandatory disclosures are compelled by the government, such that continued availability is not in question. In such instances, the governmental interest is in the continued *reliability* of the disclosed information. 975 F2d at 878. Thus, for voluntary disclosures, information is "'confidential' for the purpose of Exemption 4 if it is of a kind that would customarily not be released to the public by the person from whom it was obtained." 975 F2d at 879. This test is objective, based on the disclosing party's custom.

In applying this test, counsel should recognize three important points. First, although *Critical Mass* significantly revised the analysis of *National Parks* with respect to voluntary disclosures, the court specifically and repeatedly reaffirmed the *National Parks* analysis for mandatory disclosures. Second, *Critical Mass* may not be followed in all circuits. See, *e.g., New York Pub. Interest Research Group v EPA* (SD NY 2003) 249 F Supp 2d 327, 335; *Comdisco, Inc. v Gen. Serv. Admin.* (ED Va 1994) 864 F Supp 510, 518; *Freeman v Bureau of Land Mgmt.* (D Or 2007) 526 F Supp 2d 1178, 1187 (noting that the Ninth Circuit has declined to decide whether to adopt the *Critical Mass* test). See also *Dow Jones Co. v Federal Energy Regulatory Comm'n* (CD Cal 2002) 219 FRD 167, 176 (comparing tests for Exemption 4 in *Critical Mass* and *National Parks*, criticizing *Critical Mass* and following *National Parks*); *Lahr v NTSB* (CD Cal 2006) 453 F Supp 2d 1153, 1175, rev'd on other grounds (9th Cir 2009) 569 F3d 964 (stating that *National Parks* is appropriate test when information is voluntarily given to agency). The District of Columbia Circuit that decided

Critical Mass, however, tends to be influential for FOIA matters affecting government contractors. Third, *Critical Mass* did not address the question of what is a voluntary, as opposed to a mandatory, disclosure. But see *McDonnell Douglas Corp. v EEOC* (ED Mo 1996) 922 F Supp 235, 242 (disclosure may be voluntary rather than mandatory if information was subpoenaed but no court enforcement of subpoena obtained).

A district court in California has determined that agreements for confidentiality, standing alone, are insufficient to satisfy the requirements for nondisclosure under Exemption 4. *Dow Jones Co.,* 219 FRD at 178. The court in *Dow Jones* noted that if confidentiality agreements alone were sufficient, then theoretically any agency could simply hand out promises of confidentiality to individuals who gave information in order to avoid judicial review of the issue of whether a record could be withheld. 219 FRD at 178.

Another debate centers on the government's ability to release a contractor's unit pricing under a FOIA request. In *McDonnell Douglas Corp. v NASA* (DC Cir 1999) 180 F3d 303, 305, the court held that line item pricing information is protected in instances in which a contractor can establish that release of the price information would allow competitors to underbid the company in future or current contracts. The court felt that this clearly qualifies as "substantial competitive harm" and therefore falls under Exemption 4 of the FOIA. 180 F3d at 306. See 5 USC §552(b)(4). The court also held that the disclosure was precluded under the Trade Secrets Act. 18 USC §1905. Shortly after this decision, the government issued new FOIA guidelines for its agencies in which it considered the *McDonnell Douglas* case to be fact-specific and not a categorical nondisclosure principle. Memorandum from U.S. Department of Justice, Office of Information and Privacy for the Unit Price Officers Conference (2000). This issue reappeared in *MCI Worldcom, Inc. v General Servs. Admin.* (D DC 2001) 163 F Supp 2d 28, 29, as a reverse FOIA action. In *MCI Worldcom,* the court granted summary judgment in favor of the contractors, stating that the release of the contractor's price information was barred under the FAR. The court found that the contractors' information was not "unit pricing" and therefore outside the specified FAR regulations. 163 F Supp 2d at 33. However, the court went on to say that, even had the information been considered "unit pricing," the government still could not disclose it because the FAR expressly prohibits the release of trade secret or other confidential information, and this information clearly falls in those categories. 163 F Supp 2d at 34; 48 CFR §15.506(e). Three years later, the government prevailed in part in *McDonnell Douglas Corp. v Department of Air Force* (DC Cir 2004) 375 F3d 1182, another reverse FOIA case brought by a contractor seeking to prevent the Air Force from disclosing three categories of unit prices. The court agreed with the Air Force's decision to disclose contract information in the category "over and above" (prices for work not specifically required by the contract) because the Air Force's administrative record fully supported the argument that disclosure was not likely to result in underbidding by competitors and therefore was not likely to cause the contractor substantial competitive harm. 375 F3d at 1197. As a result of these three decisions, the Department of Justice promulgated a policy requiring agencies to (1) notify contractors after a FOIA request to obtain and consider any objections to price disclosure (see §5.15), (2) conduct a thorough competitive harm analysis of any contractor objection that is made, and (3) clearly explain their decision rationales in the administrative record. Department of Justice, *Guide to the Freedom of Information Act,* p 339 (2009), available at http://www.justice.gov/oip/foia_guide09/exemption4.pdf. See also *Canadian Commercial Corp. v Department of Air Force* (DC Cir 2008) 514 F3d 37, 40 (reaffirming *McDonnell* "substantial competitive harm" test and holding that "[c]onstituent or line-item pricing information in a Government contract falls within Exemption 4 of the FOIA").

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C. Challenging Government Release of Your Proprietary Information

§5.15 1. Executive Order 12600

Every agency of the federal government is required to establish procedures to notify submitters of records containing confidential commercial information when those records are requested under the FOIA. Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23781. The agency must notify the submitter if it determines either that (1) the requested information has already been designated as "confidential" by the submitter, or (2) the agency has reason to believe that the requested information could reasonably be expected to cause substantial competitive harm. Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23781. Therefore, it is clearly in a company's best interest to identify trade secret and confidential information submitted to the agency *at the time of submission*. This relieves the agency from having to determine which information is likely to cause competitive harm and clearly establishes information that is proprietary.

NOTE: Although clearly separating and marking confidential information as such may suffice in this context, when required materials are submitted to an agency under a government contract, it is imperative to mark these materials with the specific legends laid out in FAR or DFARS. See §5.11.

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§5.16 2. Objecting to Disclosure of Records Under FOIA Request

When a government agency notifies a submitter of a FOIA request for information, the submitter must be afforded a reasonable period of time to object to the disclosure of any specified portion of the information and to state all grounds on which disclosure is opposed. Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23782. However, notice is not always required. If certain circumstances exist, such as prior publication of the data or the existence of another law that requires disclosure, the agency need not notify the submitter. Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23782. If, after considering arguments presented by the submitter, the agency determines that disclosure is appropriate, it must provide a written statement to the submitter briefly stating why the submitter's objections were not sustained. Executive Order No. 12600 (June 23, 1987), 52 Fed Reg 23782.

When a company is notified of a records request for its proprietary information, it will need to parse through the records and argue how each particular aspect of the information contained in those records falls within the exemptions to disclosure under the FOIA. See §§5.13-5.14. The burden is on the submitting company to establish for the federal agency what documents are exempt from disclosure.

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§5.17 3. "Reverse FOIA"—Administrative Procedure Act

If a federal agency intends to disclose information identified to be trade secret by the submitting company despite the protestations discussed in §5.16, the company can seek review of the agency's decision under the Administrative Procedure Act (APA) (5 USC §702). This is known as a reverse FOIA action and is the only available option to prevent disclosure under FOIA, since the United States Supreme Court has ruled that there is no private right of action implied under FOIA or the Federal Trade Secrets Act. *Chrysler Corp. v Brown* (1979) 441 US 281, 316, 60 L Ed 2d 208, 99 S Ct 1705. Under the APA, a reviewing court may overturn an agency action if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 USC §706(2)(A). The Supreme Court has ruled that "any disclosure that violates [the Federal Trade Secrets Act] is 'not in accordance with the law'" as that phrase is used in the APA. 441 US at 318.

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§5.18 D. Federal Trade Secrets Act

The Federal Trade Secrets Act (FTSA) forbids the disclosure of trade secrets except as authorized by law (18 USC §1905):

> Whoever, being an officer or employee of the United States or of any department or agency thereof, … publishes, divulges, discloses, or makes known in any manner or to any extent not authorized by law any information coming to him in the course of his employment … *which information concerns or relates to the trade secrets, processes, operations, style of work, or apparatus,* or to the identity, confidential statistical data, amount or source of any income, profits, losses, or expenditures of any person, firm, partnership, corporation or association… shall be fined under this title, or imprisoned not more than one year, or both; and shall be removed from office or employment. [Emphasis added.]

Although the FTSA is a strong deterrent to the improper disclosure of proprietary information, the terms "trade secrets," "processes," "operations," "style of work," and "apparatus" are not defined in the statute, thus leaving them open to judicial interpretation based on a wide variety of definitions. In reality, the FTSA is rarely imposed on federal officials, in part because of the strength of the penalty. Contractors seeking to grow a continuing business with a government agency will be hesitant to impose such severe sanctions on an important client. But the greatest weakness of the FTSA as a source of protection for proprietary information is that it does not create a private right of action. See *Chrysler Corp. v Brown* (1979) 441 US 281, 316, 60 L Ed 2d 208, 99 S Ct 1705. Currently, a private party who wishes to challenge an agency decision to disclose data must either seek review under the Administrative Procedure Act (5 USC §§702, 706) (see, *e.g., Conax Fla. Corp. v U.S.* (DC Cir 1987) 824 F2d 1124, 1128; see also §5.17) or file a tort claim based on general trade secret law. See also *Taylor v Sturgell* (2008) 553 US 880, 171 L Ed 2d 155, 128 S Ct 2161 (party requesting same governmental information as previously requested by an unrelated party in an unrelated action is not precluded by virtual representation from bringing own FOIA suit).

PRACTICE TIP: To ensure that federal employees comply with the FTSA, all proprietary information submitted to the federal government should be clearly marked with an appropriate legend. For information submitted under a federal contract, counsel should review the FAR and DFARS for the proper legend. See §§5.3-5.11. If no statutory or regulatory guidance can be found, the information should be marked **"Confidential Trade Secret and Proprietary Information**," **"Confidential Commercial Information**," or **"Not Releasable Under FOIA**."

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§5.19 E. Privacy Act of 1974

In addition to statutes specifically designed to protect trade secrets, the Privacy Act of 1974 ensures the privacy of personal and financial information in the government's possession. 5 USC §552a. The Act prohibits federal agencies from disclosing any records without a written request by, or prior written consent of, the person to whom the record pertains. 5 USC §552a(b). However, the agency may disclose information requested under the Freedom of Information Act (5 USC §552) that is not exempt. 5 USC §552a(b)(2).

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III. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH STATE OF CALIFORNIA

§5.20 A. Sources of Protection

Like the federal government, California has enacted numerous statutes and regulations to protect the confidentiality of information submitted to it. These statutes can be found by searching for statutes and regulations using such terms as "confidential," "secret," and "proprietary." Absent a specific statute or regulation, individuals and companies who wish to protect proprietary information submitted to the state must rely on the California Public Records Act (Govt C §§6250-6276.48) (see §§5.21-5.23), general tort law, or contract law if information is disclosed to the government under contracts requiring confidentiality.

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B. California Public Records Act

§5.21 1. Overview

The California Public Records Act (CPRA) (Govt C §§6250-6276.48) provides that public records are open to inspection by members of the public unless exempted by law. See Govt C §§6253(a), (b), 6254. "Members of the public" include individual persons, corporations, partnerships, limited liability companies, firms, and associations, as well as public agencies. Govt C §6252(b), (c); see *Los Angeles Unified Sch. Dist. v Superior Court* (2007) 151 CA4th 759, 771, 60 CR3d 445 (ruling that public agency is "person" authorized to seek disclosure of public records held by another public agency; city and city attorney may obtain public records from school district). In general, records are exempted from disclosure under the CPRA if they are exempted from disclosure under federal or state law. Govt C §6254(k). Although principally an act that allows the disclosure of information in the government's possession, the CPRA also *protects from disclosure* certain classes of information. More than 35 categories of documents are exempt from disclosure under the CPRA (see Govt C §§6254-6254.29), including:

- A document prepared by a local agency that assesses its vulnerability to terrorist attack or other criminal acts intended to disrupt the agency's operations and that is for consideration in a closed session (Govt C §6254(aa));
- Geological and geophysical data, plant production data, and similar information relating to utility systems development or market or crop reports obtained in confidence from any person (Govt C §6254(e));
- Taxpayer information (Govt C §6254(i));
- Records for which disclosure is exempted or prohibited under federal or state law, including but not limited to provisions of the Evidence Code relating to privilege (Govt C §6254(k); see also *Sutter's Place v Superior Court* (2008) 161 CA4th 1370, 1379, 75 CR3d 9 (mental processes of legislature are privileged);
- Applications for licenses, certificates, or permits; statements of personal worth; or personal financial data (Govt C §6254(n));
- Certain pesticide safety and efficacy information (Govt C §6254.2; see *Syngenta Crop Protection, Inc. v Helliker* (2006) 138 CA4th 1135, 1170, 42 CR3d 191);
- Private industry wage data (Govt C §6254.6); and
- Data used to calculate costs of obtaining air pollution emissions offsets (Govt C §6254.7(f)).

Other statutes exempt additional classes of information from disclosure as public records. See, *e.g.,* Bus & P C §§7067.5 (application for contractor's license), 7503-7503.14, 7506.5 (application for repossession agency license); Food & A C §§29041 (registration of apiaries), 38946 (registration of milk products).

"Public records" are defined broadly to cover almost every piece of written information in the government's possession, regardless of its physical form or source. See Govt C §6252(e)-(g). The term includes "any writing containing information relating to the conduct of the public's business prepared, owned, used, or retained by any state or local agency regardless of physical form or characteristics" and, with regard to records in the custody of or maintained by the governor's office, "any writing prepared on or after January 6, 1975." Govt C §6252(e). Only purely personal information unrelated to the "conduct of the public's business" falls outside the definition. *San Gabriel Tribune v Superior Court* (1983) 143 CA3d 762, 774, 192 CR 415.

Furthermore, the definition of "writing" includes (Govt C §6252(g))

> handwriting, typewriting, printing, photostating, photographing, photocopying, transmitting by electronic mail or facsimile, and every other means of recording upon any tangible thing any form of communication or representation, including letters, words, pictures, sounds, or symbols, or combinations thereof, and any record thereby created, regardless of the manner in which the record has been stored.

Given the broad definition of "public records," most cases under the CPRA focus on specific exemptions. Because the inquiry is fact-specific, it is extremely difficult to generalize about the scope of these exemptions. However, the following general principles often come into play:

- Most cases decided under the CPRA state that disclosure is the rule and exemptions are the exception. See, *e.g., Rogers v Superior Court* (1993) 19 CA4th 469, 476, 23 CR2d 412; *City of Santa Rosa v Press Democrat* (1986) 187 CA3d 1315, 1319, 232 CR 445.
- Exemptions from the CPRA are usually narrowly construed in favor of disclosure. *Rogers v Superior Court, supra*. But see *Black Panther Party v Kehoe* (1974) 42 CA3d 645, 653, 117 CR 106, in which the court refused to apply a broad interpretation to the CPRA, stating:

> We discern no interpretative mandate in the California law other than unreserved fulfillment of the statutory objectives. The California Public Records Act evidences a legislative policy of disclosure, yet one which is mindful of individual privacy.

See also Govt C §6250; *CBS, Inc. v Block* (1986) 42 C3d 646, 651, 230 CR 362 (interest in individual privacy narrower but no less important than public's right to access to government files).

- Because the CPRA was modeled after the Freedom of Information Act (FOIA) (5 USC §552), practitioners can rely on federal case law to interpret and apply the CPRA. *San Gabriel Tribune v Superior Court* (1983) 143 CA3d 762, 772, 192 CR 415. However, the FOIA is just a guide, and the California Legislature's intent in adopting specific exemptions must still be analyzed. *Williams v Superior Court* (1993) 5 C4th 337, 352, 19 CR2d 882.
- The burden is on the public agency to show that the records are exempt from disclosure. Govt C §6255(a); *Rogers v Superior Court* (1993) 19 CA4th 469, 477, 23 CR2d 412; *City of Santa Rosa v Press Democrat* (1986) 187 CA3d 1315, 1320, 232 CR 445.
- Although the CPRA allows individuals to bring actions to *enforce* disclosure of information, it does not allow them to bring actions to *prevent* the disclosure of exempt information. Govt C §6258; *Rogers,* 19 CA4th at 479. However, trade secret holders should not hesitate to bring an action to prevent the disclosure of trade secrets under other laws. See, *e.g., Masonite Corp. v County of Mendocino* (1996) 42 CA4th 436, 455, 49 CR2d 639.
- Nonexempt information contained in records that include exempt and nonexempt information must be disclosed if the exempt portions can be deleted, unless the cost to do so is too great. See *ACLU v Deukmejian* (1982) 32 C3d 440, 453, 186 CR 235; *Northern Cal. Police Practices Project v Craig* (1979) 90 CA3d 116, 124, 153 CR 173.
- Exemptions are permissive rather than mandatory; *i.e.,* they provide a government agency with a basis not to disclose, but the agency may still choose to do so. See *Black Panther Party v Kehoe* (1974) 42 CA3d 645, 656, 117 CR 106. Therefore, even admittedly confidential information may be disclosed at the agency's discretion.

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§5.22 2. Trade Secret Exemption

The principal exemption for trade secrets provides that records are exempt from disclosure under the CPRA if their disclosure "is exempted or prohibited pursuant to federal or state law, including, but not limited to, provisions of the Evidence Code relating to privilege." Govt C §6254(k). This exemption has been held to apply only to "records which would be held not to be covered by one or more specific exemptions." *City of Hemet v Superior Court* (1995) 37 CA4th 1411, 1422, 44 CR2d 532, citing *Roberts v City of Palmdale* (1993) 5 C4th 363, 373, 20 CR2d 330.

Arguably, this "Exemption k" under CPRA (Govt C §6254(k)) incorporates by reference all statutory and common law bases for the protection of trade secrets, including the Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11), Evid C §1060, and Cal Const art I, §1 (constitutional right of privacy). At least one court has applied this exemption very narrowly, however, holding that under Evid C §1060 the exemption applied only if "allowance of the privilege will not tend to conceal fraud or otherwise work injustice." *Uribe v Howie* (1971) 19 CA3d 194, 206, 96 CR 493. See also *State Farm Mut. Auto. Ins. Co. v Garamendi* (2004) 32 C4th 1029, 1039, 12 CR3d 343 (insurance company could not shield "data from public inspection by asserting the trade secrets privilege"). In so doing, the court relied on the definitions of "trade secret" in the Restatement (First) of Torts §757, Comment b (1939) and in Govt C §6254.7(d).

PRACTICE TIP: *Uribe* predates enactment of the UTSA and other statutes specifically designed to protect trade secrets. Thus, counsel should not hesitate to argue that Govt C §6254(k) incorporates by reference the UTSA and all other laws protecting trade secrets, and that therefore the limited scope of protection for trade secrets provided by Evid C §1060 should not apply. *Uribe* also predates Restatement (Third) of Unfair Competition §39 (1995), which may be applied by courts that previously applied Restatement (First) of Torts §757, Comment b (1939).

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§5.23 3. "Catchall" Exemption

In addition to specific exemptions to the CPRA, a "catchall" exemption protects the confidential information if "the public interest served by not disclosing the record clearly outweighs the public interest served by disclosure." Govt C §6255(a). See *State Bd. of Equalization v Superior Court* (1992) 10 CA4th 1177, 1188, 13 CR2d 342. But see *City of Hemet v Superior Court* (1995) 37 CA4th 1411, 1422, 44 CR2d 532 (catchall exemption not applicable to documents subject to specific exemption).

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§5.23A 4. Recent Developments Under CPRA

Recent case law suggests that, in the future, government agencies will have greater difficulty protecting proprietary information under the CPRA's catchall exemption. The prevailing trend is toward full disclosure. For example, in *County of Santa Clara v Superior Court* (2009) 170 CA4th 1301, 89 CR3d 374, a civil rights coalition invoked the CPRA to compel Santa Clara county to disclose its geographic information system basemap. Because the software was a public record, the county resisted disclosure by asserting CPRA's catchall exemption. Applying a balancing test, the court held that the county's financial and security interests did not outweigh the public's interest in disclosure. At the heart of the court's decision was the conclusion "that the County failed to demonstrate a clear overbalance on the side of confidentiality." 170 CA4th at 1329, citing *Michaelis, Montanari & Johnson v Superior Court* (2006) 38 C4th 1065, 1071, 44 CR3d 663. Thus, the court demonstrated that any doubt about whether to disclose will be resolved in favor of making the information available. In light of this decision, a contractor that provides proprietary information to a state agency will probably not be able to use the catchall exemption to prevent that information from being disclosed.

Although the catchall exemption may not protect a contractor's secret information, the trade secret exemption (see §5.22) might provide a better theory for avoiding disclosure. Under the latter exemption, if information possessed by a state agency derives from or incorporates a contractor's trade secrets, that information will be exempt from disclosure. To take advantage of the trade secret exemption, a contractor must substantiate that (1) the information provided to the state agency was in fact a trade secret and (2) the agency information for which discovery is sought derives from or incorporates that trade secret. If the contractor cannot establish that the agency information was derived from trade secrets, then disclosure will likely be mandated, for the catchall exemption will provide little protection.

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§5.24 C. California Information Practices Act

The California Information Practices Act (CIPA) (CC §§1798-1798.78) protects the privacy of individuals. CC §1798.1. It establishes procedures for collecting, maintaining, and disclosing records containing personal information. Each state agency must establish appropriate, reasonable safeguards to ensure compliance with the CIPA. CC §1798.21.

No state agency may disclose any personal information in a manner that would link the disclosed information to the individual unless the circumstances of disclosure fall into one of 22 listed categories. See CC §1798.24. As used in the CIPA, "personal information" means (CC §1798.3(a)):

- Any information maintained by an agency that identifies or describes an individual, including but not limited to his or her name, social security number, physical description, home address, home telephone number, education, financial matters, and medical or employment history; and
- Any statements made by, or attributed to, the individual.

Although the CIPA does not directly recognize that personal information may also constitute trade secrets, it does so indirectly. No agency may disclose personal or confidential information unless the disclosure is made under the California Public Records Act (CPRA) (see §§5.21-5.23). CC §1798.24(g). To the extent such information is exempt from disclosure under the CPRA (*e.g.,* because it is protected by the Evid C §1060 trade secret privilege), it should not be disclosed.

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§5.25 IV. PROTECTING PROPRIETARY INFORMATION IN DEALING WITH LOCAL GOVERNMENT

Generally, the same practical advice and legal analysis that governs the protection of trade secrets in dealings with the State of California also apply to local governments. See §§5.20-5.24. However, counsel who are asked to advise clients about the protection of information submitted to local government should consult local ordinances, regulations, and contracts to learn whether they impose a duty of confidentiality in addition to that imposed by the California Public Records Act (Govt C §§6250-6276.48) or other California law.

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§5.26 V. LIABILITY OF GOVERNMENT AGENCIES OR EMPLOYEES FOR IMPROPER DISCLOSURE OF TRADE SECRET INFORMATION

Even though exemptions to disclosure under the Freedom of Information Act (FOIA) (5 USC §552) and the California Public Records Act (CPRA) (Govt C §§6250-6276.48) do not prohibit government disclosure, and the FOIA and CPRA do not create private rights of action for wrongful disclosure of trade secrets, government officials are not insulated from potential criminal and civil liability. For example:

- The Federal Trade Secrets Act (18 USC §1905) makes it a crime for any United States officer or employee to disclose trade secret information. See §5.18.
- It is a misdemeanor under California law for a government official or employee to disclose or use for personal gain any confidential information acquired in the course of official duties. Govt C §1098(a). "Confidential information" includes (a) information that is not a public record subject to disclosure under the CPRA; (b) information, the disclosure of which is prohibited by a statute, regulation, or rule; and (c) information, the disclosure of which will have a material financial effect on any investment or interest in real property that the officer or employee has at the time of, or acquires within 90 days after, the use or disclosure of the information. Govt C §1098(b).
- The California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) defines "person" to include a "government, governmental subdivision or agency, or any other legal or commercial entity." Therefore, government entities such as state agencies can be held civilly liable for misappropriation of trade secrets if the Government Claims Act (Govt C §§810-996.6) is followed. (For a general discussion of claims against California, local governments, and their employees, see California Government Tort Liability Practice (4th ed Cal CEB 1999).) The right to obtain specific nonmonetary relief against public entities or employees is not affected by the Government Claims Act, and an action to enjoin trade secrets misappropriation may be brought without complying with the Government Claims Act. Govt C §814.
- A private party may seek review of an agency decision to disclose data under the Administrative Procedure Act (5 USC §706) or its California equivalent (Govt C §11350). *Chrysler Corp. v Brown* (1979) 441 US 281, 60 L Ed 2d 208, 99 S Ct 1705.
- A person may base a claim on the California constitutional right of privacy (Cal Const art I, §1) and the constitutional right not to be deprived of property without just compensation (Cal Const art I, §19). Thus, an injured party may bring an action for invasion of privacy, which is not subject to the Government Claims Act. See *Hill v NCAA* (1994) 7 C4th 1, 20, 26 CR2d 834; *Payton v City of Santa Clara* (1982) 132 CA3d 152, 154, 183 CR 17. A government agency that discloses trade secrets without the owner's permission may also be subject to a claim under the takings clause of the Fifth Amendment to the federal constitution. See, *e.g., Philip Morris, Inc. v Reilly* (1st Cir 2002) 312 F3d 24, 46 (requiring tobacco companies to disclose ingredient lists to state and allowing state to publish lists to promote public health violated takings clause).

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§5.27 VI. SUMMARY

Whether choosing to disclose proprietary information to a government agency for contract purposes or being required to do so by a regulatory agency, it is necessary for corporate counsel to understand the statutes and regulations that can help protect that information. When contracting with a federal agency, this means knowing and understanding the rights and requirements laid out in the FAR and the DFARS. See §§5.4-5.12. Once the government has a company's proprietary information, it is important to understand the ways in which the government can disclose that information (through the Freedom of Information Act, as an example) and the methods for challenging and preventing government disclosure (Freedom of Information Act exemptions, the Federal Trade Secrets Act, the Privacy Act of 1974, the Administrative Procedure Act, and general tort law). See §§5.14-5.20.

When dealing with state agencies, many of the federal rules and regulations are mirrored by the California Public Records Act and the California Information Practices Act. See §§5.22-5.25. However, the state statutes and regulations are not exactly like their federal counterparts and in many instances have been interpreted differently by the state courts. Because of its trade secrets exemptions, the FOIA provides more private interest confidentiality than does the CPRA. As a result, it is essential for counsel to become familiar with the specific statutes and regulations that are appropriate for the level of agency counsel is dealing with—federal, state, or local.

By following the guidelines in the relevant statutes and regulations, giving proper notice to the government agencies, and taking all appropriate precautions, a company can maximize the available protection for its trade secret and proprietary information.

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§5.28 VII. CHECKLIST: PRACTICAL POINTERS FOR PROTECTING TRADE SECRETS WHEN DEALING WITH GOVERNMENT

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To protect the confidentiality of information submitted to the government, the following steps should be taken by individuals, businesses, and their counsel:

___ 1. Undertake reasonable efforts to **maintain the confidentiality** of all trade secret information. See chap 4.

___ 2. **Don't disclose** trade secrets to the government (or anyone else) unless required to do so.

___ 3. Whenever possible, attempt to **get a Nondisclosure Agreement signed** before disclosing any trade secret information.

___ 4. **Research and comply with all laws and regulations** that establish procedures for the submission of proprietary information to the government.

___ 5. Be aware of and **follow the rules imposed by the agency** for submitting confidential information.

___ 6. **Clearly mark** all confidential information with appropriate legends (*e.g., "*confidential," "trade secret"; see forms 6.4-1 through 6.11-1). Some regulations require specific legends. See, *e.g.,* 48 CFR §52.227-14. Marking a document as a trade secret or as "proprietary" will not suffice to put the government on notice when a more specific legend, *i.e.,* "limited" or "restricted right" notice, is required.

___ 7. Disclose only the **minimum amount** of information necessary. Whenever practicable, **provide summary information** rather than detailed trade secret information.

___ 8. When possible, **segregate trade secret information** from other information to make it easier (and therefore more likely) for government officials to maintain confidentiality of protectable information when they are required to disclose nonprotected information.

___ 9. If information must be disclosed in connection with a government contract, **consider whether the value of the secret information is outweighed by the benefit of contracting with the government.** If not, avoid disclosing important information by refusing to enter into a contract with the government.

___ 10. When contracting with the federal government, **review the Federal Acquisition Regulations** applicable to the contract and determine the steps necessary to obtain the greatest protection of the information under those regulations. See §5.11.

___ 11. Develop technology or core features **at private expense or through reimbursable independent research and development** in order to limit the rights granted to the government on delivery. Be sure to use a configuration management and accounting system that accurately tracks the development and funding of this technology.

___ 12. When appropriate, **use other means of protection**, such as patent laws (35 USC §§1-376) and copyright laws (17 USC §§101-1101).

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6

Form Protective Agreements and Provisions

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I. COLLECTING BACKGROUND INFORMATION
- A. Necessary Preliminary Information §6.1
- B. Checklist: Client Interview §6.2

II. PROPRIETARY RIGHTS LEGENDS §6.3
- A. Form: Short-Form Legends §6.4
- B. Form: Long-Form Restricted Rights Legend (General Use) §6.5
- C. Form: Long-Form Restricted Rights Legend for Electronic Mail and Facsimile Transmissions §6.6
- D. Copyright Notices
  - 1. Need for Notice §6.7
  - 2. Form: Copyright Notices §6.8
- E. Federal Acquisition Regulations
  - 1. Need for Legend §6.9
  - 2. Form: Legends for Technical Data or Computer Software and Software Documentation Provided to Government §6.10
  - 3. Form: Legend Claiming Exemption From Freedom of Information Act §6.11

III. EMPLOYEE CONFIDENTIALITY AGREEMENTS §6.12
- A. Form: Short-Form Confidentiality Agreement for Interviews With Prospective Employees §6.13
- B. Form: Long-Form Confidentiality Agreement for Interviews With Prospective Employees §6.14
- C. Form: New Employee's Acknowledgment of Confidentiality Agreement §6.15
- D. Employee Confidentiality and Invention Assignment Agreement §6.16
  - 1. Form: Title and Introduction §6.17
  - 2. Form: Definitions §6.18
  - 3. Form: Effective Date §6.19
  - 4. Form: Protection of Company's Confidential Information §6.20
  - 5. Form: Noncompetition §6.21
  - 6. Form: Prior Knowledge and Relationships §6.22
  - 7. Form: Assignment of Employee Inventions §6.23
  - 8. Form: Termination of Employment §6.24
  - 9. Form: Specific Performance §6.25
  - 10. Form: Notice; Record Addresses §6.26
  - 11. Form: Amendment §6.27
  - 12. Form: Exhibits §6.28
  - 13. Form: No Waiver §6.29
  - 14. Form: Attorney Fees §6.30
  - 15. Form: Governing Law §6.31
  - 16. Form: Severability §6.32
  - 17. Form: Binding Effect §6.33
  - 18. Form: Integration §6.34
  - 19. Form: Warning of Effect of Agreement §6.35
  - 20. Form: Signature Block §6.36
  - 21. Form: Exhibit A—Prior Knowledge and Inventions §6.37
  - 22. Form: Exhibit B—Company's Written Notification of Lab C §2870 §6.38
  - 23. Form: Exhibit C—Termination Certificate §6.39

IV. TERMINATION PROCEDURES
- A. Need for Termination Procedures §6.40

B. Checklist: Exit Interview §6.41
C. Form: Letter to Former Employee §6.42
D. Form: Letter to New Employer §6.43

V. CONFIDENTIALITY AGREEMENTS WITH OUTSIDERS
A. Casual Visitors
1. Need for Visitor's Agreement and Identification Badge §6.44
2. Form: Visitor's Agreement §6.45
3. Form: Log Book Agreement Provisions §6.46
B. Preliminary Disclosures §6.47
1. Form: Bilateral Confidential Disclosure Agreement §6.48
2. Form: Unilateral Confidential Disclosure Agreement §6.49
C. Vendors and Suppliers
1. Need for Confidentiality Provisions §6.50
2. Form: Confidential Disclosure Provisions for Inclusion in Purchase Agreements and Purchase Orders §6.51
3. Form: Confidential Disclosure Provisions for Cover Sheet on Proprietary Information §6.52
D. On-Site Employees From Another Company
1. Need for Confidentiality Agreement §6.53
2. Form: On-Site Employee Confidentiality Agreement §6.54
E. Buy-Sell Agreements
1. Introduction §6.55
2. Form: Buy-Sell Agreement Clause §6.56
F. Clients
1. Introduction §6.57
2. Form: No-Hire Provision §6.58

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I. COLLECTING BACKGROUND INFORMATION

§6.1 A. Necessary Preliminary Information

When representing a company that develops, acquires, uses, or otherwise exploits trade secrets, counsel should first gather sufficient information to determine the following:

- What existing and potential trade secrets is the company, or should the company be, aware of?
- Has the company educated its employees appropriately?
- What company attitudes and procedures require correction?
- What is the company's history regarding trade secret protection procedures and problems?
- What are the names of organizations or individuals with access to trade secrets, and what are their relationships to the company?
- What is the company's organizational structure?
- What are the company's protective methods and loopholes?

See §6.2 for form of checklist the attorney can use to collect the necessary information.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.2 B. Checklist: Client Interview

§6.2 B. Checklist: Client Interview

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1. Name of client:

_____

2. Office locations:

_____

_____

3. Nature of business:

_____

_____

4. Products and services:

_____

_____

_____

5. Principal competitors:

_____

_____

_____

6. Competitive advantages over competitors for each product or service:

_____

_____

_____

7. Areas of potential trade secret claims:

_____

_____

_____

8. Plans for development of new products or services:

_____

_____

_____

9. Persons with access to trade secret information:

_____

_____

10. Level of employee education regarding identification and protection of trade secrets:

_____

_____

_____

11. Document-marking policies, premises access restrictions, restricted areas (such as for research and development), cabinet and safe-locking systems, computer network access, use of passwords, system administrator access to databases, security checks, use of design or engineering logbooks, witnessing of invention records, and monitoring of the above:

_____

_____

_____

_____

_____

_____

12. Confidentiality/invention assignment agreements with employees, consultants, visitors, suppliers, licensees, assignees, business partners, and the like:

_____

_____

_____

_____

_____

_____

13. Frequency of security operations reviews:

_____

14. Employee termination procedures:

_____

_____

_____

_____

15. History of trade secret information losses or leaks:

_____

_____

_____

_____

PRACTICE TIP: To aid in acquiring this information, the creation, location, transfer, and destruction of information within the organization should be mapped. For example, if the engineering or marketing department creates the information, where do they store it (*e.g.,* personal laptop, company-wide computer network)? When is the information transferred to a different location (*e.g.,* backups)? This will help counsel determine whether gaps exist and identify areas where inadvertent public disclosure may occur.

WARNING: This accumulation of information should be strictly controlled by counsel to preserve applicable litigation privileges and prevent its discovery in the event of any later litigation. A litigant with access to such information could spot weaknesses in an entity's trade secret protection plan, allowing it to argue that reasonable measures to maintain secrecy were not used.

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§6.3 II. PROPRIETARY RIGHTS LEGENDS

Labeling documents distributed within an organization provides, among other things, notice to insiders about proper document handling; notice to outsiders that material received without authorization should be returned and not used or disseminated; and leverage in litigation. Labeling is not necessary to maintain the trade secret status of documents; unlabeled materials still qualify as trade secrets under the California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) if they satisfy the statutory definition of "trade secrets" in the UTSA, *i.e.,* they are the subject of reasonable efforts under the circumstances to maintain secrecy. See CC §3426.1(d). See also §§1.3-1.10. Because of its advantages, though, a company should adopt a labeling policy and clearly instruct employees on how to apply such labels.

Legends on protected documents may be very brief. See forms 6.4-1 through 6.4-3. If space is available or if documents will be distributed to a limited outside audience, the company should place expanded restrictive notices on title pages, fax cover sheets, and packaging (as well as short-form legends on each page of the document) to provide further notice and protection. See forms 6.5-1 through 6.6-3.

Although many companies use several tiers of confidentiality, a multi-level classification is not recommended, because employees and others may be unclear as to the differences between the classifications and may have difficulty adhering to a complex system. Therefore, some companies use a single "Confidential" label (or up to no more than three levels of classification), eliminating subclassifications such as "Internal Use Only," "Confidential—Restricted," and "Registered."

WARNING: A company should not overdesignate materials as "confidential" or as "trade secret" (which would be, in essence, a legal conclusion). The force of each designation could be diluted if it is overused. The company should also include a statement warning that undesignated trade secrets still qualify for trade secret protection.

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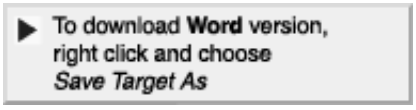
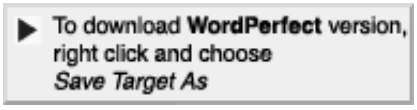
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.4 A. Form: Short-Form Legends

§6.4 A. Form: Short-Form Legends





6.4-1 Alternative: Limiting information to internal use

Proprietary Information—Internal Use Only

6.4-2 Alternative: Limiting information to need-to-know

Proprietary Information—Need-to-Know

6.4-3 Alternative: Highly confidential or restricted information

Proprietary Information—Restricted

Comment: The legends in forms 6.4-1 through 6.4-3 should be marked on each page of materials that are proprietary to the company and may be distributed to employees and others (vendors, contractors, customers) who have signed an appropriate nondisclosure agreement. Often, a company's nondisclosure agreements limit confidential information protected by the agreement to written information on which a specific legend is marked. This policy should be discouraged because unlabeled information may be excepted from the terms of the agreement. If such a provision is included in the nondisclosure agreement, the company should take care to match the form of legend actually used to the requirements of the agreement.

The legend in form 6.4-2 restricts "need-to-know" materials to employees and others who have signed nondisclosure agreements and need the information to perform their jobs. If need-to-know information is stored on a computer system network, passwords and other restrictive measures should be used to control access. See §4.25.

The "restricted" legend in form 6.4-3 is used for information that is highly sensitive and would likely cause significant, direct harm to the company if released improperly. Restricted documents should be individually stamped, numbered, and tracked to their recipients, and should not be reproduced.

See §4.22 on protective measures for photocopying.

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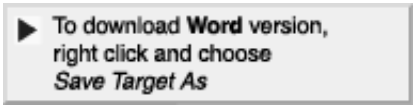
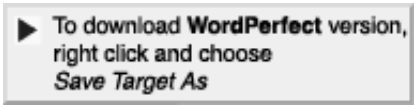
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.5 B. Form: Long-Form Restricted Rights Legend (General Use)

§6.5 B. Form: Long-Form Restricted Rights Legend (General Use)





6.5-1 Long-form restricted rights legend

This document contains proprietary information of _ _[*name of company*]_ _. Its receipt or possession does not convey any rights to reproduce or disclose its contents or to manufacture, use, or sell anything it may describe. Reproduction, disclosure, or use without specific written authorization of _ _[*name of company*]_ _ is strictly forbidden.

6.5-2 Optional addition to 6.5-1: Restriction on dissemination

This document must be kept only in _ _[*name of recipient*]_ _'s confidential files when not in use.

6.5-3 Optional addition to 6.5-1: Documents retained electronically

The recipient will take reasonable measures to prevent unauthorized access to, copying, or downloading of all or part of this document stored electronically on a networked computer system or otherwise.

Comment: This designation is more specific than that provided in the other forms. It serves several purposes:

- It satisfies any requirement that materials exchanged under a confidentiality agreement be marked as confidential or proprietary;
- It notifies and reminds the recipient of the confidentiality obligations that attach to the document;
- It notifies any unintended or second-hand recipient that the document is considered confidential by the sender;
- It constitutes one reasonable measure to maintain secrecy of information (see §§4.8-4.26 on reasonable measures generally); and
- It warns the recipient that enforceable rights or remedies might arise from the notice.

Even though the notice by itself might not be binding as a written agreement, the owner of the information is in a better position when cross-examining a recipient who ignored such a notice than when cross-examining a recipient who received an unmarked document, should litigation ensue.

See forms 6.6-1 through 6.6-3 for legend to use with electronic mail and facsimile transmissions.

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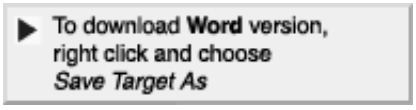
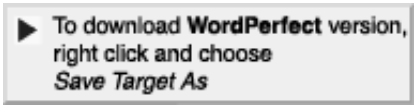
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.6 C. Form: Long-Form Restricted Rights Legend for Electronic Mail and Facsimile Transmissions

§6.6 C. Form: Long-Form Restricted Rights Legend for Electronic Mail and Facsimile Transmissions





6.6-1 Legend for electronic mail and facsimile transmissions

[__] If this box is checked, the following applies:

The messages and documents transmitted with this notice contain confidential information belonging to the sender. The information is intended only for the use of the recipient named below. If you are not the intended recipient, you are hereby notified that any disclosure, copying, distribution, or taking of any action in reliance on the contents of this information is strictly prohibited. If you have received this transmission in error, please notify the sender immediately.

6.6-2 Optional addition to 6.6-1: Limited right to copy

Any whole or partial copy, extract, or derivative work of this document will be distributed on a need-to-know basis only and will include this proprietary rights notice and any other embedded copyright notices.

6.6-3 Optional addition to 6.6-1: No right to copy

Reproduction, disclosure, or use without specific written authorization of _ _[*name of company*]_ _ is strictly forbidden. The recipient will take reasonable measures to prevent unauthorized access to, copying, or downloading of all or any part of this information stored electronically on a networked computer system or otherwise.

Comment: By providing a box that must be checked rather than applying the confidential label to all transmissions, the company may be able to avoid charges that it overdesignates all electronically transmitted materials as confidential. The danger with such a form, however, is that the transmitter may forget to check the box when appropriate. Some companies therefore implement a policy that this confidentiality legend (without the box) be applied to all transmissions that fall within certain categories. The optional language allowing a limited right to copy for internal use may be appropriate for materials provided to vendors or under license agreements.

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D. Copyright Notices

§6.7 1. Need for Notice

Copyright notices have a place in the context of unpublished and trade secret materials. Within a work—and particularly in software source code—it is common practice to repeat the copyright notice, together with additional advisories that notify the reader of any license restrictions, and to embed "telltales" to help trace copies. Placement of standard copyright notices within computer software code identifies its originator, even for code that is not published in human-readable source code form.

PRACTICE TIP: Software code that contains trade secrets may still be registered with the copyright office because copyright registration procedures do not require deposit of the entire code.

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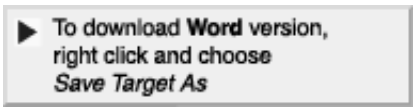
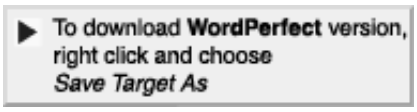
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.8 2. Form: Copyright Notices

§6.8 2. Form: Copyright Notices





6.8-1 Alternative: Short-form standard copyright legend

Copyright © _ _[*year*]_ _ _ _[*Name of holder*]_ _. All rights reserved.

6.8-2 Alternative: No copyright symbol for unpublished works

Unpublished—All Rights Reserved Under the Copyright Laws

6.8-3 Alternative: Copyright symbol for unpublished works

© _ _[*year*]_ _ _ _[*Name of holder*]_ _**. This work is unpublished, and unauthorized reproduction is prohibited. _ _**[*Name of holder*]_ _ **owns all rights to this work and intends that it be held confidential, preserved as a trade secret, and protected as an unpublished copyrighted work.**

Comment: The year, when used in the notice, should be the year in which the most recent version or edition of the work was first published.

The "All Rights Reserved" legend in forms 6.8-1 and 6.8-2 primarily applies in Honduras and Bolivia. Given the potentially global dissemination of materials over networked electronic media and wireless transmission, retaining this legend is good policy.

In an ABA committee report, Committee 402 (ABA Section of Patent, Trademark and Copyright Law, 1980 Committee Reports 218, 219) suggested that a copyright legend is not inconsistent with trade secret status but that, to avoid the inference that "©" implies publication, a company could use the language in form 6.8-3, omitting the symbol. However, the issue has not been revisited since adoption of the Berne Convention or other developments in copyright law.

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E. Federal Acquisition Regulations

§6.9 1. Need for Legend

To prevent the government from obtaining unlimited rights to technical data and computer software disclosed to the federal government under contract and to restrict the government's rights regarding such information, a company must identify the rights it will grant to the government in accordance with the Federal Acquisition Regulations (FAR), 48 CFR pts 1-53, or the Department of Defense supplements to the FAR (DFAR). Failure to do so may result in trade secret disclosure under state or federal law. For discussion of the risks and protections arising from submission of information to governmental entities, including discussion of the Freedom of Information Act (5 USC §552) and the California Public Records Act (Govt C §§6250-6270), see chap 5.

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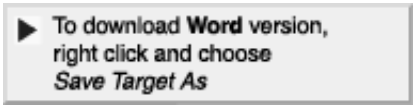
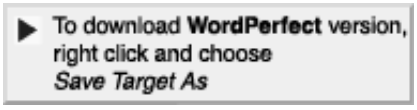
§6.10 2. Form: Legends for Technical Data or Computer Software and Software Documentation Provided to Federal Government





6.10-1 Alternative: Legend for commercial items provided to federal government

Limited and Restricted Rights. **Use, duplication, or disclosure by the U.S. Government is subject to the restrictions set forth in FAR 52.227-14(g), Rights in Data-General (December 2007), and FAR 52.227-19, Commercial Computer Software-Restricted Rights (December 2007), or, if under the Department of Defense, DFAR 252.227-7015(b), Technical Data-Commercial Items (June 2004), and DFAR 227.7202-3(a) (June 2005) in accordance with Supplier's License.**

6.10-2 Alternative: Legend for commercial software product CDs

Restricted Rights. **Use, duplication, or disclosure by the U.S. Government is subject to the restrictions set forth in FAR 52.227-14(g) (June 1987) and FAR 52.227-19 (June 1987), or in DFAR 252.227-7015(b) (June 2004) and DFAR 227.7202-3(a) (June 2005).**

6.10-3 Alternative: Legend for noncommercial items provided to federal government

Limited and Restricted Rights. **Use, duplication, or disclosure by the government is subject to Limited Rights and Restricted Rights as set forth in FAR 52.227-14, Rights in Data—General (June 1987), or, if under Department of Defense, DFAR 252.227-7013, Limited Rights in Technical Data—Noncommercial Items (June 2004) and Restricted Rights set forth in DFAR 252.227-7014, Rights in Noncommercial Computer Software and Noncommercial Software Documentation (June 2004).**

Comment: These legends apply to disclosures to the United States government. They may also apply to Foreign Military Sales (FMS) or Foreign Military Funding (FMF). Disclosures to the Department of Defense may omit the FARs and refer only to the DFARs.

For additional information, consult 48 CFR §§52.227-14 and 52.227-19 (FAR), as well as 48 CFR §§227.7202-3 and 252.227-7013—252.227-7015 (DFAR).

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.11 3. Form: Legend Claiming Exemption From Freedom of Information Act

§6.11 3. Form: Legend Claiming Exemption From Freedom of Information Act

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6.11-1 Legend claiming exemption from Freedom of Information Act

Proprietary Information. **This information was developed at private expense and includes trade secrets, commercial or financial information, or both, that is subject to exemption of 5 USC section 552(b)(4).**

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§6.12 III. EMPLOYEE CONFIDENTIALITY AGREEMENTS

A company should obtain confidentiality agreements not only from employees (see forms in §§6.15-6.39) but also from prospective employees (see forms in §§6.13-6.14). Both may be exposed to trade secret information and their actions, whether intentional or inadvertent, could threaten such trade secrets. See §4.11 for discussion of the need for confidentiality agreements for job applicants. In deciding whether to use a short-form or long-form agreement for employment interviews, the company must balance the level of protection needed (*e.g.,* interviewing for officers or department heads versus shipping clerks) against an interviewee's possible reluctance or refusal to sign a complex agreement.

PRACTICE TIP: With appropriate modifications, the confidentiality and noncompetition portions of the foregoing agreement may be used for agreements with consultants, subcontractors, suppliers, and the like. See §§10.37-10.46 for discussion of relationships, other than the employer-employee relationship, that require "reasonable efforts" to maintain the security of trade secrets. See also §§6.44-6.54 for further discussion of confidentiality agreements with outsiders.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.13 A. Form: Short-Form Confidentiality Agreement for Interviews With Prospective Employees

§6.13 A. Form: Short-Form Confidentiality Agreement for Interviews With Prospective Employees

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

INTERVIEW CONFIDENTIAL DISCLOSURE AGREEMENT

Effective Date: _ _[*date*]_ _

_ _[*Name of company*]_ _ **("Company") and** _ _[*name of applicant*]_ _ **("Applicant") agree as follows:**

1. *Relationship Between Parties.* Company is interviewing Applicant for the position of _ _[*identify position*]_ _ **and to work on the following projects:** _ _[*List projects as specifically as possible without compromising confidentiality*]_ _**. For purposes of this interview and the interview process, Company may disclose certain confidential or proprietary information of Company or its clients ("Confidential Information") to Applicant.**

2. *Confidentiality Required.* At all times during and after the interview and interview process, Applicant will keep confidential and will not make use of or disclose to any third party the Confidential Information.

3. *Confidential Information of Others.* Applicant will not use, disclose to Company, or cause Company to use any trade secret or confidential information of any other person or entity.

Date: _ _ _ _ _ _ _ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ __[*Signature of applicant*]__
Name: _ _[*Typed name*]_ _

Comment: When listing projects (see paragraph 1), counsel should do so in a manner that does not disclose details that would compromise confidentiality. Counsel must balance the need to identify the subject matter to be discussed against the threat that even naming the projects (unless code-named) could compromise a trade secret. This agreement can also be made confidential.

WARNING: Narrowly defining the position and the project may excessively limit the scope of a confidentiality agreement. For example, under copyright law, if the new employee creates software for named projects as well as unnamed projects, there is an argument that rights in software developed for the unnamed projects are retained by the new employee. To prevent this, new employees should also execute a "work made for hire" copyright assignment agreement to prevent inadvertent loss of copyright protection. For examples of such agreements, see Intellectual Property in Business Transactions, chap 8 (Cal CEB 2008); Internet Law and Practice in California, chap 4 (Cal CEB 2004).

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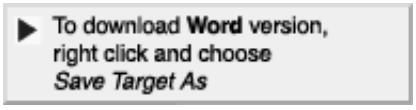
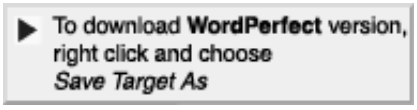
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.14 B. Form: Long-Form Confidentiality Agreement for Interviews With Prospective Employees

§6.14 B. Form: Long-Form Confidentiality Agreement for Interviews With Prospective Employees





INTERVIEW CONFIDENTIAL DISCLOSURE AGREEMENT

Effective Date: _ _[*date*]_ _

_ _[*Name of company*]_ _ **("Company") and** _ _[*name of applicant*]_ _ **("Applicant") agree as follows:**

1. *Definitions.*

a. "Confidential Information," as used in this Agreement, means information disclosed by Company to Applicant in the course of the interview and interview process and information developed or learned by Applicant while interviewing with Company. Confidential Information is to be broadly defined and includes (i) all information that has or could have commercial value or other utility in the business in which Company is engaged or in which it contemplates engaging; and (ii) all information that, if disclosed without authorization, could be detrimental to the interest of Company, whether or not such information is identified as Confidential Information by Company. By example and without limitation, Confidential Information includes all information concerning teaching techniques, processes, formulas, trade secrets, inventions, discoveries, improvements, research or development, test results, specifications, data, know-how, formats, marketing plans, business plans, strategies, forecasts, unpublished financial information, budgets, projections, and customer and supplier identities, characteristics, and agreements.

b. "Clients," as used in this Agreement, means any person or entity for whom Company performs services or from whom Company obtains information.

2. *Relationship Between Parties.* Company is interviewing Applicant for the position of _ _[*identify position*]_ _ **and to work on the following projects:** _ _[*List projects as specifically as possible without compromising confidentiality*]_ _**. For purposes of this interview and the interview process, Company may disclose certain Confidential Information to Applicant.**

3. *Confidentiality Required.* At all times during and after the interview and interview process, Applicant will keep confidential and will not make use of or disclose to any third party the Confidential Information, except as specifically authorized by Company. Applicant will not cause any Confidential Information to be transmitted, removed, or transported from Company's _ _[*principal*]_ _ **place of business.**

4. *Confidential Information of Others.* Applicant will not disclose to Company or cause Company to use trade secret or confidential information of any other person or entity. If at any time during Applicant's interview and interview process Applicant is under the opinion that such interview and interview process requires the disclosure of trade secret or confidential information of any other person or entity, Applicant will immediately inform Company and refuse to disclose such information.

5. *No Conflict.* Applicant has no agreements, relationships, or commitments to any other person or entity that conflict with Applicant's obligations to Company under this Agreement.

Date: _ _ _ _ _ _ _ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ __[*Signature of applicant*]__
Name: _ _[*Typed name*]_ _

Comment: When listing projects (see paragraph 2), counsel should do so in a manner that does not disclose details that would compromise company's confidentiality. Counsel must balance the need to identify the subject matter to be discussed against the threat that even naming the projects (unless code-named) could compromise a trade secret. This agreement can also be made confidential.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.15 C. Form: New Employee's Acknowledgment of Confidentiality Agreement

§6.15 C. Form: New Employee's Acknowledgment of Confidentiality Agreement

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STATEMENT REGARDING CONFIDENTIALITY AND INVENTION ASSIGNMENT AGREEMENT WITH _ _[*NAME OF EMPLOYEE*]_ _

Attached to this statement is your Confidentiality and Invention Assignment ("Agreement") with _ _[*name of company*]_ _ and its affiliated companies ("Company"). Please take the time to review the Agreement carefully. The Agreement contains material restrictions on your right to disclose or use during and after your employment, information learned or developed by you during your employment.

Company considers the Agreement to be vitally important to the protection of its business. Company intends to enforce the Agreement and to seek appropriate injunctions or restraining orders, as well as money damages, if you violate the Agreement.

If you have any questions about the Agreement, you may wish to consult an attorney. Company employees and agents are not authorized to give you legal advice on the Agreement.

If you have read and understood the Agreement, and if you agree to its terms and conditions, please return a fully signed and dated copy of the Agreement to Company, retaining a copy for yourself.

Reviewed, understood, and acknowledged on _ _[*date*]_ _, by:

__[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Comment: This form should accompany the Confidentiality and Invention Assignment Agreement. See forms in §§6.17-6.39. Also, a "work made for hire" copyright assignment agreement should be included. See §6.13.

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§6.16 D. Employee Confidentiality and Invention Assignment Agreement

Many states have held that confidentiality and invention assignment agreements must be made with the initial employment contract and that agreements made in consideration only of continued employment may be held void for lack of consideration. See §§2.27-2.29. In California, however, continued employment appears to be sufficient consideration for a secrecy and invention assignment agreement executed after the beginning of employment. See *Goodyear Tire & Rubber Co. v Miller* (9th Cir 1927) 22 F2d 353, 355; Hovell, *Patent Ownership: An Employer's Rights to His Employee's Invention*, 16 Intellectual Prop L Rev 93, 106 (1984). The *Goodyear* court reasoned that continued employment was sufficient consideration because the employer had no obligation to continue the employment.

The erosion of the "at will" doctrine in California suggests, however, that *some* consideration may be necessary (even if not adequate). (For discussion of theories leading to the erosion of the at-will doctrine and protection of job security, see *Gantt v Sentry Ins.* (1992) 1 C4th 1083, 4 CR2d 874, overruled on other grounds in *Green v Ralee Eng'g Co.* (1998) 19 C4th 66, 78 CR2d 16 (violation of law or public policy); *Thomka v Financial Corp.* (1993) 15 CA4th 877, 19 CR2d 382 (implied contract); and *Seubert v McKesson Corp.* (1990) 223 CA3d 1514, 273 CR 296, disapproved in part in *Dore v Arnold Worldwide, Inc.* (2006) 39 C4th 384, 394 n2, 46 CR3d 668 (breach of implied covenant of good faith and fair dealing).) Note that California law presumes consideration in written instruments. CC §1614. For further discussion of invention assignment agreements, see §2.31. Also, the agreement must not be unconscionable. On contracts of adhesion and other defenses, see §§2.30-2.32.

WARNING: Trade secret protection can be implied by law and does not necessarily require a written agreement. If a confidentiality agreement is used to protect information that does not fit the statutory definition of a trade secret and therefore is not protected as a matter of law, it must define precisely what matters are to be treated confidentially by the party signing the agreement. Courts have refused to enforce agreements when employees were not adequately placed on notice concerning the extent of their obligations to their employers. See, *e.g.*, *Motorola, Inc. v Fairchild Camera & Instrument Corp.* (D Ariz 1973) 366 F Supp 1173, 1185.

PRACTICE TIP: A company that relies heavily on trade secret protection for competitive advantage may want to have all its employees execute general confidentiality agreements to protect the company against misappropriation of its trade secrets. For certain key employees with access to particularly sensitive trade secret information, the company should consider more explicit confidentiality agreements covering the more sensitive trade secret information. The agreements will further re-emphasize for the employees the necessity of keeping such information secret and not using such information in separate businesses or for other employers. *W.L. Gore & Assocs., Inc. v Wu* (Del Ch, Sept. 15, 2006, No. 263-N) 2006 Del Ch Lexis 176.

In addition to requiring employees to execute confidentiality agreements, companies should, to the extent possible, attempt to establish fiduciary relationships with employees by title, by contract, or by other special relationship in order to impose duties of confidentiality. For example, by title, officers and directors have fiduciary obligations to their companies.

Companies should augment their efforts to maintain confidentiality of their trade secrets by means other than contracts because any contract that prohibits an individual from seeking employment is void under Bus & P C §16600. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282. Section 16600 does not appear to apply to noncontractual means of protecting secrets, such as creation of fiduciary duties. See §4.3.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.17 1. Form: Title and Introduction

§6.17 1. Form: Title and Introduction

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CONFIDENTIALITY AND INVENTION ASSIGNMENT AGREEMENT

THIS CONFIDENTIALITY AND INVENTION ASSIGNMENT AGREEMENT ("Agreement") is entered into on _ _[*date*]_ _, between _ _[*name of company*]_ _ and its affiliated companies ("Company"), and _ _[*name of employee*]_ _ ("Employee").

In consideration of Employee's employment and the compensation paid to Employee, Employee hereby acknowledges and agrees with Company as follows:

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.18 2. Form: Definitions

§6.18 2. Form: Definitions

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1. *Definitions.* As used in this Agreement, the following terms have the following definitions:

a. "Clients" means any person or entity for whom Company performs services, to whom Company sells or licenses products, or from whom Company, Employee, or both obtain information.

b. "Confidential Information" means proprietary techniques and confidential information that Company has or will develop, compile, or own, or that Company receives under conditions of confidentiality. Confidential Information includes not only information disclosed by Company (including its employees, agents, and independent contractors) or its Clients to Employee in the course of employment, but also information (including Inventions) developed or learned by Employee during the course of employment with Company. Confidential Information is to be broadly defined and includes (i) all information that has or could have commercial value or other utility in the business in which Company or Clients are engaged or in which they contemplate engaging and (ii) all information that, if disclosed without authorization, could be detrimental to the interest of Company or Clients, whether or not such information is identified as Confidential Information by Company or Clients. By example and without limitation, Confidential Information includes all information on teaching techniques, processes, formulas, trade secrets, inventions, discoveries, improvements, research or development test results, specifications, data, know-how, formats, marketing plans, business plans, strategies, forecasts, unpublished financial information, budgets, projections, and customer and supplier identities, characteristics, and agreements.

c. "Inventions" means discoveries, developments, designs, ideas, improvements, inventions, formulas, processes, techniques, know-how, and data (whether or not patentable or registrable under copyright or similar statutes) made, conceived, reduced to practice, or learned by Employee (either alone or jointly with others) during the period of employment, that (i) are related to or useful in the business of Company, (ii) result from any work performed by Employee for Company, or (iii) result from the use of premises owned, leased, or otherwise used or acquired by Company.

Comment: The term "Inventions," if not defined in the agreement, may be construed by the courts to have the plain, ordinary, and proper meaning of a patentable invention. See *Jamesbury Corp. v Worcester Valve Co.* (1st Cir 1971) 443 F2d 205. Under patent law, an idea becomes an invention only when it is reduced to a tangible form.

Identifying a trade secret with specificity (*e.g.,* buying preferences of customers) instead of making a general identification as a class (*e.g.,* customer lists) may help eliminate misunderstandings among the parties.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.19 3. Form: Effective Date

§6.19 3. Form: Effective Date

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2. *Effective Date.* This Agreement will become effective on the earlier of (i) commencement of Employee's employment with Company or (ii) the date and time at which any Confidential Information was or is first disclosed to Employee.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.20 4. Form: Protection of Company's Confidential Information

§6.20 4. Form: Protection of Company's Confidential Information

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6.20-1 Protection of company's confidential information

3. *Protection of Company's Confidential Information.*

a. At all times during and after Employee's employment, Employee will hold in trust, keep confidential, not make use of, and not disclose or reveal to any third party any Confidential Information, except in the course of Employee's employment with Company and for the benefit of Company. Employee will not cause the transmission, removal, or transport of Confidential Information or Inventions from Company's principal place of business at _ _[*address*]_ _, California, or such other place of business specified by Company, without prior written approval of _ _[*specify name or title*]_ _.

b. Employee acknowledges that the unauthorized use or disclosure of Confidential Information may be highly prejudicial to the interests of Company or its Clients, an invasion of privacy, or an improper disclosure of trade secrets.

Comment: A confidentiality agreement does not "chill former employees from voluntarily participating in legitimate investigations into alleged wrongdoing by [employers]." *In re JDS Uniphase Corp. Secs. Litig.* (2002) 238 F Supp 2d 1127. Additionally, the confidentiality agreement may not prevent the public disclosure of an employee's personal experiences while working for an employer. *Nygard, Inc. v Uusi-Kerttula* (2008) 159 CA4th 1027, 72 CR3d 210.

6.20-2 Optional addition to 6.20-1: Company policy requires prior approval for publications or presentations

c. If Employee desires to publish the results of Employee's work for Company through literature or speeches, Employee must submit such literature or speeches to _ _[*specify name or title*]_ _ at least _ _[*number*]_ _ days before dissemination of such information. Employee will not publish, disclose, or otherwise disseminate such information without the prior written approval of _ _[*specify name or title*]_ _. Whenever the approval, designation, specification, or other act of _ _[*specify name or title*]_ _ is required under this Agreement, _ _[*specify name or title*]_ _ may, by written designation, authorize an agent of Company to perform such act.

Comment: Certain equitable doctrines may restrict an employee's disclosure of the employer's trade secrets, and such disclosure may amount to an invasion of privacy. However, the employee's written acknowledgment of such restrictions provides more effective protection. See §3.5. Greater protection may be obtained by expressly asserting a privacy interest than by relying on the equitable doctrines. See Anderson & Riddle, *The Risk of Public Disclosure of Confidential Discovery Documents,* 17 CEB Civ Litigation Rep 235, 240 (Dec. 1985).

PRACTICE TIP: Counsel should use care when specifying the name or title of the company representative authorized to approve publication or private use of company information; an employee's friendly manager should not have this kind of discretion. The key goal of this provision is to notify the employee that most managers are *not* so authorized (and to include such restriction in company policy). Because the procedure for prior approval of publications could change during the course of employment, optional form 6.20-2 could be included in an employee handbook or manual instead, with a covenant in this agreement that the employee will comply with the terms of the handbook, manual, or other company policies. See *Dade Int'l, Inc. v Iverson* (MD Tenn 1998) 9 F Supp 2d 858 (employee must expressly agree to be bound by terms in employee manual for those terms to be incorporated as part of employment contract).

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.21 5. Form: Noncompetition

§6.21 5. Form: Noncompetition

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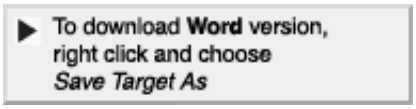

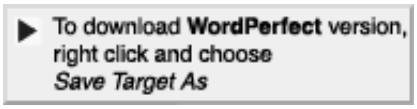

6.21-1 Noncompetition heading

4. *Noncompetition.*

6.21-2 Noncompetition during employment

a. Except with the express prior written consent of _ _[*specify name or title*]_ _, Employee will not, during the period of employment with Company, (i) engage in any employment or activity other than for Company in any business in which Company is engaged or contemplates engaging, (ii) induce any other employee of or consultant to Company to engage in any such employment or activity, or (iii) solicit any Clients or potential Clients of Company for services similar to those performed by Company, even if not directly competitive with such services.

6.21-3 Nonsolicitation after termination of employment

b. For a period of _ _[*e.g., 1 year*]_ _ immediately after termination of Employee's employment with Company, Employee will not utilize Company trade secret to interfere with Company's business by soliciting an employee to leave Company's employ, by inducing a consultant to sever the consultant's relationship with Company, or by soliciting business from any of Company's customers or clients

6.21-4 Nonsolicitation of specific client

c. During the term of employment and for a period of _ _[*e.g., 1 year*]_ _ immediately after termination of Employee's employment with Company, Employee will not utilize Company trade secret to directly solicit _ _[*insert name of one or a few significant clients of employer*]_ _ for the purpose of _ _[*insert description of goods or services being provided by employer to named clients*]_ _.

Comment: Although certain equitable doctrines hold generally that an employee may not cause harm to the employer, form 6.21-2 specifically limits the employee's ability to compete with an employer during the term of his or her employment. Even a nonemployee may be liable for aiding and abetting a breach of fiduciary duty owed to the employer. See *Neilson v Union Bank of Cal.* (CD Cal 2003) 290 F Supp 2d 1101.

California is one of the minority of states that prohibit postemployment covenants not to compete, except in the limited form of form 6.21-3 (as discussed below). See generally §§2.32-2.32D, 11.41. See, *e.g., Mattern & Assocs., LLC v Seidel* (D Del 2010) 678 F Supp 2d 256 (noncompetition clause valid when sufficient nexus exists between employee's postemployment acts and employer's legitimate business interests). In the absence of a statutory exception, the general rule is that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." Bus & P C §16600. See *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818. This general rule is subject to several statutory exceptions, but there is no "narrow restraint" or general reasonableness exception that courts may apply. *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 949, 81 CR3d 282. In *Edwards*, the court reserved without deciding the question of "the applicability of the so-called trade secret exception to §16600." 44 C4th at 946 n4.

A nonsolicitation clause prohibiting a former employee from soliciting the former employer's *clients,* such as the one in form 6.21-3, is generally enforceable *provided* that the customers' identities constitute a trade secret. *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427; *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 66 CR2d 731; *Loral Corp. v Moyes* (1985) 174 CA3d 268, 219 CR 836. See also *The Retirement Group v Galante* (2009) 176 CA4th 1226,

1238, 98 CR3d 585 (post-*Edwards* decision prohibiting misappropriation of secret customer list based on tort law rather than §16600). In the case of service professionals, companies may not be able to prevent employees from soliciting clients they personally developed. See *Smith Barney v Burrow* (ED Cal 2008) 558 F Supp 2d 1066, 1081 (industry protocol allowed former employee—a broker and financial advisor—to take information on clients he primarily developed to new business).

A nonsolicitation clause prohibiting a former employee from soliciting the former employer's *employees*, however, such as the one in form 6.21-3, will be carefully scrutinized. If the solicited employee is under contract with his or her employer, or if trade secrets are involved, the clause may not be enforceable. See *Reeves v Hanlon* (2004) 33 C4th 1140, 1155, 17 CR3d 289; *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 713, 61 CR3d 818; *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573.

WARNING: Any prohibition on the employee's ability to seek alternative employment should be limited to cover only trade secrets, because prohibitions encompassing a broader class of information, namely, confidential information, may be declared facially invalid. *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084. See also *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 102 CR3d 1. In addition to a noncompete clause being ruled unenforceable, the company may be held liable for unfair competition under Bus & P C §17200. *Applied Materials, Inc. v Advanced Micro-Fabrication Equip., supra*.

A properly drafted provision, such as form 6.21-4, may preclude an employee from soliciting business from a specific named client. *General Commercial Packaging, Inc. v TPS Package Eng'g, Inc.* (9th Cir 1997) 126 F3d 1131.

The agreement should indicate who is authorized to give consent on behalf of the employer. This power should not be left to the discretion of a friendly supervisor.

PRACTICE TIP: A company with multistate or international operations may opt to have two different form employee agreements, one with a noncompetition clause for jurisdictions in which they are enforceable and one without such a clause for California and other jurisdictions. See *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881 (noncompetition clause in employment agreement of New York company with noncompetition clause and New York choice of law provision enforced); *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73.

NOTE: For a detailed discussion of the enforceability of nonsolicitation clauses intended to prevent disclosure of confidential information by terminated employees, see Wilka, *How to Avoid Liability and Protect Trade Secrets When Hiring and Losing Employees,* 24 CEB Cal Bus L Prac 1 (Winter 2009). See also Advising California Employers and Employees §§2.60, 11.51-11.60 (Cal CEB 2005).

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§6.22 6. Form: Prior Knowledge and Relationships

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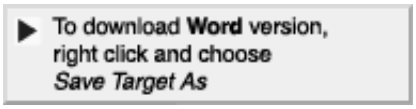

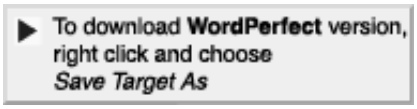

5. ***Prior Knowledge and Prior Relationships.***

a. Except as disclosed in Exhibit A, Employee has no knowledge of any of the Confidential Information other than information Employee has learned from Company.

b. Employee has disclosed in Exhibit A a complete list of all Inventions that are proprietary to Employee and that Employee wants to exclude from the application of this Agreement. Company will receive and hold all such disclosures in confidence.

c. Employee has no agreements, relationships, or commitments to any other person or entity that conflict with or would prevent Employee from performing any of Employee's obligations to Company under this Agreement.

d. Employee will not disclose to Company, use, or induce Company to use any proprietary information or trade secrets of others. Employee represents and warrants that Employee has returned all property and confidential information belonging to all others.

Comment: This provision and the exhibits provide an estoppel argument for the company if a question arises about ownership of information by giving the employee an opportunity to exclude from protected confidential information any information known before employment has begun. This provision also refers to noncompetition and confidentiality agreements that the employee may have with former employers, thus alerting the company to potential restrictions facing the employee and emphasizing to employees that they are not to violate their duties and obligations to others. These provisions help protect the company from potential claims made by previous employers. Such language is good evidence of nonwillfulness if a former employer later brings suit. For any of the employee's proprietary inventions that may become incorporated in the employee's work for the company, the company may want to consider negotiating for a nonexclusive, royalty-free license.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.23 7. Form: Assignment of Employee Inventions

§6.23 7. Form: Assignment of Employee Inventions

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6. *Assignment of Employee Inventions.*

a. Employee will promptly disclose in writing to Company all Inventions.

b. All Inventions belong to and are the sole property of Company and will be Inventions of Company subject to this Agreement. Employee will assign and does hereby assign to Company all right, title, and interest Employee may have or may acquire in and to all Inventions. Employee shall sign and deliver to Company (during and after employment) any other documents that Company considers desirable to provide evidence of (i) the assignment of all rights of Employee, if any, in any Inventions and (ii) Company's ownership of such Inventions. For a period of 1 year after termination of employment, Employee will assign and does hereby assign all inventions to Company to the extent that such inventions are based on confidential information or trade secrets of Company.

c. Any provision in this Agreement requiring Employee to assign rights to an Invention does not apply to any invention that qualifies under California Labor Code section 2870, which is reprinted in its entirety in Exhibit B.

d. Employee will assist Company in applying for, prosecuting, obtaining, or enforcing any patent, copyright, or other right or protection relating to any Invention, all at Company's expense but without consideration to Employee in excess of Employee's salary or wages. If Company requires any assistance after termination of Employee's employment, Employee will be compensated for time actually spent in providing that assistance at an hourly rate equivalent to Employee's salary or wages during the last period of employment with Company.

e. If Company is unable to secure Employee's signature on any document necessary to apply for, prosecute, obtain, or enforce any patent, copyright, or other right or protection relating to any Invention, whether due to Employee's mental or physical incapacity or any other cause, Employee hereby irrevocably designates and appoints Company and each of its duly authorized officers and agents as Employee's agent and attorney-in-fact, to act for and in Employee's behalf to execute and file any such document and to do all other lawfully permitted acts to further the prosecution, issuance, and enforcement of patents, copyrights, or other rights or protections, with the same force and effect as if executed and delivered by Employee.

f. All original works of authorship created for employer shall be considered works made for hire. To the extent any work is not a work made for hire, the copyright in such work shall be and is hereby assigned to employer.

Comment: Without a requirement that "all" inventions be reported and assigned to the company, whether or not considered patentable by the employee, the employee may be held to own or at least to have a license in ideas and suggestions rejected by the employer. See *Grepke v General Elec. Co.* (7th Cir 1960) 280 F2d 508; *B.F. Gladding & Co. v Scientific Anglers, Inc.* (6th Cir 1957) 248 F2d 483. However, Lab C §2870 prevents an employer from requiring an employee to assign to the employer the rights to certain inventions. For an invention assignment agreement to be enforceable, the employer *must* give the employee written notice of the provisions of Lab C §2870. Lab C §2872. See form in §6.38 for text of Lab C §2870.

PRACTICE TIP: The invention assignment provisions of paragraph b regarding termination of employment should be narrowly tailored to protect the company's trade secrets. Otherwise, a court may strike down the provisions without reforming them. Moreover, the company may be liable for unfair competition under Bus & P C §17200.

PRACTICE TIP: Companies often need the assistance of an inventor years after termination of employment. Paragraph d. creates a contractual obligation on the employee's part to provide that assistance. The power of attorney provision in paragraph e. assists the company if it is unable to locate the needed employee.

PRACTICE TIP: Include the "work made for hire" assignment clause in paragraph f because many engineers hired to invent also create documentation (*e.g.,* mechanical drawings) protectable by copyright.

WARNING: When contracting with an independent contractor, companies should ensure that any invention assignment provision is entered into directly with the independent contractor as well as the company through which the independent contractor is hired. Otherwise, the invention assignment provision, for lack of privity, may not operate to assign the independent contractor's inventions to the company. See generally *ViChip Corp. v Lee* (ND Cal 2006) 438 F Supp 2d 1087.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.24 8. Form: Termination of Employment

§6.24 8. Form: Termination of Employment

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7. *Termination of Employment.*

a. Employment and compensation can be terminated, with or without cause, and with or without notice, at any time, at the option of Company or the Employee. Nothing in this Agreement will limit or otherwise alter the foregoing.

b. If Employee's employment with Company is terminated for any reason, Employee shall promptly and without request (i) inform Company of and deliver to Company all documents and data pertaining to Employee's employment (*e.g.,* software and standard forms) and the Confidential Information and Inventions, whether prepared by Employee or otherwise coming into Employee's possession or control, and (ii) sign the Termination Certificate in Exhibit C. Employee shall not retain any written or other tangible material containing any information concerning or disclosing any Confidential Information or Inventions.

c. If Employee's employment with Company is terminated for any reason, Employee will protect the value of the Confidential Information and Inventions and will prevent their misappropriation or disclosure. Employee will not disclose or use any Confidential Information or Inventions for Employee's benefit or the benefit of any third party, or to the detriment of Company or its Clients.

d. Employee recognizes that the unauthorized taking of any of Company's trade secrets is a crime under California Penal Code section 499c, punishable by imprisonment for a time not exceeding one year, by a fine not exceeding $5000, or both. Employee further recognizes that such unauthorized taking of Company's trade secrets could also result in civil liability under the California Uniform Trade Secrets Act (Civil Code sections 3426-3426.11), and that willful misappropriation may result in an award against Employee for triple the amount of Company's damages and Company's attorney fees in collecting such damages.

Comment: Given the erosion of the employment-at-will doctrine, it should be made clear to the employee that this agreement does not alter the fact that employment is subject to cessation at any time. To ensure that any employee agreement will be construed as an at-will employment agreement, it is important to communicate to the employee that the employer-employee relationship may be terminated "at will" and to include that language in any agreements or correspondence with the employee or job applicant.

The warning regarding potential civil and criminal liability for misappropriation in paragraph d. of this form, informing the employee of the real risks of misappropriation, can be used in litigation to establish two key factors in trade secret enforcement: the employee's awareness of the trade secret nature of the information and the company's efforts to maintain secrecy. However, such a warning could be viewed by a jury as overbearing and may impede any efforts to initiate a harmonious company-employee relationship.

This provision and the accompanying termination certificate serve to verify that the employee leaves behind the tangible evidence of the trade secrets of the company and its clients. The termination certificate is a written reminder to the departing employee of the duty to protect the confidentiality of the trade secrets of the company and its clients. Note that an employee might refuse to sign a termination certificate if the employer did not so require in the employment agreement.

Section 7.b.i above broadens the documents that employees must return to a company on the termination of employment. These documents include easily reproducible information (*e.g.,* software or standard forms) created by the company that is not confidential or a trade secret. For software and standard forms, the company should consider copyright registration as a relatively inexpensive means of protection.

WARNING: Termination without cause may prevent enforcement of restrictive employment covenants. *UFG Int'l, Inc. v Nisselson, Trustee of UFG Int'l, Inc.* (SD NY 1998) 225 BR 51.

PRACTICE TIP: During the exit interview, specifically list trade secret information (*e.g.,* customer information, formulas) that the employee is expected to keep secret from future employers and not to use to compete with the former employer. This practice further demonstrates reasonable efforts to maintain such information as trade secrets and may indirectly educate existing employees regarding information that the company considers a trade secret (if the departing employee speaks to his or her former colleagues). See §6.42.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.25 9. Form: Specific Performance

§6.25 9. Form: Specific Performance

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8. *Specific Performance.*

a. Because Employee's breach of this Agreement may cause Company irreparable harm for which money is inadequate compensation, Company will be entitled to injunctive relief to enforce this Agreement, in addition to damages and other available remedies.

b. Employee acknowledges and agrees that the protections set forth in this Agreement are a material condition to employment with and compensation by Company.

Comment: If an employee breaches the confidentiality agreement, the company will want to bring an immediate action for specific performance and to move for temporary and permanent injunctions, as long as the company can satisfy the requirements for such relief.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.26 10. Form: Notice; Record Addresses

§6.26 10. Form: Notice; Record Addresses

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6.26-1 Alternative: Long-form notice; record addresses

9. *Notices.* Any notice, report, or statement required or permitted under this Agreement will be considered to be given or transmitted when sent by _ _[*e-mail or by*]_ _ certified mail, postage prepaid, addressed to the party for whom it is intended at its address of record; by facsimile, which notice will be effective on computer confirmation of receipt; or by courier or messenger service, which notice will be effective on receipt by recipient as indicated on the carrier's receipt. The record addresses of the parties are as follows:

Company:

_ _[*Name of company*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Employee:

_ _[*Name*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

6.26-2 Alternative: Short-form notice; record addresses

9. *Notices.* Any notice required or permitted under this Agreement will be deemed given on delivery to the party to whom it is intended at its address of record. The record addresses of the parties are as follows:

Company:

_ _[*Name of company*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Employee:

_ _[*Name*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Comment: Although the notice provision does not specifically require it, a prudent sender will obtain receipts for any notices sent. Because e-mail is easily deleted or forgotten, an employer should carefully consider what types of notice may be given via e-mail.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.27 11. Form: Amendment

§6.27 11. Form: Amendment

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10. *Amendment.* This Agreement may be supplemented, amended, or modified only by the mutual written agreement of the parties. No supplement, amendment, or modification of this Agreement will be binding unless it is in writing and signed by both parties.

Comment: Agreements should be written. Relying on oral agreements may result in an unintended oral modification of the contract.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.28 12. Form: Exhibits

§6.28 12. Form: Exhibits

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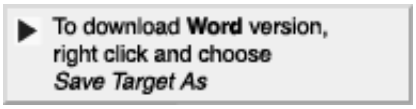

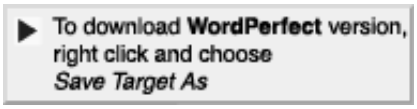

11. *Exhibits.* The following agreements and exhibits constitute a part of this Agreement and are incorporated into this Agreement by this reference:

Exhibit A—Prior Knowledge and Inventions

Exhibit B—Company's Written Notification to Employee of Labor Code section 2870

Exhibit C—Termination Certificate

If any inconsistency exists or arises between a provision of this Agreement and a provision of any exhibit, the provisions of this Agreement will prevail.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.29 13. Form: No Waiver

§6.29 13. Form: No Waiver

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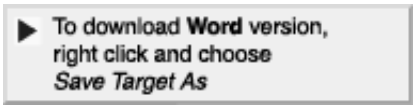

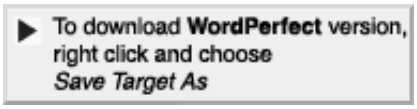

12. *No Waiver.* No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.30 14. Form: Attorney Fees

§6.30 14. Form: Attorney Fees

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13. *Attorney Fees.* In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

Comment: Generally, including an attorney fees provision is not in the company's interest. Fees are rarely recoverable and the "lottery incentive" of such a provision might encourage suits by former employees.

NOTE: A court may award reasonable attorney fees and costs to the prevailing party if (1) a claim of misappropriation is made in bad faith, (2) a motion to terminate an injunction is made or resisted in bad faith, or (3) the misappropriation was willful and malicious. CC §3426.4. A sufficient showing of "bad faith" under CC §3426.4 requires objective speciousness (as distinct from frivolousness) of the plaintiff's claim, and an improper purpose, *i.e.,* subjective bad faith, in bringing or maintaining the claim. An improper purpose will be found when a party acts with the intent to cause unnecessary delay or to harass the opposing side. *Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 116 CR2d 358. Parties could agree to arbitrate matters related to statutory rights (*e.g.,* prompt payment of wages) if the arbitration meets certain minimum requirements deemed essential for the employee to vindicate such statutory rights. *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.31 15. Form: Governing Law

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14. *Governing Law.* This Agreement, and any dispute arising from the relationship between the parties to this Agreement, shall be governed and determined by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of the law of another jurisdiction. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) shall be resolved in _ _[*type of court, e.g., a superior court*]_ _ in _ _[*county, state*]_ _, and the parties expressly waive any right they may otherwise have to cause any such action or proceeding to be brought or tried elsewhere.

Comment: The parties may each wish to limit the right of the other to litigate the terms of the trade secret license agreement to the courts, as well as the laws, of a particular state. Choice of law provisions are usually respected by California courts, and California's policy of providing access to California courts for resident plaintiffs is satisfied when the plaintiff has negotiated away the right to a California forum. Problems can arise if the parties select the laws of a foreign country to govern a trade secret agreement. When the parties agree that the law of a foreign country will prevail, the court assumes that the foreign law is similar to American law in the absence of evidence about that law. If evidence establishes that the foreign country has a strong public policy relating to a contested matter, the court will apply that policy, if possible. *Victor Equip. Co. v Armco Steel Corp*. (ND Tex 1980) 208 USPQ 434, 439. See *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330 (choice of law clause specifying that Hong Kong law would govern contract was enforceable). See also *Medimatch, Inc. v Lucent Technols., Inc.* (ND Cal 2000) 120 F Supp 2d 842 (federal district court in California court applied New Jersey law). The court will do so, however, only if the choice of law provision does not violate the fundamental public policies of California. *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 103 CR2d 320. Compare *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699 (choice of forum clause unenforceable because Consumer Legal Remedies Act (CC §§1750-1756) contains provision that waiver of right to choice of forum is void as contrary to California public policy), with *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 135 CR2d 149 (choice of forum clause enforceable because California's unfair competition law has no provision that waiver of right to choice of forum is void as contrary to California public policy). See *Google, Inc. v Microsoft Corp.* (ND Cal 2005) 415 F Supp 2d 1018 (motion for stay granted because colorable argument exists that California's interests in adjudicating validity of covenant not to compete exceeds Washington's interest). For a general discussion of choice of law and choice of forum issues, see Drafting Business Contracts: Principles, Techniques & Forms §§16.53-16.56 (Cal CEB 1994).

WARNING: The modern trend is toward enforcement of choice of forum clauses. See *Air Ion Devices, Inc. v Air Ion, Inc.* (ND Cal 2002) 2002 US Dist Lexis 12456; *Alexander v Superior Court* (2003) 114 CA4th 723, 8 CR3d 111; *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330. Limitations of venue may still be unenforceable in California, however, and an attempt to limit venue may invalidate a clause limiting jurisdiction. See *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 495, 131 CR 374; *General Acceptance Corp. v Robinson* (1929) 207 C 285, 277 P 1039. See also California Civil Procedure Before Trial, chaps 6, 8 (4th ed Cal CEB 2004). See generally *Alexander v Superior Court* (2003) 114 CA4th 723, 8 CR3d 111.

PRACTICE TIP: A forum-selection clause in a confidentiality agreement can be enforced if the entire agreement is supported by consideration. *Fleming & Hall Ltd. v Cope* (D Del 1998) 30 F Supp 2d 459; *Forrest v Verizon Communications, Inc.* (2002) 805 A2d 1007. See §2.28. However, such a clause may not provide for exclusive jurisdiction if it is in the interests of justice to favor some other forum. *Jackson v West Telemarketing Corp. Outbound* (5th Cir 2001) 245 F3d 518; *ZPC 2000, Inc. v SCA Group, Inc.* (SD NY 2000) 86 F Supp 2d 274.

CAUTION: The choice of law may determine whether noncompete clauses and other clauses are valid. See Comment in §6.21.

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§6.32 16. Form: Severability

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15. *Severability.* Any provision of this Agreement that in any way contravenes the law of any state or country in which this Agreement is effective will, in that state or country, to the extent the law is contravened, be considered separable and inapplicable and will not affect any other provision or provisions of this Agreement _ _[*, unless an essential purpose of this Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _**.**

PRACTICE TIP: Certain terms of an agreement with an employee are more likely to be struck down, *e.g.,* arbitration clauses. Potentially unenforceable clauses should be included in an agreement with a central purpose unrelated to those provisions so that they may be severed. Courts will then be more willing to sever the unenforceable or invalid terms and permit the remainder of the agreement to be enforced. See *Dunham v Environmental Chem. Corp.* (ND Cal, Aug. 16, 2006, No. C 06-03389 JSW) 2006 US Dist Lexis 61068. See generally California Law of Contracts §§5.70-5.71 (Cal CEB 2007).

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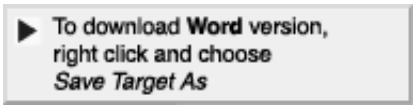

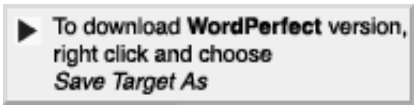

16. *Binding Effect.* This Agreement will inure to the benefit of and be binding on the successors and assigns of Company and Employee.

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§6.34 18. Form: Integration

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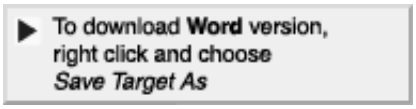

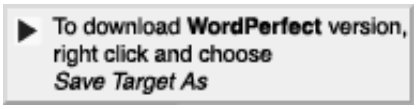

17. *Integration*. This Agreement _ _[*, the employment agreement between Employee and Company of* _ _[*date*]_ _,]_ _ **and all other agreements and exhibits referred to in this Agreement constitute the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this Agreement and supersede all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.**

WARNING: The court may or may not allow parol evidence to be admitted to show that a certain term of an employee agreement is ambiguous. See *Dore v Arnold Worldwide, Inc.* (2006) 39 C4th 384, 390, 392, 46 CR3d 668 (plaintiff's extrinsic evidence inadmissible; no "ambiguity per se" in at-will termination provision).

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.35 19. Form: Warning of Effect of Agreement

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CAUTION: THIS AGREEMENT AFFECTS YOUR RIGHTS TO INVENTIONS YOU MAKE DURING YOUR EMPLOYMENT AND RESTRICTS YOUR RIGHT TO DISCLOSE OR USE COMPANY'S CONFIDENTIAL INFORMATION DURING OR AFTER YOUR EMPLOYMENT.

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§6.36 20. Form: Signature Block

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EMPLOYEE HAS READ THIS AGREEMENT CAREFULLY AND UNDERSTANDS ITS TERMS. EMPLOYEE HAS COMPLETELY FILLED OUT EXHIBIT A AND HAS RECEIVED A COPY OF EXHIBIT B, WHICH IS THE WRITTEN NOTIFICATION TO EMPLOYEE CONTAINING CALIFORNIA LABOR CODE SECTION 2870.

Date: _ _ _ _ _ _ __[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Date: _ _ _ _ _ _ _ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.37 21. Form: Exhibit A--Prior Knowledge and Inventions

§6.37 21. Form: Exhibit A—Prior Knowledge and Inventions

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EXHIBIT A

PRIOR KNOWLEDGE AND INVENTIONS

1. I acknowledge that I know nothing about the Confidential Information or Inventions other than the following information that has been disclosed to me by Company or its Clients (if none, so state): _ _[*Specify*]_ _**.**

2. I acknowledge that I have not conceived, made, or reduced to practice (alone or jointly with others) any Inventions other than the following, which are excluded from application of this Agreement (if none, so state): _ _[*Specify generally to avoid disclosure of another's confidential information*]_ _**.**

3. I acknowledge that I have no other current or prior agreements, relationships, or commitments that conflict with this agreement or with my relationship with Company other than the following: _ _[*Specify, and, if none, so state*]_ _.

Date: _ _ _ _ _ _ __[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Comment: Before enactment of the UTSA, California courts distinguished between (a) trade secrets that an employee did not previously know, that he or she learned because of his or her employment, and that were developed by other persons; and (b) matters that the employee personally developed. *Rigging Int'l Maintenance Co. v Gwin* (1982) 128 CA3d 594, 180 CR 451; *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 288, 23 CR 198 (adopting holding in *Wexler v Greenberg* (Pa 1960) 160 A2d 430). The UTSA does not discuss any such distinction.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.38 22. Form: Exhibit B--Company's Written Notification of Lab C §2870

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EXHIBIT B

COMPANY'S WRITTEN NOTIFICATION TO EMPLOYEE OF LABOR CODE SECTION 2870

In accordance with California Labor Code section 2872, you are hereby notified that your Confidentiality and Invention Assignment Agreement does not require you to assign to Company any Invention for which no equipment, supplies, facility, or trade secret information of Company was used and that was developed entirely on your own time, and does not relate to the business of Company or to Company's actual or demonstrably anticipated research or development, or does not result from any work performed by you for Company.

The following is the text of California Labor Code section 2870:

"(a) Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information except for inventions that either:

(1) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer; or

(2) Result from any work performed by the employee for the employer.

(b) To the extent a provision in an employment agreement purports to require an employee to assign an invention otherwise excluded from being required to be assigned under subdivision (a), the provision is against the public policy of this state and is unenforceable."

I hereby acknowledge receipt of this written notification.

Date: _ _ _ _ _ _ __[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Comment: Labor Code §2872 requires an employer to provide in an invention assignment agreement a written notification to the employee that the agreement does not apply to inventions defined in Lab C §2870.

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§6.39 23. Form: Exhibit C—Termination Certificate

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EXHIBIT C

TERMINATION CERTIFICATE

I hereby certify that I have complied with and will continue to comply with all the terms of the Confidentiality and Invention Assignment Agreement of _ _[*date*]_ _ ("Agreement"), which I signed, including the prompt reporting of all Inventions conceived or made by me that are covered by the Agreement. All capitalized terms used but not defined in this certificate will have the meanings ascribed to them in the Agreement.

I further certify that I do not have in my possession, nor have I failed to return, any Confidential Information or copies of such information, or other documents or materials, equipment, or other property belonging to Company or its Clients.

I agree that, in compliance with the Agreement, I will preserve as confidential and not use any Confidential Information, Inventions, or other information that has or could have commercial value or other utility in the business in which Company or its Clients are engaged or in which they contemplate engaging. I will not participate in the unauthorized disclosure of information that could be detrimental to the interests of Company or its Clients, whether or not such information is identified as Confidential Information by Company or its Clients.

On termination of my employment with Company, I will be employed by _ _[*name of new employer*]_ _ in its _ _[*specify*]_ _ Division and will be working in connection with the following projects: _ _[*Generally describe projects*]_ _.

Date: _ _ _ _ _ _ __[*Signature of employee*]__

Name: _ _[*Typed name*]_ _

PRACTICE TIP: At the exit interview, the departing employee should sign the termination certificate, a copy of which should be attached to the confidentiality agreement. Depending on the company and the individual employee's access to confidential information, a more specific termination certificate may be appropriate to list categories of information to which the employee had access, *e.g.,* "'Business Information,' including customer and vendor contracts and their preferences and plans, business and new product plans, financial data, marketing data, personnel information, including compensation and organization charts," or "'Technical Information,' including specific product designs, capabilities of production, and patent applications."

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IV. TERMINATION PROCEDURES

§6.40 A. Need for Termination Procedures

Whenever possible, a company should have specifically trained personnel conduct an exit interview for a terminating employee. The exit interview checklist in §6.41 will aid in conducting the interview, which may be the company's last chance to protect its trade secrets and gather valuable information. At the interview, the company should review with the departing employee the termination certificate attached to the Confidentiality and Nondisclosure Agreement signed by the employee in connection with employment (see §6.39), impressing on the employee the obligation to maintain the confidentiality of the company's trade secrets. If the employee did not previously agree to sign a termination certificate, the company should request a separation agreement that addresses substantially the same information. As a follow-up to the exit interview, the company might send a letter reminding the former employee of the confidentiality obligations to the company, which continue after termination. See §6.42. The company may also send a letter informing the new employer that the former employee signed a confidentiality agreement; if it does so, a copy of the letter should also be sent to the former employee. See §6.43.

For further discussion of termination procedures, see §§4.13-4.15, 10.42.

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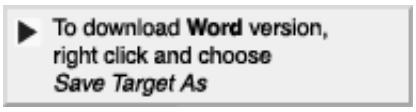
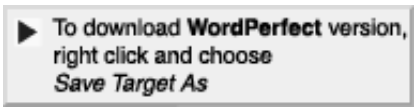
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.41 B. Checklist: Exit Interview

§6.41 B. Checklist: Exit Interview





EXIT INTERVIEW CHECKLIST

Interview employee's supervisor:

- What specific trade secrets did the employee have access to?
- Are there any documents, notes, equipment, etc., that the employee has not returned?
- Is the employee working on a project that requires his or her continued employment or consultation?
- Will the employee's resignation cause any harm to the company?
- What projects did the employee work on?
- Did any previous projects involve working with a competitor?
- Before resignation:
- What was the attitude of the employee?
- Was the employee taking home more work than usual?
- Did the employee request to take any documents home?
- Did the employee use copy machines more than usual?
- Did the employee work evenings, weekends, or other times when other employees weren't present?
- Did the employee begin to associate more with certain employees than others? (This may point to other potential defections.)

Ascertain why employee is leaving:

- If the employee has received another offer:
- From whom did he or she receive the offer?
- How did the employee receive the offer?
- Is the employee aware of offers made to other employees?
- What will the employee's new job description entail?
- Is the employee being hired for a specific project? (Elicit only general information so as not to violate another's trade secrets.)
- Will the employee's new job put him or her in a position in which trade secrets may be disclosed? (If the employee says no, ask why not.)
- Has the new employer discussed potential trade secret disclosure? What is the new employer doing to ensure nondisclosure?
- If the employee is going to form a "start-up" company:
- What is the nature of the "start-up"?
- Has the employee discussed the "start-up" with other employees? (This is an excellent opportunity to remind the employee of his or her contractual obligation not to solicit company employees.)
- Is the employee's "start-up" an appropriate venture for your company as an investment, joint venture, etc.?
- If the employee is leaving because of dissatisfaction with his or her current position:
- Why is he or she dissatisfied?

- What changes would the employee suggest?
- Are other employees dissatisfied?
- What are the other employees' suggestions for change?
- Will the employee be available as a consultant to finish up projects?

Review original Confidentiality Agreement and termination documents with employee:

- Impress on the employee the continuing obligation to maintain the confidentiality of the company's trade secrets.
- Remind the employee that the company's trade secrets are not only written documents but may also be the employee's mental impressions.
- Stress the company's need to enforce the confidentiality of trade secrets.
- Have the employee sign the Termination Certificate and review it with him or her.
- Attach a copy of the Termination Certificate to the Confidentiality Agreement.
- Have the employee sign the Notification to Employee Pursuant to Lab C §2870.

Return of company property:

- Explain to the employee that "company property" includes sketchbooks, engineering notebooks, keys, badges, business plans, customer lists, laptops, computer disks, flash drives, etc.

NOTE: If the company will rely on a checklist to ensure the return of company property, ensure that the checklist is up to date and covers all property items.

- If any company property has not yet been returned, obtain the property then or make specific arrangements for its return.
- Have another employee present during the departing employee's packing of his or her former office.
- Inventory the items taken by the departing employee from the office.

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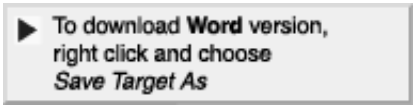
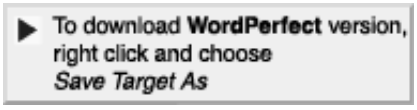
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.42 C. Form: Letter to Former Employee

§6.42 C. Form: Letter to Former Employee





Dear _ _[*name of employee*]_ _:

Your termination from _ _[*name of company*]_ _ makes it necessary to note that while you were with _ _[*name of company*]_ _ you had occasion to acquire and generate knowledge and information about our business and the businesses of our clients, which we keep confidential or proprietary to protect its competitive value. We consider this information to be proprietary within the meaning of our Confidentiality and Invention Assignment Agreement ("Agreement") of _ _[*date*]_ _.

As you recall, your responsibilities in protecting the confidential information and inventions of _ _[*name of company*]_ _ and its clients are defined in the Agreement. A copy of the Agreement is attached for your convenience.

Without in any way limiting your obligations under the Agreement, let me mention certain areas by way of example that will require particular attention: _ _[*e.g., product formulas, customer lists, source codes pertaining to products, product designs and specifications, patent applications and disclosures, facilities, personnel data, marketing strategies for new products*]_ _.

I wish to remind you that without express written permission, you were not authorized to take any such documents or records with you when you left, and no such permission was given. You may not use any of _ _[*name of company*]_ _'s confidential information for any purpose, including its use in connection with any of your or others' business activities, and you may not in any other way use it to the disadvantage of _ _[*name of company*]_ _. By way of example and not limitation, do not communicate the _ _[*company name*]_ _'s confidential information to your new employer for any reason. Moreover, do not solicit our customers for business.

Please feel free to contact _ _[*name*]_ _ if you have any questions about your obligations under the Agreement.

Sincerely,
_ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

WARNING: Great care must be taken in drafting such letters so as not to unlawfully threaten the former employee. See §4.14.

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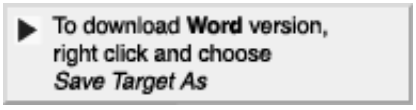
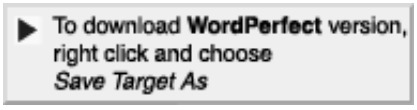
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.43 D. Form: Letter to New Employee

§6.43 D. Form: Letter to New Employee





Dear _ _[*name of president of new employer*]_ _:

We understand that our former employee, _ _[*name*]_ _, has accepted employment with your company. This letter is to advise you that _ _[*name of employee*]_ _ signed a confidentiality agreement with our company that remains in full force and effect. At the time _ _[*name of employee*]_ _ left our company, we advised _ _[*him/her*]_ _ of _ _[*his/her*]_ _ continuing obligations under the confidentiality agreement. A copy of the letter to _ _[*name of employee*]_ _ of _ _[*date*]_ _, is enclosed so that any conflict with these obligations can be avoided during _ _[*his/her*]_ _ employment with you.

Sincerely,
_ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

cc: _ _[*Name of employee*]_ _

WARNING: As in the letter to the former employee, great care must be exercised in drafting letters to new employers. See §4.15.

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V. CONFIDENTIALITY AGREEMENTS WITH OUTSIDERS

A. Casual Visitors

§6.44 1. Need for Visitor's Agreement and Identification Badge

Low-level business contacts, interviewees, employees' friends and family, and other visitors who have access to a facility could jeopardize any trade secrets they may observe there. Therefore, they should be required to sign a visitor's confidentiality and nondisclosure agreement before being admitted to company premises where trade secrets are held. See §6.45. The agreement, together with a visitor's badge, provides notice to the visitor that he or she may be exposed to confidential information, obtains the visitor's agreement to protect that confidentiality, and identifies the escorted person for the company's employees as an outside visitor.

Depending on the nature of information at issue, the exposure a visitor would have to trade secrets, and the likelihood that a visitor would refuse to sign an agreement such as the one in §6.45, the company could decide to use a simpler method of obtaining a confidentiality agreement. All visitors could be required to sign a log book before entering the premises, with each page of the book headed by language identifying confidentiality obligations. See §6.46. All visitors should also wear visitors' badges so that employees are aware of their status as outsiders.

NOTE: Available technology can provide instant photo badges with the date prominently displayed.

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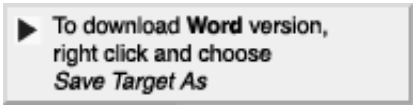
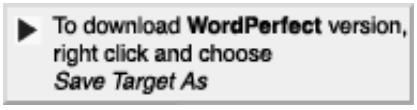
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.45 2. Form: Visitor's Agreement

§6.45 2. Form: Visitor's Agreement





__ Classified Visit **__ Unclassified Visit**

Your signature below indicates that you have read the following Confidentiality And Nondisclosure Agreement and, in consideration of being admitted to the facilities of _ _[*name of company*]_ _, have agreed to abide by its terms:

CONFIDENTIALITY AND NONDISCLOSURE AGREEMENT

1. "Proprietary Information" means technical and business information describing or relating to the activities of _ _[*name of company*]_ _ that it either has generated at private expense and holds in confidence or has received from third parties under an obligation to maintain as confidential.

2. Visitor will use the Proprietary Information only for purposes expressly authorized in writing by _ _[*name of company*]_ _.

3. Visitor will not:

a. Disclose the Proprietary Information to any third party;

b. Remove any document, equipment, or other materials from the premises;

c. Record by photograph, tape, or any other means any Proprietary Information observed or received by Visitor; or

d. Use the Proprietary Information for Visitor's own use.

4. Visitor will not expose _ _[*name of company*]_ _ to any of Visitor's proprietary or confidential information or to the confidential or proprietary information of any third party.

5. The terms of any confidentiality, nondisclosure, or similar written agreement previously executed by _ _[*name of company*]_ _ and Visitor (or Visitor's employer), if any, will prevail over the terms of this Agreement.

Date: _ _ _ _ _ _ __[*Signature of visitor*]__
Name: _ _[*Typed name*]_ _

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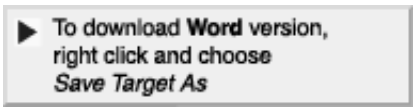
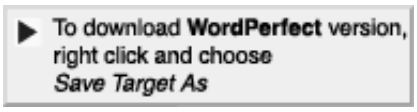
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.46 3. Form: Log Book Agreement Provisions

§6.46 3. Form: Log Book Agreement Provisions





In consideration of being admitted to the facilities of _ _[*name of company*]_ _ ("Company"), the undersigned agrees not to disclose any technical or business information describing or relating to Company's activities that Company has generated at private expense and holds in confidence or that Company has received from third parties under an obligation to maintain as confidential ("Proprietary Information"); remove any document, equipment, or other materials from the premises; record by any means any information received by the undersigned; or use the Proprietary Information for the benefit of anyone other than Company.

Name	Person Visiting	Time in	Time out
_____	_____	_____	_____

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.47 B. Preliminary Disclosures

§6.47 B. Preliminary Disclosures

Companies must often make preliminary disclosures of confidential information for evaluation purposes, *e.g.,* to evaluate potential business partners, licensing arrangements, joint developments, high-level job applicants, or highly technical job applicants. The company should not disclose any information unless the recipient of the information first signs an agreement agreeing that disclosures and use of confidential information will be made for specific purposes only. See forms in §§6.48-6.49. See also forms in §§6.13-6.14, which specifically address a job applicant's confidentiality obligations.

Before agreeing to sign such an agreement, the recipient must decide the following questions:

- Does he or she want to be exposed to the confidential information?
- What individuals within the recipient's organization should be exposed to the information?
- If the recipient is already working in the same area, should it so inform the discloser? See *Den-Tal-Ez, Inc. v Siemens Capital Corp.* (Pa Super Ct 1989) 566 A2d 1214.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.48 1. Form: Bilateral Confidential Disclosure Agreement

§6.48 1. Form: Bilateral Confidential Disclosure Agreement

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CONFIDENTIAL DISCLOSURE AGREEMENT

Effective Date: _ _[*date*]_ _

_ _[*Name of company*]_ _ **("Company") and** _ _[*name of other party*]_ _ **("Party") agree that:**

1. For purposes of this Agreement:

a. "Company Proprietary Information" means _ _[*identify confidential information to be disclosed, in sufficient breadth to cover all anticipated disclosures but not so broad as to be unenforceable*]_ _**.**

b. "Party Proprietary Information" means _ _[*identify confidential information to be disclosed, in sufficient breadth to cover all anticipated disclosures but not so broad as to be unenforceable*]_ _**.**

c. "Information" means Company Proprietary Information and Party Proprietary Information.

2. The permitted use of Information is _ _[*e.g., to evaluate the potential for a joint venture between Company and Party*]_ _**. Information shall be used only as expressly permitted in this Agreement and shall not be disclosed by the receiving party to any third party.**

3. This Agreement covers only Information disclosed from the Effective Date until _ _[*date*]_ _ **("Term").**

4. Each party shall protect Information of the other party, using the same degree of care, but no less than a reasonable degree of care, as such party uses to protect its own confidential information. Each party shall disclose the other's Information only to its employees or contractors who have a need to know and are bound by obligations of confidentiality.

5. On the earlier of termination of this Agreement or the disclosing party's written request, the receiving party shall cease use of Information and, on the disclosing party's written request, return or destroy all Information received from the disclosing party.

6. ***Extent of Obligations.***

a. Each party shall be obligated to protect only Information that is (i) disclosed in tangible form clearly labeled as confidential or proprietary at the time of disclosure; (ii) disclosed in nontangible form, identified as confidential or proprietary at the time of disclosure, and (a) summarized in writing, (b) designated as confidential or proprietary, and (c) delivered to the other party within 30 days after disclosure; or (iii) disclosed under circumstances in which a reasonable person would understand that such Information is confidential and proprietary to the disclosing party.

b. This Agreement imposes no obligation with respect to Information that the receiving party is able to demonstrate _ _[*by clear and convincing evidence*]_ _ **(i) was in the possession of or known by the receiving party before its receipt from the disclosing party, without an obligation to maintain its confidentiality; (ii) is or becomes generally known to the public without violation of this Agreement; (iii) is obtained by the receiving party from a third party, without an obligation to maintain its confidentiality; or (iv) is independently developed by the receiving party without use of the disclosing party's Information.**

c. Disclosure of the other party's Information is not prohibited if such disclosure is compelled pursuant to a legal proceeding or otherwise required by law and prior written notice is given to the other party.

7. The receiving party does not acquire any rights in Information, except the limited right to use Information as described above.

8. Nothing in this Agreement shall be construed as a representation that the receiving party will not develop or acquire information that is the same as or similar to Information, as long as the receiving party does not do so in breach of this Agreement.

9. The receiving party acknowledges that any breach of this Agreement will result in irreparable harm to the disclosing party for which damages would be an inadequate remedy and therefore, in the event of such breach and in addition to its rights and remedies otherwise available at law, the disclosing party shall be entitled to equitable relief, including injunction.

10. Neither party has an obligation under this Agreement to sell or purchase any item from the other party.

11. Any notice required or permitted under this Agreement will be deemed given on delivery to the party for whom it is intended at its address of record. The record addresses of the parties are as follows:

Company:

_ _[*Name of company*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Party:

_ _[*Name of party*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

12. This Agreement may be supplemented, amended, or modified only by mutual agreement of the parties. No supplement, amendment, or modification of this Agreement will be binding unless it is in writing and signed by both parties.

13. Unless the context clearly requires otherwise, (a) "shall," "will," and "agrees" are mandatory and "may" is permissive; (b) "or" is not exclusive; and (c) "includes" and "including" are not limiting.

14. No waiver of a breach, failure of any condition, or any right or remedy in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

15. In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

16. This Agreement, and any dispute arising from the relationship between the parties to this Agreement, shall be governed and determined by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of another jurisdiction's law. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) shall be resolved in _ _[*type of court, e.g., a superior court*]_ _ in _ _[*city, state*]_ _, and the parties expressly waive any right they may otherwise have to cause any such action or proceeding to be brought or tried elsewhere.

17. Any provision of this Agreement that in any way contravenes the law of any state or country in which this Agreement is effective will, in that state or country, to the extent the law is contravened, be considered separable and inapplicable and will not affect any other provision or provisions of this Agreement _ _[*, unless an essential purpose of this Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _.

18. This Agreement will inure to the benefit of and be binding on the successors and assigns of Company and Party.

19. This Agreement _ _[*and _ _[specify other agreements, if any*]_ _]_ _ constitutes the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this Agreement and supersedes all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.

IN WITNESS WHEREOF, the parties have caused this Confidential Disclosure Agreement to be executed by their duly authorized representatives.

_ _[*Name of company*]_ _	_ _[*Name of party*]_ _
By: __[*Signature*]__	**By:** __[*Signature*]__
Name: _ _[*Typed name*]_ _	**Name:** _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _	**Its:** _ _[*Title*]_ _

Comment: The permitted use should be relatively limited because this disclosure agreement is designed for preliminary disclosures in business negotiations. Note that such preliminary disclosures can be more harmful to the discloser, and more valuable to the recipient, because they indicate the direction of research.

In describing the extent of the confidentiality obligations, clause a.(iii) of Section 6 greatly broadens the scope of what is considered confidential. The parties should evaluate whether they want to so expand the obligation of confidentiality; if not, this clause should be deleted.

As the negotiations progress, the discloser should attempt to acquire additional protections, *e.g.,* a promise not to design around the discloser's patent. The company may be engaging the discloser to obtain confidential information for the purpose of appropriating the information after the term of the nondisclosure agreement. *Ali v Fasteners for Retail, Inc.* (CD Cal 2008) 544 F Supp 2d 1064.

This form does not detail the ownership or license issues that would arise in a full licensing or development agreement. For licensing agreements, see chaps 7-8.

Although the notice provision does not specifically require it, a prudent sender will obtain receipts for any notices sent.

An attorney fee provision is included in this form, but generally it is not in the company's interest to include such a provision. If the breaching party is not financially strong, fees are rarely recoverable, and the "lottery incentive" of such a provision might encourage lawsuits.

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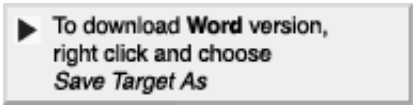
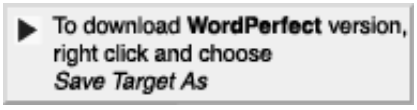
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.49 2. Form: Unilateral Confidential Disclosure Agreement

§6.49 2. Form: Unilateral Confidential Disclosure Agreement





CONFIDENTIAL DISCLOSURE AGREEMENT

Effective Date: _ _[*date*]_ _

In consideration of the disclosure of Proprietary Information (as defined below) by _ _[*name of company*]_ _ **("Company") to** _ _[*name of other party*]_ _ **("Recipient"), Recipient agrees that:**

1. "Proprietary Information," as used in this Agreement, means _ _[*identify confidential information to be disclosed, in sufficient breadth to cover all anticipated disclosures but not so broad as to be unenforceable*]_ _**.**

2. The permitted use of Proprietary Information is _ _[*e.g., to evaluate the potential for a joint venture between Company and Party*]_ _**. Proprietary Information shall be used only as expressly permitted in this Agreement and shall not be disclosed or revealed by Recipient to any third party.**

3. This Agreement covers only Proprietary Information that is disclosed from the Effective Date until _ _[*date*]_ _ **("Term").**

4. Recipient shall protect the Proprietary Information, using the same degree of care as Recipient uses to protect its own confidential information, but no less than a reasonable degree of care. Recipient shall disclose Proprietary Information only to its employees or contractors who have a need to know and are bound by obligations of confidentiality.

5. On the earlier of termination of this Agreement or Company's written request, Recipient shall cease use of Proprietary Information and, on Company's written request, return or destroy all Proprietary Information.

6. ***Extent of Obligations.***

a. Recipient shall be obligated to protect only Proprietary Information that is (i) disclosed in tangible form clearly labeled as confidential or proprietary at the time of disclosure; (ii) disclosed in nontangible form, identified as confidential or proprietary at the time of disclosure, and (a) summarized in writing, (b) designated as confidential or proprietary, and (c) delivered to Recipient within 30 days after disclosure; or (iii) disclosed under circumstances in which a reasonable person would understand that such information is confidential and proprietary to the disclosing party.

b. This Agreement imposes no obligation on the Recipient with respect to Proprietary Information that the Recipient is able to demonstrate _ _[*by clear and convincing evidence*]_ _ **(i) was in the possession of or known by Recipient before its receipt from Company, without an obligation to maintain its confidentiality** _ _[*as shown by written documentation*]_ _**; (ii) is or becomes generally known to the public without violation of this Agreement; (iii) is obtained by Recipient from a third party, without an obligation to keep such information confidential; or (iv) is independently developed by Recipient without use of Proprietary Information** _ _[*as shown by written documentation*]_ _**.**

c. Disclosure of Proprietary Information is not prohibited if such disclosure is compelled pursuant to a legal proceeding or otherwise required by law and the Recipient gives Company prior notice of the disclosure.

7. Recipient does not acquire any rights in Proprietary Information, except the limited right to use Proprietary Information as described above.

8. Nothing in this Agreement shall be construed as a representation that Recipient will not develop or acquire information that is the same as or similar to Proprietary Information, as long as Recipient does not do

so in breach of this Agreement.

9. Recipient acknowledges that any breach of this Agreement will result in irreparable harm to Company for which damages would be an inadequate remedy and therefore, in the event of such breach, in addition to its rights and remedies otherwise available at law, Company shall be entitled to equitable relief, including injunction.

10. Neither party has any obligation under this Agreement to sell or purchase any item from the other party.

11. Any notice required or permitted under this Agreement will be deemed given upon delivery to the party for whom it is intended at its address of record. The record addresses of the parties are as follows:

Company:

_ _[*Name of company*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Recipient:

_ _[*Name of employee*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

12. This Agreement may be supplemented, amended, or modified only by the mutual agreement of the parties. No supplement, amendment, or modification of this Agreement will be binding unless it is in writing and signed by both parties.

13. Unless the context clearly requires otherwise, (a) "shall," "will," and "agrees" are mandatory and "may" is permissive; (b) "or" is not exclusive; and (c) "includes" and "including" are not limiting.

14. No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

15. In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

16. This Agreement, and any dispute arising from the relationship between the parties to this Agreement, shall be governed and determined by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of another jurisdiction's law. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) shall be resolved in _ _[*type of court, e.g., a superior court*]_ _ in _ _[*city, state*]_ _, and the parties expressly waive any right they may otherwise have to cause any such action or

proceeding to be brought or tried elsewhere.

17. Any provision of this Agreement that in any way contravenes the law of any state or country in which this Agreement is effective will, in that state or country, to the extent the law is contravened, be considered separable and inapplicable and will not affect any other provision or provisions of this Agreement _ _[*, unless an essential purpose of this Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _.

18. This Agreement will inure to the benefit of and be binding on the successors and assigns of Company and Recipient.

19. This Agreement, including any exhibits, _ _[*and* _ _[*specify other agreements, if any*]_ _]_ _ constitutes the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this Agreement and supersedes all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.

IN WITNESS WHEREOF, Recipient has caused this Confidential Disclosure Agreement to be executed by its duly authorized representative.

_ _[*Name of recipient*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Title: _ _[*Title*]_ _

Comment: See Comment to form in §6.48 for discussion of the extent of confidentiality obligations and of the notice provision. If appropriate, depending on the relative bargaining strength of the parties, the bracketed phrases in Section 6.b may be included for the benefit of the disclosing party.

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C. Vendors and Suppliers

§6.50 1. Need for Confidentiality Provisions

Agreements with vendors and suppliers are often consummated using purchase orders or similar forms rather than full licensing or development agreements. In some transactions the purchaser must disclose trade secrets or confidential information to enable the vendor or supplier to produce the necessary products or supplies. If standard purchase order or purchase agreement forms are used when trade secrets or other confidential information are disclosed, the purchaser or its counsel should add confidentiality provisions. See §6.51.

Documents provided to vendors or suppliers should be marked appropriately, even when confidentiality provisions are included in the purchase orders or purchase agreements. For example, in addition to a "Proprietary Information" legend on each page (see forms 6.4-1 through 6.11-1), a cover document can help define the limitations on use (see §6.52).

PRACTICE TIP: A vendor or supplier should limit the scope of confidential or restricted use information received. For example, if the vendor does not *need* to receive business plans, customer identities, or other potentially confidential information in order to perform its function for the company, then all reference to such information should be deleted from the agreement with the company, leaving only a *specific* description of the information that *must* be disclosed for the vendor to perform. Any extraneous information disclosed by the company would then be at the company's risk. The vendor should also set time frames for the disclosures and the term during which the information must be kept confidential. If the information has applications in the vendor's core business or would be difficult to separate from the vendor's related technology, the vendor may want to negotiate a limited right of use.

WARNING: Vendors and suppliers known to disregard and disrespect confidentiality provisions may jeopardize the trade secret status of certain company information. *Silicone Image, Inc. v Analogix Semiconductor, Inc.* (ND Cal, Jan. 17, 2008, No. C-07-00635 JCS) 2007 US Dist Lexis 96073.

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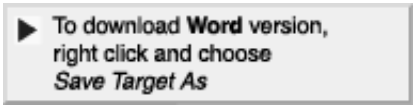
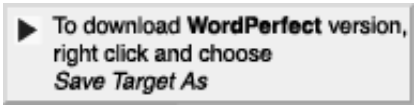
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.51 2. Form: Confidential Disclosure Provisions for Inclusion in Purchase Agreements and Purchase Orders

§6.51 2. Form: Confidential Disclosure Provisions for Inclusion in Purchase Agreements and Purchase Orders





_ _[*Name of supplier or vendor*]_ _ **("Supplier") agrees to maintain** _ _[*in strictest confidence/in confidence, using the same degree of care, but no less than a reasonable degree of care, as Supplier uses to protect its own confidential information*]_ _ **all information** _ _[*name of company*]_ _ **("Company") provides in connection with this** _ _[*agreement/order*]_ _**, including but not limited to Company's information pertaining to its products, financial condition, business plans, customer identities, technical information, and similar information, and to hold in trust and use such information only as needed to fulfill Supplier's obligations for Company's sole benefit. Supplier shall not use such information for its own benefit, publish or otherwise disclose it to others, or permit its use by others for their benefit or to the detriment of Company, and shall carefully restrict access to such information to those of its employees who clearly require it in order for Supplier to fulfill its obligations under this** _ _[*agreement/order*]_ _ **and who have executed confidentiality agreements consistent with Supplier's obligations under this agreement. On termination of Supplier's obligations under this** _ _[*agreement/order*]_ _**, Supplier shall return to Company all copies of all information provided by Company to Supplier, including partial copies and derivative works of such information. Supplier may disclose company information if required by court order.**

PRACTICE TIP: The confidential disclosure agreement may have similar terms but may be drafted to benefit one party over the other or to address the concerns of the parties. For example, a party may choose to require "clear and convincing evidence" or written documentation to prove that the receiving party had possession of the information prior to receipt from the disclosing party. See Section 6.b of the form in §6.48.

Comment: It may also be appropriate to include the exceptions allowing disclosure of confidential information as listed in Section 6.b of the form in §6.48.

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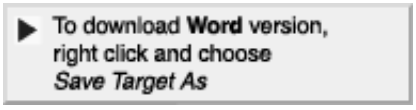
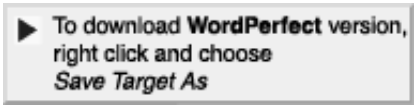
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.52 3. Form: Confidential Disclosure Provisions for Cover Sheet on Proprietary Information

§6.52 3. Form: Confidential Disclosure Provisions for Cover Sheet on Proprietary Information





The attached materials:

1. Contain information that is _ _[*name of company*]**_ _'s proprietary information;**

2. Are provided solely for use in filling purchase order no. _ _[*specify*]**_ _;**

3. Are subject to any further restrictions agreed to by the parties on _ _[*date*]**_ _; and**

4. May not be used for any other purpose.

Comment: This cover sheet is used for materials disclosed subject to other confidentiality agreements. When used alone, any restrictions would need to be specifically identified in the third paragraph. The date of the agreement may be important for identifying which agreement controls.

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D. On-Site Employees From Another Company

§6.53 1. Need for Confidentiality Agreement

Some collaborations between companies, such as joint development projects, may require that the employees of one company work for extended periods at another company's facilities. Supervision can be difficult. The visiting employee may have access to networked computers, meeting rooms, internal memorandums, and business conversations to a far greater degree than the casual or one-day visitor. The host company should require that the visiting employee enter into a confidentiality agreement to protect its information to which the visiting employee has access but which is not related to the specific project at hand.

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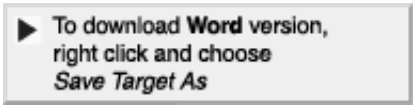
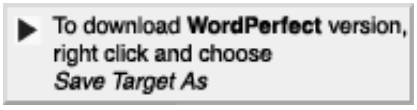
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.54 2. Form: On-Site Employee Confidentiality Agreement

§6.54 2. Form: On-Site Employee Confidentiality Agreement





ON-SITE EMPLOYEE CONFIDENTIALITY AGREEMENT

Effective date: _ _[*date*]_ _

_ _[*Name of company*]_ _ **("Company") and** _ _[*name of employee*]_ _ **("Recipient") agree that:**

1. For purposes of this On-Site Employee Confidentiality Agreement, "Proprietary Information" means _ _[*identify confidential information to be disclosed, in sufficient breadth to cover all anticipated disclosures but not so broad as to be unenforceable*]_ _**.**

2. Any Proprietary Information disclosed under this On-Site Agreement is intended to include only information pertaining to _ _[*identify technology*]_ _**, which is the subject matter of the** _ _[*identify related intercompany agreement*]_ _ **("Employer's Agreement") between Company and** _ _[*name of recipient's employer*]_ _ **of** _ _[*date*]_ _**, and which is disclosed orally or in written or other tangible form and is identified as confidential or proprietary or should reasonably be understood to be confidential. This On-Site Agreement does not provide any rights or privileges with respect to Company information not pertaining directly to the proprietary information disclosed under the Employer's Agreement ("Other Company Information").**

3. Proprietary Information may be used by Recipient only in connection with and subject to the terms of the Employer's Agreement.

4. The term of this On-Site Agreement commences on the Effective Date and expires _ _[*number*]_ _ **months thereafter. Recipient's obligations regarding Proprietary Information and Other Company Information survive the termination of this On-Site Agreement.**

5. Proprietary Information shall be used solely as permitted in the Employer's Agreement and shall not be disclosed to Recipient's employer or any other third party other than as permitted in the Employer's Agreement. Recipient shall not seek access to, receive, use, or disclose to Recipient's employer or to any other party any Proprietary Information or Other Company Information, or any confidential information of Company's affiliates, that Recipient does not have a need to know for purposes of the Employer's Agreement. Recipient shall hold Proprietary Information in strict confidence and shall provide Proprietary Information (i) only to employees of _ _[*name of recipient's employer*]_ _ **who are obligated to keep the Proprietary Information confidential, and (ii) only on a need-to-know basis. On the earlier of termination of this On-Site Agreement, the Employer's Agreement, or Company's written request, Recipient shall cease use of Proprietary Information and, on Company's request, return or destroy all Proprietary Information.**

6. ***Extent of Obligations.***

a. This On-Site Agreement imposes no obligation on Recipient with respect to Proprietary Information or Other Company Information that Recipient can establish by legally sufficient evidence (i) was in the possession of or known by Recipient before its receipt from Company, without an obligation to keep such information confidential; (ii) is or becomes generally known to the public without violation of this On-Site Agreement or the Employer's Agreement; (iii) is obtained by Recipient from a third party, without an obligation to keep such information confidential; or (iv) is independently developed by Recipient without the use of Proprietary Information.

b. Disclosure of Proprietary Information is not prohibited if Recipient gives prior notice to Company and such disclosure is compelled pursuant to a legal proceeding or otherwise required by law.

7. Company retains ownership of Proprietary Information and Other Company Information. Recipient

acquires no rights in Proprietary Information except the limited right to use Proprietary Information as described in this On-Site Agreement and the Employer's Agreement.

8. Recipient acknowledges that any breach of this On-Site Agreement will result in irreparable harm to Company for which damages would be an inadequate remedy and, therefore in the event of such breach, in addition to its rights and remedies otherwise available at law, Company shall be entitled to equitable relief, including injunction. Recipient waives any requirement for the posting of a bond or other security in the event that Company seeks such an injunction.

9. Any notice required or permitted under this Agreement will be deemed given upon delivery to the party for whom it is intended at its address of record. The record addresses of the parties are as follows:

Company:

_ _[*Name of company*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Recipient:

_ _[*Name of employee*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

10. This On-Site Agreement may be supplemented, amended, or modified only by the mutual agreement of the parties. No supplement, amendment, or modification of this On-Site Agreement will be binding unless it is in writing and signed by both parties.

11. Unless the context clearly requires otherwise, (a) "shall," "will," and "agrees" are mandatory and "may" is permissive; (b) "or" is not exclusive; and (c) "includes" and "including" are not limiting.

12. No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by this On-Site Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

13. This On-Site Agreement, and any dispute arising from the relationship between the parties to this On-Site Agreement, shall be governed and determined by _ _[*e.g., California*]_ _ **law,** _ _[*excluding/including*]_ _ **any laws that direct the application of another jurisdiction's law. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) shall be resolved in** _ _[*type of court, e.g., a superior court*]_ _ **in** _ _[*city, state*]_ _**, and the parties expressly waive any right they may otherwise have to cause any such action or proceeding to be brought or tried elsewhere.**

14. In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this On-Site Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this On-Site Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

15. Any provision of this On-Site Agreement that in any way contravenes the law of any state or country in which this On-Site Agreement is effective will, in that state or country, to the extent the law is contravened, be considered separable and inapplicable and will not affect any other provision or provisions of this On-Site Agreement _ _[*, unless an essential purpose of this On-Site Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _**.**

16. This On-Site Agreement will inure to the benefit of and be binding on the successors and assigns of Company and Recipient.

17. This On-Site Agreement, together with the Employer's Agreement _ _[*and* _ _[*specify other agreements and exhibits, if any*]_ _]_ _**, constitutes the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this On-Site Agreement and supersedes all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this On-Site Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this On-Site Agreement.**

IN WITNESS WHEREOF, Recipient has executed this Agreement.

__[*Signature of recipient*]__
Name: _ _[*Typed name*]_ _

Comment: This agreement is not designed to stand alone, but rather to supplement a related agreement between the on-site employee's employer and the company, if the employee will spend extended time on-site at the company's premises.

Although the notice provision does not specifically require it, a prudent sender will obtain receipts for any notices sent. An attorney fees provision is included in this form, but generally it is not in the company's interest to include such a provision, because fees are rarely recoverable and the "lottery incentive" of such a provision might encourage lawsuits.

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Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/ E. Buy-Sell Agreements/§6.55 1. Introduction

E. Buy-Sell Agreements

§6.55 1. Introduction

The parties should identify all nondisclosure agreements that the seller has with third parties. The buyer and seller should negotiate which agreements will be transferred to the buyer.

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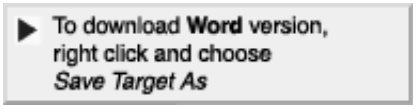
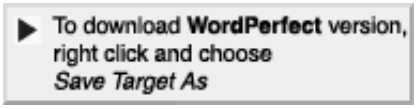
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.56 2. Form: Buy-Sell Agreement Clause

§6.56 2. Form: Buy-Sell Agreement Clause





The seller has entered into the nondisclosure agreement(s) listed in Appendix _ _[*letter*]_ _, copies of which are attached as Appendix _ _[*letter*]_ _. Seller transfers all rights in the following nondisclosure agreements to the seller:

[*Describe entity-specific nondisclosure agreements*]

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F. Clients

§6.57 1. Introduction

A service provider may enter into a contract with a client having a no-hire provision. The no-hire provision prevents the client from hiring away any employee of the service provider that actually performed work for the client. *Webb v West Side Dist. Hosp.* (1983) 144 CA3d 946, 193 CR 80, overruled on other grounds by *Moncharsh v Heily & Blase* (1992) 3 C4th 1, 10 CR2d 183. However, no-hire provisions that prevent clients from hiring any employee of the service provider, including those employees who have not actually performed work for the client, are unenforceable under Bus & P C §16600. *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818.

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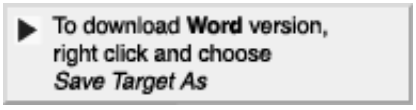
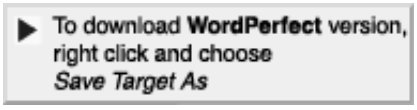
Source: Business Law/Trade Secrets Practice in California/6 Form Protective Agreements and Provisions/§6.58 2. Form: No-Hire Provision

§6.58 2. Form: No-Hire Provision





Client will not attempt to hire service provider's employees that actually provided service to the buyer for a period of _ _[*number of months*]_ _ months.

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7

Exploiting Trade Secrets by Licensing

David N. Makous
Kevin D. DeBré

I. INTRODUCTION: ASSIGNMENT OR LICENSE §7.1

II. TYPES OF LICENSES
- A. Express Versus Implied License §7.2
- B. Licenses of Trade Secrets in Combination With Patent Rights ("Hybrid Licenses") §7.3
  - 1. Special Issues Raised by Hybrid Licenses
    - a. The *Lear* Doctrine §7.4
    - b. Exceptions to the *Lear* Doctrine §7.4A
  - 2. Domestic Versus Foreign Patent Rights
    - a. Value of Patent §7.5
    - b. Effect of Patent Issuance on Trade Secret License §7.6

III. PRIMARY ISSUES IN TRADE SECRET LICENSE AGREEMENTS
- A. Grant Clause §7.7
  - 1. Licensed Property §7.8
  - 2. Licensed Product §7.9
  - 3. Licensed Territory §7.10
  - 4. Exclusivity §7.11
  - 5. Sublicenses §7.12
- B. Valuation of Trade Secrets §7.13
  - 1. Proprietor's Experience With Secret §7.14
  - 2. Cost of Developing Trade Secret §7.15
  - 3. Allocation of Percentage of Projected Net Profit §7.16
  - 4. Desirability of Trade Secret §7.17
  - 5. Alternative Costs: Projected Legal Fees, Consequences of Delay §7.18
- C. Royalty Payments §7.19
  - 1. Term §7.20
  - 2. Establishing Royalty Rate §7.21
  - 3. Basis of Royalty Calculation §7.22
  - 4. Minimum and Maximum Royalties §7.23
- D. Hybrid Licenses §7.24

IV. ANTITRUST PROBLEMS: DEPARTMENT OF JUSTICE GUIDELINES §7.25
- A. Exclusivity Issues Raised by Guidelines §7.26
- B. Territorial Restrictions §7.27
- C. Price Controls and Use Restrictions §7.28
- D. Grant-Back Provisions §7.29
- E. Tying Provisions §7.30
- F. Granting or Revoking Licenses in Concert With Other Licensees §7.31

V. DISCLOSURE BEFORE LICENSING
- A. Initial Logistic Problem §7.32
- B. Approaches to Disclosure Prior to License
  - 1. Disclosure of Nonconfidential Information §7.33
  - 2. Confidential Disclosure Agreement §7.34
  - 3. Look-See Fee §7.35
  - 4. Learned Intermediary §7.35A
  - 5. Form: Simple Confidentiality and Nondisclosure Letter Agreement §7.36

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§7.1 I. INTRODUCTION: ASSIGNMENT OR LICENSE

As businesses increasingly rely on trade secrets to commercialize products and services and compete in their markets, licensing has become an important means of exploiting the value of trade secret rights. To adequately represent a client in licensing trade secrets, the practitioner must be versed in state law, related federal law, and to some extent the law of certain foreign jurisdictions.

If the subject intellectual property is perceived to have value, its owner may seek compensation by transferring all or part of the rights inherent in that property. Regardless of the terminology used, if fewer than all the rights are granted, it is a "license," or the owner's permission for another to use the property, even if the agreement does not expressly say so. See *Abbott Labs. v Ortho Diagnostic Sys.* (Fed Cir 1995) 47 F3d 1128. Trade secrets licenses are contracts and are thus governed by the same laws as are other contracts, *e.g.,* contract law, trade secret law, and antitrust law. Licenses are analogous to real property leases and, although they can be granted orally, they are usually written. See, *e.g., Basic, Inc. v Rex* (TTAB 1970) 167 USPQ 696. A license may be as elementary as the statement: "I give you permission to use my trade secret formula in the manufacture of your radial tire product this month for $10,000," or it may be encompassed in a complex, multipage agreement.

If total ownership is purportedly granted, *i.e.,* if a complete and unrestricted transfer is made of the whole or an undivided part of it, then the transfer is conventionally referred to as an "assignment" or a "sale." *Waterman v MacKenzie* (1891) 138 US 252, 255, 34 L Ed 923, 925, 11 S Ct 334; *CMS Indus. v L.P.S. Int'l Ltd.* (5th Cir 1981) 643 F2d 289, 294. Assignments of some kinds of intellectual property, such as trademarks, patents, and copyrights, must be in writing. See 15 USC §1060 (trademarks); 35 USC §261 (patents); 17 USC §204 (copyrights).

PRACTICE TIP: There is no such requirement for a trade secret assignment, but a writing is highly recommended because it can be useful for evidentiary purposes if a dispute later arises. A written agreement may also be helpful under the Uniform Trade Secrets Act (CC §§3426-3426.11).

Although many trade secret agreements use terms such as "transfer," "grant," "sale," or "assignment," the parties' intent governs whether the agreement is a license or assignment. See *Abbott Labs. v Ortho Diagnostic Sys., supra*. Many transfers of trade secrets rights are licenses because the transferor wishes to retain some degree of control (*e.g.,* time, field of use, or territorial restrictions) over the transferee's use of the trade secret. Assignments of trade secrets are less common than licenses, and normally occur only in association with the sale of a business or assets using those trade secrets.

See chap 8 for an annotated license agreement. For further discussion of drafting license agreements, see Milgrim on Trade Secrets §§9.01-9.08 (1967); Bond, *Protecting Information in Technology Licensing,* 11 Licensing L & Bus Rep 61 (Mar.-Apr. 1989); Friedlander & Evans, The Law and Business of Licensing: Licensing in the 21st Century (2000). For the tax consequences of assignment versus license, see chap 15.

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II. TYPES OF LICENSES

§7.2 A. Express Versus Implied License

Trade secret licenses involve the licensing of confidential information, know-how, or both. See Costner & Einhorn, 1 Patent Licensing Transactions §1.06 (1996). Licenses can be created in a variety of ways. The most common form is the express written license, which can be a formal written instrument setting forth the nature of the trade secret to be transferred and the rights and liabilities of the parties. Licenses may also be created orally, by acts of the parties, or by operation of law. Such licenses are generally referred to as "implied licenses." The conduct of one party, from which a second party may reasonably infer the consent of the first to the conduct of the second, may result in an implied license. In successfully inducing a customer to purchase a particular catalyst, for example, a chemical salesperson who provides a customer with technical data on the operation of the catalyst could, by such conduct, grant an implied license for the customer to use that data. See *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442 (software developer's delivery of computer program without written license agreement was implied license for client to use and modify program's source code and access trade secrets embedded in code). A transfer by operation of law includes such transfers as devises by will or bequest, a court order, the dissolution of a company, or a related transfer for the benefit of creditors.

Oral licenses are subject to the usual limitations of oral contracts, notably the statute of frauds (CC §1624), and suffer from a lack of specifics that is likely to lead to disputes and problems of enforceability. They are not recommended.

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§7.3 B. Licenses of Trade Secrets in Combination With Patent Rights ("Hybrid Licenses")

The nature of proprietary technology is such that some of it may constitute a patentable invention while some is unpatentable (or the owner of the technology may have chosen not to pursue patent protection for some of it) and protectable only by trade secrets law. A grant of patent rights allows a licensee to manufacture an item or use a process and sell products made by using the process free from the threat of patent infringement liability. See 35 USC §271(a). See also California Business Litigation, chap 8 (Cal CEB 2002) for discussion of ascertaining whether a product infringes a patent claim. To reap the full benefit of patent rights, however, the licensee often requires additional knowledge in the form of trade secrets that are not disclosed in the patent. Without that knowledge, the patent rights are less valuable to the licensee. The trade secret may be the most useful portion of the licensed subject matter even though it does not qualify for patent protection. In such a complementary relationship, trade secrets are frequently licensed as part of a grant of patent rights (and occasionally trademarks and copyrights).

The relative value of patent rights and trade secret rights varies with the scope of the patent. Sometimes the licensor's patent is broad and little additional technical information is necessary. In this situation, the trade secret rights are secondary. Conversely, many patents or potential patents (*i.e.,* when a patent application is pending and has not been abandoned) are narrow and the real value of a license lies in the trade secrets, with patent rights as mere appendages to the agreement. For example, a proprietor of a commercially licensed chemical process who was unable to obtain a United States patent for the related formula for a catalyst could license the technical information on composition and use of the catalyst as a trade secret and license the remainder of the process as a patent.

Hybrid license agreements differentiate between the rights and obligations of the parties resulting from a combination of different and not necessarily coextensive licensed subject matter, such as patent and trade secret rights. Additional issues must be addressed in hybrid license agreements because of the tension between the federal patent policy against collecting royalties for a license of invalid patents and the principles of state contract law recognizing the freedom to contract. To avoid problems arising from such tension, a license agreement may provide a structured royalty rate permitting the licensee to suspend royalty payments or pay a reduced royalty rate for exploitation of patent rights, trade secret rights, or both, in whole or in part, based on specified events, such as:

- Nonuse of the licensed technology;
- The occurrence of substantial, nonchallenged infringement of the licensed technology by a nonlicensed third party;
- Public disclosure of the trade secret; or
- Judicial invalidation of all or some of the licensed patent claims.

In licensing a trade secret associated with a patented product, the licensor may confer on the licensee the rights to make, sell, or use that product. Counsel should draw a clear distinction between these rights. In licensing a process, the licensor normally grants the right to practice (*i.e.,* use) the process. The right to sell a resulting patented product depends on the circumstances. The grant clause may also impose restrictions on the field of use, product output, territory, and export rights. But see §§7.25-7.31 for discussion of possible antitrust issues.

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1. Special Issues Raised by Hybrid Licenses

§7.4 a. The *Lear* Doctrine

Hybrid licenses are rife with complex factual variations and twists that can affect the validity and enforceability of the license. See *Lear, Inc. v Adkins* (1969) 395 US 653, 23 L Ed 2d 610, 89 S Ct 1902, and its progeny, which have examined trade secrets as well as patents. In *Lear,* the inventor sued the licensee for using his patented invention after ceasing royalty payments, and the licensee counterclaimed for patent invalidity. The Court first reasoned that the relegation of unpatentable ideas to the public domain is necessary to ensure that inventors do not benefit from an invalid patent. To ensure that unpatentable ideas are exposed as such, licensees should not be estopped from challenging the licensed patent (nor estopped from challenging the accompanying obligation to pay royalties) at any time. These public policy considerations supersede any prohibition in the license agreement against the licensee's right to challenge the validity of the patent.

The Court then held that the licensee was not liable for royalties on an invalid patent from the moment it challenged its validity, but the Court declined to address the licensor's claim to royalties before the patent issued because the claim for such royalties questioned the extent to which state law protects the owner of an unpatented idea who is willing to disclose the idea to another only for payment of royalties. 395 US at 674, 23 L Ed 2d at 625.

Under *Lear,* a licensee could be relieved from paying *any* accrued patent royalties on the grounds of alleged patent invalidity. However, in 1997, the federal circuit rejected the *Lear* doctrine in *Studiengesellschaft Kohle, m.b.H. v Shell Oil Co.* (Fed Cir 1997) 112 F3d 1561, 1568, cert denied (1997) 522 US 996. *Kohle* held that a licensor had the right to collect patent royalties up until the time of the challenge of patent invalidity. The *Kohle* court reasoned that even though there is a public policy of encouraging the challenge of possibly invalid patents, when the equities of the contracting parties are such that one party would be unjustly enriched by avoiding royalty payments to the other, the licensee's protection under the *Lear* doctrine should not be invoked until (a) the licensee stops paying royalties, and (b) the licensee provides notice to the licensor that it has found the relevant patent claims to be invalid. A contracting party cannot reap the benefits of the patent and then challenge the patent's validity so as to avoid payment of any accrued royalties associated with that patent. 112 F3d at 1568.

A contracting party, however, need not terminate a license agreement in order to challenge the validity of the licensed patent. In *MedImmune, Inc. v Genentech, Inc.* (2007) 549 US 118, 166 L Ed 2d 604, 127 S Ct 764, a patent licensee sought a declaratory judgment that the patent was invalid, unenforceable, or not infringed by its product, while continuing to pay royalties under protest and with reservation of its rights. The court held that the licensee was not required to terminate the license agreement in order to seek declaratory relief.

For further discussion of the *Lear, Kohle,* and *MedImmune* cases, see the district court's opinion on remand in *MedImmune, Inc. v Genentech, Inc.* (CD Cal 2008) 535 F Supp 2d 1000.

A contract requiring a licensee to pay royalties after a patent has expired is per se unlawful because a patent owner abuses the leverage of the monopoly by projecting royalties into the period after expiration. *Brulotte v Thys Co.* (1964) 379 US 29, 13 L Ed 2d 99, 85 S Ct 176. However, when the patent holder did not impermissibly "condition" its license on royalty provisions covering unpatented products and activities, the mere presence of a clause permitting collection of royalties after expiration of the patent, even though unenforceable, did not per se constitute patent misuse. *Bayer v Housey Pharms.* (D Del 2002) 228 F Supp 2d 467. Further, such an agreement is only unenforceable to the extent it requires payments on patented goods after the patent expires. *Zila, Inc. v Tinnell* (9th Cir 2007) 502 F3d 1014. This principle is applicable only to contracts involving U.S. patents. The enforceability of an agreement calling for the payment of royalties beyond the term of a patent issued in another country must be examined under that country's laws. 502 F3d at 1024.

The Supreme Court has upheld a hybrid royalty agreement covering both patent and trade secret rights that set multiple royalty rates: one rate if the patent issued and a different one if it did not. *Aronson v Quick Point Pencil Co.* (1979) 440 US 257, 59 L Ed 2d 296, 99 S Ct 1096. In *Aronson,* the licensee agreed to pay royalties for sales of articles

embodying the putative invention for as long as the licensee sold them, *even though the patent was never granted*. 440 US at 259, 59 L Ed 2d at 299. The Court found merit in the licensor's contention that an agreement between two parties who contract with "full awareness of both the pendency of a patent application and the possibility that a patent might not issue" should be enforced. 440 US at 261, 59 L Ed 2d at 301. The *Aronson* court distinguished *Lear* because in *Aronson* "no patent has issued, and no ideas have been withdrawn from public use." 440 US at 264, 59 L Ed 2d at 303. It distinguished *Brulotte* because the *Aronson* licensor did not use the patent monopoly as leverage during negotiation of the license, as had occurred in *Brulotte*. In essence, the court recognized that a contract to get an early look at a trade secret is sufficient consideration for continued royalties. 440 US at 265, 59 L Ed 2d at 303.

PRACTICE TIP: If a pending patent application forms the basis for a trade secret license, the license should provide for continuation of royalty payments on patent issuance or abandonment of the application. In recognition of *Aronson*, the license should provide for a changed relationship between the parties to reflect the changed circumstances of the licensed property.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.4A b. Exceptions to the Lear Doctrine

§7.4A b. Exceptions to the *Lear* Doctrine

The Federal Circuit has created several exceptions to the *Lear* doctrine. In *RCA Corp. v Data Gen. Corp.* (Fed Cir 1989) 887 F2d 1056, 1064, the court noted that *Lear* did not

> deal with a licensor's right to terminate or rescind a license agreement, or dictate what *must* be held a breach of contract, or what damages *must* be awarded for a breach, or under what circumstances, if any, a licensee can recover royalties paid. Those questions continue to be matters dependent on particular fact situations, contract provisions and state contract law, albeit they must be resolved in harmony with general principles discernible from *Lear.*

See also *Dow Chem. Co. v U.S.* (Fed Cir 2000) 226 F3d 1334, 1344 n11 (*Lear* doctrine does not apply to licensor's right to terminate or rescind license agreement). In *Dow*, the government argued that the license it entered into was void, contending that because it did not practice the invention and thus did not repudiate the license, it did not owe any royalties to Dow. 226 F3d at 1344. The court held that the licensing agreement was not void and the contract was not rescinded. Moreover, because the government challenged not only the patent, but also the license, expressly stating that it would not pay any royalties to Dow, it was in material breach and repudiation of the licensing agreement. 226 F3d at 1346. The court concluded that the government's material breach resulted in Dow's right to terminate the license, and the government's actions of challenging the patent and the patent license, coupled with its refusal to pay royalties, rendered the absence of a termination provision in the license immaterial. 226 F3d at 1346.

Contracts resulting from settlements of litigation override *Lear*'s policy against invalid patents; parties can agree not to make certain challenges to the validity of a patent that is the subject matter of a judicial settlement (*Hemstreet v Spiegel, Inc.* (Fed Cir 1988) 851 F2d 348) or a consent judgment (*Foster v Hallco Mfg. Co.* (Fed Cir 1991) 947 F2d 469).

In *Flex-Foot, Inc. v CRP, Inc.* (Fed Cir 2001) 238 F3d 1362, the appellant agreed to a dismissal with prejudice under a settlement agreement, promising that it would not challenge the validity of the disputed patent. The Federal Circuit held that this dismissal with prejudice and accompanying settlement agreement gave rise to contractual estoppel. The court distinguished *Lear* by pointing out that *Lear* involved a license agreement that was *not* created as a result of a litigation settlement. In addition, the license agreement in *Lear* did not contain a promise by the licensee to *not* challenge the validity of the patent. 238 F3d at 1368. The court further pointed out that *Hemstreet v Spiegel, supra,* and *Foster v Hallco, supra,* both stood for the proposition that judicial economy must be fostered by encouraging settlement of patent litigation and upholding the terms of the settlement. *Flex-Foot, Inc.,* 238 F3d at 1369. The court's decision in *Flex-Foot* similarly echoed the strong public interest in settlement of patent litigation and upholding the terms of that agreement. The appellant's voluntary dismissal of the litigation with prejudice, in which it expressly agreed not to challenge the validity of the patent, amounted to clear and unambiguous waiver of any future challenge to the patent. The court held that the appellant was contractually estopped from challenging the validity of the patent, and, because it was distinguishable, this case did not conflict with the underlying public policy in *Lear*. 238 F3d at 1369.

Other courts have examined the wide factual variations in the hybrid agreement context and recognized that, if the license does not distinguish between trade secret royalties and patent royalties, the patent term applies to both. If the license does make that distinction (and it is not a sham), the court enforces patent royalties until the patent expires and enforces trade secret royalties for the term stated in the license. Court decisions have specifically held the following:

- If a licensing agreement fails to distinguish between patent and nonpatent rights in royalty payments and the patent is invalidated, then *Lear* precludes enforcement of the contract according to its terms but does not preclude compensation for the nonpatent rights in the transfer and sale of a business's assets. *Chromalloy Am. Corp. v Fischmann* (9th Cir 1983) 716 F2d 683, 685.
- A court may award compensation to a licensor even if the license agreement fails to distinguish between patent and nonpatent rights. *St. Regis Paper Co. v Royal Indus.* (9th Cir 1977) 552 F2d 309. A licensor is entitled to compensation for nonpatent rights to prevent a licensee's unjust enrichment, even if the hybrid royalty agreement was unenforceable because there was no allocation of royalties attributable to trade secrets and know-how.

Span-Deck, Inc. v Fab-Con, Inc. (8th Cir 1982) 677 F2d 1237.

- An agreement that allocates payments between patent and nonpatent rights could survive expiration or invalidity of the subject patent. The *Brulotte* per se invalidity rule applies, however, if the license agreement (a) clearly contemplates patent protection but the patent never issues, (b) requires royalty payments for 25 years, and (c) fails to provide for the reduction of royalties if a valid patent expires or is never issued. *Boggild v Kenner Prods.* (6th Cir 1985) 776 F2d 1315, 1319. Similarly, if royalties were not allocated between trade secrets and patents in the agreement and the subject pending patent is not issued, *Brulotte* applies and the agreement is per se invalid. See *Pitney Bowes, Inc. v Mestre* (11th Cir 1983) 701 F2d 1365, 1372.
- In *Baladevon Inc. v Abbott Labs.* (D Mass 1994) 871 F Supp 89, an assignment of patent and nonpatent rights was made in return for royalties. When the patents were eventually recognized as invalid (but not by judicial decree), the assignee terminated royalty payments but continued to manufacture the subject device. The assignor then sued. The court distinguished an assignment from a license and enforced the royalty payments for three reasons: (1) Royalties paid after the assignment was made are properly considered deferred compensation; (2) the assignment provided a means of reducing the payments if the patent was held invalid or was never issued (favorably citing *Aronson*); and (3) *Lear* was not controlling, because no patent had issued at the commencement of the agreement.

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2. Domestic Versus Foreign Patent Rights

§7.5 a. Value of Patent

The relative value of patent and trade secret rights varies from country to country. Patents obtained in countries that have strong patent systems, such as most Western European nations, are generally viewed as valuable and self-contained because the patent disclosure usually includes the technical information needed to use the patent. In countries where patents have limited enforceability or recognition, as in most underdeveloped nations, issued patents may be less valuable in the marketplace because the claims made in such patents may be more narrow in scope or the use of such patents may require parallel licensing of crucial technical data and know-how embodied in the nonpatented trade secrets. In the latter case, the trade secrets may be as valuable as the patent rights, if not more so.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.6 b. Effect of Patent Issuance on Trade Secret License

§7.6 b. Effect of Patent Issuance on Trade Secret License

Patent applications are published 18 months after the earliest claimed priority date. 35 USC §122(b)(1)(A). A proposed patent that contains trade secret subject matter may be kept confidential until issuance of the patent if the patentee can certify that the patent application is domestic only and will not be filed in other foreign countries (35 USC §122(b)(2)(B)(i)):

> If an applicant makes a request upon filing, certifying that the invention disclosed in the application has not and will not be the subject of an application filed in another country, or under a multilateral international agreement, that requires publication of applications 18 months after filing, the application shall not be published.

Under select foreign patent practice (*e.g.,* European Patent Office, Japan), the filed *patent application* could become available to public inspection or published at a set time (*e.g.,* 18 months) after filing and *before the patent issues.* At that time, the only matters remaining secret would be anything not disclosed by the application. Consequently, the licensed subject matter may no longer be a "secret," and hence loses value because of its disclosure in the now public patent application.

PRACTICE TIP: Once a patent is issued, the trade secret license should be converted into a patent license. The parties can provide for such conversion in the original license agreement.

NOTE: While issuance of a patent destroys any trade secrets contained in the patent, further details regarding implementation of the patented invention, or later improvements to the patented invention, may be protected as trade secrets. *Hickory Specialties, Inc. v Forest Flavors Int'l, Inc.* (MD Tenn 1998) 12 F Supp 2d 760, aff'd (6th Cir 2000) 215 F3d 1326.

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III. PRIMARY ISSUES IN TRADE SECRET LICENSE AGREEMENTS

§7.7 A. Grant Clause

In the delegation of permission through a license, a careful, unambiguous identification of the rights conferred is essential. The grant clause sets out the bounds of the property at issue and the restrictions on its usage and exploitation. Commonly included in the grant clause are identification of the licensed property (see §7.8), identification of the licensed product (see §7.9), identification of the licensed territory (see §7.10), and provisions on exclusivity (see §7.11) and sublicensing (see §7.12). The grant clause may also cite time, product, or other, similar exclusions. For form grant clauses, see §§8.6-8.7.

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§7.8 1. Licensed Property

Virtually any piece of information, know-how, invention, or technical data that qualifies as a trade secret can be licensed by its owner. A trade secret may even include a compilation of nonsecret information if the compilation provides a competitive advantage. See *San Jose Constr., Inc. v S.B.C.C., Inc.* (2007) 155 CA4th 1528, 67 CR3d 54. Conversely, information that is at the time "public" cannot be licensed by an enforceable agreement. See *Sears, Roebuck & Co. v Stiffel Co.* (1964) 376 US 225, 11 L Ed 2d 661, 84 S Ct 784; *Swartz v Schering-Plough Corp.* (D Mass 1999) 53 F Supp 2d 95 (party's extensive use of trademark before licensing discussions negated existence of such mark as trade secret).

The license agreement should identify the intellectual property subject matter by suitable particulars. Doing so will be helpful should the licensor bring an action for misappropriation of licensed trade secrets, which requires the misappropriated trade secrets to be identified with reasonable particularity. See CCP §2019.210; *Premiere Innovations, Inc. v IWAS Indus., LLC* (SD Cal, Sept. 28, 2007, No. 07cv1083 BTM(BLM)) 2007 US Dist Lexis 72755. For issued patents, patent applications, registered trademarks, or registered copyrights, the subject matter is typically identified by a reference to the pertinent government document. Trade secrets not otherwise disclosed in a patent application should be described in the body of a privately created document, such as a product specification, referring to its secret components or a detailed description of a secret method of manufacture. In the petroleum industry, for example, refining and reforming processes used to convert crude oil to desired petroleum fractions are often licensed. Exploration maps and data, market studies, customer and supplier lists, and financial and statistical data are also commonly the subject of licenses. In the electronics industry, device specifications, integrated circuit diagrams, microprocessor or other printed circuit board layouts, instrument drawings, and process technology are licensed as trade secrets. In the software industry, websites that include text, pictures, audio, and video constructed using Hypertext Markup Language (HTML) are tangible expression of ideas that are copyrightable as works of authorship and thereby licensable to a user. Normally, the expression as embodied in the series of pictures, text, and useful links to other sites would not be considered protectable trade secrets within the meaning of the UTSA. However, the series of computer symbols comprising the programming language (*e.g.,* HTML) used to construct the website can be deemed trade secrets and are thus considered proprietary, copyrightable, and protectable under the trade secret doctrine. See 17 USC §102; *Apple Computer, Inc. v Franklin Computer Corp.* (3d Cir 1983) 714 F2d 1240, 1249 (computer program in object code or source code is copyrightable). Other trade secrets that could be licensed include scientific information in technical reports, computer programs, and future know-how, *i.e.,* developments from existing secrets.

PRACTICE TIP: This information should not be revealed to a prospective licensee until the agreement is fully executed and all security measures are in place to prevent uncontrolled usurpation, disclosure, or destruction of the trade secret. See form in §8.24. When revealed to the prospective licensee, documents or other materials describing the information should be sufficiently protected to avoid unintended disclosure. See chap 4 for discussion of security measures.

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§7.9 2. Licensed Product

The parties can limit the use of the trade secret identifying the licensed product. For example, the agreement could provide that a trade secret formula could be used only to manufacture canine homeopathic antiasthmatics (limiting use of the licensed property to certain products or services) or that the licensed product could be sold only to wholesale pharmaceutical distributors (limiting the field of use of the licensed property). Any limitation on the use of the trade secret must be expressly stated in the agreement and is generally included in the definition of the licensed product, although it can be stated elsewhere. Limitations are particularly important in the website context of software development. The developer of the website (*i.e.,* the author) may have an interest in retaining (for use in connection with other website developments) the right to use the code developed for the website product for the site's owner. Accordingly, the licensor of the website must take great care in defining the licensed elements (*i.e.,* the product) and establish appropriate limitations on its use.

Such limitations may be appropriate if the licensee is engaged in a competitive business and the licensor wants to ensure that the technology will be used only in noncompetitive products or processes. In view of the U.S. Supreme Court's recent expansion of the patent exhaustion doctrine, weakening the ability of patent owners to restrict downstream sales of licensed products, patent licensors may wish to include in their license agreements restrictions on the use of their trade secrets embodied in licensed products sold by the licensee in order to prevent competitors from reselling these products. See *Quanta Computer, Inc. v LG Electronics, Inc.* (2008) 553 US 617, 170 L Ed 2d 996, 128 S Ct 2109 (patent exhaustion doctrine precluded patent owner from blocking sales of computer systems containing licensed components purchased from patent licensee). Limiting the licensed technology to use with identified products also enables the licensor to better monitor compliance with the royalty provisions of the license.

WARNING: Before including such limitations, counsel should review the antitrust laws. See §§7.25-7.31.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.10 3. Licensed Territory

§7.10 3. Licensed Territory

The licensed territory is generally the restricted geographic territory and trade channels within which the licensed property may be exploited (*e.g.,* the licensed product may be limited to sale to wholesalers for distribution to retailers with stores located in Mississippi). In some agreements, the licensed territory may be different for different trade secret uses (*e.g.,* the licensee may be allowed to manufacture a product using the licensed property only in one geographic region and allowed to sell it only in a different region).

WARNING: Any restrictions on trade territories must be carefully evaluated for their compliance with domestic and foreign antitrust laws. See §§7.25-7.31; Milgrim on Trade Secrets §10.01[2][g][i] (1967).

PRACTICE TIP: Given the global nature of the Internet, care must be taken in defining the territory if a license permits distribution through the Internet. In this case, defining the distribution territory in terms of where purchasers are located may be more relevant than geographic regions where the licensed property may be used.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.11 4. Exclusivity

§7.11 4. Exclusivity

A license can take three forms. It can be:

- "Exclusive," *i.e.,* the licensor cannot grant the same rights to anyone else or exercise them itself;
- "Semi-exclusive," *i.e.,* the licensor cannot grant the same rights to others but retains the rights for itself; or
- "Nonexclusive," *i.e.,* the licensor retains the right to grant the same rights to another and to exercise them itself but is precluded from granting an exclusive license to anyone else. A nonexclusive license is often essentially nothing more than a covenant not to sue.

Exclusivity provisions can be limited to specific aspects of the license, such as territories of use or products.

Exclusive licenses demand a higher royalty than nonexclusive licenses. Sometimes a licensee desires a considerable lead time over competitors in a particular technology or market. In this circumstance, the parties may negotiate an exclusive license or a license that is exclusive for a specified period but then becomes nonexclusive. If the subject of the license is a patent right, then an exclusive license under these circumstances means that the licensee is granted the "unconditional enjoyment of the patent" and its status as an exclusive licensee is not "dependent upon using due diligence to make, use, and sell the patented technology." *Biagro W. Sales, Inc. v Helena Chem. Co.* (ED Cal 2001) 160 F Supp 2d 1136, 1145.

Some trade secret owners are reluctant to grant exclusive licenses. If the licensee does not take full advantage of the trade secret but meets the minimum payment and other obligations, the licensor cannot receive the maximum financial return and has no recourse. To address this problem, the courts construe exclusive licenses as comprising, in part, the licensee's obligation to use its best efforts "to develop, exploit, produce and make sales." *Brawley v Crosby Research Found.* (1946) 73 CA2d 103, 112, 166 P2d 392. If this obligation to exploit extends to a guarantee of royalties and provision of process reports and royalty reports, then it is likely that the licensee is "an exclusive licensee with some rights, but not all substantial rights." *Biagro W. Sales, Inc. v Helena Chem. Co.* (ED Cal 2001) 160 F Supp 2d 1136, 1145. In other words, in a situation in which the licensee must actively be involved in promoting, making, using, and developing the patented product and process, and may not simply sit on its grant of rights under the license, then the licensor is an indispensable party to any action involving the license. Similarly, an exclusive licensee within a specific territory and field of use lacks standing to sue in its own name without joining the licensor. *International Gamco, Inc. v Multimedia Games, Inc.* (Fed Cir 2007) 504 F3d 1273 (geographic restriction does not cure prospect of multiple lawsuits arising from exclusive field of use license). The exclusive licensee is merely a licensee without all substantial rights.

PRACTICE TIP: When drafting an exclusive license for the licensee, subject to the limitations of antitrust risks, counsel should take care to draft provisions that truly grant all substantial rights to the licensee whereby the licensee is given a greater ability to manage, control, and dictate the use or nonuse of the patent rights.

WARNING: A licensor should not impose overreaching restrictions when granting an exclusive license to a licensee. The overreaching conduct by the licensor may lead to an undesired legal action, such as a claim of unfair competition. See *Sun Microsystems Inc. v Microsoft Corp.* (ND Cal 2000) 87 F Supp 2d 992 (preliminary injunction granted based on unfair competition claim).

If the trade secret proprietor cannot afford the necessary capital to commercialize a product, an exclusive license may be appropriate. In such transactions, a longer license term is generally expected. Nonexclusive licenses can provide the licensor with greater freedom while satisfying the licensor's desire to maximize the return on the trade secret by allowing it to relicense the technology.

In the absence of specificity, a license is presumed to be nonexclusive. The characterization in the licensing document as "exclusive" or "nonexclusive" is not controlling, because the court will look at all factors, including the language in the agreement, to decide what type of license was intended. However, the parties' intent is the controlling factor. See *L.G.B. v Gitano Group, Inc.* (SD NY 1991) 769 F Supp 1243. Therefore, the license should clearly state the parties' intent, specifying whether the license is exclusive, semi-exclusive, or nonexclusive.

WARNING: All exclusivity requirements, whether express or implied, are inherently risky because of potential antitrust liability. See §§7.25-7.31.

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§7.12 5. Sublicenses

May a licensee grant a sublicense to another to exploit some or all of the licensed rights? See *Shoney's, Inc. v Schoenbaum* (4th Cir 1990) 894 F2d 92. To avoid doubt, the agreement should definitively state whether or not the licensee has the right to grant a sublicense.

A licensor may decide to allow sublicensing because it increases the financial return. Part of the royalties earned by the licensee under a sublicense agreement could be paid to the licensor while the licensee retains the remainder in consideration of its services. A website licensor or developer may wish to license the program coding to the website owner so that he or she has the right to create "derivative works" from the original website. If the website owner merely has the right to use the program coding, then any use or derivative work derived from the use of the code would violate the trade secrets license. Hence, the licensor may want to grant to the owner the right to use, including the right to sublicense, the code to reap higher financial returns.

A major disadvantage to the licensor in allowing the licensee to sublicense is that it weakens the licensor's control over the trade secret, which could result in the loss of the secret or decrease its value if the licensor desires to license the trade secret to others. See Justice Black's dissent in *Lear, Inc. v Adkins* (1969) 395 US 653, 23 L Ed 2d 610, 89 S Ct 1902.

The licensor can retain some control by including appropriate restrictions on the sublicensing right, such as retaining the right to expressly approve all sublicenses, and being actively involved in the licensee's collaboration with the sublicensee. In addition, the licensor should require the licensee to include provisions in its sublicense agreements to protect the confidentiality of the trade secrets being sublicensed. The licensor may also want to be able to enforce its rights directly against the sublicensee.

NOTE: Depending on the type of technology licensed, the licensee may want the right to grant sublicenses to its customers.

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§7.13 B. Valuation of Trade Secrets

Before setting the compensation payable under the license agreement, the parties must agree on the trade secret's economic value. In setting this value, the trade secret owner must consider the amount of time, effort, and money that was spent in developing the secret, the potential gain that can be realized by the owner and others (notably competitors) through exploitation of the secret, and the ease or difficulty with which the secret might be properly acquired or duplicated by others.

Secret technical information is an extremely perishable commodity. Even when the greatest care is taken to preserve its secrecy, information tends to reach the public domain through departing employees, publications, patents, and various business channels. The proprietor must bear in mind that competitors are continually researching and developing their own technology; in time, these efforts may result in a discovery of the secret, which may then be of little or no value to the original owner. Thus secret technical information is most valuable when it is new, with its value often decreasing over time. If the owner wishes to maximize the return through licensing, valuation of a trade secret should be undertaken soon after the trade secret is developed.

There are many ways to value a trade secret. See §§7.14-7.18 for discussion of some of the principal valuation methods. See §§7.19-7.23 for discussion of factors involved in setting the royalty rate.

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§7.14 1. Proprietor's Experience With Secret

The timing of a trade secret license is largely dictated by the owner's use of the information. Often, the information is kept secret until the owner has personally exploited it and attained a lead in the particular field (*e.g.,* by building and operating a manufacturing plant or by introducing a new product into the market). Once that lead is achieved, it might then be timely to offer to sell or license the secret to others. If the trade secret has proved to be valuable or profitable to its owner, that experience should be a significant guidepost in setting a royalty rate.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.15 2. Cost of Developing Trade Secret

§7.15 2. Cost of Developing Trade Secret

The cost of development is another factor considered in valuing the trade secret. This consideration has two principal facets:

- **The cost to the owner.** By licensing the secret, the owner wants to recover a portion of the cost incurred in developing the secret. The more that was spent developing the trade secret, the greater the amount its owner will want to recover.
- **The projected cost to the prospective licensee or competitor of deriving, reverse engineering, or discovering the same technical information.** In deciding whether to obtain a license, the prospective licensee must balance the expense of independent development against the price set by the owner.

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§7.16 3. Allocation of Percentage of Projected Net Profit

The royalty can be established either by formula (*e.g.,* 5 percent of the licensee's net revenues or 10 cents per unit of product sold) or as a set amount. If a variable royalty rate is used, the parties can designate a minimum royalty amount, a maximum royalty amount, or both. See §7.23.

The real net profit that the trade secret will enable the licensee to realize is a reasonable criterion for establishing a royalty rate. Frequently, the owner can calculate the net profit from personal knowledge of the relevant manufacturing costs. The licensor may then set a fair share of that profit as the royalty, *e.g.,* 25 percent of the projected net profit. See Goldscheider, *Determining the Value of Technology and Setting Royalty Rates,* 4 J Proprietary Rts 9 (Oct. 1992). This net profit figure can also be converted to a percentage of gross revenues to set the actual license royalty rate.

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§7.17 4. Desirability of Trade Secret

A trade secret's value to another party depends on the depth of the other party's desire to gain access to the trade secret. Companies with their own research and development divisions often prefer to develop their technology in-house rather than purchase it from a competitor. On the other hand, by licensing technology, the licensee obtains a ready-made process or product without committing the substantial time, effort, and expense required for development. The existence of similar secret processes also affects a potential licensee's need for the particular secret and therefore its value. The licensing price of each secret becomes competitive with others as their owners compete for potential licensees.

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§7.18 5. Alternative Costs: Projected Legal Fees, Consequences of Delay

Frequently, a major factor in valuing a trade secret license is the cost of enforcing the licensor's rights. Employee mobility often raises the issue of a possible theft of trade secrets and resulting legal action; occasionally licenses are granted to avoid such litigation. When a dispute involving trade secret theft is settled, the trade secret owner may license the trade secret as part of the dispute settlement. The costs incurred by a delay in licensing and exploiting a trade secret often lead to diminution in its value and may be a factor in licensing negotiations.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.19 C. Royalty Payments

§7.19 C. Royalty Payments

Many variables must be considered in designing a royalties clause in a license agreement: The term for payments (see §7.20), the actual royalty rate set (see §7.21), the basis of royalty calculation (see §7.22), minimum royalties (see §7.23), and maximum royalties (see §7.23). See §§7.13-7.18 for discussion of trade secret valuation.

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§7.20 1. Term

The term of the license is typically a specified number of years. The parties can provide for material alterations of the term on the occurrence of significant events. Of principal concern are complications that arise when the license provides that the licensee (a) must continue making royalty payments even if the information is no longer secret or (b) may stop making royalty payments on a showing that the licensed subject matter is no longer secret. Trade secret agreements can provide for royalty payments even after the trade secret is lost due to the licensee's manufacture and sale of the licensed technology or products incorporating it (*e.g.,* when such manufacture or sale results in someone else reverse engineering the trade secret). *Aronson v Quick Point Pencil Co.* (1979) 440 US 257, 59 L Ed 2d 296, 99 S Ct 1096. Accordingly, provisions stating that the licensee must pay royalties as long as it uses the trade secret may remain binding even if the licensee's competitors can copy or reverse engineer the product and use it without paying a licensing fee.

The license can provide that the licensee either continue to pay the promised royalties or stop using the licensed product after it loses its secrecy owing to the licensee's manufacture and sale of the licensed technology or products incorporating it. As consideration for continued royalty payments, the licensee receives (1) earlier access than its competitors to a trade secret and (2) a head start in the manufacture and sale of the product incorporating the trade secret. Often, manufacturing economies of scale or other factors give the licensee a tremendous advantage over competitors, even when the competitors are able to copy or reverse engineer the trade secret after the licensed product reaches the open market. Few licensees are able or willing to make a lump-sum payment for this head-start advantage commensurate with the potential value of the trade secret, but they may be willing and able to pay a royalty for an extended period of time based on successful marketing of the product.

On expiration of the license term or other termination of the license, the licensee often will have the right to sell off its inventory of licensed products. This sell-off right allows the licensee to wind down production and fill pending orders for the licensed products without the risk of the licensor asserting a claim. The duration of the sell-off period varies, and the licensee remains obligated to pay royalties on such sales. If, however, the agreement fails to require the licensee to stop using the licensed trade secrets on termination, the licensee's continuing rights and obligations with regard to the trade secrets may be unclear (see *Merck & Co. v SmithKline Beecham Pharm. Co.* (Del Ch 1999) 1999 Del Ch Lexis 242, aff'd (Del 2000) 766 A2d 442) and may indicate the licensor's intent to permit the licensee to continue using the trade secrets (see *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442).

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.21 2. Establishing Royalty Rate

§7.21 2. Establishing Royalty Rate

Selecting a royalty rate can be one of the most difficult problems in negotiating a license. Few generalizations apply, except that an exclusive license usually commands a higher rate than a nonexclusive license. What the rate will be depends somewhat on the practices in a particular industry.

Some royalty rates are based on a percentage of the net sales price of the product produced by the licensed know-how when that product is the direct product of that know-how and a sales price or value may be assigned. If the product of the licensed know-how is not itself sold but is merely a component of the item ultimately sold, it may be difficult or unreasonable to use a percentage of sales price (or sales value); such a basis also may not be ascertainable. For such licenses, the parties could provide for a dollar royalty per unit or per ton of the product using the licensed know-how.

The marketplace may dictate a lower royalty rate if the sales price of the licensed product sold is high. Similarly, if few sales are anticipated, the royalty rate will also be lower because arguably there is limited utility for the licensed trade secret.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.22 3. Basis of Royalty Calculation

§7.22 3. Basis of Royalty Calculation

The agreement must designate a reasonable basis for calculation of royalties. The royalty provision is most workable and legally acceptable when it is closely related to the subject matter of the license. If, for example, the trade secret is a process for producing transistors or chemical compounds, the basis for the royalty could be the number of transistors shipped or the tonnage of the chemical produced. If the trade secret is a specific circuit or formulation, the royalty basis could be the number of devices embodying the circuit or the volume of the formulation may be the basis. For licensed subject matter used in providing online services, the royalty rate may be based on a percentage of revenues generated from the services. The following bases have each been successfully used in appropriate circumstances:

- **Licensee's sales price.** Either a percentage of gross sales price or sales price adjusted for various costs such as costs of goods, quantity, trade, and cash discounts as allowed to customers at the time of sale; returns; freight; and local sales taxes.
- **Quantity of the ultimate product.** A per unit royalty based on the quantity of material sold, *e.g.,* 50 cents a barrel or 1 cent a gallon.
- **Licensee's profit.** Some percentage of the licensee's gross or net profit, *e.g.,* 25 percent of the licensee's net profit (typical if the licensee sublicenses the technology).
- **Licensee's savings.** The savings on invested capital or operating expense achieved by the licensee's use of the licensed property.

The third and fourth bases are less common than the first two because "profit" and "savings" are difficult to ascertain by audit, giving the licensor little opportunity to verify that the licensee is making all required payments. By understanding the nature of the licensed trade secret, its use under the license, and its value to the licensee, the practitioner can select a fair and reasonable basis on which to compute royalties.

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§7.23 4. Minimum and Maximum Royalties

A minimum royalty payment ensures compensation to the licensor, even if the licensee does not fully exploit the trade secret, and it encourages the licensee to use the trade secret. The minimum royalty is especially advantageous to the licensor if secret processes are the subject of the license; even if the licensee's use of the process does not result in many sales, the licensor is entitled to a minimum compensation.

Occasionally, the parties can agree on the value of the licensed property and can set a maximum royalty equivalent to that value. It is then possible to provide in the agreement that, once the licensee has paid the licensor this amount, no further payments are due under the license, and the licensee is said to have a fully paid license under the agreement. The fully paid figure may be achieved in several ways. For example:

- The licensee makes a lump-sum down payment that constitutes the fully paid figure.
- The licensee makes no down payment, but the parties agree that all continuing (or "running") royalties be credited toward the fully paid amount.
- The licensee's payment obligations are divided between the down payment and the running royalties, with the sum of the two making up the fully paid amount.
- The licensee pays running royalties and, at any point during the term of the license, a lump-sum amount equal to the difference of the fully paid figure and the sum of running royalties paid to date.
- Only part of the annual running royalties are credited toward the fully paid amount.

The fully paid provision, also known as the "knock-out" provision, is generally negotiated by licensees who want a definite end to their royalty obligation. The licensor generally tends to resist any provision that sets an end to the income stream while permitting the licensee to continue enjoying the benefit of the licensed subject matter. However, a licensor may desire a maximum royalty if it is unwilling to incur the cost of review of an accounting or audit of the licensee, or otherwise police the licensee. Paid-up licenses are most commonly used for commercial software, for which the purchaser pays one price (*i.e.,* the sales price) and is granted the license to practice the technical information in the software. In contrast, application service providers often grant licensees access to a trade secret for a specified number of users in exchange for a flat payment each month, thus establishing a fee arrangement that is not dependent on or geared toward the output of a particular process but is strictly a function of time. These licensing arrangements do not lend themselves to setting a maximum royalty.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.24 D. Hybrid Licenses

§7.24 D. Hybrid Licenses

Hybrid licenses of trade secrets and patentable or patented technology should address the following primary issues:

- **The identity of the licensed trade secret.** See §7.8.
- **A description of the licensed product.** See §7.9.
- **The identity of the licensed patent or patent application.** Each patent is essentially composed of one or more claims, which are the exact verbal description of the scope of the invention (*e.g.,* "I claim a wheel having a rim, at least three radial spokes, and a hub"). The claims are the measure of the property right and the designated scope of a patent license. Selected claims of the same patent can be licensed even when other claims are not. However, licensing selected claims is rarely done and tends to be problematic. Whenever a license is granted on a patent, the presumption is that the whole patent is licensed unless specific language in the license expressly severs or reserves certain portions of the patent.
- **A description of the licensed territory.** Although most trade secrets licenses tend not to include territorial limitations because of the difficulty in enforcing them, these limitations are common in patent licenses because the rights to the patents are fully recognized by a government agency and therefore enforcement is less complicated. The agreement usually describes the licensed territory, even if worldwide rights are granted. See §7.10.
- **A description of licensed rights.** The licensor must decide whether to license some or all of the rights to make, use, offer to sell, sell, and import the licensed subject matter. See 35 USC §271.
- **The exclusivity or nonexclusivity of the license.** The practitioner must consider the antitrust laws of all applicable jurisdictions, particularly if the license is exclusive. United States antitrust guidelines are identified in the Antitrust Guidelines for the Licensing of Intellectual Property (1995) (Guidelines), issued jointly by the Department of Justice and the Federal Trade Commission and available at http://www.usdoj.gov/atr/public/guidelines/0558.htm. The European Union prohibits cross-border restraints of trade (the "Treaty of Rome" (updated version available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/ce321/ce32120061229en00010331.pdf)) that are in some respects stricter than those of the United States. For further discussion of exclusivity and nonexclusivity, see §7.11.
- **Sublicense rights.** See §7.12.
- **Royalty payments.** For hybrid agreements, the compensation provision should distinguish clearly between compensation for patent rights and compensation for trade secrets. See §§7.3-7.4. The licensor should request separate royalty schedules in the agreement for each licensed patent or patent application and for know-how or trade secret rights. Such bifurcation is fairly common and lessens the risk of an illegal tying of two products.

The practitioner might also consider the following royalty-related provisions in the license agreement to assure that the licensor will be fairly compensated:

- As high a down payment as possible;
- A stated valuation by the parties of the head-start advantage;
- An agreement that, if a licensed patent application is abandoned, royalties will cease or be reduced, perhaps after an agreed-on valuation has been realized in royalties;
- If the parties cannot agree on valuation, an express limitation on the number of years that the royalty will be paid after public disclosure of the trade secret;
- An express covenant that the agreement applies to both present and future trade secret developments (and maybe future consulting services by the licensor), although such a provision may affect the ability to claim all or part of the royalty income as a capital gain;
- Separate royalties for licensed patent rights and licensed trade secret rights;
- The scope of trade secret information vis-à-vis potential or actual patent disclosures and claims;
- The existence of patent applications that were actually filed or that are intended to be filed;

- Actually issued patents;
- The actual or intended scope of the claims of each patent application filed and each patent issued;
- The geographic scope of protection;
- The timing of the vesting, divesting, or loss of trade secret or patent rights; and
- The impact on the licensee's related obligations (including any expiration, increase, or reduction) to pay royalties before, during, and after these periods or events.

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§7.25 IV. ANTITRUST PROBLEMS: DEPARTMENT OF JUSTICE GUIDELINES

The Department of Justice and Federal Trade Commission jointly issued the Antitrust Guidelines for the Licensing of Intellectual Property (1995) (Guidelines). They are available online at http://www.usdoj.gov/atr/public/guidelines/0558.htm. The Guidelines, which pertain to patents, copyrights, and trade secrets, explore how field-of-use, territorial, and other limitations in licenses are subject to careful scrutiny as unfair trade practices.

In most licenses, any restraint is evaluated under the "rule of reason": Is the restraint likely to have anticompetitive effects and, if so, is the restraint reasonably necessary to achieve procompetitive benefits that outweigh the anticompetitive effects? See Guidelines §3.4. Nevertheless, some restraints are so severe as to be per se unlawful, *e.g.,* naked price-fixing, output restraints, market division among horizontal competitors, some group boycotts, and some resale price maintenance schemes. Restraints that "would always or almost always tend to decrease output or increase prices, but that may be relatively unfamiliar or may not fit neatly into traditional per se categories" are "inherently suspect." See Guidelines §3.4 n27.

For a pre-Guidelines discussion of antitrust violations generally, see California Business Litigation, chap 5 (Cal CEB 2002).

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§7.26 A. Exclusivity Issues Raised by Guidelines

The Antitrust Guidelines for the Licensing of Intellectual Property §§4.1.2, 5.4 (1995) (Guidelines) discuss in some depth the concept of exclusivity in licensing intellectual property and consider it in contexts more broadly than those usually intended by the contracting parties. A licensing arrangement may involve exclusivity in two distinct respects:

- First, the licensor may grant one or more exclusive licenses that restrict the licensor's right to license others and possibly also to use the technology itself. (Multiple exclusive licenses are possible if, for example, the licenses are limited by territory, field of use, or customers to whom the licensed product can be sold.) Generally, an exclusive license raises antitrust concerns only if the licensees themselves, or the licensor and its licensees, are in a horizontal relationship. Examples of arrangements involving exclusive licensing that may give rise to antitrust concerns include cross-licensing by parties collectively possessing market power, grant-backs, and acquisitions of intellectual property rights. A nonexclusive license of intellectual property that contains no restraints on the licensor's or licensee's competitive conduct generally does not present antitrust concerns even if the license parties are in a horizontal relationship, because nonexclusive licenses normally do not diminish competition that would occur in its absence.
- Second, exclusive dealing arises when a license prevents or restrains the licensee from licensing (sublicensing), selling, distributing, or using competing technologies. Exclusivity may be achieved by an explicit exclusive dealing term in the license agreement or by other provisions, such as compensation terms or other economic incentives.

A license stating that it is nonexclusive may nonetheless give rise to the same concerns posed by formal exclusivity. For example, it may be structured so that the licensor is unlikely to license others or to practice the technology itself. Moreover, even if it does not explicitly require exclusive dealing, the license may have that effect if it significantly increases the licensee's cost when the licensee uses competing technologies. However, a licensing arrangement will not automatically raise exclusivity concerns merely because one party chooses to deal with a single licensee or licensor or confines its activities to a single field of use or location, or because only a single licensee has chosen to take a license. See Guidelines §4.1.2.

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§7.27 B. Territorial Restrictions

A salient difference between patent rights and trade secrets rights is that a patent owner may convey an exclusive right under a patent or patent application "to the whole or any specified part of the United States." 35 USC §261. There is no such statutory support for territorial restrictions in trade secret licenses.

Restrictions, such as exclusive territorial arrangements, are not per se illegal. See *ARCO v USA Petroleum* (1990) 495 US 328, 109 L Ed 2d 333, 110 S Ct 1884. Territorial restrictions are generally evaluated under the rule of reason, in accordance with previously identified vertical nonprice restraint considerations of exclusivity. Such restrictions are permitted if they have no anticompetitive effect or are reasonably necessary to achieve procompetitive benefits that outweigh anticompetitive effects.

If the licensor and the licensee are not competitors, a valid territorial restriction is possible. *U.S. v E.I. Du Pont de Nemours & Co.* (D Del 1953) 118 F Supp 41.

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§7.28 C. Price Controls and Use Restrictions

Generally, resale price maintenance is illegal when "commodities have passed into the channels of trade and are owned by dealers." See Antitrust Guidelines for the Licensing of Intellectual Property §5.2 (1995) (Guidelines). It has been held per se illegal for a licensor of an intellectual property right in a product to fix a licensee's resale price of the product, and the applicable agencies treat resale price maintenance as a per se violation in a license. Guidelines §5.2. Yet, the U.S. Supreme Court has ruled that the per se rule is limited to restraints "that would always or almost always tend to restrict competition and decrease output," and that vertical price restraints are to be judged instead by the rule of reason. *Leegin Creative Leather Prods., Inc. v PSKS, Inc.* (2007) 551 US 877, 168 L Ed 2d 623, 634, 127 S Ct 2705. In the past, trade secret-type rights have been subject to per se evaluation when a license of those rights imposes resale price maintenance. *Cummer-Graham Co. v Straight Side Basket Corp.* (5th Cir 1944) 142 F2d 646, 647; *Barber-Colman Co. v National Tool Co.* (6th Cir 1943) 136 F2d 339, 343. In view of the U.S. Supreme Court's subsequent ruling on this issue, however, these arrangements are likely to be evaluated under the rule of reason. Resale price maintenance concerns apply equally to a restriction on the amount a licensor may charge other licensees for a license of the same rights.

When a license has the effect or significant risk of imposing price controls or coordinated pricing, an illegal restraint may be in place even if the agreement itself does not expressly provide resale price maintenance. See Guidelines §4.1.1.

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§7.29 D. Grant-Back Provisions

A grant-back clause requires the licensee to grant to the licensor the right to exploit any improvements to the trade secret made by the licensee. It is prevalent in many strategic alliances and joint ventures. The justification for this provision is that the licensor, having initially put the licensee in a position to experiment with and benefit from the trade secret, should be allowed to share in the benefits of further technical developments. Grant-back provisions are evaluated under the rule of reason and can expose the licensor to allegations of antitrust violations. See Antitrust Guidelines for the Licensing of Intellectual Property §5.6 (1995) (Guidelines); *Transparent-Wrap Mach. Corp. v Stokes & Smith Co.* (1947) 329 US 637, 91 L Ed 563, 67 S Ct 610.

A nonexclusive grant-back provision allows the licensee to practice its technology *and* license it to others. Compared with an exclusive grant-back to the licensor, a nonexclusive grant-back is less likely to have anticompetitive consequences because it leaves the licensee free to license technology improvements to others. See Guidelines §5.6.

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§7.30 E. Tying Provisions

A tying or tie-in agreement conditions the purchase of one product on the buyer's also purchasing the "tied" product. *Eastman Kodak Co. v Image Tech. Servs.* (1992) 504 US 451, 119 L Ed 2d 265, 280, 112 S Ct 2072. Package licenses (multiple rights licensed together) may create such an arrangement. Tying practices are illegal per se under §3 of the Clayton Act. 15 USC §14.

Several cases have held that it is illegal to condition the licensee's ability to license copyrights or patents on the licensee's purchase of another right or product. *U.S. v Paramount Pictures, Inc.* (1948) 334 US 131, 156, 92 L Ed 1260, 1291, 68 S Ct 915; *International Salt Co. v U.S.* (1947) 332 US 392, 92 L Ed 20, 68 S Ct 12. However, the Antitrust Guidelines for the Licensing of Intellectual Property (1995) (Guidelines) do not treat these arrangements as per se illegal just because a patent, copyright, or trade secret is involved. See Guidelines §5.3. The courts examine the market power of the tying product to determine whether there is an adverse effect on competition in the relevant market for the tied product or whether efficiency justifications outweigh the anticompetitive effects.

Recent Supreme Court precedent indicates that the Court's historically strong disapproval of tying arrangements has diminished. The Court has moved from relying on assumptions (*e.g.,* that tying arrangements ordinarily serve no legitimate business purpose) to requiring a showing of market power in the tying product. *Illinois Tool Works, Inc. v Independent Ink, Inc.* (2006) 547 US 28, 164 L Ed 2d 26, 34, 126 S Ct 1281. See also *United States Steel Corp. v Fortner Enters., Inc.* (1977) 429 US 610, 622, 51 L Ed 2d 80, 97 S Ct 861 (plaintiff's failure to offer proof on market power fatal); *Jefferson Parish Hosp. Dist. No. 2 v Hyde* (1984) 466 US 2, 13, 80 L Ed 2d 2, 104 S Ct 1551 (Sherman Act; rejecting per se rule that all tying arrangements constitute antitrust violations).

In *Illinois Tool Works, Inc. v Independent Ink, Inc., supra,* the Court rejected *International Salt*'s per se rule, holding that because a patent does not necessarily confer market power on a patentee in all cases involving a tying arrangement, a plaintiff must prove that the defendant has market power in the tying product. The Court explained that Congress's amendment of the Patent Act in 1988 to eliminate the market power presumption in patent misuse cases required assessing whether the presumption of market power in a patented product should survive as a matter of antitrust law. The Court concluded that the mere fact that a tying product is patented does not support a presumption of market power. Rather, in all cases involving a tying arrangement, the plaintiff must prove that the defendant has market power in the tying product. 164 L Ed 2d at 31.

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§7.31 F. Granting or Revoking Licenses in Concert With Other Licensees

Any provision in an agreement requiring that future licenses be subject to the consent of present licensees may subject the entire agreement to antitrust scrutiny by the courts. See *Mannington Mills, Inc. v Congoleum Indus.* (3d Cir 1979) 610 F2d 1059. Whenever there is conduct in concert with another party, the persons involved should ensure that the conduct is independent or that it had a rational basis. See Antitrust Guidelines for the Licensing of Intellectual Property §5.5 (1995) on cross-licensing and pooling arrangements.

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V. DISCLOSURE BEFORE LICENSING

§7.32 A. Initial Logistic Problem

A trade secret owner who wants to license trade secret information is faced with logistic problems. The owner must convey to the prospective licensee enough information to enable the latter to decide whether to license the trade secret but must withhold crucial information so that the trade secret is not lost by disclosure. For example, if the gist of a secret chemical process is the identity of a compound or a reaction condition, its identity or content must be kept secret until an agreement for its licensing is concluded. The prospective licensee cannot yet be given complete information about the secret itself, but must be persuaded that it is valuable enough to acquire rights to it. The problem is lessened if the subject matter of the license is readily perceived to have value (such as in a finished product), the licensee is convinced of its worth, and the licensee has decided to acquire the information necessary to create the product. For example, if the trade secret is software that enables the user to input data through mere input of sound (*i.e.,* voice recognition technology), its utility value is readily apparent.

The secrecy requirement may substantially constrain the owner's ability to license its trade secrets because the owner must usually comply with an idea submission policy (*e.g.,* conditions that must be fulfilled before a recipient will consider licensing the trade secret) of the prospective licensee. See chap 3 for full discussion of idea submission policies. The proprietor of an unpatentable and easily copied trade secret may have few practical options or little legal recourse. See *Smith v Recrion Corp.* (Nev 1975) 541 P2d 663. However, the extent of the problem may depend on the nature of the trade secret.

NOTE: Inherent in such disclosures is the problem of the prospective licensee who decides not to proceed with the license but later markets a similar product (either because it was already under development or because it was inspired by the negotiations). Chapter 3 on idea submissions discusses these risks.

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B. Approaches to Disclosure Prior to License

§7.33 1. Disclosure of Nonconfidential Information

A prospective licensee is usually given a limited amount of nonconfidential information about some aspect of the trade secret in order to whet its interest in it (*e.g.*, economic data on the comparative costs and savings achieved by the secret process or performance data such as comparative tables or charts showing stability or aging properties). To maintain the secret, the proprietor generally discloses the intended purpose, results, and savings from use of the subject matter rather than the precise structure, processes, ingredients, or other details.

Demonstrations of the trade secret's benefits may interest the prospective licensee, but the licensor must be careful not to disclose the secret during such demonstrations. For example, electronic equipment or circuits may demonstrate their advantages, if suitable precautions are taken to conceal the secret components, arrangements, or wiring; or the product of a machine might be shown if to do so would not reveal the secret structure of the machine. Demonstrated equipment might be sealed in such a way that it could not be opened without detection or destruction. A visit to the proprietor's factory could be used to show the prospective licensee either the reduction in staff produced by the process or the modest capital investment required to obtain the equipment necessary to use the technical information, as long as the subject matter is not disclosed during the tour. The licensor's concerns can be addressed through selective disclosure and use of appropriate representations and warranties.

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Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.34 2. Confidential Disclosure Agreement

§7.34 2. Confidential Disclosure Agreement

After concluding preliminary discussions and providing the prospective licensee with nonconfidential information, the prospective licensee may indicate its interest in the trade secret. If the prospective licensee is interested, the proprietor will next disclose portions or all of the trade secret with some specificity so that the prospective licensee can fully evaluate it, but this disclosure should be made only under circumstances that protect both parties. The parties may consider imposing the following conditions:

- The recipient is bound to preserve secrecy by safeguarding the trade secret from inadvertent disclosure or theft and by not disclosing it to nonessential personnel.
- The recipient must use the disclosed information and material for evaluation purposes only.
- The recipient must license the trade secret if it is of benefit or value. (Note that large company recipients are less likely to agree to this point.)
- The subject matter must to be defined with sufficient specificity so that the secrecy obligation is limited to information that is actually received.
- The recipient's obligation of secrecy terminates once the subject matter is in fact no longer a secret. The prospective licensee does not want to be bound to secrecy when its competitors are free to use the subject matter because it has been revealed in public sources, such as printed patents, journals, manuscripts, or other technical writings.

Whether a particular set of disclosure conditions is acceptable to the recipient depends largely on the parties' relative bargaining position. The trade secret proprietor will want to impose conditions as restrictive as possible to ensure substantial control over the subsequent disclosure of the trade secret. The recipient, on the other hand, will want liberal provisions so as not to risk the capture of information derived from independent sources within the purview of the nondisclosure agreement.

To accommodate these conflicting needs, the parties should enter into a confidentiality and nondisclosure agreement to protect them during their licensing negotiations and afterwards, if negotiations cease. A look-see fee arrangement may also be included in this agreement. See §7.35. If the parties ultimately enter into a trade secret license, the license should replace the earlier agreement or extend, amend, or otherwise incorporate its terms.

PRACTICE TIP: Some assurance of confidentiality, even if less than a full written nondisclosure agreement, might be suitable early in the negotiations.

For further discussion of the need for an agreement, see Finnegan, *The Black Box Problem: Using Pre-Negotiation Secrecy Agreements to Govern Disclosure of Technology to Potential Licensees*, 3 J Corp L 507 (1978); *Sikes v McGraw-Edison Co.* (5th Cir 1982) 665 F2d 731, 735; *Joseph L. Brooks Mfg. Corp. v GSC Elecs.* (ED Pa 1982) 215 USPQ 708; and *Nora Beverages, Inc. v Perrier Group of Am., Inc.* (2d Cir 1998) 164 F3d 736.

PRACTICE TIP: The practitioner should incorporate with specificity and by reference collateral documentation identifying and disclosing the secret. This documentation should not be included in the text of the basic agreement but should be given to the recipient after the agreement is executed.

Occasionally, the parties transfer all or part of the secret information before the confidential disclosure agreement is executed. If so, the definition of "confidential information" in the agreement should be retroactive (nunc pro tunc) and should include the earlier transfer. If the earlier disclosure was oral, the proprietor should recite the discussion and the particulars of the information transferred. Obligations of confidentiality may also be implied from the nature of the relationship of the parties or the nature of their communications with each other. See §4.3 for further discussion.

The agreement should specifically identify the materials that will be disclosed so that the licensor controls the disclosure procedure. All disclosed material should be stamped with a precautionary legend. See forms 6.4-1 through 6.6-3 for proprietary legends.

A trade secret owner's failure to mark materials as confidential as required by the confidentiality agreement could

result in the loss of trade secret protection. See *Gemisys Corp. v Phoenix Am., Inc.* (ND Cal 1999) 186 FRD 551.

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§7.35 3. Look-See Fee

In preparing prelicensing materials to acquaint the prospective licensee with the trade secret, its owner may incur substantial costs. These costs may be staff time only or may be out-of-pocket expenses such as charges for travel, material preparations, duplicating blueprints, or photographs. Because at this stage in negotiations (*i.e.,* before execution of a formal licensing agreement) the owner has no guarantee that these costs will be recovered through a license, all or part of the costs may be passed along to the prospective licensee outside of the license.

Recovery of some of the costs can be accomplished by requiring a payment to the trade secret owner, called the "look-see fee," before revealing the secret under the confidential disclosure agreement. It also enables the owner to test the seriousness of the prospective licensee. The amount of the look-see fee is determined by three major factors: The relative value of the trade secret to each party (see §§7.13-7.18 for discussion of trade secret valuation), the expenses the owner incurred during negotiations, and the prospective licensee's ability to pay.

The confidential disclosure agreement often includes the look-see fee provision. Frequently, the fee is credited toward the down payment or continuing royalties due under any licensing agreement concluded by the parties. The fee may also be used as consideration for an option to receive a formal license. If the fee is principally payment for the cost of providing materials to the prospective licensee, however, it might not be creditable at all.

NOTE: The licensee should ascertain the extent of the proposed trade secret's usage to ensure that it is indeed a trade secret before initiating a "look-see fee" procedure. See *Swartz v Schering-Plough Corp.* (D Mass 1999) 53 F Supp 2d 95 (wide use negates existence of trade secret).

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§7.35A 4. Learned Intermediary

Occasionally, the need to have a trade secret evaluated and understood steers the trade secret owner toward using a "learned intermediary" to serve in the capacity of a mediator. In this situation, both the prospective licensee and the trade secret owner would agree on the use of an individual who is renown in the trade secret field, such as a university professor, and who can advise both sides on the nature and extent of the disclosure necessary to enable the prospective licensee to make an informed decision. Both sides usually absolve the intermediary from liability. This method is used when the intermediary is well known and well respected.

The advantage of this approach is that the trade secret owner has a knowledgeable and impartial party who clearly understands the technology and can evaluate the limits of its use without having to disclose the trade secret to the other side. The advantage to the prospective licensee is that an impartial adviser can readily assess the trade secret's value relative to the licensee's intended use. This method is not foolproof, but it can serve as a palatable alternative to the options set forth in §§7.33-7.35.

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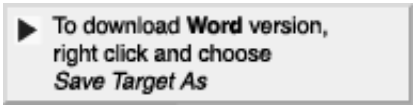
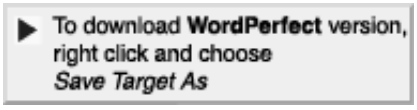
Source: Business Law/Trade Secrets Practice in California/7 Exploiting Trade Secrets by Licensing/§7.36 5. Form: Simple Confidentiality and Nondisclosure Letter Agreement

§7.36 5. Form: Simple Confidentiality and Nondisclosure Letter Agreement





_ _[*Name and address of recipient company*]_ _

Attention: _ _[*Name and title*]_ _

Re: _ _[*Generally identify confidential information*]_ _

Dear _ _[*name*]_ _**:**

This letter agreement ("Agreement") confirms that _ _[*name of recipient company*]_ _ **("Company") is interested in receiving confidential information developed by** _ _[*name of discloser*]_ _ **and pertaining to** _ _[*generally identify nature of confidential information*]_ _ **(the "Information") for the purpose of** _ _[*e.g., making a feasibility study in connection with a pollution-control project of Company*]_ _**.**

We consider the Information to be valuable proprietary information. We are willing to make the Information available to you, for the above purpose only, on the following terms:

1. "Confidential Information" shall mean all information relating to the Information, disclosed by us or on our behalf to the Company, either directly or indirectly, in writing, orally, or by your observation of our facilities. It does not include (a) information that is not subject to any obligation of confidentiality and is in documents that were not provided by us in your possession at the time of disclosure, (b) information that is now public or later made public not as a result of any action or inaction on your part, or (c) information that is now or later lawfully received by you from a third party entitled to disclose the information and not subject to any obligation of confidentiality. You shall have the burden of proving the applicability of any of such exceptions.

2. You agree not to use any Confidential Information except for the purpose of _ _[*specify*]_ _**.**

3. You agree to pay us for this right a one-time, lump-sum, nonrefundable look-see fee of _ _[*dollar amount*]_ _.

4. You agree to take reasonable steps _ _[*and to employ measures no less stringent than those applied to your own confidential information*]_ _ **to prevent disclosure of any Confidential Information to any unauthorized person or entity, and not to disclose any Confidential Information to anyone other than** _ _[*specify by name or title*]_ _ **of Company without our consent, which may be withheld in our sole discretion. Such steps shall include the following:**

a. You shall advise anyone who receives Confidential Information of the existence and scope of these restrictions.

b. You shall require anyone who receives Confidential Information to execute a separate nondisclosure agreement containing terms no less restrictive than the terms of this Agreement.

c. On termination of this Agreement or when the Confidential Information is no longer needed for the specific purposes for which it was initially disclosed, you shall request that anyone who received Confidential Information return all tangible materials embodying any portion of the Confidential Information.

5. If you are requested or ordered in any legal proceeding to disclose any of the Confidential Information, you shall not make any such disclosures without the prior written authorization of _ _[*specify*]_ _ **(in the case of a request) or, to the extent lawfully permitted, without prompt prior written notice to** _ _[*specify*]_ _ **(in the case of an order), and any disclosure by you shall be limited to the Confidential Information specified in the request**

or order. You shall cooperate with us to attempt to resist or narrow such requests or orders or to attempt to obtain appropriate protective orders or other assurance of nondisclosure that the other party elects.

6. No portion of your rights under this Agreement may be transferred, assigned, or licensed to any other party.

7. You agree to take reasonable steps _ _[*and to employ measures no less stringent than those applied to your own confidential information*]**_ _ to ensure that your employees, agents, partners, and others to whom you may grant access to the Confidential Information do not disclose this Confidential Information to third parties and that you will be responsible and liable for any unauthorized disclosure by those parties.**

8. The restrictions contained in this Agreement shall be in effect in perpetuity and shall be construed in accordance with and governed by California law without regard to conflict of laws provisions thereof.

9. All materials delivered to you by us (and all copies thereof), or created by you, containing any Confidential Information are our property and will be returned to us _ _[*e.g., 90*]**_ _ days after you sign this letter or at our written request, whichever is earlier. You shall retain no copies of such materials in any form.**

Nothing in this Agreement shall obligate either party to proceed with any transaction, and each party reserves the right, in its sole discretion, to terminate discussions concerning the business relationship contemplated by this Agreement. All Confidential Information is provided "as is," and we do not make any warranty, express or implied, regarding the accuracy or completeness of the Confidential Information provided to you.

If this letter agreement is acceptable to you, please indicate your assent by signing both copies of this letter, returning one copy to us, and keeping one for your files. We shall then send you a written description of the Information.

Sincerely yours,

_ _[*Name of disclosing company*]**_ _**

By: __[*Signature*]**__**
Name: _ _[*Typed name*]**_ _**
Its: _ _[*Title*]**_ _**

_ _[*Name of recipient company*]**_ _ accepts and agrees to the terms of this Agreement on this _ _**[*date*]**_ _.**

_ _[*Name of recipient company*]**_ _**

By: __[*Signature*]**__**
Name: _ _[*Typed name*]**_ _**
Its: _ _[*Title*]**_ _**

Comment: Most companies do not include specific protective steps that must be adopted by the recipient of the information, although some do. The practitioner may also add many additional provisions to suit particular circumstances, such as:

- Granting the prospective licensee an option to receive a formal license from the proprietor for a specified period of time.
- Limiting the time period for the duty to maintain the disclosure in confidence. Specifying a short period of confidentiality could lead to a loss of trade secret protection, however. One court has found that no duty of confidentiality existed after expiration of a nondisclosure obligation. *Expansion Plus, Inc. v Brown-Forman Corp.* (5th Cir 1998) 132 F3d 1083. Consequently, a recipient of confidential information may be able to disclose or use the information after the confidentiality period ends.
- Permitting enforcement by injunction without having to prove damages or post a bond.
- Providing for liquidated damages, but this may preclude the proprietor from asserting "irreparable harm" in seeking injunctive relief.

For example, the license may provide that, on issuance of a patent on the trade secrets, the recipient has the option to enter into a formal patent license agreement relative to the patented rights by payment of an up-front fee. Another example is relief from the obligation to maintain the secrecy of confidential information on the occurrence of certain events, such as the first commercial sale of the product or on the payment by the recipient of a certain amount of money.

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8

Form Licensing Agreements and Provisions

Peter C. Pang
Kevin D. DeBré

I. PRELIMINARY INFORMATION §8.1

II. LICENSE AGREEMENT PROVISIONS
- A. Form: Title and Introduction §8.2
- B. Form: Recitals §8.3
- C. Form: Definitions §8.4
- D. License Grant §8.5
  - 1. Form: Basic Grant Clause §8.6
  - 2. Form: Restrictive Grant Clause §8.7
  - 3. Form: Grant Clause for Trade Secret and Patent Hybrid Licenses §8.8
  - 4. Form: Grant Clause for Licensing Trade Secrets Disclosed in Patent Applications §8.9
  - 5. Form: Grant Clause for Trade Secret and Trademark Hybrid Licenses §8.10
  - 6. Form: Grant Clause With No Right of Sublicense §8.11
  - 7. Form: Grant Clause With Right of Sublicense §8.12
  - 8. Form: Grant Clause Including Licensee's Modifications to Licensed Subject Matter §8.13
- E. Compensation
  - 1. Form: Down Payment §8.14
  - 2. Royalty Payments
    - a. Form: Basic Royalty Provision §8.15
    - b. Form: Royalty Provision Providing Economic Incentive to Practice Trade Secrets in Designated Territory §8.16
    - c. Form: Allocation of Royalties if Hybrid Trade Secret and Patent License §8.17
  - 3. Form: Payment Terms; Paid-Up License §8.18
- F. Form: Use of Trademarks §8.19
- G. Form: Warranties §8.20
- H. Form: Limitation of Warranties §8.21
- I. Form: Future Improvements §8.22
- J. Form: Grant-Back §8.23
- K. Form: Disclosure of Technical Information Pursuant to Agreement §8.24
- L. Form: Secrecy §8.25
- M. Form: Effect of Disclosure §8.26
- N. Form: Reports §8.27
- O. Form: Records §8.28
- P. Form: Third Party Claims §8.29
- Q. Form: Duration of Agreement §8.30
- R. Form: Events of Default §8.31
- S. Form: Remedies §8.32
- T. Form: Arbitration §8.33
- U. Form: Notices; Record Address §8.34
- V. Form: Amendments §8.35
- W. Form: Construction §8.36
- X. Form: Integration §8.37
- Y. Form: Exhibits §8.38
- Z. Form: No Waiver §8.39
- AA. Form: Headings §8.40
- BB. Form: Governing Law and Choice of Forum §8.41
- CC. Form: Attorney Fees §8.42
- DD. Form: Severability §8.43
- EE. Form: Binding Effect §8.44
- FF. Form: Signature Block §8.45

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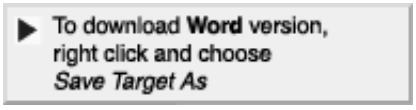
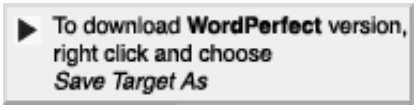
Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.1 I. PRELIMINARY INFORMATION

§8.1 I. PRELIMINARY INFORMATION





Before drafting a license agreement, the practitioner should ask the following preliminary questions and collect the responses:

- What are the names, addresses, telephone numbers, and e-mail addresses of the licensor and counsel for the licensor, the licensor's subsidiaries and affiliates, the licensee and counsel for the licensee, and the licensee's subsidiaries and affiliates?
- What property is being licensed?
- When was the property created and by whom?
- Does the licensor use the property to be licensed?
- How will the licensee use the property to be licensed?
- Who will own the improvements, and what licensing obligations are imposed on such improvements?
- Does the licensee have a right to sublicense, and if so, what conditions or restrictions apply?
- For how long is the license granted?
- What, if any, are the territorial limits?
- What, if any, are the limits on use?
- Are there any other limitations?
- What, if any, look-see fee will be charged?
- What, if any, is the down payment, and will it be applied against royalties?
- How are royalty payments calculated and when are they due?
- How will the licensor initially transfer the licensed property to the licensee and later provide the licensee with technical information and assistance?
- What specific security measures, if any, does the licensor want to impose on the licensee?
- What are the licensee's reporting and record-keeping obligations?
- What are the licensor's rights of audit?
- What remedies are available for the licensee's breach?
- What are the consequences of terminating the license?
- Will disputes be subject to arbitration?
- If the licensee is a foreign person or entity, does the licensee have assets in the United States?

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/ II. LICENSE AGREEMENT PROVISIONS/§8.2 A. Form: Title and Introduction

II. LICENSE AGREEMENT PROVISIONS

§8.2 A. Form: Title and Introduction

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

LICENSE AGREEMENT

THIS LICENSE AGREEMENT ("Agreement") is made _ _[*on/as of*]**_ _ _ _**[*date*]**_ _ ("Effective Date"), between _ _**[*name of licensor*]**_ _ ("Licensor") and _ _**[*name of licensee*]**_ _ ("Licensee").**

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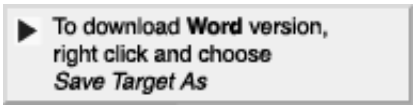
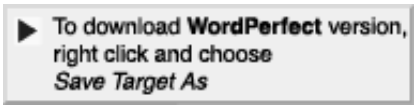
§8.3 B. Form: Recitals

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.





RECITALS

A. Licensor is _ _[*identify type of entity, e.g., a California corporation*]**_ _ with its principal place of business at _ _**[*address*]**_ _. Licensor is in the business of _ _**[*briefly identify*]**_ _.**

B. Licensee is _ _[*identify type of entity, e.g., a California corporation*]**_ _ with its principal place of business at _ _**[*address*]**_ _. Licensee is in the business of _ _**[*briefly identify*]**_ _.**

C. The parties desire to enter into this Agreement to license to Licensee, and to enable Licensee to exploit, the _ _[*briefly identify*]**_ _ on the terms stated in this Agreement, to enhance or improve the quality of _ _**[*briefly identify*]**_ _, and to compete more effectively against Licensee's competitors.**

Comment: The agreement should contain a brief statement identifying the parties by their names, places of incorporation, and principal places of business. Alternatively, this information could be included in the introduction or, for more lengthy and complex relationships, in the definitions section. See forms in §§8.2, 8.4.

The purpose of the recitals is to explain the background, basis, and objectives of the agreement. Counsel should incorporate the information in the recitals into the operative provisions of the agreement as appropriate. For antitrust purposes, it is desirable to state the relative positions of the parties and the publicly useful goal of the agreement. Licensing often has the effect of creating a competitor, and a contemporaneous arm's-length statement outlining this effect may be valuable should the matter later be litigated.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.4 C. Form: Definitions

§8.4 C. Form: Definitions

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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EXPLANATORY NOTE: This definitions clause is not complete, and some of the terms may not be applicable to all agreements. Other terms particular to a specific situation may be required. For example, quantities are often important because guaranties and royalties may be based on amounts, and the agreement should define terms of measurement with precision if there is any possibility of ambiguity; *e.g.,* the practitioner should define terms such as "net sales" if used in the agreement to calculate royalties.

This clause also includes some terms that may not be appropriate for the transaction at issue. Any unnecessary terms should be deleted.

Note that the terms are listed in alphabetical order. They could be arranged in any other order that makes sense for the transaction.

8.4-1 Definitions section heading and introduction

1. *Definitions.* As used in this Agreement, the terms below will have the meanings set forth:

8.4-2 Optional addition to 8.4-1: Improvements

a. "Improvements" means improvements, modifications, adaptations, revisions, enhancements, additions, or changes to any of the Licensed Property, or the design, construction, and operation of the manufacturing facility in which the Licensed Property will be used or practiced.

8.4-3 Optional addition to 8.4-1: Licensed manufacturing territory

b. "Licensed Manufacturing Territory" means only _ _[*specify locations*]**_ _.**

8.4-4 Optional addition to 8.4-1: Licensed patents

c. "Licensed Patents" means the patents and patent applications (as presently or hereafter comprised) listed in Exhibit _ _ _, including any and all parent applications, reissues, reexaminations, renewals, extensions, divisionals, continuations, divisions and continuations-in-part, and foreign counterparts.

8.4-5 Optional addition to 8.4-1: Licensed processes and licensed products

d. "Licensed Processes" means the following processes and methods: _ _[*Generally describe and identify, using licensor's identification system*]**_ _. "Licensed Processes" also includes any other processes covered by the Trade Secrets _ _**[*or claimed in one or more Licensed Patents*]**_ _.**

e. "Licensed Products" means the following products and parts: _ _[*Generally describe and identify, using licensor's identification system*]**_ _. "Licensed Products" also includes any other products covered by the Trade Secrets _ _**[*or claimed in one or more Licensed Patents*]**_ _.**

8.4-6 Optional addition to 8.4-1: Licensed property

f. "Licensed Property" means Trade Secrets, Technical Information, Licensed Processes, Licensed Products, Licensed Patents, and Licensed Trademarks.

8.4-7 Optional addition to 8.4-1: Licensed sales territory

g. "Licensed Sales Territory" means only _ _[*specify locations*]_ _.

8.4-8 Optional addition to 8.4-1: Licensed territory

h. "Licensed Territory" means only _ _[*specify, e.g., the United States/in a facility approved by Licensor located within _ _[specify area of permitted use*]_ _]_ _.

8.4-9 Optional addition to 8.4-1: Licensed trademarks

i. "Licensed Trademarks" means the trademarks, trade names, service marks, industrial designs, trade dress, insignias, logos, domain names, and designations listed in Exhibit _ _[*specify*]_ _.

8.4-10 Optional addition to 8.4-1: Licensee and licensor

j. "Licensee" means _ _[*name of licensee*]_ _, _ _[*e.g., a California corporation*]_ _ with its principal place of business in _ _[*specify*]_ _ and all its divisions and stock-controlled subsidiaries.

k. "Licensor" means _ _[*name of licensor*]_ _, _ _[*e.g., a California corporation*]_ _ with its principal place of business in _ _[*specify*]_ _ and all its divisions and stock-controlled subsidiaries.

8.4-11 Optional addition to 8.4-1: Primary licensed territory

***l*. "Primary Licensed Territory" means only _ _[*specify locations*]_ _.**

8.4-12 Optional addition to 8.4-1: Royalties

m. "Royalties" means the royalty payments described in Section _ _[*specify*]_ _ of this Agreement.

8.4-13 Optional addition to 8.4-1: Technical information

n. "Technical Information" means all transferable technical data, know-how, shop practices, plans, drawings, blueprints, specifications, methods of manufacture, and other information or assistance pertaining to the Trade Secrets, Licensed Processes, Licensed Products, or any of them, acquired by Licensor before _ _[*date*]_ _.

8.4-14 Optional addition to 8.4-1: Trade secrets

o. "Trade Secrets" means information, including without limitation formulas, patterns, compilations, programs, devices, methods, techniques, or processes, that (i) derives independent economic value, whether actual, potential, or both, from not being generally known to the public or to 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.

Comment:

Form 8.4-2, "Improvements": This term is used if the agreement addresses the ownership and use of improvements or modifications to the licensed property.

Forms 8.4-3, "Licensed Manufacturing Territory," and 8.4-7, "Licensed Sales Territory": It is possible, and common, to allow the licensee to practice the trade secret in a limited or restricted territory, such as the United States or Canada, and to sell the resulting product in the same or a different (either more or less expansive) geographic area. If the licensee is limited to different geographic areas for practicing the trade secrets and sales, these definitions are used. If the licensee is limited to the same geographic area for both, a single term should be used for the "licensed territory." See form 8.4-8. See also Comment to form 8.4-11.

Form 8.4-4, "Licensed Patents": This provision is used if patents or patent applications are licensed. Often a patent license involves not only the patent issued but all continuations-in-part, subsequent discoveries that "update" the original patent, and related foreign patents. Most patent licensees demand that all patent applications filed relating to the invention claimed in the licensed patent be considered part of the "Licensed Patents" for purposes of the license

agreement. This is a matter of negotiation between the parties. See §§7.3-7.6 for discussion of hybrid licenses encompassing both trade secret and patent rights. Because a patent application may go through several permutations before it issues as a patent by the United States Patent and Trademark Office (PTO), the exhibit referred to in this definition should identify issued patents by patent numbers and should identify patent applications by PTO serial numbers.

Form 8.4-5, "Licensed Processes" and "Licensed Products": Complete, detailed descriptions of processes or products should not be provided in the agreement because of the potential threat to secrecy. However, the agreement should include sufficient detail to minimize the risk of confusion on the nature of the trade secret being licensed. These definitions can briefly describe the licensed property or they can refer to a schedule that identifies them. The practitioner must avoid language that is ambiguous, overbroad, or otherwise not perfectly clear. Each process and product to be licensed should be listed with the licensor's identification system, either in this section or in a confidential appendix or exhibit to the agreement. An appendix or exhibit could explain the nature of the trade secrets in greater detail, but if so, it should be delivered only after execution of the agreement and only under an obligation of confidentiality. The parties may want to be somewhat vague in order to give the licensee some discretion as encouragement to create new or previously unknown products, yet arguably keep such new and unknown products within the scope of the licensed products and collect royalties.

Form 8.4-8, "Licensed Territory": This term is used if the licensee is limited to a single geographic area for practicing or using the licensed property and selling the resulting product. If different geographical areas apply, the agreement should use the definitions in forms 8.4-3 and 8.4-7.

Form 8.4-9, "Licensed Trademarks": This term is used if trademarks are licensed.

Form 8.4-10, "Licensee" and "Licensor": If the parties have not been defined earlier in the agreement, *i.e.,* in the introduction (see §8.2), they should be defined here. By defining "Licensee" and "Licensor" here as including all related parties, counsel ensures that the related parties are covered by the agreement. Including affiliates within the definition of "Licensee" increases the number of entities that will have access to the trade secrets, potentially making administration of the license difficult. Including affiliates within the definition of "Licensor" ensures that the license includes trade secrets that are not owned by the licensor but are instead owned by an affiliate.

Form 8.4-11, "Primary Licensed Territory": Territorial limitations for patent licenses are expressly permitted by statute (35 USC §261), but no statutory permission exists for trade secrets licenses. They have been challenged on antitrust grounds because they may tend to unduly restrict the freedom of the licensee. See §§7.25-7.31 for discussion of antitrust issues. Thus, they should be approached with caution. The safest approach is to avoid territorial limitations entirely, but if an unlimited grant is not feasible, the territory should be defined as broadly as possible. Alternatively, counsel can attempt to minimize the threat of antitrust attack by granting a nonexclusive (rather than an exclusive) license within the delineated territory. Another option is to provide an economic incentive to practice the trade secret in a designated territory, rather than restrict the licensee's right to practice the trade secrets in a particular territory. The license can be fashioned to allow a discount on the royalties otherwise due under the license if the trade secrets are practiced only within a certain geographic area. See form in §8.16. If this last option is chosen, the area for which the incentive applies should be defined in this form as the "Primary Licensed Territory."

Form 8.4-14, "Trade Secrets": This definition of "trade secrets" is based on the Uniform Trade Secrets Act definition. See CC §3426.1(d).

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.5 D. License Grant

§8.5 D. License Grant

The central provision in a license agreement is the license grant. The granting clause must be drafted so that the parties know the precise scope of the license. Drafting comprehensive grant clauses requires careful and thorough thought and anticipation. In drafting this clause, the practitioner must first decide the following issues:

- Is the grant exclusive or nonexclusive? See §7.11.
- Is the grant restrictive (*i.e.,* is the right to use the trade secret limited to certain uses or markets)?
- Does the license cover trade secrets only or other intellectual property as well? See §§7.3, 7.24.
- Does the licensee have the right to sublicense the trade secret or other technology? See §7.12.
- Who owns modifications to the licensed subject matter? See comment in §8.13.
- Where can the licensee use the technology? See §7.10.
- For how long can the licensee use the technology? (Alternatively, this question can be addressed in a separate section.)

For further discussion of grant clauses, see Makous, *Drafting Grant Clauses for License Agreements Involving Intellectual Property*, 11 CEB Cal Bus L Prac 35 (Spring 1996), from which portions of this chapter were derived.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.6 1. Form: Basic Grant Clause

§8.6 1. Form: Basic Grant Clause

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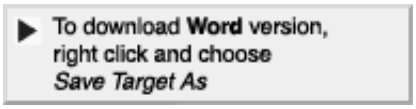

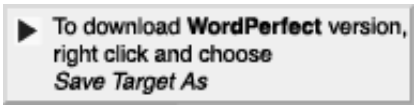

2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to use the Licensed Property for a period of _ _[*specify term*]_ _ (the "License"). This right to use the Licensed Property includes the right to gain access to the Technical Information.

Comment: The language identifying the license as nonexclusive or exclusive is not necessary, but it greatly reduces the risk of later argument over the parties' intent.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.7 2. Form: Restrictive Grant Clause

§8.7 2. Form: Restrictive Grant Clause

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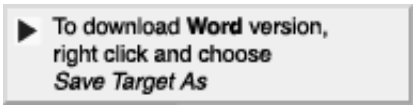

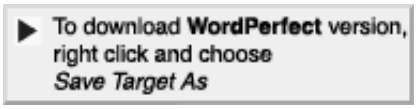

2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to use the Licensed Property in a manufacturing facility approved by Licensor to design, develop, and manufacture the Licensed Products in the Licensed _ _[*Manufacturing*]_ _ Territory and the right to distribute the Licensed Products in the Licensed _ _[*Sales*]_ _ Territory for a period of _ _[*specify term*]_ _ (the "License"). The Licensed Products will be manufactured according to the specifications set forth in Exhibit _ _ _ to this Agreement.

Comment: This provision limits the licensee's use of the licensed property. It is more restrictive than the grant clause in §8.6 because it restricts the licensee's manufacturing locations and more specifically prescribes the permitted use of the licensed processes. This provision is useful if the licensor wants to control the location of the exploitation of the trade secret or is concerned that the licensee will have the goods manufactured outside the United States in a jurisdiction where enforcement would be difficult. Note that the degree to which the license agreement is restrictive depends in part on the definition of the licensed property, the variety of products for which the licensed property may be used, and the area within which it may be used.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.8 3. Form: Grant Clause for Trade Secret and Patent Hybrid Licenses

§8.8 3. Form: Grant Clause for Trade Secret and Patent Hybrid Licenses

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to make, have made, use, sell, offer for sale, and import the Licensed Products using the Licensed Property for a period of _ _[*specify term*]_ _ (the "License").

Comment: The practitioner may insert territorial limits for the license by using the territorial language in §8.7.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.9 4. Form: Grant Clause for Licensing Trade Secrets Disclosed in Patent Applications

§8.9 4. Form: Grant Clause for Licensing Trade Secrets Disclosed in Patent Applications

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to make, have made, use, sell, offer for sale, and import the Licensed Products for a period of _ _[*specify term*]_ _ (the "License"). If any portion of the Trade Secrets is the subject of a patent application filed by Licensor, Licensee shall be required to maintain the confidentiality of that portion of the Trade Secrets only until there is a disclosure of such Trade Secrets by virtue of publication of the patent application or issuance of a patent as permitted by the Patent Cooperation Treaty.

Comment: This broad grant clause is not recommended; it could result in a myriad of problems because of its lack of clarity:

- What are the parties' rights if the patent is never issued or is issued for only a very narrow part of the initially claimed subject matter?
- A patent may issue in none, one, some, or all of the Patent Cooperation Treaty designated countries (now a total of 142 countries). See generally http://www.wipo.int/pct/en/. How does this affect the overall grant of rights, the royalty structure, and enforceability of the license?
- Does including the phrase "as now or later claimed" in the definition of Licensed Products obligate the licensee to pay in the future for products within the scope of abandoned claims?
- Is anything licensed a "trade secret"?
- If the licensed subject matter is at some time neither patented nor a secret, is it licensed?

WARNING: If the license allows the licensor to reap royalties only after patent issuance in a specific country, then, in the absence of an issued patent, royalty obligations do not commence. The practitioner should draft the license to allow for any risk that a patent may not issue in a particular jurisdiction rather than allowing the agreement to terminate or fail by operation of law (based on an essential purpose of the license not being satisfied). To accommodate this contingency, the license should state that, until a patent issues, all information is proprietary and thus constitutes trade secrets. The royalty provision should then state that the royalties are compensation for the trade secrets, but if the trade secrets result in a patent, the licensee will pay a specified additional amount that reflects the additional value of an issued patent. See form 8.15-5. The agreement should anticipate the evolution of unpatented licensed trade secrets to patented inventions.

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§8.10 5. Form: Grant Clause for Trade Secret and Trademark Hybrid Licenses

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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2. *Grant Clause*. Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ **right to make, have made, use, and sell the Licensed Products, using the Technical Information, Trade Secrets, and Licensed Processes, and to use the Licensed Trademarks in any product box, packaging, and literature to promote and advertise the Licensed Products, for a period of** _ _[*specify term*]_ _ **(the "License").**

Comment: If a trade secret license is coupled with a trademark license, the practitioner should include a quality control provision to protect the licensor's trademark. See §8.19.

The practitioner may insert territorial limits for the license by using the territorial language in §8.7.

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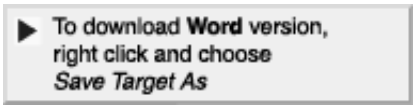
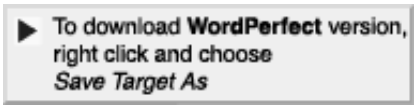
Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.11 6. Form: Grant Clause With No Right of Sublicense

§8.11 6. Form: Grant Clause With No Right of Sublicense

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.





2. *Grant Clause*. Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee _ _[*an exclusive/a nonexclusive*]_ _, nontransferable license, with no right of sublicense, to use the Licensed Property in the Licensed _ _[*Manufacturing*]_ _ Territory to make the Licensed Products until _ _[*date*]_ _, and to sell the Licensed Products in the Licensed _ _[*Sales*]_ _ Territory until _ _[*date*]_ _ (the "License").

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.12 7. Form: Grant Clause With Right of Sublicense

§8.12 7. Form: Grant Clause With Right of Sublicense

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _, nontransferable (except as otherwise stated in this Agreement) right (the "License"), until _ _[*date*]_ _:

a. To use the Licensed Property to practice the Licensed Processes within the Licensed Manufacturing Territory.

b. To use the Licensed Property within the Licensed Manufacturing Territory to make, or have made, the Licensed Products.

c. To sell or lease for use the Licensed Products within the Licensed Sales Territory.

d. To sublicense to third parties the right to practice the Licensed Processes or manufacture the Licensed Products, provided that (i) Licensee shall obtain Licensor's prior written approval of any proposed sublicense agreement before execution, which approval _ _[*may be withheld in Licensor's sole discretion/shall not be unreasonably withheld or delayed*]_ _; (ii) Licensee shall pay to Licensor an amount equal to (a) _ _[*specify, e.g., 50 percent of all royalties earned under any sublicense agreement*]_ _ or (b) the Royalties due under this Agreement, whichever is greater; (iii) the intended sublicensee shall agree to confidentiality obligations no less stringent than those imposed on Licensee in this Agreement or in any related agreement; and (iv) Licensee guarantees the full compliance of each sublicensee with these confidentiality obligations and Licensee shall be liable to Licensor for any and all violations by a sublicense of any confidentiality obligations.

No license, either express or implied, is granted by Licensor to Licensee to use the Licensed Property for any purpose except as specifically stated in this Agreement.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.13 8. Form: Grant Clause Including Licensee's Modifications to Licensed Subject Matter

§8.13 8. Form: Grant Clause Including Licensee's Modifications to Licensed Subject Matter

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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8.13-1 Alternative: Grant clause; improvements owned by licensor

2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to make or have made the Licensed Products in the Licensed Manufacturing Territory using the Licensed Process until _ _[*date*]_ _ (the "License"). Any Improvements, whether invented by Licensor or Licensee, alone or jointly with others, will belong solely to Licensor during and after the term of this Agreement but will immediately be deemed to be part of the Licensed Property and Licensee shall have a worldwide, nonexclusive, royalty-free right to use the Improvements during the term of this Agreement. Licensee hereby assigns to Licensor all rights, title, and interest in and to all Improvements in which Licensee may acquire rights.

8.13-2 Alternative: Grant clause including licensee's modifications to licensed subject matter; improvements owned by party developing them

2. *Grant Clause.* Subject to all the terms and conditions of this Agreement, Licensor grants to Licensee the _ _[*exclusive/nonexclusive*]_ _ right to make or have made the Licensed Products in the Licensed Manufacturing Territory using the Licensed Process until _ _[*date*]_ _ (the "License"). Any Improvements invented by Licensor will be deemed the property of Licensor and will immediately be deemed to be part of the Licensed Property, and Licensee shall have a worldwide, nonexclusive, royalty-free right to use the Improvements during the term of this Agreement. Any Improvements invented by Licensee will be deemed the property of Licensee, and Licensor shall have a worldwide, nonexclusive, royalty-free license of the Improvements during the term of this Agreement.

Comment: A licensee often contributes its know-how, ingenuity, and novelty to modify and improve a licensed process or product. The grant clause and its related clauses should anticipate this and carve out the relationship between the licensor and the licensee as to the ownership and other rights relating to these modifications and improvements. Counsel should also provide in the royalty or compensation section that these automatic assignments, in addition to any monetary payments, are part of the consideration being given by the licensee.

Form 8.13-1, resulting in the licensee's inventions belonging to the licensor, can be difficult to negotiate if the prospective licensee carefully considers the consequences. Transferring ownership to the licensor may result in the licensee paying too much for the license (royalty plus transfer of ownership of its own inventions) and again placing the licensee in a noncontrolling position as licensee rather than licensor. If use of an improvement requires use of the licensed process or product, the licensee may not be able to use the improvement after the license terminates, even if the licensee retains ownership of improvements as provided in form 8.13-2.

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E. Compensation

§8.14 1. Form: Down Payment

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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8.14-1 Down payment

3. *Down Payment.* Licensee shall pay to Licensor a nonrefundable down payment _ _[*on/within* _ _[*specify number*]_ _ *business days after*]_ _ execution of this Agreement, in the amount of _ _[*specify amount*]_ _. The down payment shall be nonrefundable and, if Licensee elects not to use the Licensed Property or not to proceed with the practice of the Technical Information within _ _[*specify number*]_ _ days following the Effective Date, then either party may terminate this Agreement by providing written notice to the other party and, in such event, neither party shall have any further obligations to the other.

8.14-2 Optional addition to 8.14-1: Down payment credited against royalties

If Licensee elects to use the Licensed Property after its disclosure to Licensee under this Agreement, _ _[__ *percent of*]_ _ this down payment shall be credited against the Royalties to be earned over the next _ _[*specify term*]_ _ in equal installments.

Comment: The down payment is often used to cover the licensor's administrative expenses of collecting the secret information—and organizing it for presentation to the licensee—and the licensor's legal fees incurred for negotiating and drafting the license. The license agreement is generally silent on the application of the down payment toward these costs. By narrowing the down payment to administrative costs, the court could exercise its own assessment that the deposit exceeds the administrative costs and could require the licensor to refund the difference. It may be difficult to obtain a down payment, however, if a look-see fee has been paid. See §7.35 for discussion of look-see fees.

The down payment can provide the licensor with the bulk of compensation early in the relationship, which can be important if the licensor suspects that the life of the trade secret may not be long or if to disclose the nature of the secret is to convey most of its value (*i.e.,* the licensor does not contemplate receiving much compensation in subsequent royalty payments). Strategically, a down payment is always recommended as a hedge against trade secret dilution, but a high down payment generally results in a lower royalty rate.

The down payment may also be treated as an advance against royalties, *e.g.,* as a 50- or 100-percent deduction against royalties. A nonrefundable deposit creditable against royalties provides the licensor with the opportunity to assess the seriousness of the licensee in exploiting the trade secret, as well as the licensee's confidence in being able to sell the licensed products in commercial quantities. A nonrefundable deposit may be difficult to negotiate, however; the licensee may argue that the arrangement is unfair because the licensor takes virtually no risk in the transaction.

A refundable deposit would put the licensor in a difficult spot because the licensor would not be compensated for lost opportunity costs (*i.e.,* the ability to license to others) if the licensee fails to successfully produce a commercially viable product using the trade secret.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/ 2. Royalty Payments/§8.15 a. Form: Basic Royalty Provision

2. Royalty Payments

§8.15 a. Form: Basic Royalty Provision

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8.15-1 Alternative: Basic royalty provision

4. *Royalties.*

a. Licensee shall pay to Licensor, as consideration for the rights granted under this Agreement, Royalties in an amount equal to (i) _ _[*number*]_ _ percent of the net sales or lease price collected by Licensee on each Licensed Product sold or leased, plus (ii) _ _[*dollar amount*]_ _ per _ _[*quantity*]_ _ of _ _[*identify product*]_ _ produced by the Licensed Process.

8.15-2 Optional addition to 8.15-1: Subject to minimum royalty payment

provided that Licensee shall pay to Licensor an annual minimum royalty of _ _[*dollar amount*]_ _ per calendar year, with proration of the amount otherwise due for less than a full year of operation, if such amount is greater than the amount of Royalties accrued during the same period.

8.15-3 Optional addition to 8.15-1: Subject to maximum royalty payment

b. On Licensee's payment to Licensor of Royalties under this Section _ _[*specify*]_ _ _ _[*and the down payment under Section _ _[specify]_ _ of this Agreement*]_ _ in the maximum amount of _ _[*dollar amount*]_ _, the License shall be fully paid and irrevocable for the term of this Agreement.

8.15-4 Optional addition to 8.15-1: Licensee's improvements or modifications are assigned or licensed to licensor

c. As further consideration for the right to use the Licensed Property, Licensee shall immediately transfer, convey, and assign to Licensor all rights, title, and interest that Licensee may acquire in and to the Improvements. Licensee shall execute such documents or instruments as necessary and appropriate in order to vest Licensor with title and ownership in the Improvements.

8.15-5 Optional addition to 8.15-1: Royalties are to increase on issuance of patent

d. If the Trade Secrets result in the issuance of a patent within the Licensed Territory, Licensee shall pay to Licensor, as part of the Royalties, an amount equal to _ _[*dollar amount or formula for calculating the amount*]_ _ to reflect the additional value of the issued patent.

8.15-6 Optional addition to 8.15-1: Value of licensed property may decrease on issuance of patent

e. The obligation to remit Royalties is absolute and will not be offset even if the value of the Licensed Property is diminished through loss of patentability or public disclosure of confidential information.

Comment: The licensee generally wants the right to terminate the obligation to pay royalties on public disclosure of the trade secret unless the disclosure results from the licensee's wrongful acts. See form in §8.26. Alternatively, the license might provide a specified term for payment, *e.g.,* 5 years, or, if shorter, the period of time ending on the date that the licensed subject matter becomes public, independent of any act or omission by the licensee.

8.15-7 Optional addition to 8.15-1: Expiration or invalidity of patent

f. On expiration of a Licensed Patent or in the event any claim included in a Licensed Patent is held invalid or unenforceable by a court of competent jurisdiction from which no appeal has or can be taken, Licensee's obligation to pay Royalties based on that Licensed Patent or claim will cease as of the date of expiration or of such decision and, in consideration for rights with respect to the Trade Secrets granted under this Agreement, Licensee shall instead pay to Licensor Royalties in an amount equal to (i) _ _[*number*]_ _ percent of the net sales or lease price collected by Licensee on each Licensed Product sold or leased, plus (ii) $_ _[*dollar amount*]_ _ per _ _[*quantity*]_ _ of _ _[*identify product*]_ _ produced by the Licensed Process.

Comment: Because courts will not enforce patent royalties after a patent expires or is invalidated but will continue to enforce trade secrets royalties, any licensing agreement pertaining to both patents and trade secrets should allocate royalties. See form in §8.17.

WARNING: A licensee might try to use net sales or sales through affiliates to reduce the royalty amount. It is thus important to include in the calculation of royalties net sales by subsidiaries and affiliates.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.16 b. Form: Royalty Provision Providing Economic Incentive to Practice Trade Secrets in Designated Territory

§8.16 b. Form: Royalty Provision Providing Economic Incentive to Practice Trade Secrets in Designated Territory

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4. *Royalties.*

a. Licensee shall pay to Licensor, as consideration for the rights granted under this Agreement, Royalties in an amount equal to (i) _ _[*number*]_ _ percent of net sales or lease price collected by Licensee on each Licensed Product sold or leased if Licensee practices or uses the Licensed Property in the Primary Licensed Territory and (ii) _ _[*number*]_ _ percent of net sales or lease price collected by Licensee on each Licensed Product sold or leased if Licensee practices or uses the Licensed Property outside the Primary Licensed Territory or distributes products manufactured with the use of the Licensed Property outside the Primary Licensed Territory.

Comment: See forms 8.15-2 through 8.15-6 for optional language that may be included in this royalty provision. See also Comment to form in §8.15.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.17 c. Form: Allocation of Royalties if Hybrid Trade Secret and Patent License

§8.17 c. Form: Allocation of Royalties if Hybrid Trade Secret and Patent License

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.

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5. *Allocation of Royalties.* Royalties will be allocated as follows:

a. _ _[*Number*]**_ _ percent of the Royalties will be payment for the right to practice the Trade Secrets.**

b. _ _[*Number*]**_ _ percent of the Royalties will be payment for the right to exploit the Licensed Patents.**

Comment: Because courts will not enforce patent royalties after a patent expires or is invalidated but will continue to enforce trade secrets royalties, any licensing agreement pertaining to both patents and trade secrets should allocate royalties.

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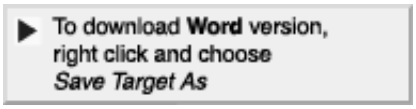
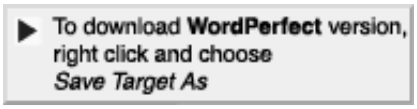
§8.18 3. Form: Payment Terms; Paid-Up License

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.





8.18-1 Payment terms

6. *Payment Terms.*

a. Licensee shall pay Royalties for _ _[*number*]_ _ years, beginning _ _[*date/with the date of the first sale of a Licensed Product or production of _ _[identify]_ _ using the Licensed Processes, by Licensee*]_ _.

b. Licensee shall pay to Licensor Royalties owed to Licensor for the preceding calendar quarter at such time as Licensee renders to Licensor each report required under Section _ _ _ of this Agreement. Within _ _[*e.g., 30 calendar days*]_ _ after the termination of this Agreement, Licensee shall pay to Licensor the amounts due to Licensor for the period from the last date covered by the last preceding payment to the date of termination. Licensee shall make all payments by _ _[*specify method of payment, e.g., company check sent to _ _[address]_ _ or wire transfer to an account designated by licensor*]_ _. Licensee shall make all payments to Licensor at _ _[*address*]_ _ or such other address as Licensor shall designate in writing.

c. Licensor's acceptance of any Royalties shall not preclude Licensor from later disputing the amount of Royalties owed.

8.18-2 Optional addition to 8.18-1: Paid-up license

d. On the payment of _ _[*dollar amount*]_ _ in the aggregate during the course of this Agreement and before its termination or expiration, the License shall be deemed to be paid up and no further payments shall be due for the balance of the Agreement as long as Licensee is not otherwise in breach of any material provisions of this Agreement.

e. Within 30 days before expiration of this Agreement, Licensee may notify Licensor of its intention to exercise the option of purchasing all rights, title, and interests to the rights granted in this Agreement, provided that Licensee is not in breach of any material provisions of this Agreement at the time of the closing of the purchase; and that on the date of the closing of the purchase the License shall have been paid up as set forth in paragraph 6d. This right to purchase is nontransferable and nonassignable. Failure to notify Licensor of Licensee's intent to exercise this option within 30 days before expiration of this Agreement shall be deemed to be an irrevocable waiver of such right.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.19 F. Form: Use of Trademarks

§8.19 F. Form: Use of Trademarks

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7. ***Use of Trademarks.***

a. Licensee shall affix the Licensed Trademarks to all Licensed Products manufactured under this Agreement. The Licensed Products should clearly indicate that the Licensed Trademarks are registered trademarks of Licensor and that the use of the Licensed Trademarks is pursuant to a license. Licensee shall submit three samples of each packaging, literature, promotion, and advertisement containing any version of the Licensed Trademarks to Licensor for review and approval before the release of such materials. Licensor's approval shall not be unreasonably withheld or delayed, but Licensor, in its sole discretion, may disapprove the use of any Licensed Trademarks if it determines in good faith that the Licensed Products are not at least comparable in quality to Licensor's product specifications or standards. Licensor's failure to respond to Licensee's submissions within _ _[*time period, e.g., 5 business days*]**_ _ after receipt will be deemed approval of the requested use of the Licensed Trademarks.**

b. Licensee's use of the Licensed Trademarks shall be in accordance with applicable trademark law and with Licensor's policies on advertising and trademark usage as established and amended by Licensor from time to time. Licensee shall use its best efforts at all times to promote and increase the awareness and acceptance of the Licensed Trademarks in a manner consistent with sound business practices. Whenever the Licensed Trademarks are used in advertising or in any other manner, Licensee shall clearly identify Licensor as the trademark owner. Licensee shall not do or cause to be done, or omit doing, any act that would in any way impair, reduce, or contest Licensor's right, title, and interest in the Licensed Trademarks. Licensee's use of the Licensed Trademarks will not create any right, title, or interest in or to the use of the trademarks, and all such uses and goodwill associated with the Licensed Trademarks will inure to the benefit of Licensor. Licensee shall not apply for the registration anywhere in the world of any trademark or domain name which is the same or confusingly similar to any of the Licensed Trademarks.

Comment: If a trade secret license is coupled with a trademark license, the practitioner should include a quality control provision to protect the licensor's trademark. The quality control provision should require that the products that bear the licensor's trademark meet the licensor's standards, giving the licensor the ongoing right to approve or disapprove all uses of the trademark with any products. If the parties elect to use a quality control provision, the licensee should submit preproduction samples of products, product packaging, advertising materials, etc., for the licensor's review. If the licensor disagrees with the proposed usage, the resulting dispute may lead to termination of the license (or at least the trademark aspect of the license) or a lawsuit for breach of contract. Note, however, that because all contracts have an implied covenant of good faith and fair dealing, the licensor's veto power is somewhat limited. It cannot be arbitrary and must be based on legitimate quality problems; the licensor may need to work with the licensee to correct such problems.

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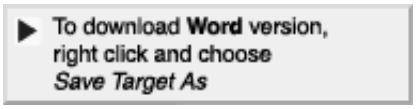
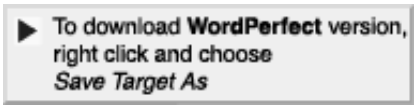
Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.20 G. Form: Warranties

§8.20 G. Form: Warranties

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.





8. *Warranties.* Licensor represents and warrants as follows:

a. Licensor is the owner of the Licensed Property, free of any liens, encumbrances, restrictions, or other legal or equitable claims _ _[*, except as specifically stated in Exhibit* _ _]_ _**.**

b. Licensor has the full right and corporate authority to grant the License to Licensee.

c. Licensor has taken reasonable measures to protect the confidentiality of the Trade Secrets. To Licensor's knowledge, none of the Trade Secrets has been disclosed or authorized to be disclosed to any third party other than in accordance with a nondisclosure agreement that protects Licensor's proprietary interests in and to the Trade Secrets. To Licensor's knowledge, no party to any nondisclosure agreement relating to the Trade Secrets is in breach or default thereof.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.21 H. Form: Limitation of Warranties

§8.21 H. Form: Limitation of Warranties

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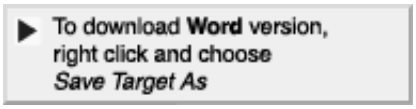

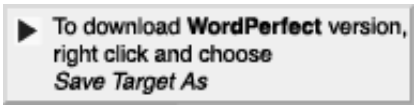

9. *Limitation of Warranties.* Licensor shall provide Licensee with access to the Technical Information, but Licensor does not assume any responsibility for Licensed Processes practiced or Licensed Products manufactured in accordance with the Technical Information. Licensor shall not be deemed to make, or to have made, any warranties, express or implied, concerning the Trade Secrets, Technical Information, Licensed Processes practiced, Licensed Products manufactured under this Agreement, or other Licensed Property, except as expressly stated in this Agreement, and Licensor disclaims all implied warranties of title, merchantability, fitness for a particular purpose, and noninfringement.

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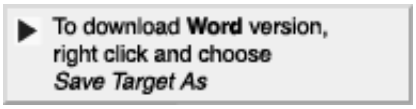
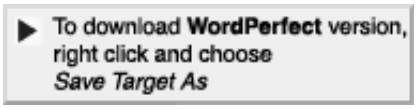
§8.22 I. Form: Future Improvements

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§8.2-8.45.





10. ***Future Improvements.***

a. Until _ _[*date/expiration of this Agreement*]_ _, Licensor shall provide Licensee with preliminary information, as it becomes available, relative to the Improvements. Licensor, on written request of Licensee made after receipt of the preliminary information, shall furnish to Licensee additional information to enable Licensee to ascertain whether the Improvements are suitable for use or manufacture by Licensee. Such preliminary information may consist of, but is not limited to, demonstrations, test results, instructions, repair and service manuals, and parts lists.

b. Licensor, on Licensee's written request, shall furnish to Licensee, to the extent available: (i) complete and detailed data to enable Licensee to fully use the Improvements; (ii) results of technical investigations, tests, operation analyses, and research related to the Improvements; and (iii) prints of assembly and detailed drawings of all special machines, tools, and other equipment used to create the Improvements.

c. On Licensee's written request, and without further action, the definitions of "Licensed Property" and of all of its components in Section _ _[*specify*]_ _ of this Agreement will be deemed amended to include the Improvements.

d. Licensee shall promptly reimburse Licensor, on receipt of an invoice, for all reasonable costs and expenses incurred by Licensor in performing its obligations under this Section.

Comment: Licensors frequently continue research and development on products and processes that originally produced the trade secrets licensed. This continuing research and development effort often produces additional trade secrets or improvements to the trade secrets already licensed. To enable the licensee to benefit from the improvements, license agreements generally provide for the transfer of information relating to future improvements made by the licensor during the term of the license or up to a certain specified date during the duration of the trade secrets license. Hence, the licensee's rights therefore include not only the trade secret as it exists on the effective date of the agreement but also improvements to the trade secret if disclosed by a specified date. A licensor generally is not obligated to provide the licensee with improvements to the trade secrets licensed in perpetuity. Improvements are generally included free of charge up to a specified date during the duration of the agreement, but never longer than the term of the agreement.

Licensees' rights to future improvements are sometimes accompanied by a reciprocal grant-back clause to the licensor. See §§7.29, 8.23. Such provisions often have antitrust implications and are subject to close judicial scrutiny. Grant-back clauses often do not involve any additional compensation or licensing fees to either party, and the territorial coverage of such clauses often mirror the coverage of the original trade secret license agreement.

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§8.23 J. Form: Grant-Back

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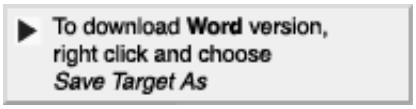

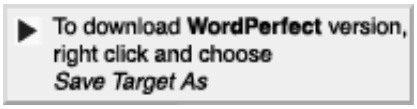

8.23-1 Grant-back

11. *Grant-Back Provision.* Licensee grants to Licensor a royalty-free, nonexclusive license _ _[*specify territory if desired, e.g., worldwide/in North America*]**_ _ to make, have made, use, sell, offer to sell, import and lease any improvements or modifications effected by Licensee to any Technical Information, Licensed Product, or Licensed Process during the term of this Agreement. This grant-back license will expire on the expiration or termination date of this Agreement or on _ _**[*date*]**_ _, whichever occurs first.**

8.23-2 Optional addition to 8.23-1: Right to sublicense granted

Licensor shall have the right to sublicense to third parties the right to practice this grant-back license, provided that (i) Licensor shall obtain Licensee's prior written approval of any proposed sublicense agreement before execution, which approval _ _[*may be withheld in Licensee's sole discretion/shall not be unreasonably withheld or delayed*]**_ _, and (ii) the intended sublicensee shall agree to confidentiality obligations no less stringent those imposed on Licensee in this Agreement.**

Comment: The parties must decide whether to include a grant-back provision. Grant-back clauses can raise antitrust issues if the bargaining power between the parties is disproportionate. If used, a grant-back clause should not give undue control to the licensor nor enhance an already dominant position. The scope of the grant-back should be limited to the subject matter of the original trade secret. It should be nonexclusive, leaving the licensee free to license improvements to others, and it should not extend beyond the term of the license agreement. If the original license is in the form of a paid-up license, the grant-back can also be in the form of a paid-up license. Strategically, this approach is advantageous for both parties because when the licenses are fully paid, the parties are free to practice the trade secret and improvements without continuing financial obligations to each other. But see §§7.25-7.31 for discussion of antitrust concerns.

If the licensor has granted or will grant similar nonexclusive licenses to other parties then, to minimize antitrust concerns, the license agreement should contain a corresponding clause that would allow the licensor to share improvements with the other licensees. Form 8.23-2 grants the licensor the right to sublicense the improvements on the same terms as licensee's right to sublicense the licensed property. See §8.12. If the licensee's improvement is so significant that the commercial value of the original license is diminished, the licensor's ability to license the improvements preserves the value of the licensor's trade secret and enables other licensees to compete on equal footing.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.24 K. Form: Disclosure of Technical Information Pursuant to Agreement

§8.24 K. Form: Disclosure of Technical Information Pursuant to Agreement

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12. *Disclosure of Trade Secrets and Technical Information.* Exhibit _ _[*specify*]_ _ to this Agreement is a true and complete list of the Licensed Property and sets forth the location of the documentation relating to any of the Licensed Property. Licensor shall provide Licensee with all such documentation, which will enable Licensee to fully exploit the Licensed Processes or Licensed Products, in accordance with the following procedures:

a. Licensor and Licensee shall each select an employee who shall act as its correspondent in transmitting documentation relating to the Licensed Property and arranging for other assistance necessary to fully exploit the Licensed Processes and Licensed Products. Each party shall indicate promptly to the other in writing the name of its correspondent. The correspondents shall jointly establish a practicable plan to keep each party informed about the other's current and planned activities relating to the use and practice of Licensed Processes and the development, manufacture, and sale of Licensed Products.

b. Licensor's correspondent shall be responsible for answering all reasonable technical inquiries received from Licensee's correspondent relating to Licensed Processes and Licensed Products, and for providing copies of pertinent documentation relating to the Licensed Property, including applicable test reports; other technical reports; operation and maintenance manuals; assembly and detail drawings; parts lists; lists of ingredients and their proportions in compositions of matter; quality control procedures; and other information on manufacturing processes and apparatus.

c. _ _[*Subject to any restrictions that may be imposed by the United States government,*]_ _ Licensor, on written notice, shall give to Licensee's duly authorized representatives access to its factories, laboratories, and other facilities, at reasonable times and under reasonable conditions, for a total maximum period of no more than _ _[*number*]_ _ hours, for the purpose of acquiring information relating to the Licensed Property and about Licensor's methods of practicing the Licensed Processes and manufacturing the Licensed Products. Licensee shall instruct its representatives who visit Licensor's facilities to maintain the confidentiality of the Licensed Property. A copy of such specific instructions and confidentiality procedures is attached to this Agreement as Exhibit _ _[*specify*]_ _.

d. Promptly on receipt of an invoice from Licensor, Licensee shall reimburse Licensor for all reasonable costs and expenses, including time and material costs, incurred by Licensor in providing documentation relating to the Licensed Property to Licensee. The cost of Licensor's technical consultants' time will be charged at an hourly rate of _ _[*specify amount*]_ _, and all other costs and expenses, such as material costs and travel expenses, will be charged at Licensor's actual out-of-pocket rate.

e. On request of Licensee, Licensor shall provide the services of no more than _ _[*number*]_ _ technical consultants who shall be fully knowledgeable about all aspects of the Licensed Property. The technical consultants shall assist Licensee in (i) practicing the Licensed Processes or manufacturing the Licensed Products, (ii) organizing and starting operations, (iii) training Licensee's technical personnel, and (iv) providing other advisory services directly related to the Licensed Property. The technical consultants shall perform these services within _ _[*e.g., 1 year*]_ _ after initial delivery of any of the Licensed Property to Licensee, for up to _ _[*number*]_ _ days.

[*If applicable, add the following option regarding compliance with export laws*]

f. Licensee agrees not to export, re-export, divert, or transfer, directly or indirectly, any of the Trade Secrets (i) in violation of any export law, restriction, or regulation, (ii) into (or to a national or resident of) Cuba, Iran, North Korea, Sudan, Syria, or to any Group D:1 or E:2 country (or any national of such country) specified in the then-current Supplement No. 1 to Part 740, or in violation of the embargo provisions in Part 746, of the Export

Administration Regulations (or any successor regulations or supplement), except in compliance with all licenses and approvals required under applicable U.S. export controls laws and regulations, or (iii) to anyone on the U.S. Export Administration Table of Denial Orders or the U.S. Department of Treasury List of Specially Designated Nationals.

Comment:

Provision of technical information. The licensor should provide the licensee with the information at the licensor's facilities, because:

- The security of the technical information is difficult to maintain if papers are physically transmitted from one office to another;
- The technical information may be too voluminous to make its inclusion in the license agreement feasible; *e.g.,* computer program data may include thousands of pages;
- The technical information may not all be in written form; *e.g.*, process methods and special techniques may be known only to certain key technical employees of licensor and transmittable only by demonstration and oral explanation; and
- If the agreement becomes public, there is a high risk of disclosure. (This concern supports imposing an obligation to maintain even the existence of the agreement confidential.)

Parties do not disclose trade secret information in the agreement itself; they transfer the information outside the agreement because of the logistic and security problems posed by such disclosure. The exhibit listing the technical information should refer to such information by title, and the licensor should provide the licensee with a numbered, sealed copy through a mutually agreeable escrow agent, using a sign-in/sign-out procedure or other procedure that protects the secrecy of the information. Trade secrets can also be appropriately disclosed by a series of well-managed visits to the licensor's facilities. Alternatively, the licensor can visit the licensee's facilities to disclose the trade secret and guide the licensee in the use of the secret, allowing the licensor to more closely control confidentiality procedures. The licensor should ensure that instructional visits are limited in frequency and duration so that the licensor can better control dissemination of the trade secrets and reduce the risk that other trade secrets that are not part of the license are inadvertently disclosed. Moreover, even if the agreement provides for a grant-back license, the licensor is in a better position if it (rather than the licensee) is the inventor of any improvements. Limiting the visits to the licensor's facilities reduces the licensee's ability to leverage the licensor's trade secret to its own benefit.

Correspondents. The high-level correspondents referred to in this form are normally either officers of the companies or the heads of the engineering or science departments.

Special assistance. Frequently, a licensee requires the direct assistance of the licensor's scientific or technical personnel, *e.g.,* office consultations, reviews of drawings or specifications, or advice on operations, including selection, purchase, and installation of special equipment required to practice the trade secret. Such training is generally conducted at either the licensee's or the licensor's facilities. Special services, such as emergency maintenance assistance or marketing guidance, may also be provided, usually at the licensee's cost. Consultant costs are generally separate from and in addition to royalty payments.

Export controls. If the licensee of the trade secret is located outside the United States or is a foreign national within the United States, the licensor must ensure that the disclosure complies with applicable export controls. The U.S. Commerce Department Bureau of Industry and Security regulates the export and re-export of technology and software, including trade secrets, that originate in the United States and that present a national security risk; the U.S. State Department, through the International Traffic in Arms Regulations, controls the use of technology that has been designated as having military applications. Export regulations require a written letter from the ultimate recipient of regulated technology to provide the licensor assurance that the recipient will not knowingly re-export the technology to any destination, or export the direct product of the technology, without complying with applicable export regulations. U.S. Export Administration Regulations, Supplement No. 2 to 15 CFR Part 748, paragraph (o)(3)(i). For this reason, a license agreement involving the transfer of trade secrets consisting of restricted technology should include such an assurance to the licensor.

NOTE: For a detailed review of U.S. export controls, see Internet Law and Practice in California §§21.21-21.61 (Cal CEB 2004).

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§8.25 L. Form: Secrecy

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13. ***Parties to Maintain Secrecy.***

a. The parties acknowledge and confirm that maintaining the confidentiality and secrecy of the Trade Secrets and Technical Information are of the utmost importance to Licensor and that any disclosure of Trade Secrets or Technical Information may diminish the value and strength of the Trade Secrets and Technical Information. Licensor and Licensee shall each take all steps (using the same degree of care, but no less than a reasonable degree of care, as each party uses to protect its own confidential information) that are reasonably necessary to protect the secrecy of the Trade Secrets and Technical Information and prevent them from entering the public domain or falling into the hands of others not bound by this Agreement or pledged to their secrecy. Reasonable security measures include, without limitation:

(1) Segregating the areas of Licensee's factory, laboratory, or other facilities where Licensee practices the Licensed Processes or manufactures the Licensed Products to prevent unauthorized personnel from acquiring significant information about the Trade Secret or the Technical Information.

(2) Restricting access to these areas to (i) technical personnel who are pledged to secrecy and are required to know the methods for the practice or manufacture of the Trade Secrets or Technical Information to use them for the purposes of the Agreement and (ii) the supervisory, executive, or other personnel who are pledged to secrecy and are required to have access to these areas in the performance of their duties.

(3) Numbering all copies of all photographs, descriptions, or representations for which Licensor's prior permission has been granted; maintaining a record of the persons entrusted with the custody of these copies; and, to the extent practicable, maintaining all copies in safes or other locked containers when not in actual use.

(4) _ _[*Add additional precautions as appropriate*]_ _**.**

b. All Licensed Property in documentary form, including but not limited to documents provided by Licensor and documents prepared by or for Licensee containing any Licensed Property, and all copies of such documents, shall be delivered promptly to Licensor on termination of this Agreement. No Licensed Property may be used by Licensee for any purpose after termination of this Agreement.

8.25-2 Optional addition to 8.25-1: Add if license is exclusive

c. Licensor shall not disclose Trade Secrets or Technical Information to anyone other than Licensee and its employees and agents, and Licensor shall disclose Trade Secrets or Technical Information to Licensee and its employees and agents:

(1) only on an as-needed basis;

(2) only if such persons are needed in order to exploit the Trade Secrets consistent with the terms and conditions of this Agreement;

(3) only if such employees and agents have executed a confidentiality agreement in a form approved by Licensor.

Comment: The value of a trade secret to both the licensor and the licensee depends on its continued secrecy.

However, the parties should not bind themselves permanently and absolutely to preserve the confidential nature of the trade secret. Third parties may independently discover the trade secret during the term of the agreement (or even before), publish it, and thus make it part of the public domain, or the trade secret may not in fact be unknown to the licensee at the time of the licensor's disclosure. Secrecy provisions are often drafted so that they terminate if the secret is publicly disclosed. See form in §8.26.

Creating practical secrecy provisions is essential to protecting trade secrets. See chap 4. Such provisions rely in large part on the scope of the license and the licensee's potential uses.

Failure to maintain secrecy is a common licensee breach of trade secret license agreements. Licensees generally do not deliberately disclose the trade secrets to unauthorized parties: it is against their interests for unlicensed third parties to have possession of that information. Nevertheless, leaks do occur, often through the licensee's failure to provide and enforce adequate safeguards. Because disclosure adversely affects the licensor's proprietary interest, it is generally grounds for termination as well as for an action for breach of contract.

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§8.26 M. Form: Effect of Disclosure

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14. ***Effect of Disclosure.***

a. Licensee shall not be liable for disclosure or use of Trade Secrets or Technical Information that:

(1) Was otherwise known to the Licensee, as evidenced by written documentation, at the time of receipt under this Agreement;

(2) Is subsequently independently developed by an employee, agent, or representative of Licensee (A) to whom the Technical Information has not been divulged or (B) without reliance on any Technical Information;

(3) Becomes known or available on a nonconfidential basis from a source other than Licensor without breach of this Agreement; or

(4) Is or becomes part of the public domain without breach of this Agreement.

[*If applicable, add one or both of the following options*]

[*Option 1: Disclosure required by legal process*]

b. Licensee may disclose such Trade Secrets and Technical Information as may be required by law or court order, provided that Licensee:

(1) Provides Licensor with prompt written notice of such requirement, to the extent permitted by applicable law;

(2) Uses diligent efforts to limit its disclosure of Trade Secrets and Technical Information and to obtain confidential treatment or a protective order; and

(3) Provides Licensor with such other cooperation that is reasonably requested to obtain confidential treatment or a protective order.

[*Option 2: Disclosure gives licensee right to terminate royalty obligations*]

[c.] If there is a disclosure of the Trade Secrets through no fault of Licensee, then Licensee shall have the right to terminate its obligation to remit Royalties as of the date Licensee notifies Licensor in writing of its desire to invoke termination of royalty obligations pursuant to this Section.

Comment:

Disclosure of improvements. Improvements developed by the licensee may fall within the scope of clauses (a)(1) and (a)(2) above. If the agreement provides that the licensor will own the licensee's improvements of the trade secrets, then the agreement should state that clauses (a)(1)-(a)(2) do not apply to those improvements.

Legally required disclosures. A licensee may need to disclose licensed trade secrets in order to comply with a legal requirement, such as in connection with a government agency filing (*e.g.,* a Food and Drug Administration application) or in response to a subpoena. The licensor will want the licensee to limit the information it discloses to only the information that is necessary to comply with the requirement, and the licensor will want to ensure that the disclosed information be maintained in confidence by way of confidential treatment or a protective order. In addition, a licensee may need to disclose licensed trade secrets to its financial and legal advisors or to investors, acquirers, or lenders

performing due diligence in connection with a transaction. The licensor will want to ensure that, unless they are bound by a professional duty of confidentiality, such parties sign confidentiality agreements to protect the licensed trade secrets disclosed by the licensee.

Effect of public disclosure. License agreements usually provide for termination of a licensee's secrecy obligations if the trade secret or technical information becomes public, because arguably it would be fundamentally unfair for the licensee to continue to follow strict secrecy procedures when the information is already in the public domain.

Termination of royalty obligation. Termination of the secrecy obligation is independent of and may or may not affect the continuing obligation to pay for the initial disclosure of the trade secret in the form of royalties. Option 2 enables the licensee to be free of any continuing payment obligations for information that has lost most of its commercial value because it is no longer a trade secret.

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§8.27 N. Form: Reports

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15. ***Required Reports.***

a. Licensee shall render to Licensor quarterly reports on or before _ _[*e.g., the last days of January, April, July, and October*]**_ _ of each year, showing separately:**

(1) The total quantity of _ _[*specify product*]**_ _ developed by using the Licensed Processes during the preceding calendar quarter;**

(2) The total quantity of Licensed Products, and parts for it, produced during the preceding calendar quarter;

(3) The total quantity of Licensed Products sold, leased, or otherwise used during the preceding calendar quarter and the gross receipts resulting from these transactions; and

(4) The amounts owed to Licensor for the preceding calendar quarter under this Agreement.

b. Licensee shall render to Licensor a similar report within _ _[*e.g., 30 calendar days*]**_ _ after the termination of this Agreement covering the period from the last date covered by the last preceding report to the date of termination.**

c. Licensor shall have the right, at all reasonable times during usual business hours and at Licensor's cost, to bring in any consultants and personnel it deems appropriate, including certified public accountants, to inspect Licensee's facilities and audit Licensee's books and records to ensure integrity and compliance with the royalty provisions of this Agreement. If the results of any such audit indicate a payment deficiency, then within _ _[*e.g., 30 calendar*]**_ _ days after receipt of the audit report, Licensee shall remit to Licensor:**

(1) The amount of such deficiency;

(2) Interest from the date the deficiency was initially due until the date of payment, at a rate not exceeding _ _[*_ _ percent per month/the lower of (1) 5 percent per year in excess of the Federal Reserve Rediscount Rate established by the San Francisco Federal Reserve Bank on the 25th day of each month, or (2) the maximum rate allowed by the laws of the State of California*]**_ _; and**

(3) If the results of such an audit indicate a payment deficiency greater than _ _[*e.g., 5 percent*]**_ _, an amount equal to the cost of such audit, including the cost of any independent accountant retained by Licensor for the purpose of conducting the audit.**

Licensor shall have the right to make copies of any records or documents as it deems reasonably necessary to accomplish Licensor's legitimate business objectives. Any work product resulting from such audits will belong to Licensor and may be shared with Licensee at Licensor's discretion.

Comment: If royalties are based on something other than quantity, *e.g.,* net sales, the reporting requirement (and recordkeeping requirement; see §8.28) must be modified to include all information necessary to calculate royalties due.

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§8.28 O. Form: Records

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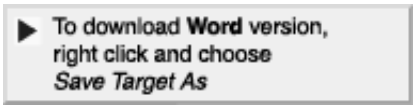

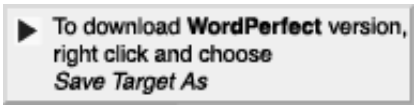

16. *Records.* Licensee shall at all times during the term of this Agreement and for _ _[*e.g., 3 years*]_ _ after termination:

a. Maintain complete and accurate records relating to the practice of the Licensed Processes and the manufacture, sale, and lease of Licensed Products and parts for it under this Agreement; and

b. Produce these records and books of accounts at the offices of Licensee during regular business hours, from time to time and on written request by Licensor, for inspection and copying by Licensor, its duly accredited representatives, or a mutually accepted third party.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.29 P. Form: Third Party Claims

§8.29 P. Form: Third Party Claims

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8.29-1 Alternative: Licensor indemnifies licensee

17. *Indemnification.* Licensor shall indemnify, defend, and hold harmless Licensee and its officers, directors, shareholders, employees, agents, representatives, and customers (collectively, "Indemnitee") against all liability, claims, costs, damages, and expenses incurred by Indemnitee relating to or arising from infringement of any third party patent or other intellectual property rights by the Licensed Property ("Losses"), as long as Licensor is (i) notified in writing within 30 calendar days after commencement of any suit or proceeding and (ii) given authority, information, and assistance by Indemnitee to defend or settle the suit or proceeding. Licensor, at its sole discretion and expense, may elect to settle the claim on such terms and conditions as it deems advisable or to undertake and direct the defense of any legal or other action based on the claim. If Licensor elects to defend, Indemnitee and Licensor shall render to each other, at Licensor's expense, all reasonable assistance that may be required to defend. Indemnitee shall not settle or otherwise compromise any claim for which it seeks indemnification under this Section without Licensor's consent.

8.29-2 Alternative: Licensee indemnifies licensor

17a. *Indemnification.* Licensee shall indemnify, defend, and hold harmless Licensor and its officers, directors, shareholders, employees, agents, and representatives (collectively, "Indemnitee") against all liability, claims, costs, damages, and expenses incurred by Indemnitee that (i) arise or grow out of any infringement or claim of infringement of patents of the United States or any foreign country held by third parties made against an Indemnitee on account of the _ _[*specify product*]_ _ or Licensee under this Agreement, or (ii) are based on product liability, breach of warranty, or negligence, or otherwise being asserted against Licensor, alleging that the _ _[*specify product*]_ _ or a portion of it manufactured, leased, or sold by Licensee (even if it was manufactured in accordance with the technology licensed in this Agreement) is faulty, provided that Licensee is (x) notified in writing within 30 calendar days after commencement of any suit or proceeding and (y) given authority, information, and assistance by Indemnitee, at Licensee's expense, to defend or settle the suit or proceeding. Licensee, at its sole discretion and expense, may elect to settle the claim on such terms and conditions as it deems advisable or to undertake and direct the defense of any legal or other action based on the claim. If Licensee elects to defend, Indemnitee and Licensee shall render to each other all reasonable assistance that may be required to defend. Indemnitee shall not settle or otherwise compromise any claim for which it seeks indemnification under this Section without Licensee's consent.

Comment: The wording of the indemnification depends on the particular facts of the situation and the parties' relative bargaining strength. Because the licensee is generally the manufacturer, it is not unreasonable for the licensee to accept the usual manufacturer's risks of patent infringement and product liability (the second alternative). However, the licensor should, if possible, control the litigation involving alleged infringement of its trade secret, and no litigation settlement should be consummated without the licensor's prior approval.

In some transactions (*e.g.,* for software licenses), it may be appropriate to grant the licensor the right to modify the licensed property to make it noninfringing or to procure a license in order to mitigate the licensor's exposure for infringing licensed property. The agreement may also exempt from the licensor's indemnification losses arising from either the licensee's modifications of the licensed property or the licensee's combination of the licensed property with products, processes, or materials not provided by the licensor.

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§8.30 Q. Form: Duration of Agreement

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18. ***Term of Agreement.***

a. This Agreement is effective as of _ _[*date*]_ _, and unless terminated sooner will continue in force until _ _[*date*]_ _, and thereafter from year to year, unless notice is given by either party to the other of termination of this Agreement on the expiration of its original period or on the expiration of any one of such additional yearly periods. Any notice of termination must be given at least _ _[*e.g., 90 calendar days*]_ _ before the termination date.

b. If this Agreement is terminated for any reason whatsoever, whether by expiration of its term or otherwise, all future and continuing rights and obligations under it will terminate, except:

(1) The obligations to make reports, to pay all sums accrued under this Agreement, and to maintain the confidential nature of the Trade Secrets and Technical Information will survive for _ _[*e.g., 1 year*]_ _ after termination of this Agreement.

(2) Licensee shall have the right for a period of _ _[*e.g., 1 year*]_ _ after termination of this Agreement to dispose of all Licensed Products and parts of it on hand at the date of termination, as long as Licensee pays Royalties and furnishes Licensor with reports in accordance with this Agreement.

(3) All of Licensee's obligations to return documents and other items will survive termination of this Agreement.

(4) Any claim or cause of action for breach or violation of this Agreement existing as of the date of termination will survive termination of this Agreement and remain in full force and effect until such rights and obligations are fully discharged.

(5) All rights and obligations of the parties under Section _ _[*specify*]_ _ of this Agreement relating to indemnification and this Section _ _[*specify*]_ _ shall survive termination of this Agreement.

Comment: Most of a licensee's obligations end on termination of the agreement. Any surviving obligations should be specifically described. These surviving obligations should include the licensee's duty to maintain the confidentiality of trade secrets and other proprietary information. The expiration of nondisclosure obligations can lead to a loss of trade secrets rights (see §7.36). A provision triggered by termination (*e.g.,* "in the event of termination of this Agreement, Licensee will not, directly or indirectly, manufacture, use, sell, or lease") is effective only on the active termination of the agreement and not on a passive termination (such as expiration). *Pitney Bowes, Inc. v Mestre* (11th Cir 1983) 701 F2d 1365. The licensor should include a termination provision stating that, on either termination or expiration of the agreement, the licensee will discontinue use of the licensor's trade secrets, including use in manufacturing the licensed apparatus. *King v Gerold* (1952) 109 CA2d 316, 240 P2d 710, disapproved on other grounds in *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.31 R. Form: Events of Default

§8.31 R. Form: Events of Default

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8.31-1 Events of default heading and introduction

20. *Events of Default.* Each of the following will constitute an "Event of Default" under this Agreement:

8.31-2 Payment defaults

a. Licensee fails to pay Royalties or any other amounts due under this Agreement

8.31-3 Optional addition to 8.31-2: Grace period provided

and such default continues for _ _[*time period*]**_ _ after _ _**[*e.g., such payment is due/Licensor gives Licensee notice that such amount was not paid*]**_ _.**

8.31-4 Failure to perform other covenants

b. Licensee fails to perform or observe any term, covenant, or undertaking in this Agreement to be performed or observed by Licensee

8.31-5 Optional addition to 8.31-4: Grace period provided

and such default continues for _ _[*specify time period*]**_ _ after _ _**[*e.g., such performance is due/Licensor gives Licensee notice of such failure to perform*]**_ _**

8.31-6 Optional addition to 8.31-5: Allowing additional time to cure

unless within that time period Licensee has promptly commenced and continues diligent efforts to remedy the default, in which event Licensee shall have such additional time as is necessary, but not more than _ _[*specify time period*]**_ _ after _ _**[*e.g., such performance is due/Licensor gives Licensee notice of such failure to perform*]**_ _ to remedy the default before an Event of Default occurs.**

8.31-7 Insolvency provisions

c. Licensee files a voluntary petition under any bankruptcy, reorganization, or insolvency law of any jurisdiction; Licensee consents to or applies for appointment of a trustee, receiver, custodian, or similar official for itself or for all or substantially all its assets; a trustee, receiver, custodian, or similar official is appointed to take possession of all or substantially all of Licensee's assets and will not be dismissed within _ _[*specify time period*]**_ _ after appointment; Licensee makes any assignment for the benefit of creditors, or other arrangement or composition under any laws for the benefit of insolvent persons; an order for relief is entered against Licensee under any bankruptcy, reorganization, or insolvency law of any jurisdiction _ _**[*and is not dismissed or stayed within _ _*[*specify time period*]*_ _ after its entry*]**_ _; or any case, proceeding, or other action seeking such order remains undismissed for _ _**[*specify time period*]**_ _ after its filing; or any writ of attachment, garnishment, or execution is levied against all or substantially all of Licensee's assets; or all or substantially all of Licensee's assets become subject to any attachment, garnishment, execution, or other judicial seizure, and the same is not satisfied, removed, released, or bonded within _ _**[*specify time period*]**_ _ after the date the writ was levied or the date of the attachment, garnishment, execution, or other judicial seizure.**

Comment: If in the event of the licensor's bankruptcy, the licensor (or bankruptcy trustee) rejects the license of trade secrets granted in an executory contract, §365(n) of the Bankruptcy Code (11 USC §365(n)) allows the licensee to

retain its rights under the license as long as it continues to pay all royalties due under the license and the licensee waives any setoff rights and administrative claims.

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§8.32 S. Form: Remedies

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8.32-1 Remedies heading and introduction

21. *Remedies.* In the Event of Default, Licensor shall be entitled to the following remedies:

8.32-2 Postdefault interest

a. If Licensee is in default on any payment due under this Agreement, the amount in arrears will bear interest from the date of the default until the amount is paid in full, at a rate equal to _ _[_ _[*specify*]_ _ *percent per month/(i) 5 percent per annum in excess of the Federal Reserve Rediscount Rate established by the San Francisco Federal Reserve Bank on the 25th day of each month, or (ii) the maximum rate allowed by the laws of the State of California, whichever is lower*]_ _. This interest will be compounded annually from the date of default and shall be payable on demand.

8.32-3 Right to terminate agreement

b. Licensor may terminate this Agreement, and such termination will be without prejudice to any other rights or claims Licensor may have against Licensee.

8.32-4 Specific performance

c. Because Licensee's breach of this Agreement may cause Licensor irreparable harm for which money is inadequate compensation, Licensor shall be entitled to obtain injunctive relief, in addition to all other rights and remedies available to Licensor, without the necessity of posting a bond or other form of security (unless otherwise required by law).

8.32-5 Liquidated damages

d. Licensee acknowledges and agrees that it would be impractical to estimate the amount of damages that Licensor would suffer arising out of any material breach of the covenants or the restrictions set forth in Section _ _[*specify*]_ _ protecting the Trade Secrets and Technical Information. Accordingly, in the event of an intentional and material breach by Licensee of Section _ _[*specify*]_ _, Licensee shall pay Licensor the sum of _ _[*dollar amount*]_ _ as liquidated damages and not as a penalty. Licensee agrees that the foregoing amount of liquidated damages is a reasonable estimate of the actual damages that Licensor would suffer and incur as a result of such breach by Licensee.

Comment:

Specific performance. Although a trade secret owner may recover damages, either as the sole remedy or in conjunction with an injunction, for misappropriation of its trade secret, an action for misappropriation generally is not available in a licensing context. Therefore, a licensor may not be able to obtain an injunction against a licensee for breach of the license agreement, unless the licensor can prove the licensee's culpability in obtaining the trade secret.

Liquidated damages. Including a liquidated damages provision may undermine the licensor's assertion of "irreparable harm" in seeking injunctive relief. Alternatively, the agreement may include a provision whereby the licensee stipulates that any decline in the licensor's profits from the licensed trade secrets after the licensee's unauthorized use or disclosure will be attributed to the licensee's breach and, accordingly, the licensor will be entitled to recover its reduced profits as compared to profits it enjoyed before the breach.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.33 T. Form: Arbitration

§8.33 T. Form: Arbitration

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22. ***Arbitration.***

a. The parties shall submit all disputes relating to this Agreement (whether contract, tort, or both) _ _[*, other than controversies or claims relating to*** _ _[***identify excluded issues***]_ _,]_ _ **to** _ _[***binding/nonbinding***]_ _ **arbitration, under California Code of Civil Procedure sections 1280 through 1294.2. Either party may enforce the award of the arbitrator under Code of Civil Procedure section 1285. The parties understand that they are waiving their rights to a jury trial.**

b. The party demanding arbitration shall submit a written claim to the other party, setting out the basis of the claim. The responding party shall have _ _[*e.g., 10 business days***]_ _ in which to respond to this demand in a written answer.**

c. Within _ _[*e.g., 10 business days***]_ _ after a dispute subject to arbitration arises, the parties shall select an arbitrator. If the parties are unable or unwilling to agree on an arbitrator within that time, each party shall designate _ _[***an arbitrator/a representative***]_ _ within _ _[***e.g., 5 business days***]_ _ thereafter, and those two _ _[***arbitrators/representatives***]_ _ shall designate _ _[***a third arbitrator/the arbitrator***]_ _ within _ _[***e.g., 5 business days***]_ _ after their designation. If either party fails to select _ _[***an arbitrator/a representative***]_ _ within the designated period, then, on the request of either party, _ _[***e.g., the American Arbitration Association***]_ _ shall select that _ _[***arbitrator/representative***]_ _.**

d. The arbitration shall take place in _ _[*city and state***]_ _, at a time and place selected by the arbitrator.**

e. Any controversy or claim arbitrated under this Section _ _[*specify***]_ _ shall be arbitrated by and in accordance with the then existing arbitration rules of _ _[***name of arbitration service***]_ _ at their office in _ _[***specify location***]_ _.**

f. Before arbitration commences, each party shall pay the arbitrator half of the expected cost of the arbitration. At the conclusion of arbitration, the arbitrator may award the prevailing party some or all of the arbitration costs.

Comment: The agreement may provide for arbitration of all disputes or only certain disputes, such as those arising from the issue of whether technical information has become public knowledge. The arbitrator's powers may be expansive or limited (*e.g.,* the agreement could limit the arbitrator's ability to grant extraordinary damages such as punitive damages). Arbitration clauses are broadly enforceable under California law (CCP §§1281-1281.9) and federal law (9 USC §2). See, *e.g., Kamakazi Music Corp. v Robbins Music Corp.* (SD NY 1981) 522 F Supp 125; *Consumer Concepts, Inc. v Mego Corp.* (SD NY 1978) 458 F Supp 543. The advantages of arbitration over litigation are usually lower costs and a prompt hearing and decision. If the parties include an arbitration section, it should explicitly recite the procedures to be followed (the number of arbitrators, how they are to be selected, the place and time of arbitration, and the scope of the arbitration), or, alternatively, the parties may adopt the rules and procedures of an established arbitration organization, *e.g.,* the American Arbitration Association or JAMS. Regardless of the rules adopted, it is generally expected that the arbitrators will comply with the ethics standards adopted by their association. In California, arbitrators are expected to adopt the ethical standards promulgated by the Judicial Council. CCP §1281.85. The ethical standards are nonnegotiable and nonwaivable. CCP §1281.85(c). However, the standards do not apply to an arbitration conducted in accordance with the terms of a public or private sector collective bargaining agreement. CCP §1281.85(b).

There are many choices that the parties can make in fashioning an arbitration provision. For general discussion of

alternative dispute resolution and for other forms and provisions, see Drafting Business Contracts: Principles, Techniques & Forms, chap 16 (Cal CEB 1994).

Although CCP §631(d) authorizes, in certain circumstances, arbitration provisions waiving the right to a jury trial for pending actions, provisions waiving the right to a jury trial before a dispute has arisen are invalid. *Grafton Partners L.P. v Superior Court* (2005) 36 C4th 944, 32 CR3d 5.

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§8.34 U. Form: Notices; Record Address

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23. *Notices.* Any notice, report, payment, or statement required or permitted under this Agreement will be considered to be given or transmitted when sent by certified mail, postage prepaid, addressed to the party for whom it is intended at its address of record; by facsimile, which notice will be effective on confirmation of receipt; or by courier or messenger service, which notice will be effective on receipt by recipient as indicated on the carrier's receipt. The record addresses of the parties are as follows:

Licensor:

_ _[*Name*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Licensee:

_ _[*Name*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

A party may change its record address by providing notice to the other party in accordance with this Section.

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§8.35 V. Form: Amendments

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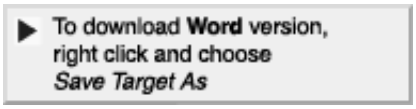

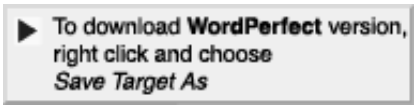

24. *Amendments.* This Agreement may be supplemented, amended, or modified only by the parties' mutual agreement. No supplement, amendment, or modification of this Agreement will be binding unless it is in writing and signed by _ _[*both parties/the party to be charged*]_ _.

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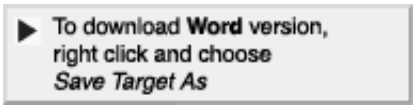

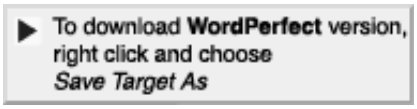

25. *Construction.* Unless the context clearly requires otherwise, (i) the plural and singular numbers are each deemed to include the other; (ii) the masculine, feminine, and neuter genders are each deemed to include the others; (iii) "shall," "will," and "agrees" are mandatory, and "may" is permissive; (iv) "or" is not exclusive; and (v) "includes" and "including" are not limiting.

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§8.37 X. Form: Integration

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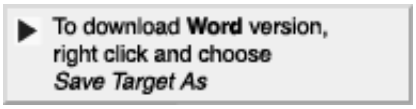

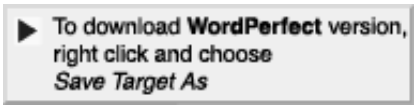

26. ***Integration.*** **This Agreement and all other agreements, exhibits, and schedules referred to in this Agreement constitute the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the License and supersedes all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.**

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§8.38 Y. Form: Exhibits

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27. *Exhibits.* The following exhibits constitute a part of this Agreement and are incorporated into this Agreement by this reference: _ _[*List exhibits by name and date*]**_ _.**

If any inconsistency exists or arises between a provision of this Agreement and a provision of any exhibit, the provision of this Agreement will prevail.

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§8.39 Z. Form: No Waiver

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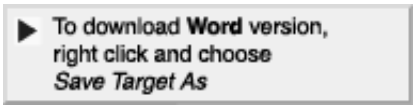

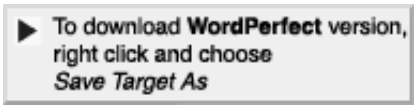

28. *No Waiver.* No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

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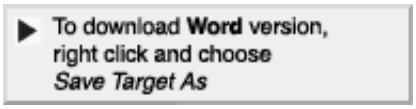

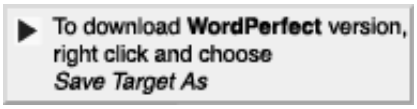

29. *Headings.* The headings in this Agreement are included for convenience only and will affect neither the construction or interpretation of any provision in this Agreement nor any of the rights or obligations of the parties to this Agreement.

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Source: Business Law/Trade Secrets Practice in California/8 Form Licensing Agreements and Provisions/§8.41 BB. Form: Governing Law and Choice of Forum

§8.41 BB. Form: Governing Law and Choice of Forum

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30. *Governing Law and Choice of Forum.* This Agreement, and any dispute arising from the relationship between the parties to this Agreement, will be governed and determined by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of another jurisdiction's law. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) will be resolved exclusively in _ _[*type of court, e.g., a superior court*]_ _ in _ _[*city and state*]_ _, and the parties expressly waive any right they may otherwise have to cause any such action or proceeding to be brought or tried elsewhere.

Comment: Each party may wish to limit the right of the other to litigate the terms of the trade secret license agreement to the courts, as well as the laws, of a particular state. Choice of law provisions are usually respected by California courts, and California's policy of providing access to California courts for resident plaintiffs may be satisfied even when the plaintiff has expressly agreed to a non-California forum. However, if enforcement of a forum selection or choice of law clause in an agreement would be the functional equivalent of a contractual waiver of certain consumer protections under the Consumer Legal Remedies Act (CLRA) (CC §§1750-1784), then the clause will not be enforceable. The seminal test is whether there is any risk that substantive law might be employed that would materially diminish rights of California residents in violation of California public policy. If the effect of a choice of a non-California forum would be a violation of California public policy, the forum selection clause would not be enforced. *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699. But see *Net2Phone, Inc. v Superior Court* (2003) 109 CA4th 583, 135 CR2d 149 (refusing to enforce forum selection clause in action brought under Unfair Competition Law (UCL) (Bus & P C §§17200-17210) and distinguishing *America Online* as brought under the CLRA, under which court found violation of public policy). In *Forrest v Verizon Communications, Inc.* (2002) 805 A2d 1007, the court held that, in the absence of fraud or mistake, when a party has been provided with adequate notice of the forum selection clause, that party is bound by it when he has had an opportunity to read it, whether or not he actually reads it. In *Forrest*, the forum selection clause was reasonable and enforceable and the appellant was bound, even though the clause effectively transferred the case to a state where the appellant's class action was not recognized. But see *Doe 1 v AOL LLC* (9th Cir 2009) 552 F3d 1077 (forum selection clause designating Virginia courts held unenforceable as violation of California public policy, because California residents would be forced to waive statutory remedies under California consumer law).

Problems can arise if the parties select the laws of a foreign country to govern a trade secret agreement. When the parties agree that the law of a foreign country will prevail, the court assumes that the foreign law is similar to American law in the absence of evidence about that law. If evidence establishes that the foreign country has a strong public policy relating to a contested matter, the court will apply that policy, if possible. *Victor Equip. Co. v Armco Steel Corp*. (ND Tex 1980) 208 USPQ 434, 439. See also *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330. For general discussion of choice of law and choice of forum issues, see Drafting Business Contracts: Principles, Techniques & Forms §§16.53-16.56 (Cal CEB 1994).

WARNING: The modern trend is toward enforcement of choice of forum clauses. See *Nedlloyd Lines B.V. v Superior Court, supra; Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 131 CR 374. See §2.28 on enforceability of forum-selection clauses in agreements supported by consideration. Limitations of venue may still be unenforceable in California, however, and an attempt to limit venue may invalidate a clause limiting jurisdiction. See 17 C3d at 495; *General Acceptance Corp. v Robinson* (1929) 207 C 285, 277 P 1039. See also California Civil Procedure Before Trial, chaps 6, 8 (4th ed Cal CEB 2004).

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§8.42 CC. Form: Attorney Fees

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31. ***Attorney Fees.***

a. In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party shall be entitled to an award of reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

b. If either party commences arbitration or litigation arising from the interpretation or performance of this Agreement, then at least _ _[*e.g., 30 calendar days*]_ _ before commencement of the arbitration or trial, each party shall submit to the other a confidential settlement offer (the "Offer"). No Offer will be admissible in evidence in any such arbitration or trial with respect to the liability of a party, and the parties shall keep each Offer confidential until the tribunal or court makes a final award. If the parties do not reach a settlement, the tribunal or court in the arbitration or litigation shall award to the prevailing party reasonable costs and expenses incurred in the arbitration or litigation, including expert witness fees and attorney fees.

c. If the final award by the tribunal or court is less than the defendant's Offer, then the defendant is the prevailing party. If the final award by the tribunal or court is more than the plaintiff's Offer, then the plaintiff is the prevailing party. If the final award by the tribunal or court is between the two Offers, neither party is a prevailing party and each party shall pay for its own costs and expenses. A party that has not made an Offer shall not be a prevailing party, and such party's Offer will be deemed to be zero if it is the defendant or the claimed amount if it is the plaintiff.

Comment: The court may award reasonable attorney fees to the prevailing party if (1) a claim of misappropriation is made in bad faith, (2) a motion to terminate an injunction is made or resisted in bad faith, or (3) there was willful and malicious misappropriation. CC §3426.4.

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§8.43 DD. Form: Severability

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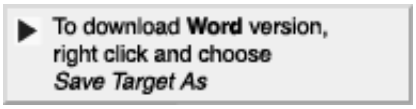

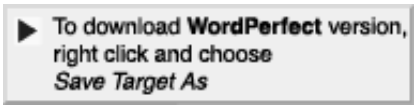

32. ***Severability.*** **Any provision of this Agreement that in any way contravenes the law of any state or country in which this Agreement is effective will, in that state or country, to the extent the law is contravened, be considered separable and inapplicable and will not affect any other provision or provisions of this Agreement** _ _[*, unless an essential purpose of this Agreement would be defeated by the loss of the illegal, unenforceable, or invalid provision*]_ _**.**

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§8.44 EE. Form: Binding Effect

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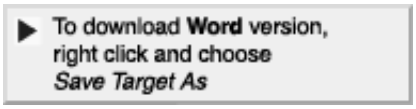

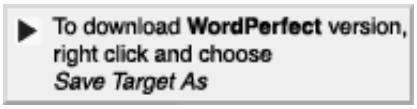

33. *Binding Effect.* This Agreement will inure to the benefit of and be binding on the successors and assigns of Licensor and Licensee.

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§8.45 FF. Form: Signature Block

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IN WITNESS WHEREOF, Licensor and Licensee have caused this Agreement to be executed by their respective duly authorized officers on the dates and at the places indicated below.

Date: _ _ _ _ _ _ _ _[*Name of licensee*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ _ _[*Name of licensor*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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9

Security Interests in Trade Secrets

Ellen A. Friedman
Lawrence T. Woodlock
Lisa L. Ditora

I. SCOPE OF CHAPTER §9.1

II. USE OF TRADE SECRETS AS COLLATERAL
- A. Advantages of Using Trade Secrets as Collateral §9.2
- B. Disadvantages of Using Trade Secrets as Collateral §9.3

III. APPLICABLE LAW
- A. California Commercial Code Governs Security Interests §9.4
- B. Definition of General Intangibles Includes Trade Secrets §9.5

IV. ATTACHMENT OF SECURITY INTEREST §9.6
- A. Written Security Agreement
  - 1. Refer to Trade Secret §9.7
  - 2. Form: Security Agreement Granting Clause Describing Trade Secrets Collateral §9.8
- B. Value Given §9.9
- C. Debtor's Rights in Collateral §9.10

V. PERFECTION OF SECURITY INTEREST
- A. Effect of Perfection §9.11
- B. Perfection by Filing §9.12
  - 1. Methods for Filing Financing Statements §9.13
  - 2. Form: Financing Statement (UCC-1)—California §9.14
  - 3. Form: Financing Statement Addendum (UCC-1Ad)—California §9.14A
  - 4. Form: Additional Language for Description of Trade Secrets Collateral §9.15
- C. Verifying Priority §9.16

VI. RIGHTS OF SECURED CREDITOR §9.17

VII. SPECIAL CONSIDERATIONS IN USE OF TRADE SECRETS AS COLLATERAL §9.18
- A. Maintaining Value of Trade Secret §9.19
- B. Obtaining Value From Trade Secret §9.20

VIII. CHECKLIST: STEPS FOR SETTING UP SIMPLE SECURED TRANSACTIONS §9.21

IX. CONCLUSION §9.22

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§9.1 I. SCOPE OF CHAPTER

This chapter presents a general overview of the process of creating and perfecting a security interest in intangible property against third party claims under the California Commercial Code. See §§9.2-9.17. Subsequent sections address the special problems posed by the use of trade secrets as the subject of a security interest. See §§9.18-9.21.

For more detailed discussion of the law of security interests, see Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

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II. USE OF TRADE SECRETS AS COLLATERAL

§9.2 A. Advantages of Using Trade Secrets as Collateral

Tangible assets like machinery and equipment and intangible assets like accounts receivable are offered every day as loan collateral. In today's economy, however, trade secrets and intellectual property can be the most important asset owned by a borrower. By definition, a trade secret is an asset that is valuable to its owner in operating its business and is not generally available to competitors. CC §3426.1(d)(1).

Even when trade secrets are not valuable enough as stand-alone assets to support loans to businesses or to provide comfort to lenders, they can have immense strategic value. Trade secrets collateral may enable a lender to sell a business (or even a piece of a business) as a going concern rather than requiring the sale of individual tangible assets. For example, a lender who takes a lien on a produce company's tangible assets such as its accounts receivable and trucks, but not on intangible assets such as a trade secret customer list, has much less valuable collateral securing the loan. The lender could liquidate the tangible assets in the event of a default but could not sell an operating produce company to a buyer, which would bring a higher price than the tangible assets. Moreover, if the lender neglected to take a lien on trade secrets, another creditor could do so and could block the first lender's ability to sell the business as a going concern.

PRACTICE TIP: Creditors planning to take a security interest in all of a borrower's assets should include a reference to "general intangibles," and may choose to include a specific reference to "trade secrets" in the collateral description in the security agreement. See §9.8.

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§9.3 B. Disadvantages of Using Trade Secrets as Collateral

Trade secrets present several special problems. Although valuable to the owner in the operation of its business, trade secrets may be of less value to others as collateral. They may be subject to federal regulations, preempting the state law rules under which security interests are ordinarily established. See §9.20. Trade secrets collateral depends particularly on the good faith of the debtor/trade secret owner because it can lose all value on general disclosure. Trade secrets are also subject to sudden obsolescence if the debtor's competitor makes a better product or develops a better process.

A creditor may be hesitant to pursue trade secrets collateral because of an inability to evaluate its benefits. When warranted, potential creditors should consult industry experts on the value of the trade secret and the sufficiency of the debtor's protective measures, to assist a creditor lacking expertise in the debtor's industry.

The disadvantages of trade secrets collateral should not deter counsel from evaluating the sufficiency of a debtor's trade secrets as collateral under the proper conditions. Creditors willing to lend against entire enterprises should pay particular attention to their debtor's intellectual property and draft their loan documentation with as much concern for trade secrets as for tangible property. Creditors under existing security agreements may already have security interests in the debtor's trade secrets, which they can preserve and protect once these interests are recognized. For discussion of how to maintain the value of trade secrets collateral, see §9.19.

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III. APPLICABLE LAW

§9.4 A. California Commercial Code Governs Security Interests

Article 9 of the Uniform Commercial Code (UCC) has been adopted by all 50 states. The law in each jurisdiction varies in greater or lesser degree from the "uniform" statute and, therefore, from each other jurisdiction. This chapter limits its discussion to California law and the California Commercial Code. All references to the "Commercial Code" or "Code" in this chapter are to the California Commercial Code.

Division 9 of the California Commercial Code (Com C §§9101-9709), California's version of Article 9 of the UCC, governs security interests in personal property.

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.5 B. Definition of General Intangibles Includes Trade Secrets

§9.5 B. Definition of General Intangibles Includes Trade Secrets

A creditor may take a security interest in general intangibles. See Com C §9308. "General intangibles," as used in the Commercial Code, are defined by exclusion as

> any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.

Com C §9102(42). The definition is intended to include a broad range of contractual rights and other personal property that are, or may become, customarily used as commercial security. UCC Comment 5d to Com C §9102(42).

This definition of general intangibles includes copyrights, trademarks, and patents. Taking a security interest in certain intellectual property under the Commercial Code, however, may be preempted by federal regulation. See Com C §9109(c)(1). For a discussion of preemptive federal regulations, see §9.11. Although trade secrets are not expressly mentioned, Commercial Code commentators uniformly regard trade secrets and related matters as "general intangibles." See, *e.g.,* 9A Hawkland, Lord & Lewis, UCC Series Rev §9-102 (2000).

Trade secrets have been held to be property for purposes of the takings clause of the Fifth Amendment to the United States Constitution. See *Ruckelshaus v Monsanto Co.* (1984) 467 US 986, 81 L Ed 2d 815, 104 S Ct 2862. See also *Philip Morris, Inc. v Reilly* (1st Cir 2002) 312 F3d 24 (Massachusetts Disclosure Act requiring tobacco companies to disclose ingredients list to state was unconstitutional as violating takings clause); *Pharmaceutical Care Mgmt. Ass'n v Rowe* (D Me 2004) 307 F Supp 2d 164, 176. Trade secrets, including the relatively valueless media on which they may be stored or represented, are intangible personal property for tax purposes. *Navistar Int'l Transp. Corp. v State Bd. of Equalization* (1994) 8 C4th 868, 875, 35 CR2d 651.

The Uniform Trade Secrets Act (CC §§3426-3426.11) provides a formal definition of "trade secrets" (see §1.3), and Pen C §499c criminalizes theft, appropriation, duplication, or delivery of trade secrets. Accordingly, secured creditors should:

- Draft security agreements granting liens on trade secrets to confirm their rights to appropriate or copy trade secrets on or before a default under the security agreement; and
- Exercise their remedies after a default to preserve the value of the trade secrets (see §9.19) and to avoid inadvertently violating the Penal Code.

See 18 USC §§1831-1839 on economic espionage by foreign agents, foreign governments, or foreign instrumentalities, and on thefts of trade secrets as defined in those sections.

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.6 IV. ATTACHMENT OF SECURITY INTEREST

§9.6 IV. ATTACHMENT OF SECURITY INTEREST

In Commercial Code parlance, "attachment" refers to the creation of a security interest enforceable between the parties to an agreement, generally the secured party and the debtor. Attachment does not usually create rights against competing third parties, such as other secured parties with perfected security interests in the same collateral or the trustee in bankruptcy. A security interest attaches to personal property, including general intangibles, on the realization of the following three preconditions (Com C §9203(b)(3)):

- Either the debtor has authenticated a security agreement describing the collateral or the collateral is in the secured party's possession under an agreement (see §§9.7-9.8);
- Value has been given (see §9.9); and
- The debtor has rights in the collateral (see §9.10).

NOTE: When the collateral is trade secrets, the first step is satisfied only by the debtor's signing the security agreement because there is nothing tangible for the secured party to possess.

For discussion of perfection of a security interest (the step generally required to make the security interest enforceable against third parties), see §§9.11-9.16.

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A. Written Security Agreement

§9.7 1. Refer to Trade Secret

Generally, a description of collateral in a security agreement is sufficient if it reasonably identifies what is described. Com C §9108(a). Collateral may be described by (Com C §9108(b)):

- Specific listing;
- Category;
- Type of collateral described in the Commercial Code (with certain exceptions);
- Quantity; or
- Computation or formula.

Therefore, if a lender is taking a security interest in all "general intangibles," listing general intangibles in the security agreement will be sufficient to obtain a security interest in trade secrets. If, however, a security interest is not being taken in all general intangibles, counsel should start with the basic security agreement (and basic Form UCC-1 that he or she uses for simple security interests in intangible property) and adapt it as necessary to cover issues unique to trade secrets generally and the specific trade secrets at hand.

WARNING: In referring to any trade secret, the practitioner must not disclose the trade secret itself and thereby destroy it.

For full discussion of the requirements of a security agreement, see Secured Transactions in California Commercial Law Practice, chap 2 (2d ed Cal CEB 2001).

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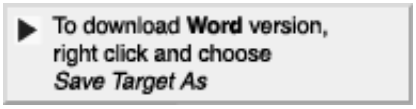
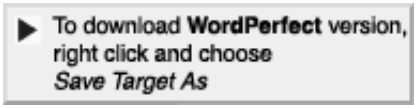
§9.8 2. Form: Security Agreement Granting Clause Describing Trade Secrets Collateral





[*Add one of the following alternatives*]

[*Alternative 1: Collateral is all general intangibles*]

Debtor hereby grants to Secured Party a security interest in all general intangibles and all tangible property that expresses trade secrets or is required for implementation of trade secrets, whether now existing or hereafter acquired or arising, together with all products and proceeds thereof, including without limitation any goodwill associated with trade secrets and insurance proceeds with respect thereto.

[*Alternative 2: Collateral includes all general intangibles as well as other collateral, and specifies the types of trade secrets that are included in the collateral*]

Debtor hereby grants to Secured Party a security interest in _ _[*identify collateral other than general intangibles*]**_ _ and in all general intangibles, including but not limited to _ _**[*Debtor's trade secrets/identify particular subcategories of trade secrets, e.g., customer lists, manufacturing processes*]**_ _, all goodwill associated with such intangibles, and all tangible property that expresses such trade secrets or is required for implementation of such trade secrets, whether now existing or hereafter acquired or arising, together with all products and proceeds thereof, including without limitation any insurance proceeds with respect thereto.**

[*Alternative 3: Secured party is obtaining only trade secrets*]

Debtor hereby grants to Secured Party a security interest in Debtor's trade secrets _ _[*identify particular subcategories of trade secrets, e.g., customer lists, manufacturing processes*]**_ _, all goodwill associated with such trade secrets, and all tangible property that expresses such trade secrets or is required for implementation of such trade secrets, whether now existing or hereafter acquired or arising, together with all products and proceeds thereof, including without limitation any insurance proceeds with respect thereto.**

Comment: Pursuant to Com C §9108(b), the description in Alternative 1 is sufficient to state a description of collateral in a security agreement. See §9.7.

Alternative 2 should be used by practitioners who wish to list "general intangibles" and then specify the trade secrets that are included in the collateral so that there can be no doubt that the debtor intended to grant a security interest in a particular type of trade secret to the secured party. A security agreement that includes other intellectual property besides trade secrets (*e.g.,* trademarks, patents, or copyrights) should include references to such intellectual property. A reference to the goodwill associated with trademarks should also be included if trademarks are part of the collateral.

Alternative 3 may be used if the secured party is being granted a security interest only in particular trade secrets.

In the context of the Commercial Code, the practitioner must be careful to differentiate among many types of collateral to ensure that the secured party obtains a security interest in all aspects of the personal property. This is particularly true with respect to intellectual property. There may be trademarks, copyrights, and patents associated with the technology of the borrower. All these should be specified. In addition, if a license is involved it may be important to obtain a security interest in accounts so as to obtain a security interest in the royalty stream. Also, certain computer programs may be characterized as goods under Division 9. Software is specifically included in the definition of "general intangibles." Com C §9102(42). However, software itself is defined as "a computer program and any supporting information provided in connection with a transaction relating to the program." Com C §9102(75). The definition of "goods" includes a computer program that is embedded in goods, if "(i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods." Com C §9102(44).

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§9.9 B. Value Given

After both parties have executed or authenticated the security agreement, value must be given. The value may be any consideration that would support a simple contract. Com C §1201(43)(d). It may include a binding commitment to extend credit and security for a preexisting claim. Com C §1201(43)(a)-(b).

WARNING: Even though giving security for a preexisting claim constitutes "giving value," a security interest based on such value may be avoided under certain circumstances as a preferential transfer in the event of the debtor's bankruptcy. 11 USC §547. See Secured Transactions in California Commercial Law Practice, chap 6 (2d ed Cal CEB 2001) for a discussion of how bankruptcy may affect the rights of a secured creditor.

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.10 C. Debtor's Rights in Collateral

§9.10 C. Debtor's Rights in Collateral

The debtor must have rights in the collateral before the security interest in that collateral can attach. Com C §9203(b). Ordinarily there is no controversy regarding the debtor's rights when the collateral is a trade secret owned and closely guarded by the debtor, but the creditor should verify the debtor's ownership before any bargain is struck based on the value of that trade secret. For discussion of trade secret ownership, see chap 2.

If the borrower holds the trade secret or other intellectual property under a license, the question of attachment is more complicated because the license may prohibit assignment. Commercial Code §9408 addresses this problem by providing that a security interest will attach even if a license contains a prohibition against assignment. Although attachment is accomplished, the secured party may not be able to enforce the security interest because assignment of the license rights will be prohibited on foreclosure. Therefore, if an interest under a trade secret or other intellectual property license is important collateral, secured parties may wish to seek the licensor's consent at the time the security interest is entered into to ensure that the license may be assigned on foreclosure. If the secured party waits until a foreclosure to seek the consent, it will have far less leverage.

This issue is particularly important in connection with intellectual property licenses. Because of applicable patent and copyright law, nonexclusive patent licenses and copyright licenses are personal and can be assigned only with the consent of the licensor. *Perlman v Catapult Entertainment, Inc*. *(In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747; *Everex v CadTrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673; *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300; *In re Patient Educ. Media, Inc.* (Bankr SD NY 1997) 210 BR 237, 242. But see *Superbrace, Inc. v Tidwell* (2004) 124 CA4th 388, 21 CR3d 404 (patent assignable under state law). The Ninth Circuit has held that an exclusive copyright license may not be assigned without consent. *Gardner v Nike* (9th Cir 2002) 279 F3d 774. (*Gardner* has been criticized by several courts because it does not provide an exclusive licensee with rights that are generally accorded to the holder of an exclusive license. See, *e.g., Traicoff v Digital Media, Inc.* (SD Ind 2006) 439 F Supp 2d 872.) In addition, certain courts, including the Ninth Circuit, have held that Bankruptcy Code §365 prohibits the assumption of a nonexclusive intellectual property license by a debtor. See *RCI Technol. Corp. v Sunterra Corp. (In re Sunterra Corp.)* (4th Cir 2004) 361 F3d 257 (copyright license); *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747 (patent license); *N.C.P. Mktg. Group, Inc. v Blanks (In re N.C.P. Mktg. Group, Inc.)* (D Nev 2005) 337 BR 230, aff'd sub nom *N.C.P. Mktg. Group, Inc. v BG Star Prods., Inc.* (9th Cir 2008) 279 Fed Appx 561 (unpublished), cert denied (2009) 556 US ___, 173 L Ed 2d 1028, 129 S Ct 1577 (trademark license); *Wellington Vision, Inc. v Pearle Vision, Inc.* (*In re Wellington Vision, Inc.)* (SD Fla 2007) 364 BR 129 (trademark license); *In re Travelot Co.* (Bankr SD Ga 2002) 286 BR 447 (trademark license); *In re Golden Books Family Entertainment, Inc.* (Bankr D Del 2001) 269 BR 300, 309 (copyright license). However, other courts have found that if there is no "actual" assignment to be considered, the debtor may assume the contract. See *Institut Pasteur v Cambridge BioTech Corp.* (1st Cir 1997) 104 F3d 489. Although not accepting the "actual" assignment reasoning of *Institut Pasteur*, the bankruptcy court of the Southern District of New York has held that if the debtor in possession, rather than a trustee, is seeking to assume the contract, the assumption will be permitted under Bankruptcy Code §365(c)(i). *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566; see also *In re Adelphia Communications* (Bankr SD NY 2007) 359 BR 65 (follows *Footstar* with respect to franchise agreements); *In re Aerobox Composite Structures, LLC* (Bankr DNM 2007) 373 BR 135.

NOTE: In a statement respecting the denial of certiorari in connection with *N.C.P. Mktg. Group, Inc. v BG Star Prods., Inc.* (9th Cir 2008) 279 Fed Appx 561, Justice Kennedy, joined by Justice Breyer, stated that "[t]he division over the meaning of §365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization." Justice Kennedy concluded, however, that *N.C.P. Mktg. Group* was not the most suitable case to resolve the conflict. *N.C.P. Mktg. Group, Inc. v BG Star Prods., Inc.* (2009) 556 US ___, 173 L Ed 2d 1028, 1029, 129 S Ct 1577, 1578.

NOTE: Practitioners should note that the previous discussion relates only to licenses in which assignments are

prohibited. If the assignment language in the license permits assignment, then the license may be assigned. *In re Quantegy, Inc.* (Bankr MD Ala 2005) 326 BR 467. A clause prohibiting the unreasonable withholding of consent is not equivalent to a clause that permits assignment. *Wellington Vision, Inc. v Pearle Vision, Inc.* (*In re Wellington Vision, Inc.)* (SD Fla 2007) 364 BR 129. For further discussion of intellectual property licenses in bankruptcy, see Secured Transactions in California Commercial Law Practice §§6.46-6.50 (2d ed Cal CEB 2001).

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V. PERFECTION OF SECURITY INTEREST

§9.11 A. Effect of Perfection

The "attachment" of a security interest is the creation of a contract intended to grant a security interest in the collateral described in the contract. Com C §9203. See §§9.6-9.10. When the security interest is perfected, the secured creditor gains an interest superior to that of third parties who might later acquire an interest in the same collateral. See Com C §9322. The Commercial Code generally assigns priorities in order of perfection: First in time is first in right. Thus, the interest of a third party with an otherwise enforceable interest in the collateral is subordinate to the interest of even a subsequent lender who perfects his or her interest first. Com C §9322(a)(1). There are exceptions for purchase money lenders and a few unusual classes of creditors, but such exceptions seldom arise with trade secrets. See Com C §§9103, 9324 for rules of priority. See Secured Transactions in California Commercial Law Practice, chap 4 (2d ed Cal CEB 2001).

The Commercial Code provides different ways to perfect a security interest depending on the type of collateral, including perfection by filing a financing statement (see §9.12), or by taking possession of the collateral. General intangibles are perfected by filing. Taking possession of the collateral is inapplicable to general intangibles. Com C §9312; see also *Braunstein v Gateway Mgmt. Serv., Ltd. (In re Coldwave Sys. LLC)* (Bankr D Mass 2007) 368 BR 91. In *Dabney v Info. Exch.* (*In re Info. Exch.)* (Bankr ND Ga 1989) 98 BR 603, 604, the court rejected the notion that a security interest in information on a computer tape could be perfected by taking possession of a copy of the tape. The court held that the information on the tape was a "general intangible" and that a security interest in such materials could be perfected only by the filing of a financing statement. See also Com C §9102(a)(44); UCC Comment 4.a to Com C §9102(a)(44) (computer programs usually constitute software, and are therefore not "goods" for purposes of Commercial Code unless they are embedded in the goods; see §9.8).

Secured creditors should also consider whether the "trade secrets" constitute material potentially subject to protection under United States copyright laws. Division 9 of the Commercial Code specifically provides that it is not applicable if a federal statute preempts Division 9 or provides a system creating, perfecting, and establishing priority or enforcement of a security interest. Com C §9109(c).

Courts have held that federal copyright law preempts Division 9 and provides a priority scheme for establishing security interests. See *National Peregrine, Inc. v Capital Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.)* (CD Cal 1990) 116 BR 194. Therefore, a security interest in a registered copyright must be perfected by filing a security agreement with the Copyright Office in Washington, D.C. *Peregrine*, however, did not differentiate between registered and unregistered copyrights, and left certain issues regarding copyrights and the proceeds of copyrighted material unaddressed. Those issues have since been clarified by the Ninth Circuit in *Aerocon Eng'g v Silicon Valley Bank (In re World Auxiliary Power)* (9th Cir 2002) 303 F3d 1120, which held that the Copyright Act and related rules only permit the filing in the Copyright Office of security agreements covering registered copyrights. If the copyright is not registered, no federal-level filing can be made. In *Aerocon Eng'g,* the Ninth Circuit held that, with respect to unregistered copyrights, the UCC is not preempted. If the copyrights are not registered, filing a financing statement under state law is sufficient to perfect the interest in the collateral. *Aerocon Eng'g v Silicon Valley Bank (In re World Auxiliary Power), supra.* The Ninth Circuit adopted the holdings of *Peregrine*, but distinguished and limited them to registered copyrights, specifically rejecting lower court opinions that had extended *Peregrine*'s holding to unregistered copyrights. 303 F3d at 1130.

In addition to holding that the proper place to perfect a security interest in copyrights is at the Copyright Office, *National Peregrine, Inc. v Capital Fed. Sav. & Loan Ass'n (In re Peregrine Entertainment, Ltd.), supra,* held that a lender cannot obtain a security interest in any type of proceeds, including accounts or royalties, unless the secured creditor has perfected against the copyright by making a federal filing. Most commentators consider this aspect of *Peregrine* wrongly decided. *Aerocon Eng'g v Silicon Valley Bank (In re World Auxiliary Power), supra,* did not address the proceeds issue. The Ninth Circuit previously distinguished *Peregrine* in *Broadcast Music, Inc. v Hirsh* (9th Cir 1997) 104 F3d 1163 by finding that proceeds may be in the form of other types of collateral, such as accounts, and may be

perfected pursuant to the UCC. It is still prudent, however, to obtain a security interest in the copyright or copyrightable material itself if a security interest in proceeds from copyrighted material is desired.

The Ninth Circuit did not address the issue of mask works when it determined that perfection by filing under the UCC was appropriate for unregistered copyrights in *Aerocon Eng'g v Silicon Valley Bank (In re World Auxiliary Power), supra*. However, the same rule that applies to copyrights should apply to mask works.

For trademarks, case law suggests that the proper way to perfect a security interest is by filing a financing statement. *Joseph v Valencia, Inc. (In re 199Z, Inc.)* (Bankr CD Cal 1992) 137 BR 778 (although creditor filed with the Patent and Trademark Office, security interest was unperfected because creditor did not file a UCC-1 financing statement). See also *In re Together Dev. Corp.* (Bankr D Mass 1998) 227 BR 439 (perfection in trademarks requires UCC filing, not filing with Patent and Trademark Office); *In re Roman Cleanser* (Bankr ED Mich 1984) 43 BR 940, aff'd (6th Cir 1986) 802 F2d 207. But see *Official Comm. of Unsecured Creditors v Hudson United Bank (In re America's Hobby Ctr., Inc.)* (Bankr SD NY 1998) 223 BR 275 (weight of authority indicated that UCC filing was sufficient to perfect security interest in trademark collateral, but noted that matter was not free from doubt). Security interests in trademarks are subject to other issues. See *Clorox Co. v Chemical Bank* (July 2, 1996) 40 USPQ2d 1098, in which the Trademark Trial and Appeal Board of the Patent and Trademark Office invalidated an absolute assignment of a trademark application given to a lender as security, as well as the underlying trademark application, because the assignment was not accompanied by a transfer of the assignor's business.

Filing a UCC-1 financing statement to perfect a security interest in patents without filing with the Patent and Trademark Office does provide the secured creditor with a perfected security interest.

The Ninth Circuit has held that the Patent Act does not displace the Commercial Code. *Moldo v Matsco, Inc. (In re Cybernetic Servs., Inc.)* (9th Cir 2001) 252 F3d 1039. Therefore, a secured party who had filed a UCC financing statement under applicable state law but did not make a filing in the Patent and Trademark Office had a perfected security interest in the patent with priority over the trustee in bankruptcy. *Moldo* did not reach the question of whether the Patent Act preempts the UCC when a security interest is created by a transfer of title in a patent to the secured party with title to revert back to the debtor when the debt is paid. Such a security device, involving a transfer of title, has been held to constitute an "assignment" of a patent. See *Waterman v MacKenzie* (1891) 138 US 252, 34 L Ed 923, 11 S Ct 334. To protect an interest in the patent or trademark against a bona fide purchaser, the creditor must file notice of its security interest with the Patent and Trademark Office. See *In re Chesapeake Fiber Packing Corp. v Sebro Packing* (Bankr D Md 1992) 143 BR 360, aff'd (4th Cir 1993) 8 F3d 817.

PRACTICE TIP: Despite the Ninth Circuit's holding in *Moldo,* in addition to filing a UCC financing statement in the Office of the Secretary of State in accordance with the Commercial Code, counsel should file a copy of the security agreement with the prescribed cover sheet in the Patent and Trademark Office or the Copyright Office, as applicable, to ensure perfection of a security interest in the applicable general intangible and to give bona fide purchasers notice of the security interest.

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§9.12 B. Perfection by Filing

Perfection of a security interest by filing is achieved by filing a financing statement (generally by completing and filing a Form UCC-1) in the appropriate filing office. Com C §9310(a). See §9.14. The appropriate jurisdiction for filing financing statements against a debtor that is a corporation, limited liability company, or limited partnership is its state of incorporation or registration. Com C §9307(e). Generally, the Secretary of State's office will be the appropriate office for filing a financing statement for the types of collateral that make up or are related to trade secrets. Com C §9501(a)(2).

Because the names and functions of the filing offices, the filing fees, and other requirements vary widely from state to state, counsel should review applicable statutes and regulations in the relevant states. Alternatively, the practitioner may use a filing service that specializes in filing financing statements in various jurisdictions.

Form UCC-1 is effective for 5 years after the date it is filed. Com C §9515(a). If a continuation statement is filed, the effect of the filing continues in 5-year increments. Com C §9515(d).

Unlike a security agreement, a financing statement merely provides notice to third parties and therefore it need not disclose much information about the underlying transaction. The only information that must be included is the debtor's name, the secured party's name, and a description of the collateral. Com C §9502(a). However, the financing statement should also include the debtor's address, place of incorporation, and organizational identification number. In addition, the secured party's address should be included. The filing office may reject the filing without this information. Com C §9516. The filing fee must also be included.

PRACTICE TIP: It is important to note that with respect to the debtor's name, if the debtor is a registered organization, the name on the financing statement must be exactly as listed on the debtor's organizational documents, such as its articles of incorporation. Com C §9503. Practitioners should obtain a copy of the organizational documents to make sure that the name is correctly stated on the financing statement. If the debtor is an individual, the secured party should obtain copies of the debtor's driver's license, tax returns, birth certificate, and passport to determine the correct full name of the individual. If more than one name appears, multiple filings may be required. For partnerships and trusts, it is important to examine the partnership or trust documents and tax returns.

For a full discussion of perfecting a security interest by Commercial Code filing, including filing requirements and when a change must be recorded, see Secured Transactions in California Commercial Law Practice, chap 3 (2d ed Cal CEB 2001).

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.13 1. Methods for Filing Financing Statements

§9.13 1. Methods for Filing Financing Statements

The Form UCC-1 (see §9.14) may be delivered by any of the following means (see 2 Cal Code Regs §22600.1):

- By certified mail, return receipt requested, to California Secretary of State, Uniform Commercial Code Division, P.O. Box 942835, Sacramento, CA 94235-0001;
- By courier delivery to California Secretary of State, Uniform Commercial Code Division, 1500 11th Street, Suite 255, Sacramento, CA 95814; or
- By electronic filing, instructions for which are included on the Secretary of State's UCC Connect website at https://uccconnect.sos.ca.gov/acct/acct-login.asp.

Further information on filing financing statements is available on the Secretary of State's website at http://www.sos.ca.gov/business. The telephone number for the Secretary of State is (916) 653-3516.

NOTE: Practitioners should be aware that although the Secretary of State's office will process filings made by any of the methods described above, electronic filing provides the quickest and most reliable turn-around time to obtain a file-stamped copy of the filing.

NOTE: The Model State Trademark Law (Bus & P C §§14200-14272) permits the recording of other instruments, including security interests, "at the discretion of the secretary, provided that the instrument is in writing and is duly executed." Bus & P C §14220(c). Thus, it may be prudent to record, in addition to a financing statement, a trademark security interest if the Secretary of State permits these filings. However, Bus & P C §14220(f) provides that

> [n]either this chapter nor the recordal of any instrument received by the secretary [of state] pursuant to this chapter shall have any effect, including, but not limited to, any effect relating to attachment, perfection, priority, or enforcement, on any security interest governed by Division 9 [of the Commercial Code].

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.14 2. Form: Financing Statement (UCC-1)--California

§9.14 2. Form: Financing Statement (UCC-1)—California

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME

OR

1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
1c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 1e. TYPE OF ORGANIZATION | 1f. JURISDICTION OF ORGANIZATION | 1g. ORGANIZATIONAL ID#, if any ☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME

OR

2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
2c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

[redacted] | ADD'L INFO RE ORGANIZATION DEBTOR | 2e. TYPE OF ORGANIZATION | 2f. JURISDICTION OF ORGANIZATION | 2g. ORGANIZATIONAL ID#, if any ☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME

OR

3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX
3c. MAILING ADDRESS	CITY	STATE / POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

Print

Instructions for National UCC Financing Statement (Form UCC1)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 1; correct Debtor name is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. The filing office cannot give legal advice.

Do not insert anything in the open space in the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and, if filing in a filing office that returns an acknowledgment copy furnished by filer, you may also send Acknowledgment Copy; otherwise detach. If you want to make a search request, complete item 7 (after reading Instruction 7 below) and send Search Report Copy, otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, use 8-1/2 X 11 inch sheets and put at the top of each sheet the name of the first Debtor, formatted exactly as it appears in item 1 of this form; you are encouraged to use Addendum (Form UCC1Ad).

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, present simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1. **Debtor name**: Enter only one Debtor name in item 1, an organization's name (1a) or an individual's name (1b). Enter Debtor's exact full legal name. Don't abbreviate.

1a. Organization Debtor. "Organization" means an entity having a legal identity separate from its owner. A partnership is an organization; a sole proprietorship is not an organization, even if it does business under a trade name. If Debtor is a partnership, enter exact full legal name of partnership; you need not enter names of partners as additional Debtors. If Debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name, organization type, and jurisdiction of organization.

1b. Individual Debtor. "Individual" means a natural person; this includes a sole proprietorship, whether or not operating under a trade name. Don't use prefixes (Mr., Mrs., Ms.). Use suffix box only for titles of lineage (Jr., Sr., III) and not for other suffixes or titles (e.g., M.D.). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual Debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.
For both organization and individual Debtors: Don't use Debtor's trade name, DBA, AKA, FKA, Division name, etc. in place of or combined with Debtor's legal name; you may add such other names as additional Debtors if you wish (but this is neither required nor recommended).

1c. An address is always required for the Debtor named in 1a or 1b.

1d. **This field has been removed pursuant to California Uniform Commercial Code, Section 9526.5.**

1e,f,g."Additional information re organization Debtor" is always required. Type of organization and jurisdiction of organization as well as Debtor's exact legal name can be determined from Debtor's current filed charter document. Organizational ID #, if any, is assigned by the agency where the charter document was filed; this is different from tax ID #; this should be entered preceded by the 2-character U.S. Postal identification of state of organization if one of the United States (e.g., CA12345, for a California corporation whose organizational ID # is 12345); if agency does not assign organizational ID #, check box in item 1g indicating "none."

Note: If Debtor is a trust or a trustee acting with respect to property held in trust, enter Debtor's name in item 1 and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a decedent's estate, enter name of deceased individual in item 1b and attach Addendum (Form UCC1Ad) and check appropriate box in item 17.If Debtor is a transmitting utility or this Financing Statement is filed in connection with a Manufactured-Home Transaction or a Public-Finance Transaction as defined in applicable Commercial Code, attach Addendum (Form UCC1Ad) and check appropriate box in item 18.

2. If an additional Debtor is included, complete item 2, determined and formatted per Instruction 1. To include further additional Debtors, or one or more additional Secured Parties, attach either Addendum (Form UCC1Ad) or other additional page(s), using correct name format. Follow Instruction 1 for determining and formatting additional names.

3. Enter information for Secured Party or Total Assignee, determined and formatted per Instruction 1. If there is more than one Secured Party, see Instruction 2. If there has been a total assignment of the Secured Party's interest prior to filing this form, you may either (1) enter Assignor S/P's name and address in item 3 and file an Amendment (Form UCC3) [see item 5 of that form]; or (2) enter Total Assignee's name and address in item 3 and, if you wish, also attaching Addendum (Form UCC1Ad) giving Assignor S/P's name and address in item 12.

4. Use item 4 to indicate the collateral covered by this Financing Statement. If space in item 4 is insufficient, put the entire collateral description or continuation of the collateral description on either Addendum (Form UCC1Ad) or other attached additional page(s).

5. If filer desires (at filer's option) to use titles of lessee and lessor, or consignee and consignor, or seller and buyer (in the case of accounts or chattel paper), or bailee and bailor instead of Debtor and Secured Party, check the appropriate box in item 5. If this is an agricultural lien (as defined in applicable Commercial Code) filing or is otherwise not a UCC security interest filing (e.g., a tax lien, judgment lien, etc.), check the appropriate box in item 5, complete items 1-7 as applicable and attach any other items required under other law.

6. If this Financing Statement is filed as a fixture filing or if the collateral consists of timber to be cut or as-extracted collateral, complete items 1-5, check the box in item 6, and complete the required information (items 13, 14 and/or 15) on Addendum (Form UCC1Ad).

7. This item is optional. Check appropriate box in item 7 to request Search Report(s) on all or some of the Debtors named in this Financing Statement. The Report will list all Financing Statements on file against the designated Debtor on the date of the Report, including this Financing Statement. There is an additional fee for each Report. If you have checked a box in item 7, file Search Report Copy together with Filing Officer Copy (and Acknowledgment Copy). Note: Not all states do searches and not all states will honor a search request made via this form; some states require a separate request form.

8. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 8 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

Comment: The Secretary of State will automatically send an acknowledgment copy of the accepted document and an

acknowledgement letter. Additional copies must be submitted for each debtor name searched. All additional copies should be marked "search copy." See the Secretary of State's website at http://www.sos.ca.gov/business for fees and other frequently asked questions regarding filing.

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.14A 3. Form: : Financing Statement Addendum (UCC-1Ad)--California

§9.14A 3. Form: : Financing Statement Addendum (UCC-1Ad)—California

UCC FINANCING STATEMENT ADDENDUM

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

9. NAME OF FIRST DEBTOR (1a or 1b) ON RELATED FINANCING STATEMENT

9a. ORGANIZATION NAME

OR

9b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME, SUFFIX

10. MISCELLANEOUS:

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

11. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one name (11a or 11b) – do not abbreviate or combine names

11a. ORGANIZATION'S NAME

OR

11b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

11c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

ADD'L INFO RE ORGANIZATION DEBTOR	11e. TYPE OF ORGANIZATION	11f. JURISDICTION OF ORGANIZATION	11g. ORGANIZATIONAL ID#, if any ☐ NONE

12. ☐ ADDITIONAL SECURED PARTY'S or ☐ ASSIGNOR S/P's NAME – insert only one name (12a or 12b)

12a. ORGANIZATION'S NAME

OR

12b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME	SUFFIX

12c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

13. This FINANCING STATEMENT covers ☐ timber to be cut or ☐ as-extracted collateral, or is filed as a ☐ fixture filing.

14. Description of real estate:

15. Name and address of a RECORD OWNER of above-described real estate (if Debtor does not have a record interest):

16. Additional collateral description:

17. Check only if applicable and check only one box.

Debtor is a ☐ Trust or ☐ Trustee acting with respect to property held in trust or ☐ Decedent's Estate

18. Check only if applicable and check only one box.

☐ Debtor is a TRANSMITTING UTILITY

☐ Filed in connection with a Manufactured-Home Transaction – effective 30 years

☐ Filed in connection with a Public-Finance Transaction – effective 30 years

Print

Instructions for National UCC Financing Statement Addendum (Form UCC1Ad)

9. Insert name of first Debtor shown on Financing Statement to which this Addendum is related, exactly as shown in item 1 of Financing Statement.

10. Miscellaneous: Under certain circumstances, additional information not provided on Financing Statement may be required. Also, some states have non-uniform requirements. Use this space to provide such additional information or to comply with such requirements; otherwise, leave blank.

11. If this Addendum adds an additional Debtor, complete item 11 in accordance with Instruction 1 on Financing Statement. To add more than one additional Debtor, either use an additional Addendum form for each additional Debtor or replicate for each additional Debtor the formatting of Financing Statement item 1 on an 8-1/2 X 11 inch sheet (showing at the top of the sheet the name of the first Debtor shown on the Financing Statement), and in either case give complete information for each additional Debtor in accordance with Instruction 1 on Financing Statement. All additional Debtor information, especially the name, must be presented in proper format exactly identical to the format of item 1 of Financing Statement.

12. If this Addendum adds an additional Secured Party, complete item 12 in accordance with Instruction 3 on Financing Statement. In the case of a total assignment of the Secured Party's interest before the filing of this Financing Statement, if filer has given the name and address of the Total Assignee in item 3 of the Financing Statement, filer may give the Assignor S/P's name and address in item 12.

13-15. If collateral is timber to be cut or as-extracted collateral, or if this Financing Statement is filed as a fixture filing, check appropriate box in item 13; provide description of real estate in item 14; and, if Debtor is not a record owner of the described real estate, also provide, in item 15, the name and address of a record owner. Also provide collateral description in item 4 of Financing Statement. Also check box 6 on Financing Statement. Description of real estate must be sufficient under the applicable law of the jurisdiction where the real estate is located.

16. Use this space to provide continued description of collateral, if you cannot complete description in item 4 of Financing Statement.

17. If Debtor is a trust or a trustee acting with respect to property held in trust or is a decedent's estate, check the appropriate box.

18. If Debtor is a transmitting utility or if the Financing Statement relates to a Manufactured-Home Transaction or a Public-Finance Transaction as defined in the applicable Commercial Code, check the appropriate box.

Comment: This addendum should only be completed and submitted with Form UCC-1 if needed to record additional

debtors and/or secured parties. See the California Secretary of State website at http://www.sos.ca.gov.

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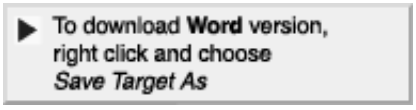
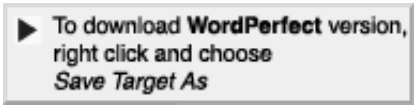
Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.15 4. Form: Additional Language for Description of Trade Secrets Collateral

§9.15 4. Form: Additional Language for Description of Trade Secrets Collateral





_ _[*Identify collateral other than general intangibles*]_ _ **and in all general intangibles, including but not limited to** _ _[*Debtor's trade secrets/identify particular subcategories of trade secrets, e.g., customer lists, manufacturing processes*]_ _**, all goodwill associated with such general intangibles, and all tangible property that expresses such trade secrets or is required for implementation of such trade secrets, whether now existing or hereafter acquired or arising together with all products and proceeds thereof, including without limitation any insurance proceeds with respect thereto.**

Comment: To the extent that the secured party is taking all of the assets of the borrower as collateral, the secured party may simply indicate "all assets" or "all personal property" in the collateral description. Com C §9504(2). However, if the collateral is less than all assets or only general intangibles, then the collateral description must conform to the requirements of Com C §9108. Com C §9504(1). See §9.7. The collateral description should be added to box 4 on Form UCC-1 (or may be attached as an addendum clearly referred to in box 6) and may be modified to include any other language counsel normally uses to describe the collateral.

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Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.16 C. Verifying Priority

§9.16 C. Verifying Priority

Counsel should take steps to confirm the priority of a security interest when the financing statement is filed. Counsel can order, either directly or through a filing service, an official Secretary of State report of all liens on file against a debtor as of a certain date. The report may include copies of the financing statements listed on the report, allowing counsel to identify who is claiming an interest in which categories of collateral. It is also possible to receive this information online.

PRACTICE TIP: The Secretary of State's office charges for copies by the page, so counsel may wish to get an estimate of copying costs before ordering a search.

Unofficial reports are also available from several credit reporting services and on-line data base services. These reports usually list only the date, time, and parties to financing statements on file. Although they may contain only limited, incomplete information, unofficial reports may be useful because they provide an inexpensive and immediate way for counsel to get a preview of the liens already on file against a debtor.

WARNING: If the priority of a lien on trade secrets—or any other type of collateral—is material to the creditor, counsel should not rely on an unofficial report.

Some counsel order a search report as soon as they begin to document a transaction and file a financing statement as early in the documentation process as possible so that they can request and receive another official search report showing their client's financing statement on file and in place before closing.

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§9.17 VI. RIGHTS OF SECURED CREDITOR

If a debtor defaults under a security agreement, the secured party is entitled to take possession of the collateral. Com C §9601(a)(1). The creditor can dispose of it through sale if so desired (Com C §9610(a)) or retain it to satisfy the debt (see Com C §9620). The debtor and junior lienholders have redemption rights before disposition of the collateral unless the security agreement provides otherwise. See Com C §9623.

A secured creditor that sells or disposes of collateral must do so in a "commercially reasonable" manner. See Com C §9610. This is a flexible concept, driven by the nature of the collateral and of the marketplace for that collateral. Because trade secrets are intangible and confidential by definition, selling or disposing of a trade secret as a discrete property right, as opposed to selling a trade secret as part of an ongoing business, may be difficult to accomplish. Failure to sell in a commercially reasonable manner may affect a creditor's right to a deficiency claim against its debtor or even subject a creditor to claims for damages. See Com C §9625.

As discussed in §9.10, if the trade secret includes a license of intellectual property, the secured creditor will not be able to assign the license to a third party if the license contains a prohibition against assignment. The secured party should seek permission from the licensor to assign the license in connection with any foreclosure proceeding.

For further discussion of the rights of secured creditors, see Secured Transactions in California Commercial Law Practice, chap 5 (2d ed Cal CEB 2001).

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§9.18 VII. SPECIAL CONSIDERATIONS IN USE OF TRADE SECRETS AS COLLATERAL

The nature of the collateral always has an effect on the parties' willingness to enter into a security agreement and on the terms of their arrangement. There is little literature and less case law on the unique problems associated with using trade secrets as collateral. However, some principles do emerge as obvious considerations to parties contemplating such a transaction: maintaining trade secret value (see §9.19), avoiding the negative effect of federal preemption (see §9.20), and obtaining value from a trade secret (see §9.21).

WARNING: The discussion in §§9.19-9.21 treats trade secrets issues in isolation. Although many of the issues discussed are common to intellectual property in general, portions of the collateral may be protected by copyright, patent, or trademark law, introducing numerous complexities not addressed in this chapter. For discussion of security interests in such other intellectual property, see Secured Transactions in California Commercial Law Practice, chap 3 (2d ed Cal CEB 2001).

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§9.19 A. Maintaining Value of Trade Secret

Even though a trade secret is a valuable asset to its owner in the operation of a business, it does not necessarily follow that it will have the same or even any value to a secured creditor, either independently or as part of a going concern. For a trade secret to have value to a creditor, the creditor must be prepared to operate a business that can use the trade secret or must be confident that a market exists for it as a discrete asset.

To fully assess its position, a creditor should consider not only the present value but also the future value of the trade secret. The trade secret whose *future* worth is in doubt is of questionable value as security. A trade secret that is disclosed to others could lose its status as a trade secret along with the competitive advantage and value otherwise accruing to one rightfully in possession. A creditor would have a common law action for impairment of security if the debtor wrongfully disclosed the trade secret to third parties, and the creditor can insist on a specific promise not to do so in the security agreement. However, there may be little practical value in such a lawsuit after the trade secret has been disclosed. The creditor must therefore have confidence in the integrity of the debtor and the security measures guarding the trade secret. Again, provisions in the security agreement could provide the creditor with more protection.

A competitor's advances may cause a trade secret to lose its value. The creditor must consider the likelihood of obsolescence of the collateral through the expected life of the loan.

A trade secret could also lose its value if the debtor's key employees abandon a failing enterprise, taking their knowledge of the trade secret to the competition. Employment contracts drafted to prevent such information leakage are an important element of the security package that a prospective creditor should consider when evaluating trade secrets collateral. See the employee confidentiality agreement in §§6.17-6.39. The creditor—or the party purchasing the trade secret from the creditor—should be prepared to take action to enforce employment contracts prohibiting breaches of confidence or to prosecute misappropriation facilitated by employee migration following the debtor's liquidation or sale. Without a grant of a security interest in general intangibles, the lender may face standing issues.

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§9.20 B. Obtaining Value From Trade Secret

The creditor should consider the place or context of the trade secret within the debtor's business if the creditor does not take over the entire business. It may be impossible to put the trade secret to practical use in any enterprise other than that operated by the debtor.

Customer lists are a useful illustration of the problem. Although a classic trade secret and often the subject of litigation alleging misappropriation, customer lists may not be separable from the goodwill built up by the debtor. A marked degree of customer loyalty may deprive the foreclosing creditor of the full value of a customer list.

For more technical trade secrets, the lender should acquire a security interest in all documentation and other tangible property practically required to implement the trade secret. Copies of such tangible items, together with the trade secret expressed in tangible media, can often be deposited or placed in escrow in a secure environment to ensure the creditor's access in a default.

There may also be circumstances in which a creditor would take a security interest in a trade secret *by itself*, without collateralizing the entire business. Preexisting creditors may have neglected to take a security interest in such intangibles, offering the opportunity of a first-time lien *only* on those assets. The trade secret may also be of special value to a lender, as in the case of a manufacturer purchasing subcomponents produced through a trade secret process by a sole source supplier. Even if narrowly focused on a trade secret, the creditor must be sure to acquire a security interest in all other properties, including such tangible property as computer diskettes and documentation that are necessary for the use or merchantability of the trade secret.

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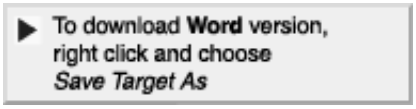
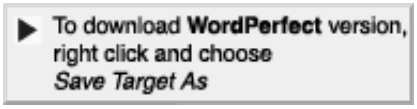
Source: Business Law/Trade Secrets Practice in California/9 Security Interests in Trade Secrets/§9.21 VIII. CHECKLIST: STEPS FOR SETTING UP SIMPLE SECURED TRANSACTIONS

§9.21 VIII. CHECKLIST: STEPS FOR SETTING UP SIMPLE SECURED TRANSACTIONS





A creditor or its counsel must follow the steps below to obtain a security interest in trade secrets:

STEP 1: Evaluate the trade secret's value as collateral, and identify any tangible property necessary for exploiting the trade secret (*e.g.,* manuals documenting use of the trade secret).

STEP 2: Undertake a search in the appropriate Commercial Code filing office to ensure that there are no other creditors with prior perfected interests in the trade secret or related tangible property. *A creditor with an existing interest in the debtor's "general intangibles" may have a prior claim on the debtor's trade secrets.*

STEP 3: If no prior claims to the collateral are disclosed through the Commercial Code search, consider searches in other filing offices, such as the Patent and Trademark Office and the Copyright Office, to ensure that no portion of the trade secret has been registered with a federal or international office or assigned or transferred to a third party.

STEP 4: After conducting the appropriate search or searches and concluding either that no superior claim exists or that a junior lien will be of economic or strategic value, draft a security agreement identifying the collateral as general intangibles. Any tangible property necessary for exploitation of the trade secret should also be separately identified as collateral in the security agreement.

STEP 5: Include in the security agreement promises by the debtor:

- Not to file or register the trade secret with any office or agency where registration might invalidate any part of the security interest being created under the instant security agreement;
- Not to transfer or disclose all or any part of the trade secret to any third party without the creditor's express written permission;
- To use security measures to protect the confidentiality of the trade secret; and
- To provide a copy of the debtor's standard nondisclosure and confidentiality agreement to ensure that the debtor is protecting its trade secrets appropriately.

STEP 6: Although prohibiting the debtor from patenting, copyrighting, or trademarking any portion of the trade secrets collateral, the security agreement should leave the debtor flexibility to develop and improve on the trade secret during the life of the relationship, preserving the creditor's right to any improvements on the trade secret that ultimately accrue to the debtor's advantage as long as there is no default. An after-acquired property clause should be included to ensure that the creditor has a security interest in any future trade secrets developed by the debtor. See §9.8.

STEP 7: Include in the security agreement a clear and practically effective method for turnover of the trade secret to the creditor upon default, further providing:

- That on foreclosure or turnover the debtor will retain no right, title, or interest in the trade secret;
- That on foreclosure or turnover the debtor will neither continue to use the trade secret nor sell, assign, transfer, or disclose the trade secret to any third party;
- Noncompetition clauses, as appropriate; and
- Any special redemption provisions that are desired.

STEP 8: Complete the financing statement, noting the security interest in the property necessary for full use of the trade secret. File the financing statement in the correct office.

STEP 9: Whenever the trade secret may also relate to patents, trademarks, or copyrights:

- File with the Patent and Trademark Office and Copyright Office as appropriate to provide notice to bona fide purchasers of the secured party's interest in the intellectual property collateral or, with respect to registered copyrights, to perfect the security interest in the registered copyright.

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§9.22 IX. CONCLUSION

Despite the challenges faced by creditors, trade secrets may add great value to a lender's collateral pool. Prudent counsel for such lenders should keep an eye on intellectual property as sources of collateral for their clients. The clients who have collateralized entire enterprises may wish to reexamine their security agreements to ensure that their trade secrets are expressly covered and realistically enforceable. Finally, counsel for businesses seeking credit should not neglect the potential utility of substantial trade secrets as collateral that can be aggressively marketed.

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10

Avoiding Misappropriation Claims

Michael J. Nader
Charles Tait Graves
Sharon K. Sandeen

I. SCOPE OF CHAPTER §10.1

II. ADOPTING CORPORATE TRADE SECRETS POLICY
- A. New Companies
  - 1. Have Trade Secret Protection Policy in Place From Inception §10.2
  - 2. Employee Confidentiality Agreements §10.3
  - 3. Confidentiality Agreements With Third Parties §10.4
  - 4. Reasonable Efforts to Maintain Secrecy §10.5
- B. Established Companies §10.6

III. REDUCING TRADE SECRET RISKS IN HIRING
- A. Counseling Employer of Prospective New Employee §10.7
  - 1. Prehiring Advice §10.8
  - 2. Investigate New Employee's Knowledge and Experience
    - a. Collect Information §10.9
    - b. Form: Client Interview Sheet: Information on Change of Employment §10.10
  - 3. Avoid Appearance of Impropriety §10.11
  - 4. Educate Employee §10.12
  - 5. Posthiring Conduct §10.13
  - 6. Responding to Threatening Letter §10.14
- B. Counseling Mobile Employees
  - 1. Attorney's Role §10.15
  - 2. Review Relevant Agreements §10.16
  - 3. Identify Information Owned by Former Employer §10.17
  - 4. Ascertain Character of Information Acquired by Employee §10.18
  - 5. Comply With Announcement Rule §10.19

IV. COUNSELING IN DISPUTES OVER NONDISCLOSURE AGREEMENTS §10.20

V. COMPETITIVE INTELLIGENCE GATHERING §10.21

VI. COUNSELING FORMER EMPLOYER §10.22

VII. WHAT INFORMATION IS AVAILABLE FOR USE?
- A. Overview §10.23
- B. Is Information Available for Use? §10.24
  - 1. Preutilization Checklist §10.25
  - 2. Method of Searching for and Evaluating Trade Secret Information §10.26
  - 3. Method of Searching for and Evaluating Copyright Information §10.27
  - 4. Method of Searching for and Evaluating Patent Information §10.28

VIII. SOURCES OF INFORMATION
- A. Information in Public Domain Not Trade Secret §10.29
  - 1. General and Basic Knowledge §10.30
  - 2. Published Literature and Internet Websites §10.31
  - 3. Expired United States Patent §10.32
  - 4. Foreign Patents §10.33
- B. Nonpublic, Specialized Knowledge May Be Protected as Trade Secret §10.34
- C. Information Obtained by Independent Research and Investigation
  - 1. Results of Independent Research May Be Used §10.35

2. Results of Reverse Engineering May Be Used §10.36
D. Information Obtained Under Confidentiality Obligation §10.37
1. Employee-Employer Relationship §10.38
2. Licensee-Licensor Relationship §10.39
3. Officer's or Director's Relationship With Corporation §10.40
4. Relationship With Partner or Joint Venturer §10.41
5. Relationship With Consultants and Independent Contractors §10.42
6. Relationship With "Idea Man": Unsolicited Disclosures §10.43
7. Relationship With Suppliers and Vendors; Purchaser's Specifications and Technical Manuals §10.44
8. Relationship With Prospective Purchaser or Licensee §10.45
9. Relationship With Buyer of Business §10.46
E. Information Obtained by Theft §10.47
F. Information Obtained by Accident or Mistake §10.48

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§10.1 I. SCOPE OF CHAPTER

With the U.S. economy increasingly based on technology and information sectors, most California businesses own confidential, proprietary, and trade secret information that gives them a valuable advantage over their competitors and that must be protected from disclosure. Thus, California companies need to adopt policies and practices that will deter intellectual property claims. These claims include trade secret misappropriation lawsuits, which have become more complex, more technical, and more expensive in recent years. However, many companies pay less attention to lawsuit prevention than to protecting their own information against misappropriation, when both are necessary. California companies that are usually at the highest risk of a lawsuit are technology start-up enterprises, but all companies should implement trade secret policies and practices, including comprehensive employee training, from the time they commence operations.

Trade secret lawsuits typically arise from four possible situations: (1) a group of founders forms a new business; (2) an established company hires employees from a competitor; (3) companies share information under a nondisclosure agreement, but then the partnership dissolves; or (4) companies undertake competitive intelligence gathering. Although all companies that value protecting their trade secrets and minimizing litigation costs should adopt the policies and practices described in this chapter, these four situations are the most critical—when companies need to be most vigilant in taking steps to ensure that their businesses proceed without appearing to benefit from misappropriated trade secrets.

This chapter addresses each of these four contexts as well as the policies and practices that companies should adopt to deter litigation. The chapter begins with a discussion of risk-reduction strategies for new businesses to implement and how established businesses that lack such policies and practices can adopt them (see §§10.2-10.6). The chapter also sets forth strategies for representing the employer of a prospective new employee (see §§10.7-10.14), the mobile employee (see §§10.15-10.19), and the former employer when trade secret misappropriation claims may be an issue (see §10.22). The chapter further addresses counseling clients in disputes over nondisclosure agreements (see §10.20) and competitive intelligence gathering (see §10.21). The chapter concludes with a detailed discussion of how to ascertain what categories of information may be the intellectual property of others and what categories are likely free for all to use. See §§10.23-10.48.

For discussion of the dangers of misappropriation claims relating to unsolicited ideas, see chap 3. This chapter addresses civil liability risks; see chap 13 for discussion of criminal liability.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/ II. ADOPTING CORPORATE TRADE SECRETS POLICY/ A. New Companies/§10.2 1. Have Trade Secret Protection Policy in Place From Inception

II. ADOPTING CORPORATE TRADE SECRETS POLICY

A. New Companies

§10.2 1. Have Trade Secret Protection Policy in Place From Inception

In *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 949, 81 CR3d 282, the California Supreme Court rejected the "narrow restraint" doctrine for noncompetition agreements, although it allowed for the possibility of an exception for trade secret protection. 44 C4th at 949 n4. See §§6.21, 10.16. See also Wilka, *How to Avoid Liability and Protect Trade Secrets When Hiring and Losing Employees,* 24 CEB Cal Bus L Prac 1 (Winter 2009). It is therefore vital for all companies to review and update their trade secret policies and practices to ensure protection of their trade secrets and to deter trade secret litigation from their competitors.

Entrepreneurial start-up companies are a major component of California's economy—particularly in the technology sector. Start-up companies face the highest risk of trade secrets lawsuits because their founders are often former employees of a competitor, and start-ups are vulnerable targets for crippling litigation. Adopting trade secrets policies from the beginning can be the "ounce of prevention" that reduces the risk of liability for trade secret misappropriation later on. Similarly, established companies that have not yet adopted such policies should do so. This chapter provides a basic framework for avoiding trade secret misappropriation claims, but it should be stressed that because every business is different, consultation with an attorney for specific advice is highly recommended.

For new companies, the process of developing a trade secret policy can begin even before incorporation. The company's founders are often coworkers who resign together to form the new company or skilled individuals who have recently left competitors. As described in more detail in §2.10, the "preparing to compete" doctrine allows some leeway for individuals who are thinking about and preparing to form a new business before resigning from their former employer. See *Fowler v Varian Assocs., Inc.* (1987) 196 CA3d 34, 41, 241 CR 539 ("California law does permit an employee to seek other employment and even to make some 'preparations to compete' before resigning"). At the same time, founders of a prospective new company should proceed with caution because actions that may ultimately be found lawful can still trigger a debilitating lawsuit.

Prospective company founders should avoid creating any new intellectual property before resigning, because former employers may have contractual and trade secret claims to such property. Founders should also avoid taking any company property or information, including stored cell phone numbers and e-mail addresses and messages, before resigning. Because many employees work from home on occasion, the departing employees (the founders) should carefully review their home computers for any company information such as PDF files originally attached to e-mail. Similarly, the founders should avoid any use of the employer's time or machines to discuss and plan their ideas for forming the new company. Fiduciaries should be especially careful to resign before serious planning begins and should not solicit coworkers before resigning. Although coworker nonsolicitation contracts are of questionable legality in California, founders can reduce the risk of a trade secret lawsuit by hiring employees from several different companies to staff the new entity.

New businesses should enact trade secret policies and train new employees from the day they begin work. This can be difficult because new companies are often disorganized, ill-funded, and focused on rapid technology development above all else. But effective trade secret policies and practices reduce litigation risks and can favorably impress potential investors and acquirors.

Every new employee should sign a contract providing that no nonpublic information of any former employer will be used, and each should report to company management that he or she has conducted a search for any property belonging to a former employer. See §10.3. New companies should designate a founder or a human resources manager to provide trade secret instructions to each new employee. Newly hired sales employees should be trained to use the company's existing customer lists so that they do not rely on their former employers' customer information.

The most important question for a new company in preventing intellectual property litigation is: "If the company were

sued, can the company show that every idea and piece of information that it uses is either in the public domain or was developed independently?" The new company's documentation of the answer to this question will reduce this liability risk. From the start, the founders and other employees should keep records showing the independent development of their ideas. When public domain information is used—Institute of Electrical and Electronics Engineers (IEEE) papers, website materials, trade show materials, textbooks, and the like—this information should be kept on file and, if possible, noted in engineering notebooks. Records of mistakes, dead ends, and software errors should be maintained as evidence of independent work. Sales and marketing employees can print from websites and copy other material from potential customers to show independent derivation of customer lists.

NOTE: For further discussion of the elements of a company trade secret protection program, see chap 4A.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.3 2. Employee Confidentiality Agreements

§10.3 2. Employee Confidentiality Agreements

Although it is common for founders to agree to work for free or only for equity (noncash) compensation at the initial stage of a start-up company, California's labor code prohibits agreements that contravene the requirement that all employees receive at least the state minimum wage for all hours worked. Lab C §§219, 1197. The founders, along with all other company employees, should enter into confidentiality agreements that provide adequate protections for the new company's confidential, proprietary, and trade secret information. The confidentiality agreements should set forth provisions to protect the company's trade secrets, including the following:

- A description of the company's confidential information that includes a reasonably particular listing of categories of the company's confidential, proprietary, and trade secret information applicable to the company's anticipated business, including its research space, marketing activities, products, financing, client lists and clients, and related business information.

NOTE: Care should be taken to not make this description overly broad; an overly broad definition will weaken the provision's notice to the employee and to the trier of fact attempting to enforce the provision. An overly broad definition of a company's "confidential information" also risks rendering the confidentiality agreement an invalid noncompete provision. *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 568, 102 CR3d 1. In *Dowell,* the court invalidated an employment agreement provision that defined "confidential information" as information "disclosed to or known by the employee." The court found that the definition was overly inclusive, making it nearly impossible for the employee to work for another company. 179 CA4th at 578.

- An agreement to maintain the confidentiality of the company's confidential information during and after employment.
- An agreement not to use or disclose (or induce the new company to use) any confidential, proprietary, or trade secret information of any former employer or of any other entity.
- An agreement to maintain the confidentiality of all third party confidential information that the new company receives from third parties, both during and after employment with the new company.
- An agreement to record, disclose, and assign all inventions created during the employee's employment with the new company or created with the new company's equipment and supplies. The agreement must also include a recital of the provisions of Lab C §2870.
- A representation that the employee has no other agreements or relationships that conflict with his or her duties to the new company and that the employee has returned all property and confidential information to any and all prior employers.
- An agreement that, on termination of employment with the new employer, the employee will return all company property and confidential, proprietary, and trade secret information and certify the employee's compliance with this agreement.
- In the event of the employee's departure from the company, the employee's consent to notification of the new employer of the employee's continuing obligations under the employment agreement.

For sample forms of employee confidentiality agreements, see chap 6. See also Intellectual Property in Business Transactions, chap 8 (Cal CEB 2008); Internet Law and Practice in California, chap 4 (Cal CEB 2004).

Employee handbooks (personnel policies) should also set forth a provision that requires employees to maintain the confidentiality of the company's confidential, proprietary, and trade secret information, both during and after employment, and to return all such information and company property on termination of employment. The handbook should also include an individual acknowledgment form for the employee to sign and date, confirming receipt of the confidentiality policy. Further, the employee's offer letter should include the employer's confidentiality requirements and incorporate by reference the company's employment agreement and employee handbook, both of which should be signed before the employee commences employment.

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§10.4 3. Confidentiality Agreements With Third Parties

If the new company engages independent contractors to perform specific tasks for limited periods (to ensure that the individuals do not function as employees and risk misclassification liability for the company), the contractors should also sign consulting agreements that include provisions described in §10.3 to the extent applicable, as well as the following:

- An agreement to maintain the secrecy of the company's confidential information during and after the consulting relationship; and
- An agreement not to use or disclose (or induce the new company to use) any confidential, proprietary, or trade secret information of any former or concurrent employer or contractor of the consultant.

New companies should also secure nondisclosure agreements (NDAs) from vendors, suppliers, licensees, joint venture partners, potential business partners to whom confidential information will be exchanged, visitors to its offices and facilities, and other third parties who will receive the company's confidential information. The NDAs should clarify the purpose of the company's disclosure of its confidential information, that such disclosure is for the recipient's agents on a need-to-know basis, that the recipient of the information has an ongoing duty to maintain the confidentiality of the information, including after the end of the business relationship, and (if possible) that the recipient has a duty to return or destroy all of the company's confidential information at the end of the relationship.

However, companies should use caution with "no hire" provisions in their agreements, including NDAs, with customers, contractors, and potential business partners. Such provisions have been held to violate Bus & P C §16600. See *Thomas Weisel Partners, LLC v BNP Paribas* (ND Cal, Mar. 31, 2010, No. C 07-6198) 2010 US Dist Lexis 11626 (California law equates "no hire" clause between company and its customers with unlawful noncompete provision because "no hire" clauses similarly restrict employee mobility).

For sample forms of confidentiality agreements with independent contractors, vendors, and other third parties, see chap 6. See also Intellectual Property in Business Transactions, chap 8 (Cal CEB 2008); Internet Law and Practice in California, chap 4 (Cal CEB 2004).

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§10.5 4. Reasonable Efforts to Maintain Secrecy

Companies cannot rely entirely on contractual agreements to protect their trade secret information. They must also make reasonable efforts to maintain secrecy to secure the trade secret status of their information. CC §3426.1(d)(2). See also *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 1430, 7 CR3d 427 ("Labeling information as a trade secret or as confidential information does not conclusively establish that the information fits this description"). See generally chap 4. The company should establish a comprehensive policy to identify and protect its trade secrets. The company should also educate its employees about its trade secrets, the need to protect them, and the need to refrain from using or disclosing any trade secrets of other entities. This policy should include the following:

- A provision in the employee handbook that employees have no expectation of privacy in their use of company systems, with a separate acknowledgment form for employees to sign and date to confirm their notice and review of the handbook.
- Regular monitoring and inspection of company systems (including computers, storage drives attached to computers, PDAs, and voicemail) to ensure that use and disclosure of third party trade secrets is not occurring at the company.
- Designation of company documents and other material as "trade secret" or "confidential" as required. See *Hoffman v Impact Confections, Inc.* (SD Cal 2008) 544 F Supp 2d 1121, 1126 (summary judgment granted for defendant on plaintiff's misappropriation claim when plaintiff failed to take certain steps to designate information as confidential).
- Security for communication and transfer of company trade secret and confidential information and materials.
- Restrictions on visitor and employee access to company offices, documents, files, machines, and materials.
- Ensuring that new hires with specific trade secret issues are separated from company projects that pose special litigation risks.
- Prohibitions on employee use of e-mail or company servers to upload trade secrets or other confidential information from prior employers and monitoring the same for such conduct.
- Documentation of all instructions to incoming employees to demonstrate the company's comprehensive, good faith efforts to secure the confidentiality of its trade secrets as well as those of other entities.

These efforts will help secure the status of the company's trade secrets and deter misappropriation claims against the company. See *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142, 150 (court found ample trial testimony of security precautions to ensure trade secret status, including that company (1) required employees to sign invention and nondisclosure agreements, (2) provided periodic reminders from management to employees to keep developments confidential, (3) obtained appropriate confidentiality assurances from outsiders when disclosing proprietary information, and (4) maintained a secure workplace as precaution against burglary).

NOTE: For further discussion of elements of company trade secret protection program, see chap 4A.

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§10.6 B. Established Companies

For many established companies, the threat of trade secret litigation is clear when a letter arrives from a law firm accusing the company of stealing trade secrets or "raiding" employees with "intimate" knowledge of another company's information. Too often, the recipient of such a letter has done little in the way of adopting a trade secrets policy other than having new hires sign a contract prohibiting the use of nonpublic former employer information. Therefore, established companies that have not yet adopted trade secret policies need to implement them. Developing a process for employee trade secret training can help reduce liability risks; companies may consider training employees by job category, *e.g.,* conducting separate training for salespeople and engineers. If a company has existed for a lengthy period, the company should consider a review of its information that was derived independently.

Moreover, Security and Exchange Commission (SEC) regulations for Section 404 of the Sarbanes-Oxley Act (2002) (Pub L 107-204, 116 Stat 745) (15 USC §7262) require public companies to "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements." 17 CFR §240.15d-15(f)(3). The company's assets include digital assets such as source code and other computer files that contain the company's trade secret information about its customers and products. As such, a public company should conduct a comprehensive review of its trade secrets policies and practices, including the following:

- Proper designation and protection of the company's confidential, proprietary, and trade secret information;
- Employment, confidentiality, consulting, and nondisclosure agreements to ensure that in light of the California Supreme Court's rejection of the "narrow restraint" doctrine in *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, such agreements do not contain noncompetition, nonsolicitation of customer, or invention assignment provisions that would be invalid under Bus & P C §16600; and
- Procedures for hiring and exiting employees and independent contractors to protect trade secrets and ensure the nonuse or nondisclosure of trade secrets from third parties at the company.

For discussion of the procedures for conducting a trade secrets audit, including a sample audit checklist, see chap 4A.

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III. REDUCING TRADE SECRET RISKS IN HIRING

§10.7 A. Counseling Employer of Prospective New Employee

Businesses often hire from competitors, which means that they hire employees who may possess trade secrets of their prior employers. Thus it makes sense to implement policies and procedures to train new employees regarding what information they may or may not use or disclose at the new job. Such training programs can reduce the potential of a lawsuit or preliminary injunction against the company. Some courts outside California have examined the hiring company's good faith when considering "inevitable disclosure" injunctions. See, *e.g., Bendinger v Marshalltown Trowell Co.* (Ark 1999) 994 SW2d 468, 474 (former employee and new employer were honest and respected former employer's information); *Bridgestone/Firestone v Lockhart* (SD Ind 1997) 5 F Supp 2d 667, 682 (same). Such injunctions are not available in California because the state courts have concluded that the inevitable disclosure doctrine is "contrary to California law and policy because it creates an after-the-fact covenant not to compete, restricting employee mobility." *Whyte v Schlage Lock Co*. (2002) 101 CA4th 1443, 1447, 125 CR2d 277. California does permit claims for "threatened misappropriation," however. Therefore, the best practice for the hiring company is to make good faith efforts to show that it had no intent to obtain, use, or disclose the former employer's trade secrets by hiring the employee. *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 95 CR3d 307; *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 528, 75 CR3d 771 ("threatened misappropriation" based on imminent threat of misuse given defendant's possession of trade secrets and prior misuse).

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§10.8 1. Prehiring Advice

When a company plans to hire an employee from a competitor, it should begin the process of preventing trade secret problems before the new hire arrives.

The task of providing legal advice when an employee is hired from another company requires striking a balance between (1) the public policy that supports a person's right to move freely in the labor market and a new employer's right to the general knowledge and skills acquired by an employee in the course of earlier employment and (2) the need to protect the former employer's property and trade secrets. As stated in *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 286, 23 CR 198, quoting *Wexler v Greenberg* (Pa 1960) 160 A2d 430:

> [A]ny form of post-employment restraint reduces the economic mobility of employees and limits their personal freedom to pursue a preferred course of livelihood. The employee's bargaining position is mentioned because he is potentially shackled by the acquisition of alleged trade secrets; and thus, paradoxically, he is restrained, because of his increased expertise, from advancing further in the industry in which he is most productive.

Because of the right each person enjoys to move freely in the labor market (absent an enforceable agreement to the contrary), employees are free to seek and accept new employment even while employed by another. See *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 49 CR 825. Thus, hiring a new employee because of his or her general knowledge—even an employee who previously worked for a competitor—does not by itself constitute trade secret misappropriation. Similarly, merely informing a former employer's customers of the employee's change of employment, without more, is not improper. *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 204, 246 P2d 11. Unless the identity of a former employer's customer constitutes a trade secret, a former employee is free to solicit that customer. *Thompson v Impaxx, Inc*. (2003) 113 CA4th 1425, 1428, 7 CR3d 427 (customers' identities not secret when company made no effort to maintain secrecy, posted names on company's website, and provided samples on request, from which customers' names were easily deduced).

Liability results if the actions of a new employer or prospective new employee cross the line from acceptable job search and announcement activities to the use of nonpublic information. The issue facing each company in such situations is what information can be used and what cannot be used. Simplistic, generalized instructions and policies may not be enough to provide meaningful guidance to new employees who want to do the right thing but lack the knowledge to decide properly where to draw the line. Generally, the more competitive the industry and the more important the alleged trade secrets, the more careful an employer should be to avoid misappropriation claims when hiring an employee away from a competitor.

The new employer may be advised to do the following:

- Instruct the prospective employee to refrain from using the current employer's computer, e-mail system, or telephones to communicate about the potential new position;
- Secure a written agreement with the potential employee that no trade secrets are sought by the new employer or will be disclosed by the new employee;
- Refrain from discussing trade secrets (of either the current or potential new employer) during prehiring discussions and interviews;
- Limit recruitment discussions to an as-needed basis because high-volume communications may indicate the transfer of trade secret or other confidential information;
- Ensure that the prospective employee refrains from soliciting or recruiting for the new employer while the individual is still employed with the current employer;
- Require the new hire to return all company property and confidential, proprietary, and trade secret information to the former employer; and
- Consider the timing of the individual's departure to avoid the appearance of a breach of the individual's nonsolicitation agreement or other agreements.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/ 2. Investigate New Employee's Knowledge and Experience/§10.9 a. Collect Information

2. Investigate New Employee's Knowledge and Experience

§10.9 a. Collect Information

There are few clear-cut answers in trade secret law. Whether a particular action constitutes trade secret misappropriation depends on a variety of unpredictable factors, including the leanings of the trier of fact. At a minimum, the prospective employer should obtain sufficient knowledge about the extent of information possessed by the prospective new employee in order to ascertain the risks and benefits in hiring the individual. To make an informed decision, the prospective employer should evaluate the following information about the prospective employee:

- The employee's educational background, including attendance at professional or trade seminars;
- The employee's employment history, particularly as it relates to the anticipated employment;
- All agreements binding the prospective employee, including employment, confidentiality, and invention assignment agreements;
- The general nature (without revealing detailed information or disclosing trade secrets) of each project on which the employee previously worked and whether the former employers, partners, or business associates considered any portion of any project to be trade secrets;
- All secrecy warnings given by the former employers, partners, or business associates;
- All professional articles written by the employee;
- All issued patents and published foreign patent applications in which the employee is listed as inventor or co-inventor or which resulted, at least in part, from the employee's efforts;
- General information (without disclosing details) possessed by the employee that the employee wishes to use in the new job and the source of such information;
- Publicly distributed advertising materials on commercialized products that the employee worked on; and
- Whether the prospective employee has ever been a party to trade secret litigation in the past.

See the sample Client Interview Sheet in §10.10.

Depending on the nature of the prospective employee's new job responsibilities and how directly they relate to the former employment, more in-depth inquiries may be necessary. For example, a company may need to ask whether the applicant's former employer considers any of the projects that the employee worked on to be secret. The nature of the employee's knowledge, whether general or specific, may also need to be explored.

The new employer should ask the applicant whether he or she can work in the same field without using another's trade secrets. If the answer is yes, the applicant should identify the knowledge base from which work in the field can be conducted. The employer can provide the new hire with the company's existing technology, customer lists, or other applicable information from the start in order to provide a foundation for the new hire's work. The employer should also ask whether the applicant has any objection to the new employer's communicating with the former employer. A prospective employee's reaction to such a question may indicate the need for further investigation.

The company itself should avoid taking any actions that might be perceived as seeking trade secret information from the new employee's former employer. For example, companies should avoid asking detailed questions about technical matters at job interviews and should instruct job applicants not to disclose such details in resumes. When hiring from competitors, and especially when litigation is feared, companies can have interviewees sign pre-interview agreements not to disclose nonpublic information, with a statement that the company does not wish to learn such information. Companies may wish to instruct a new employee to meet with an outside counsel retained to allow the individual to receive detailed instructions and a review of potential problem areas without the unnecessary disclosure of information to the hiring company. Such counsel can also aid the new employee in such important tasks as making sure that the individual does not possess any proprietary information of the former employer, even inadvertently, at home, in a computer, or in a cell phone or handheld device, and also in ensuring that the individual obtains any needed permission to retain property that he or she may or may not have a right to keep.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.10 b. Form: Client Interview Sheet: Information on Change of Employment

§10.10 b. Form: Client Interview Sheet: Information on Change of Employment

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

List the name, address, and industry of the new employer:

_____
_____
_____
_____

List the name, address, and industry of the former employer:

_____
_____
_____
_____

When was the employee working for the former employer?

_____

Describe the primary job duties with the former employer:

_____
_____
_____
_____

Describe the primary job duties with the new employer:

_____
_____
_____
_____

List the employee's education:

_____
_____
_____
_____

List the employee's previous work experience:

_____
_____
_____
_____

List the titles and dates of publication of any relevant articles written by the employee:

_____
_____
_____
_____

List all of the employee's patents, patentable inventions, and copyrightable works:

_____
_____
_____
_____

Describe the circumstances leading to the change in employment (*i.e.,* Who initiated the change? Were any discussions held with the new employer during work hours?):_____

_____
_____
_____
_____
_____

List all confidentiality agreements, employment agreements, and invention agreements between the employee and former employers, partners, or business associates:_____

_____
_____
_____
_____

Describe the nature and source of all information that the employee wishes to use in the new employment:

_____
_____
_____
_____

Other relevant information:

_____
_____
_____
_____

WARNING: Individual shareholder officers and directors of a corporation can be held personally liable for misappropriation of trade secrets if they knew or had reason to know of the misappropriation. *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 93 CR2d 663, modified at 79 CA4th 1144A.

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§10.11 3. Avoid Appearance of Impropriety

The new employer should avoid the appearance of impropriety in dealings with prospective employees. If the actions of a business "look bad," a trier of fact may find liability even if the law or distinguishing precedent must be stretched to fit the facts. See, *e.g., Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352.

An open and honest approach to hiring generally reduces misappropriation claims. During an employee search, the employer should not expressly or inadvertently encourage the disclosure of trade secrets and should educate prospective employees not to use or disclose trade secrets of former employers during the interview process or later. See §10.12. The employer should try to avoid diverting the prospective new employee's attention from his or her current work by scheduling interviews during the employee's time off. Similarly, the employer should advise the new employee not to use a former employer's time, resources, or telephone or e-mail service for any purpose related to the new job. Such acts, even if innocent, can be used as "color" when trade secret allegations are raised. And as noted above, all new employees should be instructed to carefully search all of their personal belongings to ensure that they retain no property of a former employer without permission. Innocent acts such as forgetting to purge customer contact numbers from a cell phone can also be used as "color" to create an inference of wrongdoing even when no misconduct exists. By contrast, voluntarily returning this information at an exit interview or afterward can create a record of good faith. Finally, prospective employees need not inform anyone of their potential new employment, but if they choose to do so, they should be admonished not to make any misrepresentations. See *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262 (defendant's misrepresentations cited by court as reason for granting plaintiff's request for preliminary injunction). For example, a new employee should be advised to tell the truth if the former employer asks about the new job and the job search itself.

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§10.12 4. Educate Employee

The new employer should inform the new employee, orally and in writing, that the company respects the proprietary rights of others and that the employee is not to use or disclose any trade secrets of former employers, partners, or business associates in the course of the new employment. The employee should also be required to sign a contract agreeing not to bring any nonpublic property of a former employer into company facilities. This rule of conduct serves two functions: First, it helps to prevent the disclosure and use of trade secrets. Second, even if the new employee takes and uses trade secrets in the new employment, the new employer can attempt to defend a misappropriation action brought against it by arguing that it neither knew nor should have known that the employee was using trade secret information. CC §3426.1(b)(2)(B)-(C); *Ralph Andrews Prods. v Paramount Pictures Corp.* (1990) 222 CA3d 676, 271 CR 797.

It should be stressed, however, that generic trade secret policies may not be enough to help a new employee understand what information can and cannot be used. The line between general skills and knowledge and a trade secret can sometimes be difficult to ascertain. Employers can help by giving the new employee files of existing company information—such as customer contacts—when he or she arrives. New employees can also be instructed to ask, when considering the use of information, "Can this information be found in the public domain?" If it can, the new employee should print out the public domain source or maintain a record of websites visited. It is always a good idea to list public sources consulted in an engineering notebook. If the information cannot be located in the public domain, the new employee should be instructed to seek further guidance before using it, without disclosing the information to anyone.

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§10.13 5. Posthiring Conduct

After a decision is made to hire a competitor's employee, the employer should consider taking the following cautionary steps:

- Advise the new employee in writing that employment was not based on his or her knowledge of trade secrets.
- Obtain the employee's signed agreement that the employee will not disclose the trade secrets of previous employers, partners, or business associates. This provision should be part of an employment agreement.
- Assist the employee in properly announcing the change of employment to customers of the former employer in a manner that does not constitute improper solicitation.
- If feasible, do one or both of the following: (1) assign the new employee to a project that is totally different from that engaged in for a competitor, and (2) institute "clean room" procedures (see §10.35) to isolate the new employee from research and development work similar to the work he or she performed for the former employer. For example, in *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142, 147*,* the court stated that the plaintiff did not need to prove its misappropriation claim by showing that defendant had created an "identical" display list driver. VMI just had to show that the defendant's display list driver was "substantially derived" from the architecture of its display list driver to support its claim. To reduce a similar liability risk, the new employer should segregate a new hire from similar projects of its competitors.
- Require the employee to document all work done in the new employment. For example, if the employee created a new version of source code, the employee should clearly identify himself or herself as the author of the code as well as the author of any debugging work and enhancements to the code.
- Periodically review the new employee's work to ascertain the source of the employee's ideas (which may reveal whether the former employer's trade secret information is being used).
- Review the new employee's prior agreements with the former employer and disclose the nature of the employee's work to the former employer to demonstrate no wrongdoing and to limit the risk of claims by the former employer. This communication may take the form of a letter initiated by the new employer or a letter in response to a cease-and-desist letter from the former employer.

The employee's promise not to disclose trade secrets gives the employer a breach of contract and indemnity claim if the employee discloses or uses the former employer's trade secrets. Assigning the employee to a totally different job as a practical matter lessens the former employer's concerns. Assuming that the employee does not use a former employer's trade secrets, keeping records of and periodically reviewing the employee's work helps ensure that the employee is trustworthy.

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§10.14 6. Responding to Threatening Letter

Many trade secret disputes begin with a letter from the former employer's attorney to the new employer and the former employee, accusing the former employee of trade secret misappropriation. How one responds to such letters may determine whether the matter can be resolved without litigation and whether the former employer can avoid an injunction if litigation does arise.

Some letters from former employers are merely admonitions not to do anything wrong. Others make inflammatory accusations without presenting evidence. Still others, the most serious, provide evidence that the former employee may have taken information or otherwise misappropriated nonpublic items before resigning.

The new employer should take each type of letter seriously and provide a meaningful response. A cursory rejection of the accusations may invite litigation that could have been resolved informally. A better response, and one more likely to impress a judge and resolve the matter without litigation, is to provide a detailed response to each accusation. The new employer should, if it has not done so already, require the new hire to conduct a complete search for any material taken from the former employer, even inadvertently, and deliver it to outside counsel. Counsel should then report the results in a confidential response letter that demonstrates the new employer's good faith and may prevent an injunction by divesting the new employer of questionable material before litigation begins. If possible, the response letter should (1) state that the company investigated the former employer's assertions, (2) (if applicable) provide assurances that the new hire does not have any of the former employer's property or trade secret information in his or her possession, and (3) (if applicable) state that the new hire has not used or disclosed such material or information with the new employer, and will not do so. A serious response letter can also point to public domain citations to demonstrate that certain information at issue is not secret.

In many cases, a showing of good faith will lead to a resolution. Attorneys on both sides often can reach a creative solution to minimize risks, satisfy the former employer, and allow the new hire to proceed with his or her new job.

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B. Counseling Mobile Employees

§10.15 1. Attorney's Role

If an employee seeks legal advice before terminating employment and going to work for a competitor, counsel can recommend preventive measures to help the client avoid trade secret misappropriation problems. To provide useful advice, counsel must first review the facts involving the change in employment, the nature of the new employment, and the agreements entered into between the mobile employee and the current employer, which should indicate whether there are any contractual provisions governing the employee's change in employment. Next, to the extent the employee intends to bring information to the new employment, outside counsel should analyze the information to ascertain whether it is protected by patent, copyright, or trade secret law or whether the employee has an ownership interest in the information. In this analysis, no details should be disclosed to the new employer's management or in-house counsel. The employee should be reminded of the details of any confidentiality provisions signed and of the fiduciary nature of the employer-employee relationship. See §10.38. The practitioner should also advise the employee on how to conduct himself or herself when seeking new employment and announcing a new job.

Unfortunately, mobile employees generally do not seek legal advice on trade secret issues until after they have terminated their employment, and they generally do not consult with counsel unless they receive a cease-and-desist letter from a former employer or, worse, are sued. Counsel must then act quickly to learn whether the employee possesses any trade secret information or other property of the former employer. Any *tangible* property that the mobile employee may have removed from the former employer should be collected and secured by counsel in a manner that prevents its use or disclosure until it is found that such property does not represent or include the property or trade secrets of the former employer. The same is true for electronic files on a portable device that counsel can retain, such as a small hard drive or a cell phone. Any *intangible* information (such as e-mail or other electronic files generated during the former employment) that the former employee may possess on a home computer or other device that cannot readily be delivered to counsel should be copied for preservation purposes, and the former employee should be advised not to access or remove such files pending further instructions. These actions may limit damage claims against the employee, particularly if the employee properly acquired the information. See CC §3426.1(b)(1). Once the tangible property and any electronic files are secured, counsel should analyze the situation and, if concluding that information in the employee's possession constitutes trade secrets or the personal property of another, should instruct the employee not to use or disclose that information. If counsel is not sufficiently knowledgeable to make this determination alone, counsel should consult with an expert in the field.

NOTE: When outside counsel assists employees in preventing trade secret misappropriation or in responding to allegations of theft, the former employer sometimes accuses counsel of theft as well. California courts have never considered whether an attorney's assistance in reviewing potential trade secrets itself constitutes misappropriation. It stands to reason, however, that such conduct should not be actionable as long as all information is kept confidential under the attorney's duty of confidentiality. Counsel for employees needs to be able to review potential trade secret information to ascertain whether it is in the public domain, whether the prospective employer already possesses the same information, and whether the new employee has used the information. Without such assistance, the employee may be unable to raise valid defenses to misappropriation allegations. Because attorneys are subject to a duty of confidentiality and do not put such information to commercial use, the only result of such disclosure is that the best possible defenses will be raised. At the same time, in-house counsel who engage in competitive decision making should retain outside counsel to investigate trade secret issues and should avoid situations in which they might learn potential trade secrets of a third party.

As further protection against misappropriation claims, the employee should ask the new employer to identify job duties and follow other posthiring guidelines identified in §10.13. Whether the employee should return the trade secrets or tangible property to the former employer is a difficult question. Although the return of such property is usually advisable as a sign of good faith, that action could be construed as an admission of wrongdoing. Therefore, counsel

should carefully consider potential civil and criminal liability, as well as the ethical and legal consequences of retaining the property, before any materials are returned.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.16 2. Review Relevant Agreements

§10.16 2. Review Relevant Agreements

A review of the mobile employee's agreements should include the following:

Nonsolicitation of customer agreements. If the mobile employee has signed an agreement prohibiting solicitation of the employer's customers or clients, counsel should review it to confirm that it is limited to the protection of trade secrets that are reasonably defined and, if not, to determine whether it is an invalid noncompete under *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 955, 81 CR3d 282 (nonsolicitation of customer agreements invalid under Bus & P C §16600). See generally §§2.32-2.32D, 11.41. In *The Retirement Group v Galante* (2009) 176 CA4th 1226, 1238, 98 CR3d 585, a post-*Edwards* decision, the court concluded that §16600 "bars a court from specifically enforcing (by way of injunctive relief) a *contractual* clause purporting to ban a former employee from soliciting former customers to transfer their business away from the former employer to the employee's new business." See also *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 577, 102 CR3d 1 (invalidating nonsolicitation-of-customer agreement because it was not narrowly tailored or carefully limited to protection of trade secrets); *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, 758, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442 (citing *Edwards* that "non-competition agreements are unenforceable unless necessary to protect an employer's trade secret"); *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 1432, 7 CR3d 427 ("in the absence of protectable trade secret, the right to compete fairly outweighs the employer's right to protect clients against competition from former employees."). Even if the provision makes no mention of protecting trade secrets, counsel should still advise the mobile employee (1) about the potential trade secret nature of the former employer's customer information and (2) that the employee should document and retain the public origin of the customer information that he or she will be using with the new employer.

Nonsolicitation of employee agreements. The mobile employee may also be bound to an employee nonsolicitation agreement. *Edwards* did not address such agreements and thus their enforceability remains unclear. In *Loral Corp. v Moyes* (1985) 174 CA3d 268, 279, 219 CR 836, the court permitted employee nonsolicitation agreements because "the restriction only slightly affects" the mobility of the employees of the target employer—"all they lose is the option of being contacted by him first." *Loral* appears inconsistent, however, with the *Edwards* court's rejection of the narrow-restraint exception to §16600. As discussed in §10.38, it is probable that courts will continue to enforce employee nonsolicitation provisions for officers, directors, and other high-level executives with fiduciary duty obligations. See *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 351, 49 CR 825 (it is "beyond question" that corporate officer breaches his fiduciary duties by supplying competitor with selective list of corporation's employees with abilities and characteristics desirable to competitor and salary information along with suggestions for competitive salary offers). See also *Loral*, 174 CA3d at 280 n6. Such agreements may be enforceable if the breach involves the misappropriation of trade secrets. Just as a mobile employee should not use or disclose trade secret information regarding the employer's customers, the mobile employee should be admonished not to use trade secrets or other confidential information to solicit employees of the former employer.

NOTE: In California, information about employee wages and working conditions may not constitute trade secret information. See *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 862, 27 CR2d 573 ("Simply hiring personnel who possess the requirements specified by a customer does not convert the employee into a 'trade secret'"). For example, employees have a fundamental right, rooted in public policy, to discuss the amounts of their wages and their working conditions. See *Grant-Burton v Covenant Care, Inc.* (2002) 99 CA4th 1361, 1372, 122 CR2d 204 (citing Lab C §232, which prohibits employers from requiring employees to refrain from disclosing the amount of their wages). See also Lab C §232.5, which prohibits employers from requiring employees to refrain from disclosing their working conditions. Moreover, Lab C §923, along with similar provisions under the National Labor Relations Act (29 USC §§151-169), gives California employees the fundamental right to discuss the amount of their wages and their working conditions. 99 CA4th at 1374.

Invention assignment agreements. Many high-technology companies include intellectual property assignment clauses in their employment agreements that continue to apply for some period of time after termination of employment.

For samples of invention assignment agreements, see §6.23; Intellectual Property in Business Transactions, chap 8 (Cal CEB 2008); Internet Law and Practice in California, chap 4 (Cal CEB 2004). Counsel should closely examine these clauses to ensure that they are based on valid protections of the former employer's trade secrets and confidential information and are not overly broad provisions that are essentially invalid noncompetes. In *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co*. (ND Cal 2009) 630 F Supp 2d 1084, 1090, the court examined an assignment clause that required, within 1 year post-employment, the new employee to assign a new invention that "relates to" the employee's work with his former employer. The court noted that such clauses are enforceable to the extent that the inventions related to ideas and concepts that were based on secrets or confidential information of the former employer (citing *Armorlite Lens Co. v Campbell* (SD Cal 1972) 340 F Supp 273, 275). 630 F Supp 2d at 1090. The court also noted that in *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 145, the Ninth Circuit upheld an assignment clause that required employees to assign inventions "conceived within one year of termination of employment [that] were based upon confidential information." Similarly, in *Armorlite Lens,* the court invalidated the assignment clause because it required the employee "to assign and communicate all ideas and concepts whether they are based upon the employer's secrets or confidential information or not." *Armorlite Lens Co.,* 340 F Supp at 275.

In *Applied Materials,* the court found that because the assignment clause could include inventions in the broad field of semiconductor research and manufacturing, and not just confidential and trade secret information of the former employer, it unduly restricted the employee's mobility in violation of Bus & P C §16600. *Applied Materials, Inc.,* 630 F Supp 2d at 1091. Accordingly, counsel should closely review the wording of assignment clauses for the scope of their enforceability. If such a clause is properly drafted, counsel should call the employee's attention to the provision's notification and assignment obligations, require the employee to notify the company when the employee believes that any ideas, concepts, or inventions are subject to the provision, and ensure the employee's compliance with the provision's requirements.

"No hire" agreements. If a mobile employee has signed a "no hire" agreement with his or her former employer, counsel should review it to determine if it violates §16600. In *Thomas Weisel Partners, LLC v BNP Paribas* (ND Cal, Mar. 31, 2010, No. C 07-6198) 2010 US Dist Lexis 11626, the court concluded that a former employee's "no hire" agreement would serve to restrain mobility in much the same way as a covenant not to compete. The court explained that when an employee transitions to new employment as a manager with hiring responsibilities, that individual is not bound to the former employer's "no hire" provision because the new company would likely consider itself restrained from hiring any former employees of the prior employer. The court also ruled, however, that while the "no hire" clause would be invalidated, the illegal provision did not necessarily render the entire agreement void. 2010 US Dist Lexis 11626 at *23.

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§10.17 3. Identify Information Owned by Former Employer

In California, all property that an employee acquires by virtue of employment belongs to the employer, except the employee's compensation. Lab C §2860. This statute applies to trade secret information as well as to tangible property. *California Intelligence Bureau v Cunningham* (1948) 83 CA2d 197, 203, 188 P2d 303. An employer is also the legal author and owner of all original works of authorship (including computer software) created within the scope of employment (17 USC §101) and is the owner of patent rights in any patentable invention created by an employee who was employed to make the invention (*U.S. v Dubilier Condenser Corp*. (1933) 289 US 178, 187, 77 L Ed 1114, 1118, 53 S Ct 554).

The extent of an employer's ownership rights is limited, however, by Lab C §2870, which provides in pertinent part that

> (a) Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time, without using the employer's equipment, supplies, facilities, or trade secret information, except for those inventions that either:
>
> (1) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer; or
>
> (2) Result from any work performed by the employee for the employer.

For further discussion of trade secret ownership, see chap 2.

PRACTICE TIP: If the alleged trade secret also constitutes a "work of authorship" (see 17 USC §102), it is not owned by a company unless it is a "work made for hire" (see 17 USC §101). Under the work-made-for-hire doctrine, many works of authorship created by independent contractors are owned by those contractors, not by the companies that paid for the creation of the works. See *Avtec Sys. v Peiffer* (4th Cir 1994) 21 F3d 568, 571.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.18 4. Ascertain Character of Information Acquired by Employee

§10.18 4. Ascertain Character of Information Acquired by Employee

Generally, information acquired by an employee falls into one of the following categories:

- Information in the public domain (see §§10.29-10.33);
- Knowledge and skill acquired through education, independent research, and thought (see §§10.30, 10.35-10.36);
- General knowledge and skill acquired through work experience (see §10.30);
- Trade secrets developed by the employee for the employer during employment (see §10.38);
- Trade secret or proprietary information disclosed to the employee in circumstances that give rise to a duty of confidentiality (see §§10.37-10.38); and
- Information obtained by theft, accident, or mistake (see §§10.47-10.48).

Trade secret law prohibits only the use or disclosure of the last three types of information. Therefore, the characterization of information is crucial to deciding whether it can be used by the mobile employee (as well as the new employer) without fear of infringing the rights of others. Accordingly, counsel should analyze the character of the information by considering the potential sources outlined in §§10.29-10.48. Counsel should also consider whether the assertions and demands of the former employer violate the public policy in California of permitting individuals to move freely in the workplace (see §10.38).

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§10.19 5. Comply With Announcement Rule

Sales employees have a right to announce their change of employment to the customers of their former employer. At the same time, trade secrets cannot be used to solicit business from these customers. *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 636, 262 CR 92. The line between lawful announcement and unlawful solicitation can be thin or unclear. "Solicitation" generally means any communication that entreats the recipient to engage in business. See *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 203, 246 P2d 11 (defining term). Counsel working with a newly departed sales employee should limit any announcement to providing bare notice of the individual's change of employment and contact information, without any language suggesting an invitation to discuss business (if trade secret use is at issue).

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§10.20 IV. COUNSELING IN DISPUTES OVER NONDISCLOSURE AGREEMENTS

Trade secret problems may also arise from disputes over information subject to nondisclosure agreements (NDAs). Technology companies frequently share nonpublic information with business partners under NDAs, and these agreements typically require that the information disclosed be used only for narrow, defined purposes. Disputes can arise when a party to an NDA is suspected of using the information for unauthorized purposes or simply when the business deal falls apart and both companies are left with the other's nonpublic information in computers, e-mail, and the minds of their respective employees.

In such cases, counsel can assist by ascertaining how the information has been used and, if necessary, by taking steps to stop any unauthorized use. Similarly, when partnerships go awry, counsel can assist by helping to ensure that all nonpublic information is collected from all possible sources where it has been stored and is either destroyed or returned to the information owner.

In some cases after a partnership ends, a company may wish to replicate independently a technology once licensed from the former partner. To reduce risks, it is important that engineers who have actual knowledge of nonpublic information from the former business partner be segregated from any such development effort. The safest course is a "clean room" development, using outside consultants and non-networked computers that do not contain any trace of the former business partner's information.

Because NDA disputes often arise between business partners with more economic incentive to compromise than to litigate, counsel can assist in creating solutions to address NDA violations. For example, the parties to an NDA can retain a neutral third party to investigate the matter and prepare a report on the extent of any unauthorized use. Such disputes and their resolution can be kept confidential.

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§10.21 V. COMPETITIVE INTELLIGENCE GATHERING

Competitive companies naturally seek to learn as much as possible about their rivals, but some information-gathering techniques may give rise to concerns about trade secret misappropriation. Lawsuits about competitive intelligence gathering are rare, but proactive companies should prepare for this circumstance. Providing guidelines to employees responsible for studying the competition can help minimize risks.

Many intelligence-gathering techniques are fair game. Purchasing and reverse engineering a competitor's product or reading a competitor's public papers, trade show disclosures, and patents do not pose problems from a trade secret perspective.

Trade secret problems may arise, however, when companies obtain a rival's nonpublic information under false pretenses. Employees should be trained not to solicit obviously confidential information and documents during informal conversations with employees from another company or from third party vendors or suppliers that do business with the competition, including at trade shows and similar events. Lower-level employees in particular may not be authorized to make such disclosures.

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§10.22 VI. COUNSELING FORMER EMPLOYER

When counsel is contacted by an employer whose employee has been hired by a competitor, the first steps counsel should take are the following:

- Identify all the client's trade secrets that are put at risk by the departure;
- Review the employee's contractual (and policy) obligations to protect the company's trade secret information and not solicit its employees;
- Advise the client to conduct a search of the former employee's e-mail and computer records to check for deletions, unauthorized downloads, and other suspicious activities;
- If there are serious concerns about trade secret misappropriation, work with the client and a forensics specialist to obtain legally defensible copies of the employee's computer, PDA, and any storage drives, and conduct a thorough review of the devices for evidence of misappropriation (*e.g.,* rapid access and downloading of the company's confidential files before departure; e-mail transfer of sensitive data and documents to personal e-mail addresses; use of cleaning software to erase high-volume activity before to departure); and
- Review the employee's building access logs and use of company server and e-mail systems.

If the former employer has not instituted a comprehensive trade secret and confidentiality program, counsel must identify the information to which the former employee was given access and determine whether it was a trade secret. This can be done by analyzing the source and character of the information. See §§10.29-10.48. Typically in such situations, particularly if emotions are running high, the former employer will assert that a wide range of information is trade secret. However, if the former employer cannot put a label or title to the information or produce tangible evidence of the secrets, it will be difficult and time-consuming for counsel to accurately evaluate the legal character of the information. Thus, counsel should work with the former employer to identify all the information that the employer believes to be a trade secret and that may have been taken by the former employee, ranking the information in terms of importance.

It is important to conduct a reasonable review in advance of litigation to ensure that the information the employer believes to be secret is not in the public domain. If the information is indeed secret, the employer will be in a better position to identify the secrets and to explain why they are secret if litigation arises, which can help in obtaining an injunction. If the information is not secret, the employer will be saved from raising an allegation that might have resulted in attorney fees and costs for the defendant under CC §3426.4. See, *e.g., FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 95 CR3d 307 (over $1 million in attorney fees and costs awarded in trade secret action brought in bad faith). A review for secrecy might include searching competitors' websites or looking over industry or research publications.

If the employee had access to trade secret information or a contractual obligation to maintain certain information in confidence, the employer or counsel should write a letter to both the employee and the new employer to advise them of the employee's continuing obligations of confidentiality. These letters should be carefully drafted to avoid overreaching in the assertion of rights, because an overbroad or bad faith assertion of rights may be the basis for a complaint for unfair competition or interference with contract. Before the letters are sent, counsel should perform a conflicts check and should direct the letter to the new employer's general counsel (if applicable). The letters should provide enough information to give notice to the employee. If the former employer has located direct evidence of potential wrongdoing, such as last-minute downloads to a private e-mail account before the employee's departure, disclosing such evidence in the letter may help lead to an early resolution. The new employer may wish to avoid trouble when presented with direct evidence regarding a new hire. In addition, the letter should advise the former employee to retain and return any and all property (tangible or electronic) that belongs to the former employer. See the sample letters in §§6.42-6.43.

If the former employer's demands are ignored and evidence suggests that trade secrets have been improperly disclosed or used, the client must consider litigation options to protect the trade secrets. See chaps 11-12.

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VII. WHAT INFORMATION IS AVAILABLE FOR USE?

§10.23 A. Overview

When adopting trade secret policies—whether as a new company, for newly hired employees, or when sharing confidential information with business partners—the most vexing issue is often determining what information is available for a company to use. Sections 10.24-10.48 lay the groundwork and provide strategies for deciding whether a given item of information is available for use.

Not all information that comes into the possession of an individual or a company is available for unfettered use. The most obvious examples of restricted information are the federally protected categories of information: patents, copyrights, trademarks, and trade dress. Trade secrets are more difficult to identify because information that constitutes a trade secret is not registered with any government agency and because what is secret or nonsecret changes with the constant flow of innovation and disclosure. Thus, any time a company receives information from a source that is not clearly in the public domain, the company should be concerned that it may be appropriating another's trade secrets or proprietary rights. Generally, the closer the relationship between the owner of information and the disclosing party, the more likely the disclosing party owes the owner a duty of nondisclosure that would support a claim for wrongful disclosure or use of that information.

The California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) prohibits the improper acquisition, disclosure, or use of trade secrets. The UTSA covers virtually any type of confidential information valuable to competitors, regardless of the source, and can extend to individuals with oral or implied nondisclosure obligations. United States copyright laws protect original works of authorship from being reproduced, distributed, performed, displayed, or made into derivative works without the permission of the copyright owner. 17 USC §§102, 106. See California Business Litigation, chap 7 (Cal CEB 2002). United States patent laws make it improper for anyone to make, use, sell, or offer to sell a patented invention without the patent holder's permission. 35 USC §271. See Bus Litigation §§8.115-8.125.

NOTE: Information that does not qualify as a trade secret cannot be transformed into a trade secret (and thereby be granted trade secret protection) by agreement. See *American Paper & Packaging Prods., Inc. v Kirgan* (1986) 183 CA3d 1318, 1325, 228 CR 713, citing *State Farm Mut. Auto. Ins. Co. v Dempster* (1959) 174 CA2d 418, 426, 344 P2d 821. Similarly, unpatented ideas in the public domain are available for use by the public, and although parties may impose contractual limits among themselves, such limitations are not binding on the public as a whole. See *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 103 L Ed 2d 118, 109 S Ct 971; *Aronson v Quick Point Pencil Co.* (1979) 440 US 257, 59 L Ed 2d 296, 99 S Ct 1096.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.24 B. Is Information Available for Use?

§10.24 B. Is Information Available for Use?

To determine whether information is available for free use, the following questions should be answered:

- **What is the *nature* and *subject matter* of the information?** This question must be answered *without* disclosing any specifics of the information, because the mere acquisition and disclosure of trade secrets may be actionable. CC §3426.1(b)(1)-(2). If the information is in the public domain, it cannot be the subject of patent or copyright protection. For example, a software algorithm made available for public use by a university or in open source software is free for all to use. A more difficult case is drawing the line between what general concepts are known to the industry and what specific implementations of the concept may be one company's trade secret. For example, a company could have a trade secret in code written to implement a public domain open source algorithm.
- **From what *source* was the information acquired?** A trade secret may exist if the source of the information is a person subject to a written, oral, or implied nondisclosure obligation. Unless it is the subject of a valid patent, information obtained through independent research, by reverse engineering, or from a third party without breach of a duty of nondisclosure can be used freely without fear of infringing the rights of others. Similarly, a business may use public domain information even if it is obtained from a person subject to a duty to protect other, nonpublic information. For a discussion of possible sources of information, see §§10.29-10.48.
- ***How* was the information acquired?** Was the information acquired by theft, accident, or mistake? See §§10.47-10.48. Because a valid claim of trade secret misappropriation can be based on wrongful acquisition (and not just wrongful disclosure or use; see CC §3426.1(b)), the means of acquisition can be a key issue in a trade secret infringement action. At the same time, the "knew or had reason to know" and "mistake" language in the UTSA (see CC §3426.1(b)) has not been well defined, and it is unclear exactly when the acquisition of a third party's trade secret from another company can give rise to liability, especially if the circumstances do not put the party acquiring the information on notice that the information might be another's trade secret. Also, the physical embodiment of that information may constitute "property" that can be the subject of theft even if the information is unprotected by patent, copyright, or trade secret laws. See chap 13 on criminal liability.
- **Is the information protected by *copyright or patent laws*?** If so, it cannot be freely used without a license from the patent or copyright owner until the patents or copyrights are no longer in effect. Depending on the type of patent, the date the patent application was filed, and the date the patent was issued, patent protection can last for 14 to 20 years. See 35 USC §§154-156, 173. Copyrights in a qualified work of authorship can exist for 70 years or longer, depending on the length of the author's life and applicable law. 17 USC §§301-305. See §§2.34, 10.27.
- **Is the information the subject of *reasonable efforts to maintain its secrecy*?** A trade secret is defined as information that (1) derives independent economic value from not being generally known to the public and (2) is the subject of reasonable efforts to maintain its secrecy. CC §3426.1(d). An affirmative answer to this question indicates that it may qualify for trade secret protection. If, by contrast, a business has openly disclosed the information, such as at a trade show or on the Internet, the information would not qualify as a trade secret. For further discussion of the "reasonable efforts" requirement, see §1.10.

Counsel can use the preutilization checklist in §10.25 to collect the information necessary to answer these questions.

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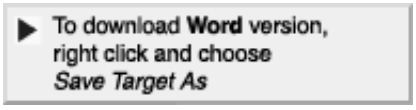
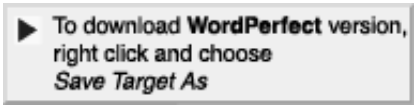
Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.25 1. Preutilization Checklist

§10.25 1. Preutilization Checklist





- Identify the nature and subject matter of the information:
- Is the information in the public domain?
- Does the information consist of general and basic knowledge or laws of nature, physical phenomena, or abstract ideas?
- Identify the source of the information:
- Was the information developed through independent research, reverse engineering, or a public source free of restrictions?
- Was the information acquired through a relationship that gives rise to a duty of confidentiality?
- Other?
- Identify how the information was acquired:
- By theft?
- By accident or mistake?
- Other?
- Ascertain whether the information is protected by copyright law:
- Is the information a "work of authorship"?
- Does the information include a copyright notice?
- Is the information registered with the U.S. Copyright Office?
- Have any applicable copyrights expired?
  Consult copyright attorney and, if necessary, obtain a written opinion on the issue of whether the information is protected by the copyright laws.
- Ascertain whether the information is protected by patent law:
- Is the information part of a "useful process, machine, manufacture, or composition of matter"?
- Does the information include a notice of patent?
  Conduct an "art search" (*i.e.,* review United States and foreign patents and technical publications) and have someone knowledgeable in the "art" prepare a memorandum stating what is known or done in the art by knowledgeable persons of average skill. Consult a patent attorney and, if necessary, obtain a written opinion on whether the information is protected by a patent.
- Ascertain whether the information is protected by trade secret law:
- Does the information have economic value from its not being known to the public?
- Is the information subject to reasonable efforts to maintain its secrecy?
- Document and save all research concerning the information:
- Save the results of the art search, including copies of all relevant public document.
- Save all publicly purchased or viewed articles, together with laboratory notebooks or other permanent research records.
- Save copies of all government invitations to bid, contract specifications, or military specifications.
- Save all original work, including experimental sketches, work drawings, vellums, shop orders, notebook

entries, work time records, drafts, e-mail messages, all versions of the work, and other relevant writings.

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§10.26 2. Method of Searching for and Evaluating Trade Secret Information

Copyright registration records are available for some works of authorship (see §10.27), and patent records can be searched to ascertain patent protection for a given invention (see §10.28), but trade secrets by definition do not exist in any officially registered form that can be searched by the public. The information must be tested against the statutory definition of a trade secret: Does it have economic value by not being known to the public, and is it the object of reasonable security measures? See CC §3426.1(d) and generally §§1.3-1.10. As a practical matter, businesses should assume that if the information they acquire from third parties is worth putting to use, it has economic value. Therefore, the focus of the inquiry shifts to whether the information is in the public domain, which includes an analysis of security measures adopted by the original owner and any subsequent owner of the information. For discussion of reasonable security measures, see chap 4.

In the absence of the type of detailed evidence that is usually only subject to discovery during litigation, businesses normally do not have a sufficient basis to conclude that the information in question was subject to reasonable efforts to maintain its secrecy. If the information is in the public domain, the business can use it. But if it is difficult to ascertain whether the information is common knowledge, counsel must analyze it to see whether it is of a character that qualifies for trade secret protection by learning the source and ownership of the information and whether it was disclosed in circumstances that give rise to a duty of nondisclosure. See §§10.29-10.48 for discussion of typical sources of acquired information and the risks associated with using information so acquired.

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§10.27 3. Method of Searching for and Evaluating Copyright Information

To learn whether a party claims copyright protection of information, counsel should examine a copy of the work for such elements as a copyright notice, place and date of publication, author, and publisher. See Circular 22 of the United States Copyright Office, *How to Investigate the Copyright Status of a Work*. See also the United States Copyright Office website at http://www.copyright.gov. The presence of a copyright notice does not necessarily mean, however, that the asserted copyrights are valid or that they apply to all the information to which they attach. Conversely, absence of a copyright notice does not necessarily mean that the information is in the public domain, because the use of a copyright notice is not a prerequisite to protection under applicable law.

If a copyright notice is present on the information, counsel should obtain copies of applicable copyright registrations and determine the scope of copyrighted material and whether the copyrights are valid. Although copyright registration or preregistration is a prerequisite to filing a claim of copyright infringement (17 USC §411), it is not a prerequisite to securing copyright protection (17 USC §408(a)). Effective January 1, 1978, copyrights automatically attach to original works of authorship that are set in any tangible medium of expression. 17 USC §102.

If a copyright notice is not present on the information, a search of the Copyright Office's catalogs should be made either personally or by requesting that a search be conducted by the Copyright Office. Microfiche copies of the Catalog of Copyright Entries are available at a number of libraries throughout the United States. The original records of the Copyright Office are located in the Library of Congress in Washington, D.C. On request, the Copyright Office will search its records. See 37 CFR §201.1(d) and Circular 4 of the United States Copyright Office, *Copyright Fees*.

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§10.28 4. Method of Searching for and Evaluating Patent Information

To learn whether a party claims patent protection in information, counsel should look for a patent notice. See 35 USC §287. The presence of the notice, however, does not necessarily mean that the asserted patent is valid or that it applies to all information to which it is attached. Conversely, the absence of a patent notice does not mean the information is in the public domain, because the use of patent notices is not a prerequisite to protection under applicable law.

If a patent notice is present on the information, counsel should obtain copies of the relevant patents to evaluate the scope of the patent. Copies may be ordered from the United States Patent and Trademark Office (see 37 CFR §§1.13, 1.19) or may be found by searching patent records available at various libraries throughout the country and on the Internet at http://www.uspto.gov. The prosecution history of relevant patents can also be acquired by ordering the "file wrapper" from the United States Patent and Trademark Office. See California Business Litigation, chap 8 (Cal CEB 2002).

If a patent notice is not present on the information, or if the scope of a known patent is arguably narrower than the information that is the subject of evaluation, counsel should search all relevant, existing patents.

PRACTICE TIP: Many companies specialize in patent searches. These companies and patent counsel should be retained as necessary to conduct patent searches and to render an opinion about possible patent infringement.

NOTE: The patent office is required to keep all patent applications and abandoned patent applications in confidence, and not open to public inspection, for a period of at least 18 months. 35 USC §122. A search of patent records, therefore, may not reveal inventions for which a patent may be issued in the future. For many reasons—such as the marketing and sale of the product that is the subject of the patent application—a patent applicant may choose to disclose information that is the subject of a patent application while the patent is still pending. If the information is so disclosed, anyone copying and using the disclosed information after patent issuance without the patent owner's permission would be liable for infringement.

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VIII. SOURCES OF INFORMATION

§10.29 A. Information in Public Domain Not Trade Secret

All ideas in general circulation, *i.e.,* in the public domain, are dedicated to the common good unless they are protected by a valid patent. *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 159, 103 L Ed 2d 118, 109 S Ct 971, citing *Lear, Inc. v Adkins* (1969) 395 US 653, 668, 23 L Ed 2d 610, 89 S Ct 1902. Copyright laws protect only a particular expression of an idea, not the idea itself. *Sid & Marty Krofft Television v McDonald's Corp.* (9th Cir 1977) 562 F2d 1157, 1163. Trademark and trade dress laws may further limit use of information.

The doctrine of federal preemption prevents the states from enforcing any law, whether judicially or legislatively created, that would deter anyone from copying an unpatented product. *Sears, Roebuck & Co. v Stiffel Co.* (1964) 376 US 225, 11 L Ed 2d 661, 84 S Ct 784; *Compco Corp. v Day-Brite Lighting, Inc.* (1964) 376 US 234, 11 L Ed 2d 669, 84 S Ct 779. "The offer of federal [patent] protection from competitive exploitation of intellectual property would be rendered meaningless in a world where substantially similar state law protections were readily available." *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 151, 103 L Ed 2d 118, 135, 109 S Ct 971. Thus, trade secret protection is not available for information in the public domain.

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§10.30 1. General and Basic Knowledge

General and basic knowledge that is anticipated by prior art cannot be the subject of patent protection. See 35 USC §102; California Business Litigation, chap 8 (Cal CEB 2002); Rosenberg, Patent Law Fundamentals §§1.04, 7.00 (2d rev ed 2004). Also excluded from patent protection are laws of nature, physical phenomena, and abstract ideas. *Parker v Flook* (1978) 437 US 584, 589, 57 L Ed 2d 451, 98 S Ct 2522. This rule "is founded upon the proposition that in granting patent rights, the public must not be deprived of any rights that it theretofore freely enjoyed." 437 US at 593, 57 L Ed 2d at 459. For the same reason, general and basic knowledge cannot be protected as trade secrets.

General knowledge and skill acquired through work experience may be used in subsequent employment without incurring liability for trade secret infringement. A mobile employee is also free to use any knowledge and skill acquired through education and independent research. *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 246 P2d 11; *Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 108, 148 P2d 9; *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 23 CR 198. This freedom to use general knowledge includes the right to use specialized skills, processes, and methods of doing business that are skillful variations of general processes known to a particular trade.

Individuals are free to use their unique personalities and talent. An employee who creates a performance and wears a specific costume related to the employer may not be enjoined by that employer from performing in another but similar costume. *KGB, Inc. v Giannoulas* (1980) 104 CA3d 844, 164 CR 571. See also *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 862, 27 CR2d 573 (trained, talented employees do not qualify as employer's trade secret). A similar and still unresolved question is the degree to which software engineers can carry their authorial or signature styles of coding from job to job, and where the line will be drawn between trade secrets and a coding style that is deemed part of the engineer's general skills, knowledge, and experience.

For further discussion of the difference between general knowledge and trade secrets, see §1.9.

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§10.31 2. Published Literature and Internet Websites

Information gleaned from published literature and computer databases is highly unlikely to be protected by trade secret law, but it may be protected by copyright, patent, trademark, or other intellectual property law. See *Religious Technol. Ctr. v Netcom On-Line Communication Servs.* (ND Cal 1995) 907 F Supp 1361. In general, information on publicly accessible Internet websites is not a trade secret. See *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 251, 10 CR3d 185 (even unauthorized Internet postings can extinguish trade secrecy if widespread). For example, information in an operating manual made freely available to the public on the company's website could not constitute a trade secret. *Polimaster Ltd., NA&SE Trading Co. v Rae Sys., Inc*. (ND Cal Sept. 6, 2005, No. 05-01887-JF) 2005 US Dist Lexis 33847 (under CC §3426.1(d), information must be secret and have independent economic value to competition, and reasonable efforts must have been used to keep information secret). Similarly, the identities of customers and potential customers were not secret when the company made no effort to maintain its secrecy, posted the names on the company's website, and provided samples on request from which customers' names were easily deduced. *Thompson v Impaxx, Inc*. (2003) 113 CA4th 1425, 1428, 7 CR3d 427.

Indeed, the Internet has radically expanded the public domain in recent years because it has made readily available a vast amount of research and business information. Specialized websites such as http://www.archive.org that store materials posted on other websites also expand the public domain by allowing the public to access information from expired Internet postings that otherwise would be unavailable.

WARNING: Misappropriation includes the disclosure or use of trade secrets by one who knows or should know that his or her knowledge of the trade secret was obtained by another who used improper means to acquire it. CC §3426.1(b)(2)(B)(i). See §1.11. Therefore, a business may be liable for trade secret misappropriation if it receives and then uses published information, knowing that it was published by someone who obtained it by improper means.

WARNING: Counsel should not assume that all information posted on the Internet is available for unrestricted use. Such information may be protected by copyright, patent, or trademark law or may be the result of an unauthorized or unintended posting. In particular, a suspicious or unattributed website posting might not be an authorized disclosure, and further inquiry may be needed before a decision can be made to use such information.

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§10.32 3. Expired United States Patent

The bargain struck with patent holders under patent law is that, in exchange for the exclusive right to use their invention for the length of the patent term (see 35 USC §§154-155, 155A, 156, 173), "the invention inures to the people, who are thus enabled without restriction to practice it and profit by its use." *U.S. v Dubilier Condenser Corp.* (1933) 289 US 178, 187, 77 L Ed 1114, 53 S Ct 554. Accordingly, the law requires that patent applications include a disclosure allowing others skilled in the art to understand the invention and how to put it to use. 35 USC §112. Expired patents can therefore be a valuable source of information.

When dealing with information gleaned from an expired patent, counsel should seek the assistance of experienced patent counsel to learn the exact scope of the invention disclosed in the expired patent. Even though information in an expired patent is freely usable (subject to possible trade dress protection), a different but related invention may be protected by another, valid patent. Additionally, other information outside the patent, such as improvements to the patented device or an employee's know-how, may still be protected by trade secret law, a valid license, or a confidentiality agreement. For example, in *Thermotics, Inc. v Bat-Jac Tool Co.* (Tex Civ App 1976) 541 SW2d 255, the court granted an injunction against copying plaintiff's drawings when the device shown on the drawings was an improvement of a device described in an expired patent.

WARNING: A duty of confidentiality may protect certain information that was disclosed in confidence before a valid patent was issued, even if the information was subsequently disclosed in an invalid or expired patent. See *Engelhard Indus. v Research Instrumental Corp.* (9th Cir 1963) 324 F2d 347.

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§10.33 4. Foreign Patents

Foreign patent files are a fertile source of information. Foreign patent applications are usually published 18 months after filing, even if the patent has not issued within that time. If the foreign patent owner does not obtain a United States patent, then information in the issued foreign patent or published foreign application is available for use in the United States.

Applications for United States patents are published after the expiration of a period of 18 months from the earliest filing date unless the applicant, on filing the patent application, makes a request that the application not be published and certifies that the subject of the patent application will not be the subject of an application filed in another country, or under a multilateral international agreement, that requires publication of applications 18 months after the filing. 35 USC §122(b)(2). As a result, U.S. patent files of applications that are also filed and published in a foreign country are a source of information on trade secrets, even if no patent is granted, because the subject of the patent application will enter the public domain after the 18-month holding period.

A foreign patent may issue while the patent owner's U.S. patent is pending and still secret; if a U.S. patent is later issued, the information may not thereafter be used in the United States. As with expired U.S. patents, the scope of disclosure in the foreign patent may be limited in a manner that does not disclose all claimed trade secrets. See *Shamrock Technols., Inc. v Medical Sterilization, Inc.* (ED NY 1992) 808 F Supp 932, 938, aff'd without written opinion (2d Cir 1993) 6 F3d 788.

PRACTICE TIP: Given the special nature of patents, counsel should consult experienced patent counsel when considering the applicable scope of current and expired United States and foreign patents. See Cal Rules of Prof Cond 3-110.

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§10.34 B. Nonpublic, Specialized Knowledge May Be Protected as Trade Secret

Many courts have recognized that trade secret law can provide broader protection for ideas and inventions than patent law. See, *e.g., Rivendell Forest Prods. v Georgia-Pacific Corp.* (10th Cir 1994) 28 F3d 1042, 1045 (patent); *S.O.S., Inc. v Payday, Inc.* (9th Cir 1989) 886 F2d 1081 (copyright); *ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 286 CR 518 (patent); *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 223, 116 CR 654 (patent). The *Sinclair* court distinguished the scope of trade secret and patent protection when it observed (42 CA3d at 222):

> [I]t has been said that a trade secret may be a device or process which is clearly anticipated in the prior art or one which is merely a mechanical improvement on a machine or device. Novelty and invention are not requisite for a trade secret as they are for patentability.

Consistent with this principle, state protection of trade secrets is not preempted by patent law as long as state protection does not conflict with the federal policies of encouraging both patentable inventions and their prompt disclosure. *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 155, 103 L Ed 2d 118, 109 S Ct 971; *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 40 L Ed 2d 315, 94 S Ct 1879.

For a description of the types of information that can constitute a trade secret, see §§1.3-1.10.

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C. Information Obtained by Independent Research and Investigation

§10.35 1. Results of Independent Research May Be Used

Trade secret law offers no protection against discovery by fair and honest means, such as independent invention or reverse engineering. *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 476, 40 L Ed 2d 315, 94 S Ct 1879. Trade secret ownership does not give the owner a monopoly in its use (as do patents) but only a proprietary right that equity protects against usurpation by unfair means. *Droeger v Welsh Sporting Goods Corp*. (9th Cir 1976) 541 F2d 790, citing *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 283, 23 CR 198. Thus, information that a business acquires through truly independent research and investigation generally does not give rise to trade secret misappropriation concerns. See *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 1675, 3 CR3d 279 (explaining concept); *Lloyd Pest Control Co. v Lopez* (1959) 173 CA2d 606, 610, 343 P2d 757 (no liability when former employee using independent means came across former employer's allegedly secret customers).

The distinction between general and special knowledge (see §§10.30, 10.34) must be applied first, however, to learn whether the research and investigation were tainted with special knowledge that rightfully belongs to another. For example, if the person conducting research previously worked on specialized projects for a competitor, that person may have difficulty conducting research without using specialized knowledge acquired from the former employer. It is important to note in this respect that liability can arise when an employee modifies the trade secret of a former employer such that the new design or invention is like "fruit of the poisonous tree." See *Thermodyne Food Serv. Prods., Inc. v McDonald's Corp.* (ND Ill 1996) 940 F Supp 1300, 1308 (defendant modified stolen oven process). To avoid claims of trade secret misappropriation, the employer should either assign the researcher to a different project or institute "clean room" procedures to ensure the independence of the research. *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142, 147.

NOTE: A "clean room" is a procedure used by some industries to allow researchers and developers to work in an environment that is free of the proprietary information of others. This procedure allows a company to argue that its discoveries and products do not infringe others' trade secrets.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.36 2. Results of Reverse Engineering May Be Used

§10.36 2. Results of Reverse Engineering May Be Used

Reverse engineering is an accepted and lawful form of independent research that involves starting with a known product and working backward to discover the process by which it was developed and manufactured. *People v Gopal* (1985) 171 CA3d 524, 533, 217 CR 487. See §1.13. A company is allowed to freely copy a product that is available in the open market (unless the product is subject to patent, copyright, trademark, or other intellectual property protection). To the extent information is acquired through reverse engineering, no trade secret misappropriation has occurred. See Commissioners' Comment to CC §3426.1.

PRACTICE TIP: Counsel should carefully evaluate the procedures of the reverse engineering process to be certain that no specialized knowledge is used to obtain results. See *Williams v Curtiss-Wright Corp*. (3d Cir 1982) 681 F2d 161, 163 (certain products could not have been reverse engineered without knowledge contained in trade secret design drawings); *People v Gopal, supra* (possession of computer chip manufacturing process by-products streamlined claimed reverse engineering process).

WARNING: A trademark, trade dress, or design patent infringement claim may arise if the design features of a product are copied too closely. See, *e.g., Vision Sports, Inc. v Melvill Corp.* (9th Cir 1989) 888 F2d 609, 613; *Bogene, Inc. v Whit-Mor Mfg. Co.* (SD NY 1966) 253 F Supp 126.

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§10.37 D. Information Obtained Under Confidentiality Obligation

Because trade secret law centers on the receipt and misuse of nonpublic information, it is important to recognize the varying types of confidentiality obligations that can give rise to trade secret concerns.

The definition of "misappropriation" in the Uniform Act specifically includes "disclosure or use of a trade secret … by a person who … at the time of disclosure or use, knew or had reason to know that his or her knowledge of the trade secret was … *derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use.*" (Emphasis added.) CC §3426.1(b)(2)(B)(iii). See §1.11.

Employment relationships, fiduciary relationships, business relationships under negotiated confidentiality agreements, and other examples can all give rise to trade secret concerns. And although such relationships do not render secret any preexisting knowledge, public domain information, or general skills and experience (see §§1.3-1.10), nonpublic information disclosed under a confidentiality obligation can constitute a trade secret.

The following sections discuss relationships that have been held to give rise to a duty of confidentiality.

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§10.38 1. Employee-Employer Relationship

During the term of employment, an employer is entitled to its employees' "undivided loyalty." *Fowler v Varian Assocs., Inc.* (1987) 196 CA3d 34, 41, 241 CR 539. This duty of loyalty includes the duty "not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party." *Huong Que, Inc. v Luu* (2007) 150 CA4th 400, 416, 58 CR3d 527 (citing Restatement (Third) of Agency §8.05(2) (2005)). Moreover, Lab C §2863 requires employees who are transacting business similar to that of one's employer to "always give the preference to the business of the employer." In *Huong Que*, the court recognized that "California law permits an employee to seek other employment and even to make some 'preparations to compete' before resigning." 150 CA4th at 417 (quoting *Fowler*, 196 CA3d at 41). The *Huong Que* court also found a breach of the duty of loyalty when the appellants used their employer's customer list to divert customers to a new company while they remained employed with their current employer. 150 CA4th at 416. Similarly, in *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 351, 49 CR 825, the court found that a corporate officer breached his fiduciary duties by supplying a competitor with a selective list of his corporation's employees who possessed the ability and characteristics desirable to the competitor, together with salary information and suggestions for competitive salary offers. See also *ViChip Corp. v Lee* (ND Cal 2006) 438 F Supp 2d 1087, 1099 (taking proprietary information and deleting relevant electronic files was breach of fiduciary duty).

This duty of loyalty applies to officers and directors of corporations and other managers and supervisory personnel. See, *e.g., James v Childtime Childcare, Inc.* (ED Cal, June 1, 2007, No. Civ. S-06-2676 DFL DAD) 2007 US Dist Lexis 43753, *9 (duty of loyalty recognized when employee "was the director of the center, not a mere employee"); *Fowler,* 196 CA3d at 41 (duty of loyalty applied to marketing manager). Moreover, the case law indicates that the duty of loyalty applies to all employees, including nonsupervisory employees. The Ninth Circuit, considering a case involving Hawaiian law, applied the Restatement (Second) of Agency to find that the duty of loyalty extends to all employees, including laborers and others who are not officers or directors. *Eckard Brandes, Inc. v Riley* (9th Cir 2003) 338 F3d 1082, 1086. See also *Otsuka v Polo Ralph Lauren Corp.* (ND Cal, Nov. 9, 2007, No. C 07-02780 SI) 2007 US Dist Lexis 86523, *4 (noting that California courts recognize the authoritative nature of the Restatement and agreeing with *Eckard Brandes* that the duty of loyalty applies to all employees).

Thus, when advising the mobile employee prior to his or her departure, counsel should explain the employee's duty of loyalty obligations in the context of trade secret protection obligations, whether the employee is an officer, director, manager, or nonsupervisory employee. See *Eaton Corp. v Giere* (8th Cir 1992) 971 F2d 136, 141 (product engineer breached his duty of loyalty by soliciting his employer's customers for himself). Although the employee has the right to prepare to compete, he or she cannot divert business opportunities to competitors prior to separating from employment nor retain the employer's trade secrets with the intent to use or disclose them to third parties.

Despite the foregoing law, when dealing with trade secret infringement claims against former employees, counsel should consider the strong public policy in California that favors the ability of individuals to move freely in the workplace. This policy is reflected in Bus & P C §16600 and is discussed in detail in §2.32. For further discussion of trade secret ownership issues in the employer-employee relationship, see §§2.2-2.11.

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§10.39 2. Licensee-Licensor Relationship

When a company licenses to another the right to use certain technology and know-how, the licensee can use that information only in accordance with the terms of the license agreement. *Gilliam v American Broad. Co.* (2d Cir 1976) 538 F2d 14, 20. To maintain trade secrets and protect the licensor's interest, license agreements typically require that the licensed information be held in confidence and be returned on the termination of the agreement. See, *e.g.,* the model licensing agreement provisions concerning secrecy in §8.25. The owner of licensed trade secrets may also require the licensee's employees to acknowledge the duty of secrecy and agree not to use or disclose the information. *Monovis, Inc. v Aquino* (WD NY 1994) 905 F Supp 1205. Failure to abide by the confidentiality provisions of a license may lead to liability for breach of contract as well as for trade secret misappropriation. See *Aronson v Quick Point Pencil Co.* (1979) 440 US 257, 59 L Ed 2d 296, 99 S Ct 1096; *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 116 CR 654. See chap 7 for discussion of license agreements. Therefore, when negotiating with someone who has a trade secrets license, a company must be careful not to acquire or use the licensor's trade secrets.

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§10.40 3. Officer's or Director's Relationship With Corporation

Like employees, current or former officers or directors of a corporation owe a duty of confidentiality regarding trade secrets and can also violate fiduciary duties when they make inventions before resigning and fail to report them. See, *e.g., Daniel Orifice Fitting Co. v Whalen* (1962) 198 CA2d 791, 800, 18 CR 659. In *GAB Bus. Servs., Inc. v Lindsey & Newsom Claim Servs., Inc.* (2000) 83 CA4th 409, 420, 99 CR2d 665, overruled on other grounds in *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289, however, the court distinguished between "an officer who participates in the management of the corporation, exercising some discretionary authority," and a "nominal" officer when deciding if a fiduciary duty applied to the officer.

Further, there is a distinction between a fiduciary who merely seeks and accepts employment with another company and one who engages in activities that disrupt existing relationships between the corporation and its employees and contractors. *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 49 CR 825. The line between lawful preparations to compete and unlawful competition by a fiduciary is discussed in §2.10. For discussion of cases on officer liability, see *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 93 CR2d 663, modified at 79 CA4th 1144A. The court in *PMC* held that an officer or director who (1) invested in a corporation, the principal assets of which were the product of misappropriated trade secrets; (2) took control of the corporation and appointed people to run it; and (3) knew or had reason to know of the misappropriation may be liable for trade secret misappropriation. 78 CA4th at 1372.

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§10.41 4. Relationship With Partner or Joint Venturer

The relationship between partners and joint venturers is a fiduciary relationship. *Thompson v California Brewing Co.* (1957) 150 CA2d 469, 475, 310 P2d 436. Therefore, a duty of confidentiality can arise from a partnership or joint venture relationship. See *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 12 CR2d 741. Hence, the parties should enter into written agreements that secure adequate protection of the trade secrets disclosed between them.

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§10.42 5. Relationship With Consultants and Independent Contractors

The use of consultants and independent contractors is prevalent in American business today. Rather than incur the costs of a new employee, businesses often retain expert advice for discrete projects. The two parties may establish a confidential relationship, regardless of a contract between them, when one engages the other as an independent contractor. See *Crocan Corp. v Sheller-Globe Corp.* (ND Ill 1974) 385 F Supp 251, 253, citing *Jones v Ulrich* (Ill App Ct 1950) 95 NE2d 113. When hiring a consultant for his or her expertise, a business must be concerned with whether the expertise is based on specialized knowledge acquired from a previous client of the consultant. Using such knowledge may lead to liability for trade secret misappropriation. See §10.34. See also discussion of trade secret ownership in independent contractor relationships in §2.11. As discussed in §10.2, companies should require consultants (and independent contractors) to sign agreements that set forth adequate provisions for the protection of the company's trade secrets. The agreements should include appropriate warranties that the job can and will be completed using only information that the consultant has the right to use freely and that the consultant will not use or disclose trade secret information derived from nonparties.

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§10.43 6. Relationship With "Idea Man": Unsolicited Disclosures

Often, unsolicited ideas are sent to a business. "In California … 'idea men' have been able to protect their interests, financial or otherwise, in their literary ideas by the legal 'fiction' of the implied-in-fact contract." *Rokos v Peck* (1986) 182 CA3d 604, 616, 227 CR 480. See chap 3 for discussion of confidentiality obligations arising in connection with the unsolicited submission of ideas.

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§10.44 7. Relationship With Suppliers and Vendors; Purchaser's Specifications and Technical Manuals

A supplier of component parts owes a duty not to disclose a customer's trade secrets to another and owes a duty not to use the customer's secrets in manufacturing products for another. *Bowser, Inc. v Filters, Inc.* (9th Cir 1968) 398 F2d 7, 10. "A disclosure made to one in a confidential relationship, such as a vendee-vendor, relating to the item under negotiation does not cause secret information to lose its protectable character." *Allis-Chalmers Mfg. Co. v Continental Aviation & Eng'g Corp.* (ED Mich 1966) 255 F Supp 645, 653; *Hollywood Motion Picture Equip. Co. v Furer* (1940) 16 C2d 184, 105 P2d 299 (machine shop operator retained by plaintiff owed duty to keep information about plaintiff's product confidential). See also *Crocan Corp. v Sheller-Globe Corp.* (ND Ill 1974) 385 F Supp 251 (confidential relationship between supplier and manufacturer); *Riteoff, Inc. v Contact Indus.* (App Div 1973) 350 NYS2d 690 (patent formula given in confidence).

Similarly, if specifications or technical manuals are submitted to a potential contractor in confidence, the information so disclosed is protected until otherwise disclosed to the public. *Brunswick-Balke-Collender Co. v Kuehne Mfg. Co*. (ND Ill 1956) 110 USPQ 481; *Newell v O.A. Newton & Son Co.* (D Del 1952) 104 F Supp 162; *Holley v Hunt* (1936) 13 CA2d 335, 56 P2d 1240. The information cannot be disclosed by the potential contractor without exposing both the contractor and the recipient to liability for trade secret misappropriation. The parties should enter into written agreements that secure adequate protection of the trade secrets disclosed between them.

PRACTICE TIP: All requests for quotes and purchase order forms should include simple notice language and restrictive legends. See §§6.50-6.52.

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§10.45 8. Relationship With Prospective Purchaser or Licensee

During the course of negotiations for the sale of a business or the licensing of technology, parties frequently exchange trade secret information. Before entering into merger discussions, negotiations for the sale of a business, or license negotiations, confidentiality obligations should be established in writing. Trade secrets disclosed during negotiations for a license must not be used in the absence of the license agreement for any purpose other than facilitating the royalty agreement or other mutually advantageous relationship. *Laurie Visual Etudes, Inc. v Chesebrough-Pond's, Inc.* (Sup Ct 1980) 432 NYS2d 457, rev'd on other grounds (1981) 441 NYS2d 88. The negotiating parties to whom such secrets are disclosed may have a duty to maintain in confidence the information shared during the negotiations, even in the absence of an express confidentiality agreement. *Metallurgical Indus. v Fourtek, Inc.* (5th Cir 1986) 790 F2d 1195.

NOTE: As discussed in §§10.4 and 10.16, companies should avoid "no hire" clauses because courts have found that they unlawfully restrict employee mobility. See *Thomas Weisel Partners, LLC v BNP Paribas* (ND Cal, Mar. 31, 2010, No. C 07-6198) 2010 US Dist Lexis 11626.

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§10.46 9. Relationship With Buyer of Business

Many agreements for the purchase and sale of a business include a noncompetition clause, as allowed by Bus & P C §§16601-16602.5, to prevent solicitation of the business's customers for a subsequent business venture. Even without such a provision, a court may still find that the seller of the business has an implied duty not to directly solicit customers of the business. See, *e.g., Anderson Crop Dusters, Inc. v Matley* (1958) 159 CA2d 811, 324 P2d 710; *Bergum v Weber* (1955) 136 CA2d 389, 288 P2d 623.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.47 E. Information Obtained by Theft

§10.47 E. Information Obtained by Theft

Misappropriation includes the acquisition, disclosure, or use of a trade secret that a person knew or had reason to know was acquired by improper means. CC §3426.1(b). "Improper means" includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means. CC §3426.1(a). If the acquisition of information is "too good to be true" or if it is not reasonable for the person supplying the trade secret to possess such information given his or her educational background and work experience, the company should carefully consider the possibility that the information was acquired by improper means.

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Source: Business Law/Trade Secrets Practice in California/10 Avoiding Misappropriation Claims/§10.48 F. Information Obtained by Accident or Mistake

§10.48 F. Information Obtained by Accident or Mistake

The UTSA prohibits disclosure or use of another's trade secret, without express or implied consent, by a person who, "[b]efore 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*." (Emphasis added.) CC §3426.1(b). "The type of accident or mistake that can result in a misappropriation … involves conduct by a person seeking relief that does not constitute a failure of efforts that are reasonable under the circumstances to maintain its secrecy." Legislative Committee Comment to CC §3426.1.

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11

Litigation Issues

Lowell Anderson
Robert B. Milligan

I. OVERVIEW §11.1

II. PRELIMINARY ISSUES

A. Prefiling and Filing §11.2

B. Whom to Sue

1. General Considerations §11.3

2. Declaratory Judgments §11.4

3. Insurance Coverage §11.5

C. Where to Sue

1. Evaluating Jurisdiction §11.6

2. Contractual Limitations on Jurisdiction §11.6A

3. Choice of Law Issues §11.6B

4. Jurisdiction and the Internet §11.6C

5. Federal Versus State Court; Applicable Law §11.7

6. Removal to Federal Court §11.8

7. Diversity Jurisdiction §11.9

8. Federal Question Jurisdiction §11.10

9. Supplemental Federal Jurisdiction §11.11

10. Unfair Competition Claims Related to Patent, Trademark, or Copyright Claims §11.12

D. When to Sue

1. Three-Year Statute of Limitations §11.13

2. Reasonable Diligence Requirement §11.13A

3. Continuous Misappropriation; Third Party Misappropriation §11.13B

4. Tolling Statute of Limitations §11.13C

E. What Other Claims Can Be Made §11.14

III. PRETRIAL MOTIONS

A. Injunctions §11.15

B. Transfer §11.16

C. Demurrers Under CCP §430.10 and Motions to Dismiss Under Fed R Civ P 12(b)(6) §11.17

D. Anti-SLAPP Motions Under CCP §425.16 §11.17A

E. Summary Judgment §11.18

IV. INVESTIGATION AND DISCOVERY ISSUES

A. Prefiling Investigation §11.19

B. Protective Orders

1. Negotiating Protective Orders Before Discovery §11.20

2. Effect of Protective Orders §11.20A

3. Federal Court Issues §11.20B

4. Internet Issues §11.20C

5. Penalties §11.20D

C. Identifying Trade Secret

1. CCP §2019.210, Generally

a. Identification of Trade Secret Required §11.21

b. "Reasonable Particularity" Requirement §11.21A

2. CCP §2019.210 in Federal Court §11.22

3. Identification Strategies §11.23

4. Effect of Failure to Identify §11.24

D. Discovery Schedules or Plans §11.25

E. Party and Nonparty Discovery §11.26

F. Employee Interviews §11.27

G. Standing: Ownership of Trade Secrets §11.28

H. Estoppel §11.29

I. Testimony and Litigation Privileges

1. Testimony Privilege (CC §47) §11.30

2. Trade Secret Exception to Testimony Privilege (CC §3426.11) §11.30A

3. Advice of Counsel §11.30B

4. Anti-SLAPP Claims (CCP §425.16(e)(2)) §11.30C

5. California Reporter's Shield Law (Cal Const art I, §2(b), Evid C §1070(a)) §11.30D

J. Fifth Amendment §11.31

K. Freedom of Information Act and Other Disclosure Laws §11.32

V. TRIAL ISSUES §11.33

A. Experts and Special Masters §11.33A

B. Motions In Limine §11.33B

C. Public Access §11.33C

VI. POSTRESOLUTION ISSUES §11.34

VII. CLAIMS NOT BASED ON UTSA §11.35

A. Antitrust Violations §11.36

B. Breach of Confidence §11.37

C. Breach of Implied-in-Fact or Written Confidentiality Agreements

1. Nature of Cause of Action §11.38

2. Actions Arising From Assignment of Inventions §11.39

3. Punitive Damages for Breach of Contract §11.40

D. Breach of Noncompetition Agreements §11.41

E. Civil Conspiracy §11.42

F. Conversion and Trespass to Chattels §11.43

G. Fraud and Constructive Fraud §11.44

H. Breach of Fiduciary Duty §11.45

I. Common Law Misappropriation §11.46

J. Interference With Prospective Business Advantage §11.47

K. Trade Libel §11.48

L. Unfair Competition §11.49

M. Unjust Enrichment §11.50

N. Civil Writ of Possession for Stolen Property §11.51

O. Copyright Act of 1976 §11.52

P. Lanham Act §11.53

Q. Patents §11.54

R. Racketeer Influenced and Corrupt Organizations Act §11.55

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§11.1 I. OVERVIEW

Protection of trade secrets in California is governed primarily by the Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11). See generally chap 1. This chapter identifies litigation issues in trade secret misappropriation cases from the perspectives of both the trade secret owner and the accused misappropriator. In analyzing litigation procedure, this chapter identifies preliminary issues (see §§11.1-11.14), pretrial motions (see §§11.15-11.18), discovery issues (see §§11.19-11.30), trial issues (see §§11.31-11.33C), and postresolution issues (see §11.34). The chapter also addresses other remedies against trade secret misappropriation not based on the UTSA (see §§11.35-11.55). The relationship of trade secret protection under the UTSA and protection under other state and federal statutes is also discussed.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/ II. PRELIMINARY ISSUES/§11.2 A. Prefiling and Filing

II. PRELIMINARY ISSUES

§11.2 A. Prefiling and Filing

In federal court, an attorney must conduct a reasonable investigation into the circumstances forming the basis of the complaint before filing it. Fed R Civ P 11. The investigation need not establish facts sufficient to survive a summary judgment motion, and because the information in trade secret cases is often in the possession of the opposing party, reasonable inferences suffice to comply with Rule 11. *Vista Mfg., Inc. v TRAC-4, Inc.* (ND Ind 1990) 131 FRD 134 (applying Illinois UTSA).

In California state courts, counsel should conduct an adequate prefiling investigation to ensure that there is a good faith basis for asserting a misappropriation claim, to avoid imposition of sanctions (see CCP §128.7, California's equivalent to Fed R Civ P 11) or an award of attorney fees and costs for a "bad faith" action (see CC §3426.4; §12.23; *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 1275, 95 CR3d 307). The prohibition against bad faith actions includes not only the initial filing but prosecution of litigation if a claim is pursued that is "without substance in reality, if not frivolous." *Stilwell Dev. v Chen* (CD Cal 1989) 11 USPQ2d 1328 (sanctions awarded); see *Computer Prepared Accounts, Inc. v Katz* (1991) 235 CA3d 428, 286 CR 556 (sanctions for seeking temporary restraining order based on fraudulent documents). Bad faith requires objective speciousness in the claim and subjective bad faith in bringing or maintaining the claim. *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 1279, 95 CR3d 307 (attorney fees awarded in objectively specious action when no misappropriation threatened by defendants and no harm suffered by plaintiffs, whose purpose in filing was anticompetitive); *Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 1262, 116 CR2d 358 (lack of economic value established objective speciousness and pursuing claims after notice of the defects established subjective bad faith). Costs awarded by the court may also include fees for independent expert witnesses incurred during pretrial, trial, or arbitration investigations. CC §3426.4. An unfounded trade secret lawsuit against a competitor may also expose the plaintiff to antitrust litigation. *CVD, Inc. v Raytheon Co.* (1st Cir 1985) 769 F2d 842, 850; Croll, *Implementing a Trade Secrets Protection Program*, 8 CEB Cal Bus L Prac 153, 158 (Summer 1993). In *CRST Van Expedited, Inc. v Werner Enters., Inc.* (9th Cir 2007) 479 F3d 1099, 1112, the court found no abuse of discretion in awarding fees where the plaintiff was told no secrets existed and haggled over a release before abandoning its claims when a motion was filed under Fed R Civ Proc 12(b)(6). Apportioning an award between fees related to trade secret claims and those unrelated to trade secret claims is "within the trial court's discretion." *Abdallah v United States Sav. Bank* (1996) 43 CA4th 1101, 1111, 51 CR2d 286.

WARNING: A bad faith action, or an action filed without adequate investigation, may also expose a plaintiff to sanctions. CCP §§128.5, 128.7. A party filing an action should continually assess the merits of the case and be prepared to dismiss the action if the facts discovered contradict the party's earlier, reasonable assumptions. A party that continues to prosecute the matter may be subject to an award of attorney fees, even if the action was properly filed initially. See *CRST Van Expedited, Inc. v Werner Enters., Inc.*, *supra*.

When trade secret issues arise, there is often insufficient time to investigate the facts thoroughly. Typically, clients believe that a departing employee has not only left to join a competitor but is taking trade secret information to the competitor. The client wants immediate action, which means that extensive investigation of the client's past efforts to maintain secrecy is not possible. The need for immediate action precludes specific identification of all confidential information that the former employee may possess and usually precludes investigation of what information, if any, has actually been conveyed to the competitor. The specific facts of the case will establish whether it is appropriate to send a strongly worded letter, to file a complaint, or to seek injunctive relief.

WARNING: Counsel should be mindful that sending a letter to a potential trade secret misappropriator could risk triggering the statute of limitations. Courts have decided this issue differently. Compare *Epstein v C.R. Bard, Inc.* (1st Cir 2006) 460 F3d 183 (affirming dismissal of claims when licensor sent early letter that "wondered out loud" if licensee's continued sales after expiration of license were legitimate) with *Porex Corp. v Haldopoulos* (Ga App 2007) 644 SE2d 349. In *Porex*, the plaintiff had sent two letters prior to initiating litigation. The first letter stated that the plaintiff had "strong reason to believe" a misappropriation of trade secrets had occurred, and the second letter claimed it was "inconceivable" that the defendant had been able to establish a competing business in so short a time frame. 644 SE2d at 351. The *Porex* court reversed the trial court's grant of summary judgment based on a statute of limitations defense. The court found that the plaintiff had only discovered "objective facts" indicative of misappropriation more than 5 years after the letters had been sent, when it toured the defendant's facilities during the process of a potential acquisition.

A plaintiff is not required to reveal its secrets in the complaint; rather, the discovery process is the proper vehicle for exploring the claim in more detail. See *Static Control Components, Inc. v Darkprint Imaging, Inc.* (MD NC 2001) 135 F Supp 2d 722, 727 (denying motion to dismiss brought on grounds that plaintiff pleaded only concepts); *777388 Ontario Ltd. v Lencore Acoustics Corp.* (ED NY 2000) 105 F Supp 2d 56, 65 (denying motion for more definite statement). See generally §§11.19-11.27.

A verified complaint makes the client responsible for the allegations in the complaint but exposes the client to cross-examination on the words chosen to express the claim. If the client is a corporation, it must be represented by counsel who signs for the corporation. *Merco Constr. Eng'rs v Municipal Court* (1978) 21 C3d 724, 730, 147 CR 631. The statements in a verified complaint can be used as sworn statements to support a temporary restraining order (TRO) or a request for a preliminary injunction. CCP §527(a). In California courts, the answer to a verified complaint must also be verified. CCP §446(a). Obtaining a verified answer can offer some discovery and procedural advantages, because the answers are under oath and have a response time that is typically shorter than the time within which the discovery responses are obtained. In federal court, the answer need not be verified even if the complaint is verified. Fed R Civ P 11(a). For further discussion of pretrial relief, see §§12.3-12.6.

PRACTICE TIP: When it is unclear what information, if any, has been conveyed to a competitor, private investigators may be used if time permits. Care should be taken in informal investigations that do not use court authorized processes, because the testimony privilege may not exempt from liability the investigator's pretrial acquisition of trade secret information from the competitor. See §11.27.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/ B. Whom to Sue/§11.3 1. General Considerations

B. Whom to Sue

§11.3 1. General Considerations

Trade secret misappropriation is a tort, and as such any person or business entity involved in the misappropriation may be sued. Any joint tortfeasor can be sued without joining other joint tortfeasors. *Salton, Inc. v Philips Domestic Appliances & Personal Care BV* (7th Cir 2004) 391 F3d 871, 877 (reversing dismissal for failing to join indispensable party who was joint tortfeasor in trade secret and copyright violations). See also *AccuImage Diagnostics Corp. v Terarecon, Inc.* (ND Cal 2003) 260 F Supp 2d 941, 950 (denying motion to dismiss conspiracy to commit misappropriation claim against corporate shareholder defendant); *Components for Research, Inc. v Isolation Prods.* (1966) 241 CA2d 726, 729, 50 CR 829 (officers and corporation liable). Counsel should identify and consider naming as parties any agents or coconspirators, such as other former employees, vendors, business partners, or sources of financing involved in the misappropriation, to help ensure adequate injunctive relief and monetary recovery. See §11.42 (civil conspiracy). See also *Silicon Knights, Inc. v Crystal Dynamics, Inc.* (ND Cal 1997) 983 F Supp 1303, 1308 (naming others in claims other than, but related to, misappropriation). Liability can also extend to those who know of a misappropriation and either ignore or actually approve of the misappropriation to their subsequent benefit. *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 66, 37 CR3d 221.

WARNING: Investors who became officers and directors of a company that was originally formed through the use of misappropriated knowledge brought over by former employees of another company may be found personally liable even for torts that occurred before they invested or became directors. *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 1385, 93 CR2d 663, modified at 79 CA4th 1144A. The court concluded that they might have invested in the company at a bargain price knowing that the sole business assets consisted of stolen confidential information and processes. It also found that an officer's reliance on an expert's advice to excuse personal liability for misappropriation must be reasonable and is unreasonable if the officer had reason to know of the misappropriation.

Counsel may individually name a tortfeasor's spouse to bind community assets, but it is not necessary to do so. See Fam C §910; *The Reynolds and Reynolds Co. v Universal Forms, Labels & Sys., Inc.* (CD Cal 1997) 965 F Supp 1392, 1396. If a nondebtor spouse is named solely as a community representative to bind the community for acts committed by the tortfeasor spouse during the marriage, however, the nondebtor spouse may opt not to participate in the litigation and may be dismissed on request. 965 F Supp at 1397.

One advantage of joining individual tortfeasors is the possibility that damages arising from willful misappropriation cannot be discharged in bankruptcy. See *KV Pharmaceutical Co. v Harland (In re Harland)* (ED Pa 1999) 235 BR 769, 782 (state court judgment of trade secret misappropriation creates nondischargeable debt).

PRACTICE TIP: Naming additional individuals or entities as parties makes discovery for such defendants easier, because discovery may proceed by notice rather than by subpoena, and sanctions may be obtained by motion rather than in contempt proceedings. Moreover, if a plaintiff wants to sue in state court and prevent removal to federal court, and if a nonfrivolous claim may be made against a defendant whose presence prevents removal, that defendant should be named in the original complaint. However, naming individual defendants may be tactically disadvantageous because it may provoke jury sympathy, invoke lawsuit defense coverage from the additional individuals' insurance carriers, and add additional lawyers to the defense team. Naming too many parties also may create problems if there is an inconsistent verdict. See, *e.g., Gaia Tech. Inc. v Recycled Prods. Corp.* (5th Cir 1999) 175 F3d 365, 370 (jury finding that there was no misappropriation of trade secrets by individual defendants could not be reformed to impose liability, because federal court can reform verdict only on issues not submitted to jury).

In the corporate arena, special consideration must be given to suits by shareholders or directors against the corporation. Neither a shareholder nor a director has authority to bring an action on the corporation's behalf against another shareholder or director for misappropriation and related causes of action. *Anmaco, Inc. v Bohlken* (1993) 13 CA4th 891, 899, 16 CR2d 675. A shareholder's derivative action accusing corporate officers of trade secret misappropriation must first be tendered to the corporation to see whether it wants to file a suit. *Lewis v Sporck* (CD Cal 1985) 612 F Supp 1316, 1322. But see *Lewis on Behalf of Nat'l Semiconductor v Sporck* (ND Cal 1986) 646 F Supp 574, 576 (suit based on belated demand permitted when corporation acts on demand). Further, not all jurisdictions automatically find an employer liable for misappropriation of an employee, so care must be used in naming corporate parties and in establishing sufficient corporate knowledge or approval of the misappropriation to warrant liability. See *Infinity Prods., Inc. v Quandt* (Ind 2004) 810 NE2d 1028, 1034 (doctrine of respondeat superior conflicts with and is displaced by Indiana UTSA).

PRACTICE TIP: Counsel representing a trade secret owner should consider sending a cease and desist letter before filing suit

because trade secret disputes are often costly and disruptive and are not without risk of adverse consequences. Often, such a letter will resolve the dispute without the need for litigation. Any such letter should be drafted carefully to avoid exposure to a cross-claim or separate actions for defamation or invasion of privacy. Not all prefiling demand letters enjoy protection from the litigation privilege of CC §47(b). *Nguyen v Proton Technol. Corp.* (1999) 69 CA4th 140, 81 CR2d 392 (reversing summary judgment in favor of attorney, who wrote letter, and client). But see *Neville v Chudacoff* (2008) 160 CA4th 1255, 1261, 73 CR3d 383 (affirming dismissal of defamation claims premised on prelitigation letters notifying customers of fired employee's alleged misappropriation on anti-SLAPP grounds).

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§11.4 2. Declaratory Judgments

The accused misappropriator can seek relief through a declaratory judgment action naming the accuser as the defendant. Accusations of misappropriation and comments to customers that the misappropriator would be sued create a case or controversy warranting a declaratory judgment action in federal court, assuming a separate basis exists for federal subject matter jurisdiction. 28 USC §2201; *American Specialty Foods, Inc. v McGlynn Bakeries, Inc.* (D ND 1993) 28 USPQ2d 1638. If the trade secret involves technology, then either threatening to assert the trade secrets or filing a lawsuit on the trade secrets may give rise to a declaratory judgment involving previously unasserted patents covering the same technology. See *Vanguard Research Inc. v PEAT Inc.* (Fed Cir 2002) 304 F3d 1249, 1255. Similar declaratory judgment relief may be sought in California under CCP §1060.

Declaratory judgment claims asserted in a cross-complaint or counterclaim in a trade secret misappropriation suit may be subject to challenge on grounds that the claims are simply denials of the affirmative suit and merely restate issues already before the court. *General of Am. Ins. Co. v Lilly* (1968) 258 CA2d 465, 470, 65 CR 750 (sustaining, without leave to amend, demurrer of complaint that sought declaration on issues being addressed in already-pending action); *Sanijet Corp. v Lexor Int'l, Inc.* (ND Tex, May 15, 2008, No. 3:06-CV-1258-B) 2008 US Dist Lexis 39959, *8 (courts often reject declaratory judgment claims seeking resolution of matters already resolved as part of lawsuit); *Atlantic Recording Corp. v Serrano* (SD Cal, Dec. 28, 2007, No. 07-CV-1824 W(JMA)) 2007 US Dist Lexis 95203, *11 ("[c]ourts often dismiss 'mirror image' counterclaims where they merely restate issues already before the court as part of plaintiff's affirmative case").

If the alleged trade secret owner and the alleged defendant file related suits in two different jurisdictions, the first court to have jurisdiction usually has priority, and the second court should decline consideration of the action until the proceedings before the first court are terminated or consolidated with those of the second court. *Hill's Pet Prods. v A.S.U., Inc.* (D Kan 1992) 808 F Supp 774, 775 n1 (transferring action to California). See also *Google, Inc. v Microsoft Corp.* (ND Cal 2005) 415 F Supp 2d 1018, 1025 (staying California case pending earlier-filed Washington case).

WARNING: A first-filed declaratory judgment action does not guarantee that the litigation will take precedence over a later filed action in a different state court. *DeFeo v Procter & Gamble Co.* (ND Cal 1993) 831 F Supp 776, 780 (dismissing action to construe noncompetition agreement in favor of later-filed Ohio state court action). See also *Advanced Bionics Corp. v Medtronic, Inc.* (2002) 29 C4th 697, 707, 128 CR2d 172 (reversing injunction against second-filed sister-state litigation, on grounds of sovereignty and comity, because other state had reasonable connection with dispute); *TSMC N. Am. v Semiconductor Mfg. Int'l Corp.* (2008) 161 CA4th 581, 596, 74 CR3d 328 (no exceptional circumstances that outweighed threat to principles of judicial restraint and comity supported antisuit injunction barring later-filed suit in China); *Biosense Webster, Inc. v Superior Court* (2006) 135 CA4th 827, 837, 37 CR3d 759 (vacating TRO barring enforcement of noncompetition agreement in courts other than Superior Court of Los Angeles County).

WARNING: A declaratory judgment action suspends the running of the statute of limitations during the pendency of the action so that a trade secret misappropriation counterclaim arising out of the same facts can be filed any time during the action even though the limitations period would lapse but for the pendency of the lawsuit. *B. Braun Med., Inc. v Rogers* (9th Cir 2006) 163 Fed Appx 500, cert denied (2006) 549 US 824 (unpublished decision citing *Sidney v Superior Court* (1988) 198 CA3d 710, 714, 244 CR 31). Counsel should check potential limitations periods before starting a lawsuit to see if the client can or should wait awhile before beginning the fight. See §11.13.

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§11.5 3. Insurance Coverage

In deciding whom to sue and what to sue them for, the plaintiff should consider whether it wants to trigger insurance coverage for the alleged violations. On one hand, insurance coverage increases the likelihood of recovering any damages awarded at trial, and it may provide contributions to a settlement fund to resolve the case before trial. On the other hand, insurance coverage may either enable an otherwise impecunious misappropriator to defend the suit, or it may fund a more aggressive defense than would otherwise occur. The actual coverage will depend on the particular wording of the insurance policy regarding the allegations in the complaint or counterclaim and on the facts and allegations inferred. See chap 14 for discussion of insurance coverage for trade secret misappropriation.

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C. Where to Sue

§11.6 1. Evaluating Jurisdiction

Once the potential defendants are identified, counsel should review their residence and actions to see what courts have jurisdiction over the various defendants. Personal jurisdiction may be based on an individual tortfeasor's actions or on an agency theory, as in *Magnecomp Corp. v Athene Co.* (1989) 209 CA3d 526, 536, 257 CR 278 (jurisdiction over Japanese corporation under agency theory; an independent contractor can be an agent). See *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1344, 267 CR 787. The personal jurisdiction statutes of each relevant state must be consulted.

Jurisdiction has been denied when the defendant neither conducted business nor committed tortious acts in the state. *Blue Beacon Int'l v American Truck Washes, Inc.* (D Kan 1994) 866 F Supp 485 (applying Kansas UTSA). Selling products embodying misappropriated trade secrets constitutes a tort and can establish personal jurisdiction. *Vault Corp. v Quaid Software Ltd.* (5th Cir 1985) 775 F2d 638 (applying Louisiana UTSA). Sending an invention disclosure agreement in response to an inquiry from a New Hampshire resident subjected an Ohio corporation to personal jurisdiction in New Hampshire for tort claims, including trade secret misappropriation. *Anderson v Century Prods. Co.* (D NH 1996) 943 F Supp 137. A nonresident defendant (a former employee of the plaintiff) who was a resident of Dallas and only came to California to visit the plaintiff-employer's headquarters for administrative business trips was found to have purposefully availed himself of the privileges of California; a majority of the noncompetition and separation agreement negotiations were conducted within California and the defendant continued to receive benefits from the plaintiff. *Pedus Bldg. Servs., Inc. v Allen* (2002) 96 CA4th 152, 116 CR2d 542. Employing a competitor's former employee who entered into an employment agreement containing a noncompetition clause and a trade secrets clause could subject a defendant to jurisdiction in the state where the former employee and competitor entered into the employment agreement, even if the defendant corporation did not do business in the state and the former employee was not employed in the state. *Astro-Med, Inc. v Nihon Kohden Am., Inc.* (1st Cir 2009) 591 F3d 1 (finding personal jurisdiction over California corporation in Rhode Island).

In *Integral Dev. Corp. v Weissenbach* (2002) 99 CA4th 576, 122 CR2d 24, the appellate court reversed the lower court's grant of a motion to quash service for lack of personal jurisdiction over a German citizen, holding that "California has a manifest interest in providing a local forum to redress injuries inflicted by out-of-state defendants. [Citations omitted.] The enactment of the Uniform Trade Secrets Act in California indicates a strong legislative intent to protect California residents against the misappropriation of their trade secrets." 99 CA4th at 592.

When evaluating jurisdiction, counsel should investigate related claims that may arise from the acts of misappropriation as a basis for obtaining jurisdiction in the forum of choice. For example, trade secret misappropriation may be a predicate act for a Racketeer Influenced and Corrupt Organizations Act (RICO) claim. See §13.7. RICO has such a broad definition of personal jurisdiction that it could provide a statutory basis for jurisdiction over related claims when a traditional due process analysis would not. See *Bray v Kendall* (ND Cal, Jan. 5, 2010, No. 08-0535 SC) 2010 US Dist Lexis 281, *10; *Armstrong v American Pallet Leasing Inc.* (ND Iowa 2009) 678 F Supp 2d 827; *ESAB Group, Inc. v Centricut, Inc.* (4th Cir 1997) 126 F3d 617, 626.

Because trade secret misappropriation is a tort, jurisdiction is proper where the tort of misappropriation occurs. Thus, a state may exercise jurisdiction and apply its trade secret law even if none of the parties are citizens of the state. *Softel, Inc. v Dragon Med. & Scientific Communications* (2d Cir 1997) 118 F3d 955, 968 (applying NY common law). In assessing whether suit can be brought in California, counsel should also consider whether injury within California was caused by action intentionally initiated outside of California but expressly aimed at or targeting California, with knowledge that the action would cause harm in California. Those conditions can provide personal jurisdiction under the "effects" test. *Archdiocese of Milwaukee v Superior Court* (2003) 112 CA4th 423, 426, 5 CR3d 154 (California court had jurisdiction over Wisconsin archdiocese that transferred pedophile priest to California in order to remove him from Wisconsin).

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§11.6A 2. Contractual Limitations on Jurisdiction

Counsel should review any agreements among the parties to learn whether they contain a forum selection clause or an arbitration clause. *Tracer Research Corp. v National Envtl. Servs. Co.* (9th Cir 1994) 42 F3d 1292, 1294 (no arbitration); *Valentine Capital Asset Mgmt., Inc. v Agahi* (2009) 174 CA4th 606, 94 CR3d 526 (trade secret dispute not subject to mandatory arbitration under Financial Industry Regulatory Authority (FINRA) rules). But see *Simula, Inc. v Autoliv, Inc.* (9th Cir 1999) 175 F3d 716, 726 (arbitration order affirmed on broad language of contract); *Noodles Dev., LP v Latham Noodles, LLC* (D Ariz, Aug. 26, 2009, No. CV 09-1094-PHX-NVW) 2009 US Dist Lexis 81773 (motion to compel arbitration granted in dispute between franchisee and franchisor based on arbitration clause in franchise agreement). If the case involves extensive expert witness effort, note that reasonable fees may be recovered as part of an award of costs if the misappropriation claim is brought in bad faith or if willful misappropriation exists. CC §3426.4 (effective January 1, 2007). A forum selection clause may not limit venue to a particular county in California and it may not specify that the action must be brought in this state if such a provision would be unreasonable. See 2 Witkin, California Procedure, *Jurisdiction* §§355-359 (5th ed 2009). An agreement stipulating to venue may be unenforceable if it violates the public policy underlying California's venue statute, CCP §395. *Alexander v Superior Court* (2003) 114 CA4th 723, 731, 8 CR3d 111.

Some federal district courts in California have shown a willingness to enforce forum selection clauses mandating non-California forums in disputes involving former employees. *Besag v Custom Decorators, Inc.* (ND Cal, Feb. 10, 2009, No. CV08-05463 JSW) 2009 US Dist Lexis 13582 (enforcing Oregon forum selection clause); *Mahoney v DePuy Orthopaedics, Inc.* (ED Cal, Nov. 8, 2007, No. CIV F 07-1321 AWI SMS) 2007 US Dist Lexis 85856 (enforcing Indiana forum selection clause); *Swenson v T-Mobile USA, Inc.* (SD Cal 2006) 415 F Supp 2d 1101 (enforcing Washington forum selection clause).

Employment agreements often include arbitration clauses because many employers require employee disputes to be arbitrated, with the goal of preventing employees from submitting claims for injuries. If the clause states that arbitration applies to "all disputes," it may prevent or at least severely hamper the employer's access to the courts. See CCP §1281.8, permitting an application to the court for provisional relief pending arbitration. There is no federal case law to the same effect.

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§11.6B 3. Choice of Law Issues

If a choice of forums is available, counsel should analyze the local laws of each forum to evaluate whether the inconvenience of a distant forum is outweighed by the advantages of its laws. For example, some states may enjoin employees from working for a competitor if the employment will inevitably result in disclosure of trade secrets. *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262, 1269 (applying Illinois UTSA). In California, the prohibition against restraining trade under Bus & P C §16600 makes such relief significantly less likely. See *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1119. Similarly, covenants not to compete may be enforced more readily in forums outside California. *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034 (refusing to apply Pennsylvania law to enforce covenant in California); *Baxter Int'l v Morris* (8th Cir 1992) 976 F2d 1189, aff'd (8th Cir 1993) 11 F3d 90 (Illinois court applied California agreement to Missouri employee); *Robinson v Jardine Ins. Brokers Int'l Ltd.* (ND Cal 1994) 856 F Supp 554 (enjoining enforcement of injunction in U.S., but not in England). *Estee Lauder Cos. v Batra* (SD NY 2006) 430 F Supp 2d 158 (enforcing New York forum selection clause and imposing 5-month preliminary injunction against California resident based on noncompetition agreement).

WARNING: Counsel should specify the applicable law after careful investigation because the forum where a lawsuit is filed may treat some important issues (*e.g.,* statute of limitations) as procedural and apply the forum's law while simultaneously applying the substantive law of a different jurisdiction as specified in the agreement. *Architectronics, Inc. v Control Sys.* (SD NY 1996) 935 F Supp 425 (applying New York limitations to Minnesota UTSA).

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§11.6C 4. Jurisdiction and the Internet

In the Internet context, the California Supreme Court has adopted a sliding scale analysis to determine whether Internet use can justify the exercise of personal jurisdiction. This determination turns on the degree of interactivity of the Internet site and the commercial nature and extent of the exchange of information. At one end of the spectrum, a defendant clearly does business over the Internet if the defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the Internet, and personal jurisdiction is proper. At the opposite end, a defendant simply posts information on a passive Internet website that is accessible to users in foreign jurisdictions and the site does little more than make information available to interested persons, and personal jurisdiction is not proper. The middle ground is occupied by interactive websites that permit users to exchange information with the host computer. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity and the commercial nature of the exchange of information that occurs on the website. *Pavlovich v Superior Court* (2002) 29 C4th 262, 274, 127 CR2d 329 (purely passive website did not target California even though defendant was aware that entertainment and computer industries in California would be affected by misappropriation); see *Zippo Mfg. Co. v Zippo Dot Com, Inc.* (WD Pa 1997) 952 F Supp 1119, 1124.

In *Pavlovich,* because the website was passive in that it only posted information and had no interactive features, it did not target California residents, and no evidence suggested that a California resident had ever visited or downloaded information from the site, the assertion of personal jurisdiction was unfair. In *Snowey v Harrah's Entertainment, Inc.* (2005) 35 C4th 1054, 29 CR3d 33, the court held that the defendant hotels were subject to specific jurisdiction in California based on their heavy advertising in California, the resulting significant increase in their business from California residents, and the hotels' interactive Internet website and toll-free phone number where people could obtain room quotes and make reservations. This website falls within the middle ground of the sliding scale, where the determination of what constitutes purposeful availment has been less than consistent. 35 C4th at 1063 (collecting cases). The *Snowey* court did not need to decide on a particular approach because the defendants' website, by any standard, established purposeful availment: By touting the proximity of their hotels to California and providing driving directions from California to their hotels, the site specifically targeted residents of California.

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§11.7 5. Federal Versus State Court; Applicable Law

If diversity jurisdiction or federal question jurisdiction arises, counsel must still review state laws because a federal court applies the laws of the state in which the court is located (unless the case is transferred from another state, in which event the law of the transferring court is applied). *GlobeSpan, Inc. v O'Neill* (CD Cal 2001) 151 F Supp 2d 1229 (applying California choice of law rule in discussing New Jersey law). See also *Computer Assocs. Int'l v Altai, Inc.* (ED NY 1991) 775 F Supp 544, 566, aff'd in part and vacated in part (2d Cir 1992) 982 F2d 693 (applying New Jersey governmental interest choice of law rule in discussing New York and Texas law). In California, the courts consider whether the state has a "governmental interest" in the subject matter in deciding whether to apply state trade secret law. *GlobeSpan, Inc.,* 151 F Supp 2d at 1233. Both federal and state courts apply the applicable choice of law rules, and may enforce a covenant not to compete against a California resident in a decision properly resolved under the laws of another state. *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 29 CR3d 881 (arbitration decision enforcing noncompete covenant under New Jersey law upheld).

If suit is brought under the wrong state's trade secret law, in the absence of a forum selection clause, the remedy is not dismissal; rather, the court will apply the law of the correct state. *C & F Packing Co. v IBP, Inc.* (Fed Cir 2000) 224 F3d 1296.

If the plaintiff's complaint includes any claim arising under federal patent law, then the United States Court of Appeals for the Federal Circuit will have jurisdiction over an appeal. 28 USC §1292(c). The Federal Circuit's jurisdiction is based only on those claims "arising under the patent laws" as determined under the well-pleaded complaint rule. Thus, a plaintiff's pleadings must arise under patent law. The plaintiff's pleadings do not include compulsory counterclaims for patent infringement. The Federal Circuit thus lacks jurisdiction over a trade dress claim in which patent infringement was alleged in a counterclaim (that was later dismissed). *Holmes Group Inc. v Vornado Air Circulation Sys., Inc.* (2002) 535 US 826, 834, 153 L Ed 2d 13, 122 S Ct 1889. Thus, for example, in *Board of Regents v Nippon Tel. & Tel. Corp.* (Fed Cir 2005) 414 F3d 1358, a lawsuit based on filing a Japanese patent application that allegedly used misappropriated trade secrets, the suit did not require proof that the subject matter overlapped with a U.S. patent and thus did not "arise under" patent law. Therefore, the Federal Circuit did not have appellate jurisdiction. The standards for evaluating whether personal jurisdiction exists for declaratory judgment actions involving patents are governed by Federal Circuit law, while jurisdiction over claims for breach of contract and trade secret misappropriation is governed by regional circuit law. *Electronics for Imaging Inc. v Coyle* (Fed Cir 2003) 340 F3d 1344, 1348. The existence of a trade secret is governed by state trade secret law principles rather than patent law requirements. Thus, patent law tenets that require corroborating evidence of an invention are inapplicable to the state trade secret action. *C & F Packing Co. v IBP, Inc., supra*.

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§11.8 6. Removal to Federal Court

A state court trade secret action can be removed to federal district court if the federal court could have exercised jurisdiction over the action had it been filed in federal court originally. 28 USC §1441. Thus, a state law claim for misappropriation under the UTSA can be removed to federal court only if there is diversity jurisdiction, federal question jurisdiction, or supplemental federal jurisdiction. 28 USC §§1332, 1338(a), 1367(a). A complaint filed in state court challenging ownership of patented inventions is not one "arising under" federal law that justifies removal to federal court. *Prize Frize, Inc. v Matrix (U.S.) Inc.* (9th Cir 1999) 167 F3d 1261, 1264. Nor is federal jurisdiction invoked merely because a patent is somehow involved in the case. See *Uroplasty, Inc. v Advanced Uroscience, Inc.* (Fed Cir 2001) 239 F3d 1277 (complaint alleged only misappropriation of trade secrets in preparation of patent application, so state law governed).

Counsel should be aware of the many nuances of removal. For example, removal statutes are strictly construed against removal. *California v U.S.* (9th Cir 2000) 215 F3d 1005, 1010. See *Schmitt v Insurance Co. of N. Am*. (9th Cir 1988) 845 F2d 1546, 1551 (30-day removal period strictly construed). Further, a strong presumption exists against removal. *Gaus v Miles* (9th Cir 1992) 980 F2d 564, 566. The Supreme Court has clarified that the 30-day period for removal is triggered by formal service—*i.e.,* simultaneous service of summons and complaint; receipt of the complaint, through service or otherwise, after and apart from service of the summons; or, if local rules do not require service of the complaint, the date when the complaint filed in court becomes available to the defendant. *Murphy Bros., Inc. v Michetti Pipe Stringing, Inc.* (1999) 526 US 344, 353, 143 L Ed 2d 448, 119 S Ct 1322 (receipt of faxed complaint unattended by formal service insufficient to start removal period). In multidefendant cases, however, courts are split on whether the removal period begins with service of the first defendant or the last defendant. See *Brierly v Alusuisse Flexible Packaging, Inc.* (6th Cir 1999) 184 F3d 527, 532 (last-served rule); *Smith v Mail Boxes, Etc.* (ED Cal 2002) 191 F Supp 2d 1155, 1158 (same); *Ford v New United Motors Mfg.* (ND Cal 1994) 857 F Supp 707, 711 (same). But see *McAnally Enters., Inc. v McAnally* (CD Cal 2000) 107 F Supp 2d 1223, 1229 (followed first-served rule and disagreed with *Ford*). Noting the intracircuit split, an Idaho district court has adopted the last-served rule. *Tomlinson Black N. Idaho v Kirk-Hughes* (D Id, June 8, 2006, No. CV06-118-N-EJL) 2006 US Dist Lexis 38020. See also *Rivera v Miller* (D Md, July 29, 2009, No. L-09-01141) 2009 US Dist Lexis 65281, *4 (following first-served rule). Moreover, the joinder, and later dismissal of a nondiverse party to destroy diversity, can bar removal if the removal is to occur more than 1 year after commencement of the action. *Teitelbaum v Soloski* (CD Cal 1994) 843 F Supp 614, 615.

WARNING: Because strict time limitations apply to filing a removal petition, counsel should give high priority to consideration of the desirability of removal.

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§11.9 7. Diversity Jurisdiction

Diversity jurisdiction generally requires complete diversity, which means that all defendants must reside in different states from all plaintiffs. Therefore, if one resident plaintiff properly joins one resident defendant, diversity is destroyed and removal to federal court on diversity grounds is improper. The possibility that a fictitious defendant, sometimes called a "Doe" defendant, might destroy diversity is not considered at the time of removal and will not bar removal. 28 USC §1441(a).

Remand back to state court is proper if diversity is based on a fraudulently joined resident defendant. Fraudulent joinder does not require wrongful intent but merely that the "plaintiff has no chance of succeeding against the challenged defendant." *Federal Beef Processors, Inc. v CBS, Inc.* (D SD 1994) 851 F Supp 1430, 1435 (removing claim under South Dakota UTSA for fraudulent joinder). In evaluating the joinder, federal courts differ on the extent to which they will pierce the pleadings and consider facts in addition to those stated in the complaint. See 851 F Supp at 1435 (piercing pleadings).

PRACTICE TIP: A plaintiff that wishes to remain in state court should be careful whom it sues for misappropriation and related claims, in order to minimize the likelihood of removal. Counsel's "home-town advantage" may be greater in state court than it would in federal court. Many defendants fear this, and a case will often have more settlement value if it remains in state court. However, a local entity plaintiff who is suing a defendant with strong ties to other states may wish to initiate the suit in federal court to forestall removal. Unfortunately, it is far easier to pursue a change of venue motion in federal court under 28 USC §1404 than it is to persuade a California court to grant a forum non conveniens motion. See *Westinghouse Elec. Corp. v Weigel* (9th Cir 1970) 426 F2d 1356.

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§11.10 8. Federal Question Jurisdiction

A complaint stating at least one claim arising under federal law can be removed to federal court, and may not be remanded to state court, even if the state court has concurrent jurisdiction over the federal claim. *Stanford Telecommunications, Inc. v U.S. Dist. Court* (9th Cir 1989) 11 USPQ2d 1480 (granting writ of mandamus barring remand of Lanham Act claim (see discussion of Act in §11.53)). To maintain an action in state court, counsel should prepare pleadings carefully to avoid wording claims for misappropriation and unfair competition as if they were claims for federal trademark, patent, or copyright infringement.

For a claim arising under federal law, the complaint should establish that either (1) federal law creates the cause of action or (2) the plaintiff's right to relief necessarily depends on resolving a substantial question of federal law. *Christianson v Colt Indus. Operating Corp.* (1988) 486 US 800, 808, 100 L Ed 2d 811, 825, 108 S Ct 2166; *Duncan v Stuetzle* (9th Cir 1996) 76 F3d 1480, 1486. Under the second prong of this test, a claim supported by alternative theories in the complaint may not form the basis for federal jurisdiction unless federal law is essential to each theory. *Christianson,* 486 US at 810, 100 L Ed 2d at 826; *Duncan v Stuetzle, supra*. Stated another way, "if a single state law based theory of relief can be offered for each of these causes of action in the complaint, then the exercise of removal jurisdiction" is improper. *Duncan v Stuetzle, supra*.

In *Duncan,* claims for misappropriation, unfair competition, and civil conspiracy were removed as arising under the federal patent or trademark law. A motion to remand, filed a week before trial, was denied, and summary judgment was entered for the defendant. The Federal Circuit found no claims arising under the patent laws and remanded the case to the United States District Court to consider whether jurisdiction existed under federal trademark law. The Ninth Circuit Court of Appeals found no jurisdiction under federal trademark law (the Lanham Act) and also remanded to the United States District Court with instructions to enter an order granting Duncan's motion to remand the case to state court. More precise pleading could have avoided the multiple appeals and delay.

Claims for unfair competition involving trademarks, service marks, trade names, product configurations, or false advertising are especially subject to being construed as claims arising under the Lanham Act (15 USC §1125(a)). To avoid stating a claim under the Lanham Act, a plaintiff must carefully word the complaint to avoid tracking the language of Lanham Act §43(a) and to avoid any reference to interstate usage by either plaintiff or defendant. *Duncan v Stuetzle* (9th Cir 1996) 76 F3d 1480, 1488.

Because of the express preemptive scope of the federal Copyright Act of 1976, a complaint containing only state law claims that are preempted under 17 USC §301(a) is treated as a federal claim for removal purposes. The court in its discretion may award attorney fees for such preempted actions and will consider the parties' motives, the objective reasonableness of the legal and factual positions, compensation, deterrence, and any other relevant factors presented. 17 USC §505; *Rosciszewski v Arete Assocs.* (4th Cir 1993) 1 F3d 225, 234 (preempting Virginia Computer Crimes Act).

The mere involvement of a patent in a disputed transaction does not mean that a federal question exists. See *Prize Frize, Inc. v Matrix (U.S.) Inc.* (9th Cir 1999) 167 F3d 1261, 1264. The well-pleaded complaint rule, in which jurisdiction is based solely on the plaintiff's pleadings, can be used to avoid federal court jurisdiction even over cases in which patent infringement counterclaims may be expected. *Holmes Group Inc. v Vornado Air Circulation Sys., Inc.* (2002) 535 US 826, 831, 153 L Ed 2d 13, 122 S Ct 1889.

PRACTICE TIP: To avoid federal jurisdiction, counsel should carefully plead both the trade secret misappropriation claim and any associated claims.

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§11.11 9. Supplemental Federal Jurisdiction

If a federal court has original jurisdiction over one claim, it may extend supplemental jurisdiction over all other claims that are so related "that they form part of the same case or controversy under Article III of the United States Constitution." 28 USC §1367. Supplemental jurisdiction codifies much of what was formerly referred to as "pendant" or "ancillary" jurisdiction. See 28 USC §1338(a). If a claim giving rise to federal question jurisdiction accompanies a claim for trade secret misappropriation, the federal question claim may be removed and supplemental jurisdiction may extend federal jurisdiction over the trade secret claim.

A federal court must exercise supplemental jurisdiction over the pendent state claims unless they are expressly precluded by either federal statute or one of the exceptions listed in 28 USC §1367(c), in which case they are remanded to state court. These exceptions arise when:

- A claim raises a novel or complex issue of state law;
- A state claim substantially predominates over the claim on which the federal court has original jurisdiction;
- The court has dismissed all claims over which it had original jurisdiction; or
- Exceptional circumstances exist, giving rise to other compelling reasons for declining jurisdiction.

The standards for remanding because of "compelling reasons" or "exceptional circumstances" are more stringent than the "economy, convenience, fairness, and comity" standards of *Carnegie-Mellon Univ. v Cohill* (1988) 484 US 343, 349, 98 L Ed 2d 720, 108 S Ct 614, and *Executive Software N. Am. v U.S. Dist. Court* (9th Cir 1994) 24 F3d 1545, 1558 (overruled on other grounds in *California Dep't of Water Resources v Powerex Corp.* (9th Cir 2008) 533 F3d 1087, 1093). Although supplemental jurisdiction is fairly broad, the state claims are sometimes not sufficiently related to the federal question claim to avoid remand of the state claims. *Verdegaal Bros. v Union Oil Co.* (Fed Cir 1984) 750 F2d 947, 952 (misappropriation and unfair competition claims insufficiently related to patent claims).

One strategy for plaintiffs that prefer having their trade secrets claims heard in federal court is to plead a cause of action for violation of the Computer Fraud and Abuse Act (18 USC §1030). The Act provides a private right of action for injunctive relief and damages against anyone, including former employees and competitors, who intentionally access a computer without authority or exceed authorization and thereby obtain information from any protected computer involved in interstate communications. Any computer with an Internet connection can fall squarely within this statute, providing a powerful tool for the protection of proprietary information. Some courts have interpreted the concept of authorization broadly and have permitted employers to sue former employees under the Act for e-mailing confidential information to their personal e-mail accounts (see *U.S. v John* (5th Cir 2010) 597 F3d 263; *International Airport Ctrs., LLC v Citrin* (7th Cir 2006) 440 F3d 418; *Guest-Tek Interactive Entertainment Inc. v Pullen* (D Mass 2009) 665 F Supp 2d 42; *Shurgard Storage Ctrs., Inc. v Safeguard Self Storage, Inc.* (WD Wash 2000) 119 F Supp 2d 1121) while other courts have refused to apply the Act in those situations and have adopted a narrow view of unlawful authorization (see *LVRC Holdings LLC v Brekka* (9th Cir 2009) 581 F3d 1127; *U.S. v Nosal* (ND Cal, Jan. 6, 2010, No. C 08-0237 MHP) 2010 US Dist Lexis 24359; *Shamrock Foods Co. v Gast* (D Ariz 2008) 535 F Supp 2d 962).

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§11.12 10. Unfair Competition Claims Related to Patent, Trademark, or Copyright Claims

Federal courts have original jurisdiction over claims for unfair competition when such claims are joined with a substantial and related claim for copyright, patent, or trademark infringement. 28 USC §1338(b). The facts giving rise to claims of unfair competition may also give rise to claims of trade secret misappropriation; both claims are commonly asserted in the same complaint. Section 1338(b) provides another way to bring trade secret claims into federal court in conjunction with a related claim of patent, copyright, or trademark infringement.

Numerous other federal claims may also accompany a trade secret claim and give rise to federal jurisdiction (*e.g.,* a RICO claim for which federal and state courts have concurrent jurisdiction). *Tafflin v Levitt* (1990) 493 US 455, 107 L Ed 2d 887, 110 S Ct 792. See §13.7 for discussion of RICO claims for trade secret misappropriation.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/ D. When to Sue/§11.13 1. Three-Year Statute of Limitations

D. When to Sue

§11.13 1. Three-Year Statute of Limitations

The UTSA has a 3-year limitations period that begins to run when the misappropriation "is discovered or by the exercise of reasonable diligence should have been discovered." CC §3426.6. Although pre-UTSA decisions required "actual and appreciable harm" to start the limitations period (*Whittaker Corp. v Execuair Corp.* (9th Cir 1984) 736 F2d 1341, 1346; *Davies v Krasna* (1975) 14 C3d 502, 514, 121 CR 705), adoption of the UTSA, under which mere disclosure constitutes misappropriation, rejected any requirement of actual and appreciable harm (*Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1993) 822 F Supp 634, 642 n7). See also *Crowley v Peterson* (CD Cal 2002) 206 F Supp 2d 1038, 1047 (any compensable injury, however slight, starts running of limitations period).

NOTE: Most of the Comments to the Uniform Act have not been expressly adopted in California, including the Comments on the limitations period, but the Comments imply that the test for commencing the limitations period is an objective one: "If *objectively* reasonable notice of misappropriation exists, three years is sufficient time to vindicate one's legal rights." (Emphasis added.) Comment to Uniform Act §6; see 822 F Supp at 643. Because most other states have adopted the Comments, and because CC §3426.8 states that the statute must be construed consistently with the laws of other states, objective reasonableness is probably the appropriate test in California.

Once misappropriation is commenced, limitations accrue. See *Glue-Fold, Inc. v Slautterback Corp.* (2000) 82 CA4th 1018, 1026, 98 CR2d 661 (recovery was barred even though misappropriator was inactive for 4 years before recommencing misappropriation). Non-California courts have stated that for the limitations period to begin "all that is required is that plaintiff have sufficient facts to plead its cause of action" and that "an injured party has a positive duty to use diligence in discovering his cause of action within the limitations period." *McCaffree Fin. Corp. v Nunnink* (Kan 1993) 847 P2d 1321, 1330 (applying Kansas UTSA), quoting *Pilkington Bros., PLC v Guardian Indus. Corp.* (ED Mich 1986) 230 USPQ 300. In general, if a claimant knows or should have known that a trade secret was disclosed, the limitations period commences. See *Cypress Semiconductor Corp. v Superior Court (Silvaco Data Sys.)* (2008) 163 CA4th 575, 587, 77 CR3d 685 (in suit by trade secret owner against customer, statute of limitations began to run when owner had any reason to suspect that third party knew, or reasonably should have known, that information was trade secret); *McLeod v Northwest Alloys Inc.* (Wash App 1998) 969 P2d 1066, 1069 (applying Washington UTSA); but see *Bliss Clearing Niagra, Inc. v Midwest Brake Bond Co.* (WD Mich 2003) 270 F Supp 2d 943, 952 (rule that limitations period does not run until plaintiff discovers or should have discovered possible cause of action does not apply in trade secret cases; criticizing *Pilkington Bros., PLC v Guardian Indus. Corp.* (ED Mich 1986) 230 USPQ 300). Additionally, the accrual rule is the same whether or not the plaintiff had a relationship with the misappropriator. See *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1993) 822 F Supp 634, 647.

Because misappropriation can be the mere disclosure or acquisition of trade secrets, the limitations period begins to run very early. The courts recognize that the statute of limitations should not be used "in a way that pressures litigants to file suit based merely on suspicions and fears." *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1991) 775 F Supp 1258, 1266. They freely grant leave to add misappropriation claims based on facts discovered during litigation. When granting leave to amend, the court may require counsel to specify when the misappropriation was discovered and to plead any tolling or fraudulent concealment. *Intermedics, Inc.,* 822 F Supp at 643.

The specific facts can give rise to variations on when the limitations begin. *Ashton-Tate Corp. v Ross* (9th Cir 1990) 916 F2d 516. For example:

- The limitations period did not begin to run when suspicions and fears first began, but only when knowledge of the misuse arose from a sale to a third party. *Sokol Crystal Prods. v DSC Communications Corp.* (7th Cir 1994) 15 F3d 1427, 1430 (applying Wisconsin UTSA).

- When a product sample was unlawfully acquired and reversed engineered, the limitations period began when the trade secrets were reversed engineered, not when the sample was wrongfully acquired, because mere acquisition of samples does not constitute trade secret disclosure. *Minnesota Mining & Mfg. Co. v Johnson & Johnson Orthopaedic, Inc.* (D Minn 1991) 22 USPQ2d 1401, 1411 (applying Minnesota UTSA).

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§11.13A 2. Reasonable Diligence Requirement

The determination of what constitutes the exercise of reasonable diligence in discovering trade secret misappropriation is often disputed. Widespread publicity attending the product that incorporates the alleged trade secrets may constitute constructive knowledge that commences the limitations period (see §11.13). *Stutz Motor Car of Am. v Reebok Int'l* (CD Cal 1995) 909 F Supp 1353, 1362, aff'd (Fed Cir 1997) 113 F3d 1258. See *Ralph Andrews Prods. v Paramount Pictures Corp.* (1990) 222 CA3d 676, 682, 271 CR 797 (discussing constructive knowledge under CC §19 and duty to inquire but formulating no definitive test). If a prudent person has sufficient information that further inquiry is warranted, then the knowledge available from that further inquiry is deemed acquired. *Ralph Andrews Prods. v Paramount Pictures Corp., supra.*

Failure to investigate when information is publicly available can result in a finding of actual or constructive notice of the misappropriation. The inaction may also be deemed a failure to take reasonable steps to maintain secrecy and thus negate the existence of a trade secret. *Alamar Biosciences, Inc. v Difco Labs., Inc.* (ED Cal 1995) 40 USPQ2d 1437. Further, arguing that the statute of limitations does not bar the action can constitute bad faith and warrant an award of attorney fees. 40 USPQ2d at 1444. On the other hand, if the facts would not warrant inquiry, it is irrelevant that information was actually available but never acquired. *Ralph Andrews Prods. v Paramount Pictures Corp., supra*.

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§11.13B 3. Continuous Misappropriation; Third Party Misappropriation

A continuous misappropriation constitutes a single claim (CC §3426.6); it is not a continuous tort for which a new 3-year limitations period would continually accrue with each new misappropriation. *Ashton-Tate Corp. v Ross* (9th Cir 1990) 916 F2d 516, 524; *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1993) 822 F Supp 634, 643; Commissioner's Comment to Uniform Act §6. But see *Harry Miller Corp. v Mancuso Chem., Ltd.* (ED Pa 2007) 469 F Supp 2d 303, 318 (under Pennsylvania law, misappropriation of trade secret is "continuing tort," allowing plaintiff to recover for at least the limitations period). This long-standing rule was questioned and ultimately affirmed when the California Supreme Court answered a certified question from the Ninth Circuit Court of Appeals and stated that a "claim for misappropriation of a trade secret against a defendant arises only once, when the trade secret is initially misappropriated, and each subsequent use or disclosure of the secret augments the initial claim rather than arises as a separate claim." *Cadence Design Sys., Inc. v Avant! Corp.* (2002) 29 C4th 215, 227, 127 CR2d 169.

In *Cypress Semiconductor Corp. v Superior Court (Silvaco Data Sys.)* (2008) 163 CA4th 575, 77 CR3d 685, a trade secret owner sued a customer, a third party purchaser of an original misappropriator, alleging that the customer had notice and continued to use a software product incorporating the owner's source code. The reviewing court held that the customer was entitled to a jury determination of its statute of limitations defense under CC §3426.6, and that the single-claim rule did not apply. 163 CA4th at 589. The court explained that if the trade secret owner had a misappropriation claim against the customer, it was a separate claim with its own limitations period because the owner did not allege that the customer was involved in the original misappropriation and sought damages only from the customer's use of the software after learning of the misappropriation. 163 CA4th at 587. In this case, the statute of limitations began to run when the owner had any reason to suspect that a third party knew, or reasonably should have known, that the information was a trade secret. 163 CA4th at 587. The court rejected the notion that there is only one limitations period when there are multiple defendants, and held that the third party's actual state of mind does not affect the running of the statute. 163 CA4th at 582, 587.

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§11.13C 4. Tolling Statute of Limitations

The limitations period may be tolled under certain conditions. For example, it may be tolled for fraudulent concealment if (*Stutz Motor Car of Am. v Reebok Int'l* (CD Cal 1995) 909 F Supp 1353, 1363, aff'd (Fed Cir 1997) 113 F3d 1258):

- The alleged misappropriator concealed an affirmative act or representation that would cause a reasonable person to believe that there was no basis for a claim for relief; and
- The claimant had neither actual knowledge nor constructive notice of the facts constituting the claim for relief.

Believing that the misappropriator went out of business, however, is not an acceptable basis for tolling the limitations period. *Forcier v Microsoft Corp.* (ND Cal 2000) 123 F Supp 2d 520, 526.

The limitations period is also tolled during the pendency of a lawsuit for actions arising out of the same facts. *B. Braun Med., Inc. v Rogers* (9th Cir 2006) 163 Fed Appx 500, cert denied (2006) 549 US 824 (unpublished opinion citing *Sidney v Superior Court* (1988) 198 CA3d 710, 244 CR 31; counterclaim for misappropriation timely filed because plaintiff's declaratory relief action tolled limitations period). Thus, if the limitations period will soon expire on potential counterclaims against the client, counsel should consider delaying filing the complaint.

California tolls claims against nonresident defendants who have not entered the state and resident defendants who are temporarily absent from the state. CCP §351. If a party moves out of the state, however, the tolling provisions may not apply because they may impermissibly burden interstate commerce by penalizing persons who move out of California by imposing a longer statute of limitations on them than on those who remain in California. *Heritage Mktg. & Ins. Servs., Inc. v Chrustawka* (2008) 160 CA4th 754, 759, 73 CR3d 126 (dismissing trade secret misappropriation claims as barred by statute of limitations).

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§11.14 E. What Other Claims Can Be Made

The facts that give rise to a claim for trade secret misappropriation may also give rise to other causes of action. See §§11.35-11.54 for discussion of these other potential claims.

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III. PRETRIAL MOTIONS

§11.15 A. Injunctions

Preliminary injunctions and temporary restraining orders are available under the UTSA. These remedies are discussed in detail in chap 12.

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§11.16 B. Transfer

A federal action can be transferred under 28 USC §1404(a) to any other district or division for the convenience of parties and witnesses and in the interests of justice as long as venue is proper in the district to which the case is transferred. Although the plaintiff's choice of forum is given strong preference, even actions filed first can be transferred. *Hill's Pet Prods. v A.S.U., Inc.* (D Kan 1992) 808 F Supp *774* (transferring UTSA action to California). Because the decision to transfer is within the court's discretion, it is difficult to overturn on appeal. 808 F Supp at *776*.

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§11.17 C. Demurrers Under CCP §430.10 and Motions to Dismiss Under Fed R Civ P 12(b)(6)

A defendant in a California state court may attack the sufficiency of the pleadings by demurrer under CCP §430.10. A plaintiff's failure to plead facts establishing misappropriation and the nature of a trade secret, or failure to plead the existence of a fiduciary's duty to disclose information, can lead to dismissal. *Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 253, 67 CR 19.

The Supreme Court has held that certain minimal pleading is required to withstand dismissal. In order to survive dismissal, a plaintiff must proffer "enough facts to state a claim for relief that is plausible on its face." *Bell Atlantic Corp. v Twombly* (2007) 550 US 544, 570, 167 L Ed 2d 929, 935, 127 S Ct 1955. A plaintiff must plead facts that allow a court "to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v Iqbal* (2009) ___ US ___, 173 L Ed 2d 868, 874, 129 S Ct 1937. "[W]here the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint… has not 'show[n]'—'that the pleader is entitled to relief.'" 173 L Ed 2d at 884 (citing Fed R Civ P 8(a)(2)).

A motion to dismiss for failure to state a claim may be brought in federal court under Fed R Civ P 12(b)(6), but this motion is "strongly disfavored" and will be granted only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Morton v Rank Am., Inc.* (CD Cal 1993) 812 F Supp 1062, 1065. In Rule 12(b)(6) motions, all allegations are taken as true, and leave to amend is freely given to correct any perceived defects. In *Morton,* allegations stating that secrets existed and were misappropriated were found sufficient, although a more definitive statement was ordered on the reasonable steps to maintain secrecy. 812 F Supp at 1073. See *Silicon Knights, Inc. v Crystal Dynamics, Inc.* (ND Cal 1997) 983 F Supp 1303 (granting and denying dismissal of related claims). If the court takes judicial notice of facts outside the pleadings, the federal court, on adequate notice to the parties, may convert a Rule 12(b)(6) motion into a summary judgment motion under Fed R Civ P 56. *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1991) 775 F Supp 1258, 1261.

PRACTICE TIP: Before filing motions attacking the sufficiency of the pleadings, counsel should carefully weigh the benefits and the costs, such as the delay, the increased financial cost, the disclosure to opposing counsel of what must be proved, and the likelihood of dismissal without leave to amend.

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§11.17A D. Anti-SLAPP Motions Under CCP §425.16

Defendants may consider filing a special motion to strike, or an anti-SLAPP motion, pursuant to California's CCP §425.16. The anti-SLAPP statute provides (CCP §425.16(b)(1)):

A cause of action against a person arising from any act of that person in furtherance of the person's right of petition or free speech under the United States or California Constitution in connection with a public issue shall be subject to a special motion to strike, unless the court determines that the plaintiff has established that there is a probability that the plaintiff will prevail on the claim.

The benefits of bringing an anti-SLAPP motion are that (1) the filing of the motion stays discovery, (2) a successful motion can strike an entire cause of action, and (3) if the party filing the anti-SLAPP motion prevails, attorney fees are available.

The issue of anti-SLAPP motions in the trade secret context was examined in *World Fin. Group, Inc. v HBW Ins. & Fin. Servs., Inc.* (2009) 172 CA4th 1561, 92 CR3d 227. In *World Financial Group,* the plaintiff filed a complaint for breach of contract, breach of the implied covenant of good faith and fair dealing, conversion, violation of the Uniform Trade Secrets Act (CC §§3426-3426.11) and the Unfair Competition Law (Bus & P C §§17200-17210), intentional and negligent interference with prospective economic advantage, and unjust enrichment. 172 CA4th at 1565. The complaint alleged that the individual defendants, who had formerly been affiliated with the plaintiff and had entered into contracts with the plaintiff, were using the plaintiff's confidential information and trade secrets, including associate and customer lists as well as sales and marketing information and documents, to solicit the plaintiff's agents to leave the plaintiff and join defendant HBW. 172 CA4th at 1566.

The defendants filed a special motion to strike the complaint as a SLAPP suit pursuant to §425.16, contending that all of plaintiff's claims were based on defendants' speech and conduct in furtherance of the exercise of their right of free speech in connection with a public issue. The public issue identified by defendants was "the pursuit of lawful employment pursuant to [Bus & P C §16600]" as well as "workforce mobility and free competition." 172 CA4th at 1567. The plaintiff opposed the anti-SLAPP motion, arguing that the complaint involved private conduct, which was done in a nonpublic forum, resulting in a violation of a private contract and unfair misappropriation of plaintiff's confidential trade secret information. The trial court denied the anti-SLAPP motion, finding that defendants failed to show that the conduct and communications on which plaintiff's claims were based involved a matter of public interest. 172 CA4th at 1567.

The trial court's decision was affirmed. The court of appeal found that all of the alleged conduct took place in a business capacity and was directed at a competitor's associates and customers for the sole purpose of promoting the competing business as a superior employer and provider of products and services. 172 CA4th at 1569. The court found that in evaluating the first prong of the anti-SLAPP statute, a court must focus on "the *specific nature of the speech* rather than the generalities that might be abstracted from it." 172 CA4th at 1569. See also *Raining Data Corp. v Barrenechea* (2009) 175 CA4th 1363, 1371, 97 CR3d 196 (grant of cross defendant's anti-SLAPP motion affirmed when "gravamen of the cross-complaint was directed at [cross defendant's] filing of the complaint—a protected activity").

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§11.18 E. Summary Judgment

Although some authority describes the existence of a trade secret as a question of law (see *Uribe v Howie* (1971) 19 CA3d 194, 207, 96 CR 493), in practical terms it is a mixed question of law and fact. Whether the information is of a type that may be protected as a trade secret is a question of law. Whether the information meets the other statutory requirements of independent economic value and having been reasonably maintained in secrecy is a question of fact. *Uncle B's Bakery Inc. v O'Rourke* (ND Ia 1996) 920 F Supp 1405, 1428 (Iowa Trade Secrets Act); *Weins v Sporleder* (SD Sup Ct 1997) 569 NW2d 16 (South Dakota UTSA).

In some trade secret cases, factual issues on these other requirements or on aspects of misappropriation make summary judgment difficult to achieve, but it is not impossible. See *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27 (affirming summary judgment of misappropriation because alleged misappropriator never possessed or had access to source code that was allegedly trade secret); *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511, 522 (affirming summary judgment of misappropriation on some aspects, reversing on others as fact questions exist); *Architectronics, Inc. v Control Sys.* (SD NY 1996) 935 F Supp 425, 433 (denying summary judgment under Minnesota UTSA because fact issues remained on whether combination of information shown in isolated disclosures was generally known and whether each disclosure was inferior in performance to corresponding trade secret element). But see *Alagold Corp. v Freeman* (MD Ala 1998) 20 F Supp 2d 1305, 1316, aff'd (11th Cir 2000) 237 F3d 637 (unpublished opinion) (granting summary judgment when plaintiff had made customer list available to all employees without confidentiality markings and had failed to secure nondisclosure agreement from defendant former employee). When an alleged secret is clearly in the public domain, summary judgment can be obtained with a proper evidentiary foundation. *Self Directed Placement Corp. v Control Data Corp.* (9th Cir 1990) 908 F2d 462, 465 (affirming summary judgment on trade secret claim because claimed secrets "were a matter of common public knowledge").

In state court, the party accused of misappropriation bears the initial burden of showing that the action has no merit, that is, that one or more elements of the cause of action cannot be established or that a complete defense exists to that cause of action. CCP §437c(a), (p)(2). If the party accused of misappropriation fails to meet this burden, then it is unnecessary to examine the plaintiff's opposing evidence. *San Jose Constr., Inc. v S.B.C.C., Inc.* (2007) 155 CA4th 1528, 1534, 67 CR3d 54 (reversing summary judgment of no misappropriation because factual issues existed regarding whether overall combination of information was secret with economic value).

In federal court, the party accused of misappropriation need only point to the absence of evidence to support the nonmoving party's case, after which the trade secret owner must submit evidence sufficient to raise a genuine issue of material fact. *MDTV Med. News, Inc. v Weinstock* (SD Cal, Feb. 6, 2007, No. 03CV371-BEN) 2007 US Dist Lexis 8806 (granting summary judgment upon finding no misappropriation). In federal court, if counsel has not conducted sufficient discovery to acquire the facts needed to adequately respond to a summary judgment motion, a proper and timely motion under Fed R Civ P 56(f) (motion for summary judgment when affidavits are unavailable) must be filed to obtain the additional discovery before the summary judgment motion is decided. The motion must identify the specific discovery requested, identify the anticipated evidence to be acquired, and be filed before the hearing on the summary judgment motion. Failure to comply with any of these requirements can be fatal to the case, *i.e.,* summary judgment will be granted. *Ashton-Tate Corp. v Ross* (9th Cir 1990) 916 F2d 516, 519. Presenting oral testimony at hearings in California's federal courts is the exception, not the rule. As long as the parties have a full opportunity to submit written testimony and to argue the matter, there is no abuse of discretion in denying live testimony. *Stanley v University of S. Cal.* (9th Cir 1994) 13 F3d 1313, 1326.

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IV. INVESTIGATION AND DISCOVERY ISSUES

§11.19 A. Prefiling Investigation

Counsel should always investigate a trade secret claim as thoroughly as the circumstances allow. See generally §11.2. Even if a claim must be filed quickly to seek pretrial injunctive relief, that claim should be informed by counsel's reasonable inquiry. How serious was the alleged theft? What secrets are at issue? How does counsel know that the alleged secrets are in fact secret and valuable? Who are the main witnesses? What are the realistic chances of obtaining meaningful relief? Does the client understand the costs and risks of litigation? Should the authorities be contacted about a possible criminal violation? These and similar questions need to be answered as soon as possible in order to make sensible decisions about litigation strategy. At the same time, all relevant documents and other evidence need to be marshaled and analyzed.

In addition to ensuring thoughtful decision making, a careful investigation will provide insurance against claims for damages and sanctions against the plaintiff. Civil Code §3426.4 provides for an award of attorney fees and costs, including fees for independent expert witnesses incurred in pretrial or arbitration efforts if a trade secret misappropriation claim is made in "bad faith." See §12.23. Federal Rule of Civil Procedure 11 permits a federal court to award severe sanctions against a plaintiff and its counsel for failing to make a "reasonable inquiry" to establish that the complaint has "evidentiary support" or is likely to be supported after discovery. This does not mean that a trade secret plaintiff must begin with sufficient evidence to survive summary judgment, but there must be enough to support a reasonable inference of defendant's misappropriation. See *Vista Mfg., Inc. v TRAC-4, Inc*. (ND Ind 1990) 131 FRD 134, 138.

Hard luck stories reeking of unfairness always exist. An attorney must resist the assumption that there is a remedy for every wrong and develop facts supporting potential claims before filing suit. See Fed R Civ P 11. Sometimes there are no remedies. Sending designs to companies without a prior confidentiality agreement gives rise to no actionable claims even if the recipients start using those designs. *ConFold Pacific Inc. v Polaris Indus., Inc.* (7th Cir 2006) 433 F3d 952 (no contract, no unjust enrichment, no trade secret; state protection for designs in public domain is preempted by patent law). In *Paramanandam v Herrmann* (Ind 2005) 827 NE2d 1173, 1180, the information technology person who set up a website for selling weighing scales created his own mirror image website that turned up on searches with the original website. But the website owner chose not to restrict access to the information on its website, so there was no secret information to misappropriate and a preliminary injunction was vacated.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/ B. Protective Orders/§11.20 1. Negotiating Protective Orders Before Discovery

B. Protective Orders

§11.20 1. Negotiating Protective Orders Before Discovery

Before discovery begins in a trade secret case, the parties typically agree to a protective order that restricts each party from using or disclosing outside the litigation information obtained in discovery from the other party. Plaintiffs often seek such an order before serving a CCP §2019.210 trade secret identification statement. Although courts are sometimes skeptical of stipulated orders that delegate to the lawyers the responsibility for designating secrets (see *Stadish v Superior Court* (1999) 71 CA4th 1130, 1144, 84 CR2d 350), such "umbrella" orders are commonly used. They facilitate discovery by making it possible to exchange large numbers of documents without resolving abstract disputes over the trade-secret status of individual records.

PRACTICE TIP: Model protective orders can be found on the websites of several federal and state courts, including the website of the U.S. District Court for the Northern District of California (http://www.cand.uscourts.gov/cand/form.nsf) and the website of the Santa Clara County Superior Court (http://www.sccomplex.org/docfiles/protectorder.htm). In addition, the Intellectual Property Law Section of the State Bar of California, Trade Secrets Subcommittee, is in the process of finalizing a proposed protective order that can be utilized in trade secrets cases. When adopted, this model protective order is expected to be available on the website of the Trade Secrets Committee (http://calbar.ca.gov/state/calbar/calbar_sections_generic.jsp?cid=11474&id=7983).

When negotiating the terms of a protective order, counsel will have to decide whether to adopt a "two-tier" protective order or a "single-tier" protective order. A two-tier protective order, entered in cases in which the parties are direct competitors and the risk of misuse of discovery is greatest, allows the most sensitive information to be produced only to counsel and selected other nonparties. See, *e.g., A Major Difference, Inc. v Wellspring Prods., LLC* (D Colo 2006) 243 FRD 415. If this is not the case, and if a party must rely on its employed scientists for advice, a single-tier protective order may be more appropriate. *MGP Ingredients, Inc. v Mars, Inc.* (D Kan 2007) 245 FRD 497.

The negotiation of a protective order often focuses on disclosure of the alleged trade secrets to three groups: (1) the accused wrongdoer(s), (2) in-house counsel and other employees and agents for both parties, and (3) experts for both parties.

- **Accused wrongdoer(s):** Disputes sometimes arise about whether the person accused of misappropriation should be allowed to review the alleged secrets. The issue is important, because the accused individual is often in the best position to assist the defense with issues such as preexisting knowledge, independent derivation, and nonsecrecy.

PRACTICE TIP: To secure the accused wrongdoer's access to the alleged secrets, the defense should use Evid C §777(c) or Fed R Evid 615 to point out that an individual defendant or corporate representative can be present at trial and that communications with counsel, including strategy and settlement discussions, require access to relevant information. Conversely, the plaintiff should argue that experts can advise counsel sufficiently about technical matters, that the defendant should not be "reeducated," and that a defendant's need for access to particular information can be addressed separately.

- **In-house counsel, and other employees and agents:** In-house counsel involved in "competitive decision making" may be prohibited under a protective order from access to an opposing party's trade secret materials. See *Brown Bag Software v Symantec Corp.* (9th Cir 1992) 960 F2d 1465; *Intel Corp. v VIA Technols., Inc.* (ND Cal 2000) 198 FRD 525 (in-house counsel whose activities include settling lawsuits through licenses was denied access to confidential information under protective order). Similarly, protective orders may include a "prosecution bar," prohibiting access by lawyers who also prosecute patents in the relevant area of technology. See, *e.g., Gen-Probe Inc. v Becton, Dickinson & Co.* (SD Cal, Apr. 28, 2010, No. 09cv2319 BEN) 2010 US Dist Lexis 41828 (discussing majority and minority views on patent prosecution bar); *Mikohn Gaming Corp. v Acres Gaming, Inc.* (D Nev 1998) 50 USPQ2d 1783, vacated on other grounds (Fed Cir 1998) 165 F3d 891. Patent counsel (but not outside corporate counsel) was barred from receiving information designated "outside counsel eyes only" in *Infosint S.A. v Lundbeck A.S.* (SD NY, May 16, 2007, No. 06CIV2869LAKRLEj) 2007 WL 1467784, *5 ("While Infosint's desire to have its trusted counsel involved in the litigation is understandable, Lundbeck's desire to keep its proprietary information is a superior interest"). But see *Avocent Redmond Corp. v Rose Electronics, Inc.* (WD Wash 2007) 242 FRD 574 (allowing access to confidential information by patent prosecution counsel) and *Intervet, Inc. v Merial Ltd.* (D DC 2007) 241 FRD 55, 58 (company's inside intellectual property counsel and its outside patent litigation counsel were not "competitive decision-makers" and therefore could have access to confidential information). See also *In re Deutsche Bank Trust Co. Americas* (Fed Cir 2010) 605 F3d 1373 (vacating order exempting litigation counsel from patent prosecution bar and remanding for determination of whether counsel's role in patent prosecution constituted competitive decision making).

- **Experts:** Parties typically agree on a procedure under which each party can object to the other party's proposed expert, and each expert typically must sign a contract not to use the information he or she received outside the litigation. To gain access to secret information, a designated expert may be required to relinquish nonlitigation consulting duties for the hiring party and agree to forgo such duties in the future. *Digital Equip. Corp. v Micro Tech.* (D Colo 1992) 142 FRD 488, 491. Conversely, disclosing trade secret information received under a protective order to an expert who had a long-standing and ongoing business relationship with the plaintiff, while concealing that relationship from the defendant, warrants sanctions. *Beam Sys. v Checkpoint Sys.* (CD Cal 1997) 42 USPQ2d 1461. Counsel disclosing trade secret information to an expert under a protective order should know that the expert must be independent, *i.e.,* not dependent on a party, not affiliated with a party, not subject to the control or influence of a party, and lacking a social or business relationship with a party. For further discussion of the use of experts in trade secret misappropriation cases, see §11.33A.

PRACTICE TIP: Whatever the form of the protective order, counsel in trade secret cases should be sure to comply with the procedural requirements of the protective order throughout the litigation. If counsel does not comply with these procedural requirements, the client may lose its trade secret rights. In *In re Guidant Corp. Implantable Defibrillators Prods. Liability Litig.* (D Minn 2007) 245 FRD 632, a protective order was entered. However, at a hearing on motions for summary judgment, no attorney requested that the courtroom be sealed. Moreover, during the hearing, certain confidential documents and information were referred to. Because members of the press were present at the hearing, the trade secret status of the confidential documents and information was lost. In *Pettrey v Enterprise Title Agency, Inc.* (ND Ohio 2006) 470 F Supp 2d 790, 795, the court denied a motion to designate documents and deposition testimony as confidential because the motion was not filed within the time frame contained in the protective order.

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§11.20A 2. Effect of Protective Orders

Information produced under a protective order is not necessarily immune from access by other parties. A motion to intervene can give third parties access to information subject to a protective order in another lawsuit. See, *e.g., Beckman Indus. v International Ins. Co.* (9th Cir 1992) 966 F2d 470, 475 (ordering access to depositions despite protective order). A court-imposed protective order may also allow access to similarly situated counsel in other lawsuits. *Raymond Handling Concepts Corp. v Superior Court* (1995) 39 CA4th 584, 45 CR2d 885. See also *In re Jenoptik AG* (Fed Cir 1997) 109 F3d 721 (allowing confidential information obtained under protective order to be used in foreign court). But see *Massachusetts v Mylan Labs., Inc.* (D Mass 2007) 246 FRD 87 (trial court refused to modify protective order to allow plaintiff to distribute confidential discovery material to authorities in 49 states and federal government absent specific threat to public health); *Ford Motor Co. v Manners* (Mo 2007) 239 SW3d 583 (reversing trial court's modification of protective order to allow plaintiff to disclose confidential information to counsel for other potential plaintiffs). Because "agreements to suppress evidence have long been held void as against public policy," a court may order a witness to testify even if such testimony is barred by a stipulated injunction entered in another state. *Smith v Superior Court* (1996) 41 CA4th 1014, 1025, 49 CR2d 20. Further, terms of agreements that violate public policy may be unenforceable. Thus, because an agreement by a customer to keep confidential the terms of a settlement with a securities broker concerning mishandling of securities trades was against public policy, the customer did not violate the agreement by complaining to the broker's supervisor. *Cariveau v Halferty* (2000) 83 CA4th 126, 99 CR2d 417.

Even information that is not secret may be subject to an order requiring its return. Courts may order that documents containing confidential information and obtained in an unauthorized manner be returned to their owner. *Pillsbury, Madison & Sutro v Schectman* (1997) 55 CA4th 1279, 64 CR2d 698 (relying in part on California claim and delivery statutes, CCP §§511.010-516.050). But see *Go-Video v Motion Picture Ass'n (In re Dual-Deck Video Cassette Recorder Antitrust Litig.)* (9th Cir 1993) 10 F3d 693, 695 (vacating order of contempt and fine for "technical" violations of protective order resulting from use of information in subsequently filed action against same party); *McGinty v Superior Court* (1994) 26 CA4th 204, 215, 31 CR2d 292 (reversing order precluding use of expert witness and documents improperly supplied by same expert from another case in violation of protective order, when documents were discoverable in second action and there was no history of discovery abuse). On civil writs of possession for stolen property, see §11.51. Finally, consider that counsel bears personal risk when handling documents known to be produced under a protective order, even when a court mistakenly places them in a public file. See *Wallis v PHL Assocs., Inc.* (2008) 168 CA4th 882, 86 CR3d 297 (attorney sanctioned for alerting client that document was available for inspection in court file). See §11.20D.

PRACTICE TIP: Privileged information received inadvertently is best treated, at least initially, as if it were subject to a protective order. An attorney inadvertently receiving work-product-privileged documents of opposing counsel is permitted to review them only to the extent necessary to recognize that they are privileged; he or she must then notify opposing counsel of his or her possession of material that appears privileged. Counsel or the court can then resolve any disagreement over how to handle the documents, by motion for protective order if needed. *Rico v Mitsubishi Motors Corp.* (2007) 42 C4th 807, 68 CR3d 758 (counsel and expert witnesses were disqualified for misuse of inadvertently received work product).

California courts have noted that the joint defense or common interest doctrine does not create a new privilege or extend an existing one, but rather is analyzed under standard waiver principles applicable to the attorney-client and work product privileges. *Meza v H. Muehlstein & Co.* (2009) 176 CA4th 969, 981, 98 CR3d 422; *OXY Resources, LLC v Superior Court* (2004) 115 CA4th 874, 897, 9 CR3d 621 (ordering in camera review of withheld documents). The attorney-client privilege requires an expectation of confidentiality with regard to the information, and the information must be reasonably necessary to accomplish the purpose for which the attorney is consulted. Merely stating that documents are covered by a joint defense agreement fails to establish these requisite elements. 115 CA4th at 890. Communications between a nontestifying trial consultant and a witness are not protected by the work product privilege. *In re Cendant Corp. Securities Lit.* (3d Cir 2003) 343 F3d 658, 668. Furthermore, otherwise protected work product that is communicated to a testifying expert and considered in the formation of the expert's opinion is likely discoverable. *South Yuba River Citizens League v National Marine Fisheries Serv.* (ED Cal 2009) 257 FRD 607, 612.

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§11.20B 3. Federal Court Issues

In federal court, if one party resists disclosure, then an order compelling disclosure requires proof that the information is relevant and necessary to trial of the lawsuit. *Bare Escentuals Beauty, Inc. v Costco Wholesale Corp.* (SD Cal 2007) 85 USPQ2d 1317 (affirming magistrate's order for disclosure of supplier's identity under protective order regardless of trade secret status, in part because identity was needed for affirmative defenses, including first-sale defense). Moreover, in federal court the First Amendment interest in public dissemination of information obtained in discovery can be considered and may tip the balance toward disclosure in appropriate cases. *Spindler v Baker & Daniels, LLP* (ND Ind, Mar. 12, 2010, No. 1:09-CV-5) 2010 US Dist Lexis 23343 (denying approval of proposed stipulated protective order); *Humbolt Baykeeper v Union Pac. R.R. Co.* (ND Cal 2007) 244 FRD 560, 566 (denying protective order restricting dissemination of tests showing contamination levels).

PRACTICE TIP: Parties in federal court should be careful not to designate too many court filings as confidential under a protective order. In *Nycomed US, Inc. v Glenmark Generics, Inc.* (ED NY, Mar. 8, 2010, No. 08-CV-5023) 2010 US Dist Lexis 20788, a magistrate judge in the Eastern District of New York found that parties were "overdesignating" court filings as confidential. The court ordered the parties to review all court briefs and other documents filed with the court and to make a particularized showing as to why any portion of the filings should be retained under seal. Each party submitted a request to maintain limited portions of court filings under seal. The court denied the requests of both parties, citing the common law right of public access to judicial documents and the First Amendment right of public access. Therefore, parties should only designate necessary documents as confidential and should be careful to limit the scope of documents that are filed under seal.

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§11.20C 4. Internet Issues

Cases involving distribution of information over the Internet create special problems. Because the Internet allows widespread distribution of information in an extremely short time, unless a defendant is one of the first persons to distribute information over the Internet, it may be difficult to prove that information was a trade secret at the time later-involved defendants acquired or distributed the information over the Internet. See *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 254, 10 CR3d 185 (vacating preliminary injunction on the grounds that "a preliminary injunction cannot be used to protect a secret if there is no secret left to protect").

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§11.20D 5. Penalties

Persons violating protective orders are subject to penalties for civil contempt. See, *e.g., Kehm v Procter & Gamble Mfg. Co.* (8th Cir 1984) 724 F2d 630 (attorney ordered to pay $10,000 for selling trade secrets to plaintiffs in related product liability actions). Under appropriate circumstances, violators may be subject to separate liability for tort or breach of contract for disclosing information subject to a protective order. See *Westinghouse Elec. Corp. v Newman & Holtzinger* (1995) 39 CA4th 1194, 46 CR2d 151. At the same time, information gained from independent sources does not violate a protective order even if it is the same as information obtained under a protective order. See *Seattle Times Co. v Rhinehart* (1984) 467 US 20, 34, 81 L Ed 2d 17, 27, 104 S Ct 2199; *Marriage of Candiotti* (1995) 34 CA4th 718, 724, 40 CR2d 299.

A California appellate court decision underscores the importance of following the terms of a protective order and acting cautiously when handling materials that arguably may be protected under a protective order. In *Wallis v PHL Assocs., Inc.* (2008) 168 CA4th 882, 86 CR3d 297, the trial court imposed sanctions of $43,678.42 against an attorney and the client. 168 CA4th at 884. Opposing counsel had filed a declaration with accompanying exhibits under seal, and the declaration contained the client's alleged trade secrets. The declaration and exhibits inadvertently were placed in the court's file and were not filed under seal. The attorney discovered the alleged confidential documents in the court's file and alerted the client that the purported confidential information was in the court's file. The client sent three people to view the confidential information and to take notes, so that an argument could be made that the information was publicly disclosed. The appellate court affirmed the award of sanctions and found that the attorney's actions were frivolous and were taken in bad faith. 168 CA4th at 894. The appellate court also found that the actions of the attorney's clients were frivolous and taken in bad faith. 168 CA4th at 902. While other courts may disagree about the attorney's and the client's conduct, the case serves as an important reminder concerning protective order provisions.

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C. Identifying Trade Secret

1. CCP §2019.210, Generally

§11.21 a. Identification of Trade Secret Required

California requires trade secret plaintiffs to identify alleged trade secrets before trade secret discovery begins. CCP §2019.210. This requirement presents perhaps the most contentious issue in California trade secrets litigation. Trade secret law differs from copyright, trademark, and patent law in that no federal registration certificate defines the boundaries of the plaintiff's intellectual property. Most of the time, trade secrets are defined only during litigation.

Proper identification of its trade secret can help a plaintiff obtain an injunction by showing that specific nonpublic information has been misappropriated, and allows the defendant to prepare defenses such as nonsecrecy and independent derivation. Identification also allows the court to rule accurately on whether information is secret. Trade secret plaintiffs often seek to proceed by identifying only general categories of information such as "customer lists" or "custom software and ASICs" rather than specific secrets. It is not sufficient for a plaintiff to describe what it owns with conclusory general labels. Until the allegedly misappropriated trade secrets are identified with reasonable particularity, no discovery should occur on any claim related to misappropriation, including breach of contract, breach of covenant of good faith and fair dealing, unfair competition, unfair business practices, interference with prospective business advantage, conversion, unjust enrichment, and declaratory relief. *Advanced Modular Sputtering, Inc. v Superior Court* (2005) 132 CA4th 826, 835, 33 CR3d 901.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.21A b. 'Reasonable Particularity' Requirement

§11.21A b. "Reasonable Particularity" Requirement

Code of Civil Procedure §2019.210 requires that the plaintiff "identify the trade secret with reasonable particularity" under any appropriate protective order. Motion practice regarding "reasonable particularity" under the statute is common, and the outcome will vary with the court and the facts.

PRACTICE TIP: One California decision, although not explicitly defining "reasonable particularity," is instructive. In *Diodes, Inc. v Franzen* (1968) 260 CA2d 244, 253, 67 CR 19, the court stated that a plaintiff "should describe the subject matter of the trade secret with sufficient particularity to separate it from matters of general knowledge in the trade or of special knowledge of those persons who are skilled in the trade." The *Diodes* court also stated that the plaintiff must provide the defendant with "reasonable notice of the issues which must be met at the time of trial" and "reasonable guidance in ascertaining the scope of appropriate discovery." 260 CA2d at 253. The *Diodes* decision is codified in CCP §2019.210.

The court in *Computer Econs., Inc. v Gartner Group, Inc.* (SD Cal 1999) 50 F Supp 2d 980, 985, set forth four primary purposes behind CCP §2019.210:

(1) Promoting well-investigated claims and dissuading the filing of trade secret complaints that have no merit;

(2) Preventing plaintiffs from conducting "fishing expeditions" in discovery as a means to obtain a defendant's trade secrets;

(3) Assisting the court in framing the appropriate scope of discovery; and

(4) Enabling defendants to form complete and well-reasoned defenses and ensuring that defendants need not wait until the eve of trial to effectively defend against trade secret claims. See *Perlan Therapeutics, Inc. v Superior Court* (2009) 178 CA4th 1333, 1343, 101 CR3d 211.

One court has directly addressed how much identification is needed, but the guidance is vague and does not fit every case. Defining the secrets with "sufficient particularity" serves "to limit the permissible scope of discovery by distinguishing the trade secrets … from matters of general knowledge in the trade or of special knowledge of those persons … skilled in the trade." *Advanced Modular Sputtering, Inc. v Superior Court* (2005) 132 CA4th 826, 835, 33 CR3d 901 (citations omitted). Reasonable particularity does not require minute detail, but "some showing that is reasonable, *i.e.,* fair, proper, just and rational … under all of the circumstances to identify its alleged trade secret in a manner that will allow the trial court to control the scope of subsequent discovery, protect all parties' proprietary information, and allow them a fair opportunity to prepare and present their best case or defense at a trial on the merits." 132 CA4th at 835.

In *Advanced Modular Sputtering*, the alleged misappropriator brought successive motions for further definitions, supported by expert declarations that the previous disclosures were too vague to distinguish the alleged secrets from public information, and the trade secret owner countered with its own expert declarations. Disagreements on the adequacy of the definition should be resolved in favor of disclosure. Expert declarations may be determinative since "[w]here, as here, credible experts declare that they are capable of understanding the designation and of distinguishing the alleged trade secrets from information already known to persons in the field, the designation should, as a general rule, be considered adequate to permit discovery to commence." 132 CA4th at 836. Moreover, absent unusual circumstances, the trade secret holder does not have to explain how the alleged secrets differ from information that is generally known. *Brescia v Angelin* (2009) 172 CA4th 133, 147, 90 CR3d 842.

The defendant in *Brescia* filed cross complaints against several parties alleging that they had misappropriated the defendant's trade secrets, which were described in the cross-complaint as a "formula, manufacturing process, marketing plan, funding plan, and a distribution and sales plan for a high protein, low carbohydrate pudding." 172 CA4th at 138. After several challenges to the defendant's trade secret designation, the trial court found the trade secret designation to be inadequate and granted a demurrer. The court of appeal reversed. Citing *Advanced Modular Sputtering,* the court held that CCP §2019.210 does not require in every case that a trade secret claimant explain how the alleged trade secret differs from the general knowledge of skilled persons in the field to which the secret relates. Rather, the *Brescia* court held (172 CA4th at 138),

such an explanation is only required when, given the nature of the alleged secret or the technological field in which it arises, the details provided by the claimant to identify the secret are themselves inadequate to permit the defendant to learn the boundaries of the secret and investigate defenses or to permit the court to understand the designation and fashion discovery.

The *Brescia* court also held that the trade secret designation is to be liberally construed, and reasonable doubts regarding its adequacy are to be resolved in favor of allowing discovery to go forward. 172 CA4th at 138. For a lengthy discussion of *Advanced*

Modular Sputtering and *Brescia,* see *Perlan Therapeutics, Inc. v Superior Court, supra*.

Providing general categories of information may be sufficient if it is possible to distinguish between truly secret information and information publicly disclosed. In *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277, the court found that most categories of trade secret information were defined with reasonable particularity, including categories such as the pricing of products; profit margins; production costs; pricing concessions, volume rebates, trade discounts, and payment terms offered to customers; the company's market research data; advertising strategy plans for a specific year; rebate incentives; the company's advertising, sales, and promotion budgets; finishing processes for products; composite material process technologies; and specific strategic plan documents. The category of "new product" information, however, was not adequately defined, because it did not differentiate between truly secret information and information that was publicly disclosed.

NOTE: The plaintiff in *Whyte* sought to identify its alleged secrets in TRO papers, other pleadings, and a CCP §2019(d) statement. See CCP §2019.210 (formerly CCP §2019(d)). Unfortunately for practitioners seeking guidance on this issue, the court based its ruling in part on information contained in the plaintiff's §2019(d) statement, which was not disclosed in the published opinion. The court did not interpret the statute or otherwise provide guidance regarding what a §2019(d) statement should contain.

Other courts have found that general categories of information like research and development information, financial information, and income statements are not sufficiently specific to qualify for trade secret protection. See, *e.g., Luigino's Inc. v Peterson* (8th Cir 2003) 317 F3d 909, 912 (applying Minnesota law). See also *Del Monte Fresh Produce Co. v Dole Food Co.* (SD Fla 2001) 148 F Supp 2d 1322, 1325 (plaintiff's generalized identifications, such as "the glassy appearance of MD-2 fruit," were insufficient).

Lengthy descriptions of the alleged trade secrets, however, are not necessarily adequate. In *IDX Sys. Corp. v Epic Sys. Corp.* (7th Cir 2002) 285 F3d 581, 583, the court found that the plaintiff's 43-page description of allegedly misappropriated software failed to distinguish between trade secrets and other information known in the trade that was readily ascertainable by ordinary users without reverse engineering.

Finally, courts have found that parties are "not entitled to include broad, 'catch-all' language as a tactic to preserve an unrestricted, unilateral right to subsequently amend [a] trade secret statement." *Perlan Therapeutics, Inc. v Superior Court* (2009) 178 CA4th 1333, 1350, 101 CR3d 211. The *Perlan* court affirmed a lower court ruling that a trade secret designation was vague because the plaintiff appeared to be pursuing a claim for misappropriation of several trade secrets but the disclosure statement did not clearly identify all of the trade secrets at issue. The court found that the trade secret designation hid trade secrets in "plain sight" by including surplusage (objections, qualifications, explanations, allegations) and voluminous attachments.

PRACTICE TIP: Consider retaining a competent expert extremely early in the litigation. The expert's declaration can affect the scope of discovery as well as the commencement of discovery. See *Advanced Modular Sputtering, Inc. v Superior Court* (2005) 132 CA4th 826, 836, 33 CR3d 901. Misstatements at the outset can prejudice your case and shortness of time favors such misstatements. Plaintiffs have more time than defendants, and should use prefiling time to review and select trade secret definitions likely to pass scrutiny.

CAUTION: Out-of-state cases often differ from California cases because they typically address the issue of identification of the trade secret at a later stage of the litigation. These cases can be inconsistent on the degree of specificity required, although it appears that the trend is toward more detail. See, *e.g., Motorola v DBTEL, Inc.* (ND Ill, July 19, 2002, No. 02C3336) 2002 US Dist Lexis 13240 (generalized categories not sufficient); *FSI, Int'l, Inc. v Shumway* (D Minn, Feb. 26, 2002, No. 02-402) 2002 US Dist Lexis 3388 (no injunction when plaintiff listed only generalized categories); *Analog Devices, Inc. v Michalski* (NC Ct App 2003) 579 SE2d 449, 454 (no injunction when plaintiff failed to identify alleged secrets). But see *Roton Barrier, Inc. v Stanley Works* (Fed Cir 1996) 79 F3d 1112, 1117, aff'd without opinion (Fed Cir 1997) 108 F3d 1394 (sufficient to identify "areas" of technology).

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§11.22 2. CCP §2019.210 in Federal Court

There is a split of authority regarding whether CCP §2019.210 applies in federal cases involving claims under California's Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11). See *Hilderman v Enea Teksci, Inc.* (SD Cal, Jan. 8, 2010, No. 05cv1049 BTM) 2010 US Dist Lexis 1527, *5. In *Computer Econs., Inc. v Gartner Group, Inc.* (SD Cal 1999) 50 F Supp 2d 980, the trial court held that CCP §2019(d) (subsequently renumbered to CCP §2019.210) does not conflict with the relevant discovery provisions of the Federal Rules of Civil Procedure. Moreover, applying the California statute would discourage forum shopping. Observing that the primary reason for enactment of the California statute was to "curb and deter plaintiffs from asserting unsupported trade secret claims" (50 F Supp 2d at 988), the court cited three other reasons, derived largely from non-California authority, for requiring a plaintiff to identify its trade secrets with some particularity: (1) it prevents plaintiffs from using the discovery process as a means to obtain the defendant's trade secrets; (2) it assists the court in framing the appropriate scope of discovery; and (3) it allows the accused party to formulate thoughtful defenses. 50 F Supp 2d at 985. See also *Callaway Golf Co. v Dunlop Slazenger Group Am., Inc.* (D Del 2004) 318 F Supp 2d 205 (applying California law).

However, the Eastern District of California, in *Funcat Leisure Craft, Inc. v Johnson Outdoors, Inc.* (ED Cal, Jan. 29, 2007, No. S-06-0533 GEB GGH) 2007 US Dist Lexis 8870, refused to apply §2019.210. The *Funcat* court noted that the applicability of §2019.210 in federal courts had not been determined and cited several decisions that discussed the applicability of §2019.210 in federal court. The *Funcat* court held that §2019.210 had no application in federal court because it was a procedural rather than a substantive rule. See also *Hilderman,* 2010 US Dist Lexis at *6 (§2019.210 conflicts with Fed R Civ P 26); *Proven Methods Seminars, LLC v American Grants & Affordable Hous. Inst.* (ED Cal, Jan. 31, 2008, No. S-07-1588 WBS EFB) 2008 US Dist Lexis 10714 (agreeing with reasoning in *Funcat* and finding §2019.210 to be state rule of civil procedure inapplicable in federal court).

The federal courts may also apply circuit common law to the identification question. In *Imax Corp. v Cinema Technols., Inc.* (9th Cir 1998) 152 F3d 1161, decided a year before *Gartner Group,* the Ninth Circuit granted summary judgment against a plaintiff that had failed to identify with precision the allegedly secret tolerances and dimensions of a movie projection system. The court stated that the plaintiff should "describe the subject matter of the trade secret with sufficient particularity to separate it from matters of general knowledge in the trade or of special knowledge of those persons … skilled in the trade." 152 F3d at 1164.

A number of other federal cases have emphasized the need for a plaintiff to define its secrets. See, *e.g., Leucadia Inc. v Applied Extrusion Technols., Inc.* (D Del 1991) 755 F Supp 635, 637 (scope of discovery); *AMP, Inc. v Fleischhacker* (7th Cir 1987) 823 F2d 1199, 1203 (injunction). Sometimes, however, the federal courts seem to confuse the standards for trade secrets with those of patents, and they apply an inappropriately restrictive view of what qualifies as a trade secret. See, *e.g., Struthers Scientific & Int'l Corp. v General Foods Corp.* (D Del 1970) 51 FRD 149, 153 (stating incorrectly that claimed trade secret must provide "a valuable contribution differing materially from other methods taught by the prior art"). In other cases, a very general form of description has been found acceptable. See, *e.g., Roton Barrier, Inc. v Stanley Works* (Fed Cir 1996) 79 F3d 1112, 1117, aff'd without opinion (Fed Cir 1997) 108 F3d 1394 (sufficient to identify "areas" of technology).

NOTE: The process of determining the level of disclosure that is considered "reasonable" can bog down litigation with a series of defense motions directed at the sufficiency of the plaintiff's description in the complaint. The issue can arise again later, as the defendant employs interrogatories and other discovery means to draw boundaries on what will be claimed at trial.

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§11.23 3. Identification Strategies

The cases indicate that counsel should adopt a flexible approach in identifying the trade secret—one that attempts to strike a balance between a plaintiff's right to protect its trade secrets and a defendant's right to be free from the burdens associated with unsupported trade secret claims. This approach considers the following:

- The nature of the secret involved. Most trade secrets can be identified in detail, but some categories of information are more easily identified than others. A formula can be precisely stated, while a body of research cannot. Technical information such as software code can be identified in a number of ways, some more detailed than others. With software, should the plaintiff merely identify the files, algorithms, and the like alleged to be secret, or should it set forth the actual code claimed as secret? Other categories of information, such as customer lists, do not give rise to such issues—there is no middle ground between identifying a customer and not making such an identification.

- How close the information is to personal skill (the closer, the more particularity required).

- The manner of identification. Parties often reach agreement on the manner by which the plaintiff will identify its alleged secrets under CCP §2019.210, such as by a Person Most Knowledgeable deposition, a written statement, or some combination of the two.

- The stage of the litigation (more specificity may be required later in the case).

- The possible need for amendment. There is a conflict in the case law concerning the plaintiff's ability to amend its CCP §2019.210 statement. Compare *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 51 n16, 6 CR2d 602 (plaintiff may change the trade secret description up to the time of trial), with *Perlan Therapeutics, Inc. v Superior Court* (2009) 178 CA4th 1333, 1350, 101 CR3d 211 (statement may be amended only on showing of good cause if, through discovery, plaintiff uncovers information suggesting defendants misappropriated additional trade secrets).

- Whether an injunction is to be entered (see *E.W. Bliss Co. v Struthers-Dunn, Inc.* (8th Cir 1969) 408 F2d 1108, 1114).

- The extent to which the information may be in the exclusive possession of the defendant (*e.g.,* a departed employee suspected of having concealed inventions that should have been assigned to the former employer). In most cases, the plaintiff's ability to identify its alleged secrets does not depend on information from the defendant. If a plaintiff alleges that a former employee did not properly assign an invention, however, a different standard may apply.

- The effect of UTSA preemption. Preemption under CCP §3426.7 can include claims for breach of duty of confidence (*K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247), conversion (*MDTV Med. News, Inc. v Weinstock* (SD Cal, Feb. 6, 2007, No. 03CV371-BEN) 2007 US Dist Lexis 8806), unfair competition (*K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc. supra*), unjust enrichment, and intentional interference with contractual relations (*Airdefense, Inc. v Airtight Networks, Inc.* (ND Cal, July 26, 2006, No. C 05-04615JF) 2006 US Dist Lexis 55364) if the same facts support all claims. California's UTSA preempts common law trade secret misappropriation. *AccuImage Diagnostics Corp. v Terarecon, Inc.* (ND Cal 2003) 260 F Supp 2d 941, 955. Accordingly, plaintiffs may not be able to avoid CCP §2019.210 by pleading alternative claims such as common law misappropriation or unfair competition when the claims are "based on the same nucleus of facts as trade secret misappropriation." See *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 232, 109 CR3d 27.

PRACTICE TIP: A plaintiff in a trade secret action should prepare a separate CCP §2019.210 statement when filing the complaint and refer to it (without attaching it) in the complaint if the description might reveal some of the substance of the claimed trade secrets. Pursuant to stipulation or court order, such a statement can be provided to opposing counsel under appropriate obligations of confidentiality. A plaintiff seeking an injunction should provide a specific and detailed statement to assure the court that the information at issue is not in the public domain.

PRACTICE TIP: Obtaining a precise identification of alleged secrets is crucial for a defendant. A defendant should examine the plaintiff's §2019.210 statement critically for compliance. On receiving a §2019.210 statement that does not identify each alleged secret, a defendant should immediately serve an interrogatory on the plaintiff requesting a precise and detailed identification of each alleged secret. If meet-and-confer efforts are unsuccessful, the defendant should consider moving to compel a more specific statement and to request a protective order that the plaintiff be barred from taking its discovery until the court has found compliance with §2019.210.

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§11.24 4. Effect of Failure to Identify

Plaintiffs that fail to identify trade secrets with reasonable specificity during motions, discovery, or trial risk being denied injunctive relief. See *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511, 522 (applying UTSA). See also §12.8. Moreover, at least one court has found bad faith under CC §3426.4 for a plaintiff's repeated failure to identify its alleged secrets, coupled with other factors. See *Computer Economics, Inc. v Gartner Group, Inc, supra*. For further discussion of the issue of bad faith, see §11.2. Similarly, refusing to produce information on the grounds that the information is secure can lead to sanctions when the information contains no secrets. *Australian Gold, Inc. v Hatfield* (10th Cir 2006) 436 F3d 1228, 1245 (list of distributors supplying product was not secret, so sanctions were appropriate for refusing to disclose distributors). Other consequences for failing to comply with CCP §2019.210 include restrictions on discovery and even the granting of summary judgment against the trade secret plaintiff. See *Pixion, Inc. v Placeware Inc.* (ND Cal 2005) 421 F Supp 2d 1233 (trade secret misappropriation plaintiff was bound by its description of secrets in pretrial disclosure statement and could not assert additional details in response to defendant's summary judgment motion; plaintiff had previously resisted defendant's objections to adequacy of disclosure statement). See also *Imax Corp. v Cinema Technols., Inc.* (9th Cir 1998) 152 F3d 1161 (affirming summary judgment against trade secret plaintiff based on its failure to designate trade secrets with sufficient specificity).

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§11.25 D. Discovery Schedules or Plans

Often, when an established business is accusing a newly formed competitor of misappropriating trade secrets, the new competitor may lack the financial resources to conduct extensive and expensive discovery. Discovery then becomes a tool for a plaintiff to either win the lawsuit or drive the new company out of business.

One of the few ways to limit discovery is to have the court impose a limiting discovery plan. Some courts are willing to consider creative discovery procedures in an attempt to resolve trade secret litigation efficiently. See *Klein v King* (ND Cal 1990) 132 FRD 525. For example, in a customer list case, discovery from the defendant was limited to customers who were formerly plaintiff's customers. *Nalco Chem. Co. v Hydro Technols., Inc.* (ED Wis 1993) 149 FRD 686, 696 (applying Wisconsin UTSA).

Discovery of electronically stored or transmitted information creates a variety of issues, most of which are not unique to trade secret litigation. Under Fed R Civ P 26(a), the parties must address the exchange of electronically stored information for the initial conference with the court. Fed R Civ P 26(f). The cost allocation for obtaining electronic information from parties and third parties will vary with the particular facts. See *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72 (parties share costs).

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.26 E. Party and Nonparty Discovery

§11.26 E. Party and Nonparty Discovery

Trade secret information, even a third party's, is not automatically immune from discovery, as long as the court enters a suitable protective order. *Upjohn Co. v Hygieia Biological Labs.* (ED Cal 1993) 151 FRD 355, 358 (discovery compelled from third party). See §11.20 on protective orders. Once a person establishes that the requested information is a secret and that its disclosure would be harmful, the burden shifts to the party seeking discovery to establish that the disclosure is relevant and necessary to the action. *In re Worlds of Wonder Secs. Litig.* (ND Cal 1992) 147 FRD 214, 216. In *Worlds of Wonder,* a third party was asked to disclose its audit manuals to competitors to establish the industry standards used by the third party. The court denied the discovery request because disclosure to competitors would probably be harmful. See also *Citizens of Humanity, LLC v Costco Wholesale Corp.* (2009) 171 CA4th 1, 13, 89 CR3d 455. But see *Official Unsecured Creditors Comm. of Media Vision Technol. v Jain* (ND Cal 2003) 215 FRD 587 (audit manual was discoverable because, even assuming it was trade secret, disclosure would not be harmful; manual was almost 10 years old and only limited disclosure was sought).

In most states, a privilege exists not to disclose secret information. In federal court, Fed R Civ P 26(c) provides an enforcement mechanism for this principle through protective orders. In practice, this privilege is usually easily overcome, especially with respect to the parties to the litigation. However, this is not always the case. In *Bridgestone Ams. Holding, Inc. v Mayberry* (Ind 2007) 878 NE2d 189, a case involving products liability, the defendant was a tire manufacturer that refused to produce a rubber formula in its possession. The *Bridgestone* court applied a three-factor test to determine whether disclosure was required: (1) Is the information a trade secret; (2) Is the information necessary to the requesting party's case; and (3) Does the "balance of interests" favor production? The first factor is satisfied by a prima facie showing. The second factor requires the requesting party to show that "suitable substitutes" for the information are "completely lacking." In *Bridgestone,* the court found that the defendant had carried its burden under the first factor, and that the plaintiff could not satisfy its burden under the second factor. Production was denied. This multistep test was also applied in *Pincheira v Allstate Ins. Co.* (NM App 2007) 164 P3d 982, 993, aff'd (NM 2008) 190 P3d 322. The *Pincheira* court noted that the multistep test is less stringent in state courts, where good cause is usually presumed from establishing secrecy. In federal courts, the party resisting discovery must usually show specific, serious harm under Rule 26.

Discovery will be denied unless both relevance and necessity are established. *American Standard, Inc. v Pfizer, Inc.* (Fed Cir 1987) 828 F2d 734, 743. Objections to discovery can also be based on relevance and overbreadth. See Fed R Civ P 26(a)-(c); *Cacique Co. v Robert Reiser & Co.* (9th Cir 1999) 169 F3d 619, 623 (if plaintiff's damage theory untenable as matter of law, evidence to support it is irrelevant and not discoverable); *B&H Mfg. v Owens-Illinois Glass Container, Inc.* (ED Cal, Dec. 8, 1989, No. CVF-89-252) 1989 US Dist Lexis 17538 (disclosure compelled under stipulated protective order).

PRACTICE TIP: Counsel should be very careful when drafting written discovery in a trade secret matter. One federal judge has held that use of the terms "relating to," "pertaining to," or "concerning" in a document request under Fed R Civ P 34 can render the request objectionable. *In re Urethane Antitrust Litig.* (D Kan, Jan. 8, 2008, No. 04-MD-1616-JWL-DJW) 2008 US Dist Lexis 1733. These terms are commonly used when drafting discovery, both in the trade secret context and in litigation in general.

The owner of a trade secret, or the owner's agent, has the privilege of refusing to disclose the secret if "the allowance of the privilege will not tend to conceal fraud or otherwise work injustice." Evid C §1060. This section also applies when misappropriation is not involved, as when the trade secret is collateral to the main legal issues. *Bridgestone/Firestone, Inc. v Superior Court* (1992) 7 CA4th 1384, 1397, 9 CR2d 709 (formulas for making tires in product defect suit). *Firestone* cited with approval *Willson v Superior Court* (1924) 66 CA 275, 225 P 881. In *Willson,* an employee was injured by a flare that exploded when he attempted to use it. In response to the plaintiff's request for the substances that made up the flare, the defendant refused, claiming that it was a trade secret. The *Willson* court stated (66 CA at 280):

No man is entitled to be protected in his property right to a trade secret where, by the exercise of such right, he has wrought an injury to another and the disclosure of such secret is indispensable to the ascertainment of the truth and the ultimate determination of the civil rights of the parties.

The party claiming the Evid C §1060 privilege has the burden of establishing its existence, while the party seeking discovery of the secret information must make a prima facie case showing that the information is relevant and necessary to the proof of, or defense against, a material element of at least one cause of action, and that it is reasonable to conclude that the information is essential to a fair resolution of the case. A party seeking to avoid disclosure has the burden of showing that any proposed alternatives to disclosure will not be unduly burdensome and will maintain the same fair balance that would be achieved by disclosing the trade secret. *Bridgestone/Firestone, Inc. v Superior Court*, *supra* (movant failed to show that formulas were necessary); *Upjohn Co. v Hygieia Biological Labs.*, *supra* (applying §1060 on basis of diversity jurisdiction and Fed R Evid 501). See also *Stadish v Superior Court* (1999) 71 CA4th 1130, 1141 n10, 84 CR2d 350, suggesting that the process for determining preliminary questions of trade secrecy in a criminal action should be employed in civil actions as well.

Discovery of electronic information from third party e-mail providers may also conflict with the Electronic Communications Privacy Act (18 USC §§2510-2522 and 2701-2712). See *O'Grady v Superior Court* (2006) 139 CA4th 1423, 1451, 44 CR3d 72 (quashing subpoenas to produce e-mails stored on servers or to identify senders and recipients of e-mails).

PRACTICE TIP: Before seeking formal discovery from a nonparty, counsel should consider the potential hostility of the witness, the ill will that is likely to be caused, the financial cost, and the potential value or harm of the discovery. Counsel should begin any third party discovery very early because motions can delay completion of discovery beyond the discovery cutoff dates.

An order denying discovery from a third party is immediately appealable in federal courts. *American Standard, Inc. v Pfizer, Inc.* (Fed Cir 1987) 828 F2d 734, 739. However, an order to compel discovery of trade secrets from a nonparty is interlocutory and not immediately appealable as a collateral order. *MDK, Inc. v Mike's Train House, Inc.* (4th Cir 1994) 27 F3d 116, cert denied (1994) 513 US 1000. Relief is available by a writ of mandate if the court abuses its discretion by ordering discovery that is too broad or offers inadequate protection. *Hartley Pen Co. v U.S. Dist. Court* (9th Cir 1961) 287 F2d 324, 327 (writ issued to reverse order to compel); *Hoffmann Corp. v Superior Court* (1985) 172 CA3d 357, 362, 218 CR 355 (overturning order to produce entire customer list so plaintiff could send letter asking about safety issues). Review is also available through a finding of contempt for refusing to comply with an order to disclose the trade secret. See *Hartley Pen Co.,* 287 F2d at 329.

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§11.27 F. Employee Interviews

Ex parte communications with a former employee of an opposing party do not violate Cal Rules of Prof Cond 2-100 (a communication with a party represented by counsel), but such communications with a current employee may violate the rule in some circumstances. See *State Farm Fire & Cas. Co. v Superior Court* (1997) 54 CA4th 625, 652, 62 CR2d 834 (counsel may meet ex parte with former employees of corporate client, even if they were managerial employees, but can inquire only about facts, not privileged communications); *Continental Ins. Co. v Superior Court* (1995) 32 CA4th 94, 117, 37 CR2d 843. For a review of ethical pitfalls and suggestions for avoiding them, see *Snider v Superior Court* (2003) 113 CA4th 1187, 7 CR3d 119 (reversing trial court's order disqualifying lawyer for contact with employees).

Whether an attorney's questions or instructions to a witness are privileged depends on the specific facts. Under California law, attorney conversations with a former corporate employee about ongoing litigation are not protected by the attorney-client privilege but are protected by work product privileges under federal law. *Connolly Data Sys. v Victor Technols., Inc.* (SD Cal 1987) 114 FRD 89, 96. Communications between a subsidiary's employee and a parent corporation's attorney are privileged if the employee information is vital to counsel's representation of the parent corporation and if it concerns matters within the scope of employment. *Admiral Ins. Co. v U. S. Dist. Court* (9th Cir 1989) 881 F2d 1486, 1493 n6.

An attorney contacting a party employee should ask at the outset about the employee's status and whether he or she is represented by counsel. *Snider v Superior Court* (2003) 113 CA4th 1187, 1213, 7 CR3d 119 (contact with unrepresented employees permitted if it does not involve communications that would bind or be imputed to employer; contact with officers, directors, and managing agents not permitted). Applicable laws may vary with the particular state where the witness resides, so care must be taken in pretrial investigations.

PRACTICE TIP: It is always safest to assume that counsel's comments to potential witnesses may be discoverable; therefore, counsel should say nothing that he or she would not want repeated in court. If the witness's truthfulness is in doubt, counsel should have a nonattorney witness present to dispute any inaccurate statement that the witness may attribute to counsel.

WARNING: When dealing with ex-employees of the opposing party, counsel should take care not to receive any information properly covered by the employee's nondisclosure obligations.

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§11.28 G. Standing: Ownership of Trade Secrets

In most cases, the plaintiff owns the information it contends was misappropriated. If an employee compiles information amounting to trade secrets during the course of his or her employment, the employee does not own the information, even when he or she collects the information through application of his or her knowledge and skill and restricts access to it by other employees. *Northern Elec. Co. v Torma* (Ind App 2004) 819 NE2d 417, 422 (automobile repair information compiled by employee of auto repair shop was owned by employer; employee was enjoined from using information at new shop). In *Hicklin Eng'g L.C. v Bartell* (7th Cir 2006) 439 F3d 346, 349, the court found that a company presumptively owns information developed by the company, such that an independent contractor may use that information only with consent of the company. Thus, a contractor's use of secret information on car transmissions in his competing business could constitute misappropriation.

In some cases, however, the defendant can prove that the plaintiff is not the owner of the alleged trade secrets and thus lacks standing to assert the claim. This can occur if the plaintiff has sold the information to a third party, or if it never owned the information at all. Discovery focused on ownership is therefore an important issue in some cases. See *Omnitech Int'l, Inc. v Clorox Co*. (5th Cir 1994) 11 F3d 1316, 1323 (plaintiff did not own alleged secrets); *SI Handling Sys., Inc. v Heisley* (3d Cir 1985) 753 F2d 1244, 1257 (plaintiff improperly claimed secrets in third party vendor's pricing information). But see *Jasmine Networks, Inc. v Superior Court (Marvell Semiconductor, Inc.)* (2009) 180 CA4th 980, 103 CR3d 426 (plaintiff that sold its rights in trade secrets in bankruptcy while reserving its rights of action for misappropriation commencing before date of transfer had standing to sue for misappropriation).

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§11.29 H. Estoppel

Sometimes a party will sign a nondisclosure agreement stating that certain information is a trade secret. That party is not estopped from contesting the existence of a trade secret if it had no knowledge of whether the information was actually a trade secret when the agreement was signed, but the party can possibly be estopped if it developed the secret or otherwise knowingly acknowledged the trade secret. *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1530 (applying Colorado law on equitable estoppel).

If the definition of the trade secret is narrowed during litigation to sustain the trade secret claims, then the owner is estopped from broadening that definition when the court considers the scope of relief. *American Can Co. v Mansukhani* (7th Cir 1984) 742 F2d 314, 330; *Stutz Motor Car of Am. v Reebok Int'l* (CD Cal 1995) 909 F Supp 1353, 1360, aff'd (Fed Cir 1997) 113 F3d 1258. There is authority that trade secret claims may be amended during litigation. *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 51 n16, 6 CR2d 602 (plaintiff's original notice identifying trade secret amended several times after discovery commenced). But see *Perlan Therapeutics, Inc. v Superior Court* (2009) 178 CA4th 1333, 1350, 101 CR3d 211 (trade secret statement may be amended only on showing of good cause if, through discovery, plaintiff uncovers information suggesting defendants misappropriated additional trade secrets). See §11.20.

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I. Testimony and Litigation Privileges

§11.30 1. Testimony Privilege (CC §47)

Trade secret information is excluded from the statutory testimony privilege except in certain circumstances, such as involuntary disclosure under a court-authorized process (deposition) or a disclosure with permission of the trade secret owner. CC §47(b). To put the exclusion in perspective, counsel should understand that protection under CC §47(b) is normally granted to attorneys, jurors, witnesses, and other court personnel from liability arising from publications made during judicial proceedings. The privilege generally applies to quasi-judicial activities such as arbitration, to pretrial activities, and sometimes to prelitigation events. See *Silberg v Anderson* (1990) 50 C3d 205, 212, 266 CR 638. The usual formulation is that the privilege applies to any communication (1) made in judicial or quasi-judicial proceedings; (2) by litigants or other participants authorized by law; (3) to achieve the objects of the litigation; and (4) that has some connection or logical relation to the action. *Rusheen v Cohen* (2006) 37 C4th 1048, 1057, 39 CR3d 516 (quoting *Silberg*). In addition, the privilege may apply to postlitigation events, such as actions to collect a judgment, including obtaining a writ of execution and levying on a judgment debtor's property. In *Rusheen v Cohen, supra,* the California Supreme Court granted review to resolve a conflict as to the extent of the litigation privilege. See *Brown v Kennard* (2001) 94 CA4th 40, 50, 113 CR2d 891 (privilege protects both process of applying for writ of execution and levy on judgment debtor's property, as act of carrying out writ); *Drum v Bleau, Fox & Assocs.* (2003) 107 CA4th 1009, 1028, 132 CR2d 602 (although privilege protects application for writ of execution, it does not extend to "subsequent, noncommunicative acts" in levying on property). The *Rusheen* court followed *Drum,* concluding that, when the cause of action is based on a communicative act, the litigation privilege extends to those noncommunicative actions that are necessarily related to that communicative act. For example, when a claim for abuse of process is based on the communicative act of filing allegedly false declarations of service to obtain a default judgment, the postjudgment enforcement efforts, including the application for writ of execution and the act of levying on property, are protected by the litigation privilege. *Rusheen,* 37 C4th at 1057.

This privilege typically protects witnesses who disclose trade secrets during testimony at trial and in depositions from being sued for tortious disclosure of the trade secrets. It has also insulated individuals reporting alleged criminal theft of trade secrets to the police from liability, and it protected communications assisting the police in investigating those thefts. *Forro Precision, Inc. v International Bus. Mach. Corp.* (9th Cir 1982) 673 F2d 1045, 1056 (reversing finding of interference with business advantage by using police investigation to create adverse publicity).

To come within the litigation privilege of CC §47(b), a communication "must have some relation to an imminent lawsuit or judicial proceeding which is actually contemplated seriously and in good faith to resolve a dispute, and not simply as a tactical ploy to negotiate a bargain." *Edwards v Centex Real Estate Corp.* (1997) 53 CA4th 15, 36, 61 CR2d 518. It does not shield communications among potential defendants who fear potential litigation from information they had but the potential plaintiffs did not.

The statute also provides that a "fair and true" account of litigation made in a press release or other communication to the press is privileged, unless it (1) violates Cal Rules of Prof Cond 5-120, (2) breaches a court order, or (3) violates any confidentiality requirement imposed by law. CC §47(d).

The litigation privilege is limited to parties and witnesses. Nonlitigants and nonparticipants to judicial proceedings are not protected from liability. Thus, a consumer agency selling landlords reports on tenants involved in wrongful detainer actions can be sued by a tenant who claims the reports are misleading. *Schoendorf v U.D. Registry, Inc.* (2002) 97 CA4th 227, 243, 118 CR2d 313.

The litigation privilege of CC §47 was amended as of January 1, 2003, to make privileged communications by a current or previous employer to a prospective employer regarding whether the first employer would rehire a current or former employee. See CC §47(c).

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§11.30A 2. Trade Secret Exception to Testimony Privilege (CC §3426.11)

Civil Code §3426.11 excepts from the testimony privilege of CC §47(b) any "voluntary, intentional disclosure of trade secret information, unauthorized by its owner, to a competitor or potential competitor of the owner of the trade secret." Any unauthorized disclosure to the agent or representative of a current or potential competitor is also not privileged. These limitations on the privilege are not intended to limit the court's authority to control, order, or permit access to evidence in a pending suit. CC §3426.11.

Thus, a witness is immune from legal action for disclosing trade secrets only if a court orders testimony or authorizes discovery. Because the statutory phrasing implies that a case must be pending for the §47(b) privilege to apply, any prefiling exploration of trade secret matters from present or former employees may not be privileged. Further, the privilege may not apply to informal discovery during the lawsuit. Thus, although counsel may be able to contact witnesses and ask about trade secret matters, any disclosure of trade secrets by witnesses may not be privileged unless it is made during a lawsuit and under court-sanctioned discovery procedures. See §11.37.

WARNING: Because the litigation privilege is limited, counsel should be careful in conducting both prelitigation discovery and informal pretrial discovery.

There is an express exception in CC §3426.11 clarifying that employees of public entities are privileged to report improper government activity, and an exception clarifying that private persons can report improper activities of private businesses. In a case implicating related issues under Evid C §1060, but not mentioning either CC §47 or §3426.11, there was no "whistleblower" privilege protecting the identity of a corporate employee who sent confidential information to a party suing the corporation for sexual harassment, because the employee was not a true whistleblower and because there was no privilege. *Gonzalez v Superior Court* (1995) 33 CA4th 1539, 1547, 39 CR2d 896. Similarly, the privilege applies to litigants and persons providing information to government agencies who investigate and remedy wrongdoing, but does not protect unauthorized disclosures by nonlitigants. Thus, a drugstore that provided information to a spouse who used the information in a custody dispute was liable in tort for unauthorized disclosure of private information held by the drugstore. *Wise v Thrifty Payless, Inc.* (2000) 83 CA4th 1296, 1307, 100 CR2d 437.

Most quasi-judicial administrative proceedings are within CC §3426.11 because the statute encompasses legislative proceedings and any other official proceeding either authorized by law or reviewable under CCP §§1084-1097. Because no reported cases discuss the limitation imposed by CC §3426.11, the boundaries of the privilege in trade secret cases have not been tested.

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§11.30B 3. Advice of Counsel

Sometimes, as a defense to willful misappropriation, a party will assert that it relied on advice of counsel. This defense may waive a number of privileges seldom addressed in the trade secret context. The issue has been addressed in the patent context, in a case where disclosure was found to have waived the attorney-client and work product privileges except for work product never communicated to the client and not reflected in communications to the client. *In re Echostar Communications Corp.* (Fed Cir 2006) 448 F3d 1294, 1304, cert denied (2006) 549 US 1096. Using redaction and in camera review, the court in *Echostar* balanced privilege, immunity, and waiver policies to prevent a party from using privilege and immunity to shield adverse communications while waiving them to create a sword against willful infringement. See also *V. Mane Fils, S.A. v International Flavors & Fragrances Inc.* (D NJ, July 1, 2009, No. 06-2304) 2009 US Dist Lexis 56462.

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§11.30C 4. Anti-SLAPP Claims (CCP §425.16(e)(2))

Statements regarding litigation that are not privileged may subject the declarant to claims of defamation or trade libel. An anti-SLAPP claim can arise, however, if those statements are privileged or fall within the "protected activity" of CCP §425.16(e)(2). The litigation privilege under CC §47 is not coextensive with the broader definition of protected activity under CCP §425.16(e)(2). *Neville v Chudacoff* (2008) 160 CA4th 1255, 1261, 73 CR3d 383 (affirming anti-SLAPP dismissal of defamation claims based on prelitigation letters notifying customers of fired employee's alleged misappropriation).

PRACTICE TIP: If either party publishes allegations to the trade, customers, or employers before or during litigation, be careful in asserting any defamation claims because they may be related to First Amendment rights. The anti-SLAPP statute protects comments relating to "any written or oral statement or writing made in connection with an issue under consideration or review by a legislative, executive, or judicial body." CCP §425.16(e)(2). Evaluate the outcome of a potential anti-SLAPP suit before alleging any defamation claims.

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§11.30D 5. California Reporter's Shield Law (Cal Const art I, §2(b), Evid C §1070(a))

In *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72, Apple Computer, Inc. (Apple) sued several "Doe" defendants for misappropriation of trade secrets after their online publication of proprietary information about a new and yet unreleased Apple product. O'Grady and another individual were the publishers of online news magazines in which articles about the new product were posted. Denying the publishers' motion for a protective order, the trial court (see *Apple Computer, Inc. v Doe* (Cal Super, Mar 11, 2005, No. 1-04-CV-032178) 74 USPQ2d 1191) allowed Apple to subpoena the publishers' Internet hosting services for purposes of identifying the defendants who had disclosed Apple's trade secrets. The trial court ruled that, despite the California reporter's shield law (see Cal Const art I, §2(b) and Evid C §1070(a)), the defendants' identity was not protected from discovery because, in the trial court's view, they had stolen Apple's trade secrets and there was no exception in the Uniform Trade Secrets Act or the Penal Code to protect journalists.

The court of appeal overturned the trial court's ruling, holding that the federal Stored Communications Act (SCA) (18 USC §§2701-2712) prohibited disclosure of the information sought, and there was no exception for civil discovery. The court found that Apple was seeking the contents of private messages stored on the hosts' servers, and disclosure would have violated the SCA. The court also found that the petitioners were protected by Cal Const art I, §2(b) and Evid C §1070(a), the California reporter's shield law, and by the privilege enjoyed by a free press to safeguard the identity of confidential sources. Applying the factors in *Mitchell v Superior Court* (1984) 37 C3d 268, 208 CR 152, the court held that the circumstances favoring disclosure (including Apple's argument that the matter involved theft of trade secrets) were outweighed by countervailing factors, particularly Apple's failure to exhaust alternative sources of the information.

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§11.31 J. Fifth Amendment

The Fifth Amendment typically arises in trade secret litigation in two contexts. First, the Fifth Amendment prohibits an improper taking without just compensation. Such a taking may occur in the context of government taking.

Second, the Fifth Amendment grants a privilege against self-incrimination. This issue arises in criminal trade secret theft contexts. In civil contexts, the self-incrimination privilege offers little protection in federal court, where it is permissible to conduct civil and criminal cases concurrently and where the civil trier of fact can draw adverse inferences from asserting the privilege. *Keating v Office of Thrift Supervision* (9th Cir 1995) 45 F3d 322, 325.

Self-incriminating information cannot be subject to discovery in California lawsuits, even in civil proceedings. Evid C §940. Some courts have coupled this privilege with a defendant's right not to be penalized for asserting the privilege, and stayed civil actions pending completion of pending criminal actions. See, *e.g.*, *Pacers, Inc. v Superior Court* (1984) 162 CA3d 686, 690, 208 CR 743. When a plaintiff seeking affirmative relief also asserts the privilege, courts are unsympathetic and in appropriate circumstances may strike the complaint. See *Alvarez v Sanchez* (1984) 158 CA3d 709, 712, 204 CR 864.

PRACTICE TIP: Counsel should decide how criminal prosecution will affect counsel's civil case before asking the district attorney to consider pursuing criminal charges for theft of trade secrets.

The Fifth Amendment privilege is personal and protects the individual from compulsory incrimination; it does not extend to business documents or records. *Bellis v U.S.* (1974) 417 US 85, 89, 40 L Ed 2d 678, 685, 94 S Ct 2179; *Craib v Bulmash* (1989) 49 C3d 475, 486 n13, 261 CR 686. Determining the scope of the privilege can be complex, because the mere act of producing documents may be privileged even if the documents' contents are not privileged. 49 C3d at 486 n14. Thus, counsel must be careful in comparing the scope of the privilege with the scope of the information requested.

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§11.32 K. Freedom of Information Act and Other Disclosure Laws

Discovery efforts are not limited to court-assisted discovery. Counsel can explore publicly available information through the Freedom of Information Act (5 USC §552), the California Public Records Act (Govt C §§6250-6270), and other disclosure laws. See chap 5 (discussing use of disclosure law exemptions to prevent disclosure of information submitted to government agencies).

A government regulation requiring businesses to maintain records is not sufficient justification for a government agency to seize the records in a warrantless search under an administrative subpoena, when the agency has not established criteria for issuing such subpoenas, and there is no provision for judicial review before or after the subpoena issues. *De la Cruz v Quackenbush* (2000) 80 CA4th 775, 96 CR2d 92.

Only the persons or entities specifically identified in a FOIA request have standing to appeal an agency's refusal to provide documents. *Mahtesian v U.S. OPM* (ND Cal 2005) 388 F Supp 2d 1047, 1050 (FOIA request by attorney acting for unidentified client conferred standing for client to appeal refusal to produce documents).

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§11.33 V. TRIAL ISSUES

There is a right to trial by jury for misappropriation claims under the UTSA. *Evans v General Motors Corp.* (Conn 2006) 893 A2d 371, 385. To prevail at trial counsel must establish each element of a claim or defense. *Composite Marine Propellers, Inc. v Van Der Woude* (7th Cir 1992) 962 F2d 1263, 1267 (jury's verdict not supported by proof of trade secret existence or by infringer's use); *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 12 CR2d 741 (defects in evidence of reasonable royalty and unjust enrichment; submitting equitable defense of unjust enrichment to jury was harmless).

If alternative claims are pleaded, the damage request must be reconcilable with any special verdicts, usually through special interrogatories for each claim. See *Cool Light Co. v GTE Prods. Corp.* (1st Cir 1992) 973 F2d 31, 35.

Counsel should identify any issues that the judge should decide and verify that they are not inadvertently decided by the jury. *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 621, 12 CR2d 741 (unclean hands decided by jury; trial court has discretion to submit equitable defenses to jury); *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 54, 6 CR2d 602 (court has discretion to award attorney fees based on trade secret claims, but fees awarded under third party tortfeasor claim should have gone to jury).

A party has the burden of proof as to each fact the existence or nonexistence of which is essential to the claim the party is asserting. Evid C §500. Thus, to prove misappropriation of a trade secret under the UTSA, a plaintiff must show (among other things) that the defendant used the plaintiff's trade secret. On the elements of a claim of misappropriation under the UTSA, see §1.11. The plaintiff bears the burden of proof on the issue of the defendant's use of the plaintiff's trade secret. The defendant bears the burden of proof on new matter and affirmative defenses. However, reverse engineering and independent derivation are neither affirmative defenses nor new matter. *Sargent Fletcher, Inc. v Able Corp.* (2003) 110 CA4th 1658, 1669, 3 CR3d 279. Thus, a trial court correctly refused a plaintiff's proposed instruction that placed the burden of proof on the defendant to prove that it properly used the plaintiff's product because it only reverse engineered the product and did not misappropriate it. *Sargent Fletcher, Inc. v Able Corp., supra.*

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.33A A. Experts and Special Masters

§11.33A A. Experts and Special Masters

Experts: Both plaintiffs and defendants in trade secret cases typically retain experts pursuant to stipulated protective orders early in the case. Experts are often called upon to opine on whether or not information constitutes a trade secret, often with extensive citations to and discussions of both parties' technology and public domain material.

A federal court has discretion to exclude partisan experts and to allow testimony only from a court-appointed expert. *Syntex Ophthalmics, Inc. v Tsuetaki* (7th Cir 1983) 701 F2d 677, 684. To gain access to secret information, a designated expert may be required to relinquish nonlitigation consulting duties for the hiring party and agree to forgo such duties in the future. *Digital Equip. Corp. v Micro Tech.* (D Colo 1992) 142 FRD 488, 491.

In federal court, "all communications from counsel to a testifying expert that relate to the subjects about which the expert will testify are discoverable." *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1991) 139 FRD 384, 397. Counsel should adequately investigate a witness's background to uncover prior contacts by which the witness potentially acquired confidential information from the opposing party; failure to do so can lead to motions to exclude the witness or to disqualify counsel. See *Teleconnect Co. v Ensrud* (8th Cir 1995) 55 F3d 357 (applying Iowa UTSA).

Careful witness preparation is especially important if an expert is testifying in two related suits for different parties. In *McGinty v Superior Court* (1994) 26 CA4th 204, 31 CR2d 292, an expert in two cases disclosed confidential information in violation of a protective order in one case. On a peremptory writ, the court decided that because the information was discoverable and because disqualifying the expert would effectively dismiss the plaintiff's case, the expert could testify at trial.

Expert testimony can be rejected or limited in cases in which the expert opines on trade secrecy without having first canvassed the public domain. In *Atmel Corp. v Information Storage* (ND Cal 1999) 189 FRD 410, 416, rev'd on other grounds (Fed Cir 1999) 198 F3d 1374, the court limited an expert to testifying merely to his own personal knowledge because he had failed to review public domain source material and ignored published material submitted by the defense. In *Mike's Train House, Inc. v Lionel, LLC* (6th Cir 2006) 472 F3d 398, 409, expert testimony improperly relied on independently created and untested criteria for identifying similarities in drawings used to support a conclusion of copying and trade secret misappropriation, especially as some criteria (drawing number, part number, part name) were commonly used in Korea where the drawings were created. Further, an expert is precluded from testifying about the similarity of his or her conclusions with those of another (nontestifying) witness whose opinion was not admitted into evidence. Fed R Evid 703.

WARNING: If an expert creates fraudulent documents to support his or her testimony, the litigation privilege of CC §47 does not insulate the expert from a later suit for damages. *Mattco Forge v Arthur Young & Co.* (1992) 5 CA4th 392, 404, 6 CR2d 781.

Special masters: The comments accompanying the Uniform Act suggest disclosing the trade secrets to a special master who can report conclusions to the court. Commissioners' Comments to Uniform Act §5. In appropriate cases, a federal court may appoint either an expert or a special master. See Fed R Civ P 53; *Lee Pharms. v Den-Mat, Inc.* (CD Cal 1976) 197 USPQ 62 (special master to ascertain what secrets were at issue). The court decides the duties of the special master, and any objections to the master not raised are waived. *Johnson Controls, Inc. v Phoenix Control Sys.* (9th Cir 1989) 886 F2d 1173, 1176 (copyright case with trade secret claims). A court-appointed expert may be cross-examined, but a special master may not. 886 F2d at 1176. See Fed R Evid §706(a).

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§11.33B B. Motions In Limine

Motions in limine to restrict evidence, especially to eliminate undue prejudice or confusion, are as applicable in trade secret cases as elsewhere. There are no statutory procedures unique to trade secrets. For example, a motion in limine may seek to bar reference to the request for an injunction in a trade secret case because an injunction is an equitable remedy within the court's discretion to grant or deny and is not probative of the merits. See *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1530; *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 51 n16, 6 CR2d 602 (denying motion in limine to limit trade secrets to those initially disclosed under former CCP §2019(d)). Exclusion of evidence under Evid C §352 is reserved for cases where the evidence has little probative value and creates an emotional bias. Emotional bias is essential, but may be difficult to establish in business-oriented trade secret claims. *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 45, 37 CR3d 221 (affirming admission of evidence).

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.33C C. Public Access

§11.33C C. Public Access

The First Amendment grants a right of access to court documents in criminal cases, but the right in civil cases is based in common law and is not absolute. *In re Adobe Sys. Secs. Litig.* (ND Cal 1992) 141 FRD 155, 160. Federal courts are split on the scope of the common law public right of access. Local rules of court may affect the procedure and disposition of requests for access. 141 FRD at 163. The public right of access must be balanced against compelling interests in maintaining the confidentiality of that information and documents. 141 FRD at 163 (affirming protective order); *In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig.* (CD Cal 1984) 101 FRD 34 (ordering disclosure of some documents, but allowing third parties the right to intervene to protect their information). Although proprietary technology and trade secrets are not usually publicly disseminated if trade secret information is relied on in reaching a decision, there is a greater probability of public access. *In re Adobe Sys. Secs. Litig., supra.* Nevertheless, the public access right to judicial records can produce awkward disclosures (see, *e.g., U.S. v Salerno* (2d Cir 1987) 828 F2d 958) or public airing of surreptitiously obtained information (see *CBS, Inc. v Davis* (1994) 510 US 1315, 127 L Ed 2d 358, 114 S Ct 912 (case arose under South Dakota version of UTSA but was decided under First Amendment); *In re Providian Credit Card Cases* (2002) 96 CA4th 292, 116 CR2d 833 (sealed confidential records ordered unsealed)).

The right of access to attend civil trials may be restricted only on articulated findings of an overriding interest that closure is essential to preserve higher values and only if the restriction is narrowly tailored to serve that interest. In a case arising from actor Clint Eastwood's promise to help Sondra Locke's career, it was error to close the portions of the trial during which the jury was absent and to delay releasing the transcripts until the trial was over. *NBC Subsidiary (KNBC-TV), Inc. v Superior Court* (1999) 20 C4th 1178, 1225, 86 CR2d 778.

During trial, trade secret information may be disclosed through testimony or exhibits. The court may limit observer access to the courtroom and may seal pertinent portions of the record to preserve the trade secrets. A posthearing motion to place evidence under seal can suffice. *Gates Rubber Co. v Bando Chem. Indus.* (10th Cir 1993) 9 F3d 823, 848. Disclosing trade secrets in publicly accessible motion papers does not necessarily destroy the trade secrets as long as the papers are later placed under seal and there is no evidence that competitors had access to the papers. *Northwest Airlines v American Airlines* (D Minn 1994) 870 F Supp 1504, 1510. See also *Hoechst Diafoil Co. v Nan Ya Plastics Corp.* (4th Cir 1999) 174 F3d 411, 418. But failure to seek an order sealing the record or to object to the admission of confidential information into evidence can waive all claims of confidentiality. *Littlejohn v BIC Corp.* (3d Cir 1988) 851 F2d 673, 680; *Glaxo Inc. v Novopharm Ltd.* (ED NC 1996) 931 F Supp 1280, 1301, aff'd (Fed Cir 1997) 110 F3d 1562.

PRACTICE TIP: Pretrial protective orders (see §1.20) typically apply only to discovery. In planning for trial, counsel cannot assume that documents and testimony at trial will be sealed from public view—or from access by the opposing party—to the same extent as during discovery. Trade secret protection during trial must therefore be considered as a separate issue.

Merely because the parties stipulate to seal the record does not necessarily ensure that it will remain sealed. The presumption of access to court records prevents a court from sealing its records without a compelling reason and requires the court to "articulate the factual basis for its ruling, without relying on hypothesis or conjecture." *Hagestad v Tragesser* (9th Cir 1995) 49 F3d 1430, 1434. A court cannot delegate the responsibility of establishing good cause for a protective order by authorizing counsel to remove documents that contain trade secrets or other confidential information. *Citizens First Nat'l Bank of Princeton v Cincinnati Ins. Co.* (7th Cir 1999) 178 F3d 943, 944. Because an injunction must be sufficiently definite under Fed R Civ P 65, it may also have to describe trade secrets. Such injunctions can be placed under seal. *Henry Hope X-Ray Prods. v Marron Carrel, Inc.* (9th Cir 1982) 674 F2d 1336, 1343.

PRACTICE TIP: To successfully limit public access to court records containing trade secrets, counsel should make certain that the court's order sealing the record articulates a factual basis for doing so that will allow an appellate court to understand and affirm the sealing of the record.

In state court, there is a First Amendment right of access to civil litigation documents filed in court as a basis for adjudication, but that does not compel public access to discovery materials that are neither used at trial nor submitted as a basis for adjudication. *NBC Subsidiary (KNBC-TV), Inc.,* 20 C4th at 1208 n25. Thus, discovery materials that are not used at trial or submitted as a basis for adjudication may remain sealed. *Mercury Interactive Corp. v Klein* (2007) 158 CA4th 60, 100, 70 CR3d 88 (confidential discovery materials produced under stipulated protective order and attached to complaint were not submitted as "basis for adjudication" and were for further consideration). The ability to seal the appellate record is also uncertain, because a stipulated protective order is not necessarily binding on, or accepted by, the appellate court. *Champion v Superior Court* (1988) 201 CA3d 777, 789, 247 CR 624. The documents containing the confidential information must be filed separately, and a request to seal the appellate record must be filed publicly, and separately. Counsel seeking to maintain the confidentiality of the sealed records must present factual data explaining the particular needs of the case, referring to the sealed documents as needed, and explaining why the appellate court

needs the confidential information. Any confidential portions of the arguments to seal the record should be submitted separately, in a sealed brief. *Champion v Superior Court, supra.*

PRACTICE TIP: For sealing trial and appellate court records in California, counsel must comply with Cal Rules of Ct 2.550-2.551 (trial court) and 8.46 (appellate court). See also Cal Rules of Ct 2.580 (delayed public disclosure), 2.585 (in-camera conference). Notwithstanding these court rules, counsel should attempt to convince the court at an early stage in the litigation that CCP §2025.420 permits the court to enter an appropriate protective order in the trade secrets action so that counsel is not required to submit a motion to seal each time that information protected under the protective order needs to be filed with the court. See CCP §2025.420(b)(13). There is at least some authority that the sealing provisions of Cal Rules of Ct 2.550-2.551 (trial court) may not apply in trade secret actions because of CCP §2025.420. See *In re Providian Credit Card Cases* (2002) 96 CA4th 292, 299, 116 CR2d 833.

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§11.34 VI. POSTRESOLUTION ISSUES

Care must be taken to ensure that the court retains jurisdiction to enforce its order after litigation is concluded. A settlement accompanied by an injunction barring the defendant from disclosing information is enforceable in the issuing court. However, because settlement agreements sometimes provide for confidentiality terms that are different from those in an injunction, the terms of the settlement agreement are not enforceable by the issuing court unless the court retains jurisdiction or unless a settlement agreement is embodied in the dismissal order. See *Kokkonen v Guardian Life Ins. Co. of Am.* (1994) 511 US 375, 381, 128 L Ed 2d 391, 397, 114 S Ct 1673.

If a court's judgment discloses trade secrets or confidential information, then a settlement agreement vacating the judgment may avoid any disclosure of such information. In California, however, this approach is risky because the court must consider the public's interest in vacating any judgment. In general, an appellate court may not reverse or vacate a duly entered judgment on an agreement or stipulation of the parties unless the court concludes the following (CCP §128(a)(8)(A)-(B)):

- There is no reasonable possibility that the interests of nonparties or the public will be adversely affected by the reversal; and
- The reasons of the parties for requesting reversal outweigh the erosion of public trust that may result from the nullification of a judgment and the risk that the availability of stipulated reversal will reduce the incentive for pretrial settlement.

See *Muccianti v Willow Creek Care Ctr.* (2003) 108 CA4th 13, 22, 133 CR2d 1 (motion to vacate judgment denied because requirement of second prong of CCP §128(a)(8)(B) not met, in that vacation of judgment against nursing home might operate to deny public's ability to discover bad acts).

In federal court, the vacatur is not automatic, because "mootness by reason of settlement does not justify vacatur of a judgment under review" by a court of appeals. Vacatur is an equitable determination that may be warranted in "exceptional circumstances." *United States Bancorp Mktg. Co. v Bonner Mall Partnership* (1994) 513 US 18, 29, 130 L Ed 2d 233, 244, 115 S Ct 386. Alternatively, the case may be remanded for the district court's decision. Fed R Civ P 60(b); *United States Bancorp Mktg. Co. v Bonner Mall Partnership, supra*. Although this case reviewed Rule 60(b) motions before appellate courts, several courts have applied the same rationale to motions before district courts. The Ninth Circuit applies a different test that requires district courts to balance equities to determine "whether to vacate its judgment in light of 'the consequences and attendant hardships of dismissal or refusal to dismiss' and 'the competing values of finality of judgment and right to relitigation of unreviewed disputes.'" *In re Aloha Airgroup Inc.* (D Haw, Mar. 9, 2006, Nos. 05-00777 JMS/BMK, 05-00778 JMS/KSC, 05-00779 JMS/BMK) 2006 US Dist Lexis 14713, *8 (quoting *American Games, Inc. v Trade Prods., Inc.* (9th Cir 1998) 142 F3d 1164, 1165).

When trade secrets must be identified in an injunction, counsel should place them in a sealed appendix. *Henry Hope X-Ray Prods. v Marron Carrel, Inc.* (9th Cir 1982) 674 F2d 1336, 1343 (injunctive terms in confidential appendix did not violate Fed R Civ P 65(d)(1) requirement that terms be included in order).

PRACTICE TIP: During settlement negotiations and in drafting dismissal papers, counsel should anticipate unknown or future acts of trade secret misappropriation by the opposing party. In particular, language that releases claims based on misappropriation "known or unknown" should be used cautiously.

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§11.35 VII. CLAIMS NOT BASED ON UTSA

Causes of action alleging the misuse of information have been asserted under a number of different theories analogous to trade secret misappropriation over the decades in California, especially before the UTSA was enacted. The UTSA expressly allows contractual and criminal remedies, whether or not based on trade secret misappropriation, and other civil remedies not based on trade secret misappropriation. CC §3426.7. At the same time, §3426.7 implicitly preempts alternative civil remedies based on trade secret misappropriation. *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025, 1034 ("all state law claims based on the same nucleus of facts as the trade secrets claim are preempted under California's UTSA"). See *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 232, 109 CR3d 27; *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247; *Aversan USA, Inc. v Jones* (ED Cal, June 24, 2009, No. 2:09-cv-00132-MCE-KJM) 2009 US Dist Lexis 53660; *Callaway Golf Co. v Dunlop Slazenger Group Am., Inc.* (D Del 2004) 318 F Supp 2d 205, 219 (applying California law); *AccuImage Diagnostics Corp. v Terarecon, Inc*. (ND Cal 2003) 260 F Supp 2d 941, 953; and the discussion of UTSA preemption in §1.16.

PRACTICE TIP: UTSA preemption is a developing area in trade secret law, particularly in California, and requires special care. A recent decision of the Sixth District Court of Appeal found that the California UTSA preempts claims for breach of confidence, interference with contract, and unfair competition when the claims arise out of the same nucleus of facts as the trade secret misappropriation claims. See *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc., supra*. Another court of appeal found UTSA preemption in *Cypress Semiconductor Corp.,* 163 CA4th at 587. But see *Interserve, Inc. v Fusion Garage PTE, Ltd.* (ND Cal, Apr. 9, 2010, No. C 09-05812 JW) 2010 WL 1445553 (claim for misappropriation of non-trade secret business ideas not preempted by UTSA because misappropriation of business ideas is separate tort in California); *Phoenix Technols. Ltd. v DeviceVM* (ND Cal, Dec. 8, 2009, No. C 09-04697 CW) 2009 US Dist Lexis 114996 (claims for interference with contract, violation of California's Unfair Competition Law, conversion, and constructive trust not preempted by UTSA where they may be based on non-trade secret information; court should not dismiss before determining whether confidential information is trade secret); *Think Village-Kiwi, Inc. v Adobe Sys., Inc.* (ND Cal, Apr. 1, 2009, No. C 08-04166 SI) 2009 US Dist Lexis 32450 (permitting plaintiff to amend complaint to assert common law misappropriation and breach of confidence claims; plaintiff should be allowed to plead alternative theories if court finds allegedly disclosed information both protectible and not trade secret as defined by UTSA); *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 1018, 24 CR3d 720 ("[t]he court may also enjoin the use or disclosure of trade secrets under the unfair competition provisions, particularly [Bus & P C §17203]"); *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1288, 272 CR 352 (even if temporary help agency's customer list would not qualify as "trade secret" under UTSA, unfair and deceptive practices of agency's employees in stealing agency's customers should have been enjoined as unfair competition).

Sections 11.36-11.55 discuss a number of causes of action that have been used either alongside or in place of a trade secret claim to address the misuse of information. For discussion of criminal liability, see chap 13.

PRACTICE TIP: Although it seems obvious, counsel should be aware that although the limitations period in California for many of these claims are given, the periods may vary, depending on which state's law applies and on when the court decides that the limitations period begins to run.

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§11.36 A. Antitrust Violations

A trade secret does not give monopoly power over the secret information. Therefore, the possession of a trade secret by itself does not establish the monopoly power needed for an antitrust claim. See *Chicago Lock Co. v Fanberg* (9th Cir 1982) 676 F2d 400, 405; *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 224, 116 CR 654. Moreover, a trade secret owner's refusal to license its information is not an unlawful restraint of trade. *Intergraph Corp. v Intel Corp.* (Fed Cir 1999) 195 F3d 1346, 1364. However if a company that has market power sues in bad faith for trade secret misappropriation, knowing that there are no trade secrets but having the intent to suppress competition and monopolize product markets, that action may constitute a violation of the Sherman Act (15 USC §1). *CVD, Inc. v Raytheon Co.* (1st Cir 1985) 769 F2d 842, 854. Predatory practices are examined separately rather than cumulatively in evaluating antitrust violations, and failure to establish misappropriation of trade secrets disposes of one basis for antitrust liability. *Universal Analytics, Inc. v MacNeal-Schwendler Corp.* (CD Cal 1989) 707 F Supp 1170, 1176 (no actionable employee raiding or use of trade secrets).

The public interest in stopping anticompetitive practices can alter the interaction of trade secret theories with other legal theories. For example, a party's theft of trade secrets may not constitute unclean hands, which might overshadow equitable principles and otherwise bar a claim for antitrust violations. *Memorex Corp. v International Bus. Mach. Corp.* (9th Cir 1977) 555 F2d 1379, 1382. In this event, the trade secret owner should counterclaim for misappropriation rather than rely on the misappropriator's conduct to equitably bar the antitrust claim. *Memorex Corp. v International Bus. Mach. Corp., supra.*

Antitrust claims have a 4-year statute of limitations. 15 USC §15(b); *Korody-Colyer Corp. v General Motors Corp.* (Fed Cir 1987) 828 F2d 1572, 1573 (appeal from California court); Bus & P C §16750.1.

For discussion of antitrust law and the requisite elements, see California Business Litigation, chap 5 (Cal CEB 2002).

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§11.37 B. Breach of Confidence

The elements of a breach of a duty of confidence are the following:

- An offer by a trade secret owner to disclose secret information in confidence;
- The voluntary acceptance of the information in confidence by another party; and
- The second party's disclosure of the secret in violation of that confidence to the harm of the trade secret owner.

Tele-Count Eng'rs v Pacific Tel. & Tel. Co. (1985) 168 CA3d 455, 462, 214 CR 276 (approving jury instruction); see *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1344 n20, 267 CR 787.

A breach of confidence action does not require a fiduciary relationship but may exist in any number of situations, such as principal and agents, partners, joint ventures, and in buyer/seller arrangements. *Faris v Enberg* (1979) 97 CA3d 309, 323, 158 CR 704. The duty of confidence is implied from the facts. *Pachmayr Gun Works, Inc. v Olin Mathieson Chem. Corp.* (9th Cir 1974) 502 F2d 802, 807. See §4.3 for a list of various business relationships in which an obligation of confidentiality may be implied. Because the claim is quasi-contractual, a party cannot recover for both breach of confidence and breach of contract. Further, the quasi-contractual nature of the claim may prevent an award of punitive damages for a breach of confidence. See *Berkla v Corel Corp.* (9th Cir 2002) 302 F3d 909, 918 (dismissing punitive damage award as duplicating damages awarded for breach of contract).

The most common reason for denying a claim for breach of confidence is gratuitous disclosure: "The idea man who blurts out his idea without having first made his bargain has no one but himself to blame for the loss of his bargaining power." *Desny v Wilder* (1956) 46 C2d 715, 739, 299 P2d 257; *Stanley v Columbia Broad. Sys.* (1950) 35 C2d 653, 678, 221 P2d 73. Because such a disclosure is not made in confidence, it does not satisfy the first element of the claim.

A claim for breach of confidence in California must be made within 2 years after the breach is alleged to have occurred. CCP §339; *Davies v Krasna* (1975) 14 C3d 502, 505, 121 CR 705.

The Copyright Act of 1976 does not preempt claims for breach of confidence. See 17 USC §301. Patent law, however, may preempt such claims (see §1.16). At least two courts have found preemption under CC §3426.7 when the same facts supported both claims of misappropriation and breach of the duty of confidence. *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247; *First Advantage Background Servs. Corp. v Private Eyes, Inc.* (ND Cal 2008) 569 F Supp 2d 929, 936. California courts have awarded damages and injunctive relief for breach of confidence in combination with statutory trade secret claims (*Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 50, 6 CR2d 602) and for breach of confidence combined with unfair competition (*Ojala v Bohlin* (1960) 178 CA2d 292, 303, 2 CR 919). The courts have also recognized a possible breach of confidence in connection with contract and copyright remedies. *Landsberg v Scrabble Crossword Game Players, Inc.* (9th Cir 1984) 736 F2d 485, 489. Few cases grant relief based solely on breach of confidence, perhaps because the elements of the claim also give rise to other actions or remedies. *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1342 n18, 267 CR 787.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/ C. Breach of Implied-in-Fact or Written Confidentiality Agreements/§11.38 1. Nature of Cause of Action

C. Breach of Implied-in-Fact or Written Confidentiality Agreements

§11.38 1. Nature of Cause of Action

Many suits involve express or implied representations to maintain information in confidence, giving rise to claims for breach of contract. An express contract is stated in words, either written or oral. See CC §1620. A claim for breach of an express contract requires (*Lortz v Connell* (1969) 273 CA2d 286, 290, 78 CR 6; CACI 303):

- The existence of a valid contract between the parties;
- The plaintiff's performance of the contract or excuse for nonperformance;
- The defendant's unjustified failure to perform the contract; and
- Damages to the plaintiff caused by the breach.

An action based on a written contract has a 4-year limitations period. CCP §337. An action based on an oral contract has a 2-year limitations period. CCP §339.

Sometimes an agreement is "implied-in-fact," *i.e.,* manifested by conduct. CC §1621; *Silva v Providence Hosp.* (1939) 14 C2d 762, 773, 97 P2d 798. An action based on an implied-in-fact contract also has a 2-year limitations period. CCP §339. Before proving the elements of breach of contract, the plaintiff must prove conduct sufficient to establish a contract and the terms of that contract. *Chandler v Roach* (1957) 156 CA2d 435, 440, 319 P2d 776; CACI 305. An implied-in-fact contract "consists of obligations arising from a mutual agreement and intent to promise where the agreement and promise have not been expressed in words." *McGough v University of San Francisco* (1989) 214 CA3d 1577, 1584, 263 CR 404, citing 1 Witkin, Contracts §11. See *BDT Prods., Inc v Lexmark Int'l, Inc.* (ED Ky 2003) 274 F Supp 2d 880 (no implied-in-fact contract; defendant entitled to summary judgment when evidence established that manufacturer and designer conducted preliminary negotiations over contract but parties never reached agreement on material terms). If the implied-in-fact contract involves a promise to pay for use of a confidential idea, the idea need not be either novel or original for the contract to be enforceable in California. See *Reeves v Alyeska Pipeline Serv. Co.* (Alaska 1996) 926 P2d 1130, 1142 (citing *Desny v Wilder* (1956) 46 C2d 715, 733, 299 P2d 257). An express oral or written representation of compensation is not required under California law. *Gunther-Wahl Prods. v Mattel, Inc.* (2002) 104 CA4th 27, 43, 128 CR2d 50 (reversing because jury instructions required disclosure of idea to be "clearly conditioned" on agreement to pay if idea was used).

NOTE: A claim for breach of an implied-in-fact confidentiality agreement may be substantially equivalent to a claim for breach of the duty of confidence discussed in §11.37.

Contractual remedies, whether or not based on trade secret misappropriation, are not preempted by the UTSA. CC §3426.7; *All W. Pet Supply Co. v Hill's Pet Prods. Div.* (D Kan 1993) 840 F Supp 1433, 1441 (applying Kansas UTSA; dismissal of contract claim does not negate misappropriation claims). Courts may award damages for breach of a written or an implied-in-fact agreement. *Landsberg v Scrabble Crossword Game Players, Inc.* (9th Cir 1984) 736 F2d 485, 489; *Donahue v Ziv Television Programs, Inc.* (1966) 245 CA2d 593, 54 CR 130. Contract remedies include restitution to place the party in as good a position as it would have occupied had the contract been performed. Restitution may amount to disgorgement of the breaching party's unjust enrichment, as in *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 56, 37 CR3d 221. Pre-UTSA decisions transferred rights to patents that were developed with misappropriated trade secrets. In an unpublished decision, however, the Ninth Circuit held that the UTSA only authorized injunctive relief to protect a trade secret, so there was no basis for transferring patent ownership. The pre-UTSA cases were no longer applicable. *B. Braun Med., Inc. v Rogers* (9th Cir 2006) 163 Fed Appx 500, 508, cert denied (2006) 549 US 824. If the plaintiff seeks specific enforcement of the contract, the contract must be supported by ample consideration and be just and reasonable as to the party against which it is being enforced. CC §3391. Continued at-will employment is probably not sufficient consideration to support imposing confidentiality obligations after employment begins, so the employer should make certain that independent consideration is provided. See *Labriola v Pollard Group, Inc.* (Wash App 2004) 100 P3d 791, 796 (noncompetition agreement unenforceable for lack of consideration).

PRACTICE TIP: The trade secret owner should use written contracts whenever possible to provide additional relief and options for the type of relief available.

The deterrent effect of contract remedies is significant. The courts have found contractual liability when the defendant made what would otherwise be privileged statements disclosing confidential information in the course of judicial proceedings. *ITT Telecom*

Prods. Corp. v Dooley (1989) 214 CA3d 307, 320, 262 CR 773. See §11.49. Judicial proceedings include trials, pretrial proceedings, quasi-judicial proceedings, and some prelitigation activities. See *Laffer v Levinson, Miller, Jacobs & Phillips* (1995) 34 CA4th 117, 123, 40 CR2d 233. Further, contract enforcement offers another way to restrict current and former employees from informally divulging harmful confidential information.

WARNING: Enforcing confidentiality agreements to inhibit former employees from testifying during discovery or trial could give rise to an adverse inference in the underlying action. *Chambers v Capital Cities/ABC* (SD NY 1995) 159 FRD 441, 445.

Contractual actions are limited to the contracting parties, but they provide a range of significant advantages over a trade secret action alone:

- A contract can confer personal jurisdiction in a court through a forum selection clause even when the defendant resides in a different state. *Blue Beacon Int'l v American Truck Washes, Inc.* (D Kan 1994) 866 F Supp 485, 490; *Compositflex, Inc. v Advanced Cardiovascular Sys.* (WD Pa 1992) 795 F Supp 151, 157 (applying UTSA).

- A contract requiring one party on termination of employment to leave with the employer or return to the employer all materials embodying trade secrets avoids the question of whether personal notes embodying trade secrets developed by the employee and in the employee's possession are recoverable. See *Gibson-Homans Co. v Wall-Tite, Inc*. (CD Cal 1992) 26 USPQ2d 1867 (possession of personal notebook embodying trade secrets not violation of UTSA when no contractual obligation to give notebook to employer and no showing that defendant had used such information for his own commercial benefit).

- A contract can clarify that a departed employee, or persons conspiring with the departed employee, have no right to use trade secrets personally developed by the employee. *Dekar Indus. v Bissett-Berman Corp.* (9th Cir 1970) 434 F2d 1304, 1306. See §11.42.

- A contract can define ownership rights between an employer and employee. *SI Handling Sys., Inc. v Heisley* (3d Cir 1985) 753 F2d 1244, 1259 (employer has no trade secret in information never disclosed to employer). See §§2.6-2.9 for further discussion of ownership issues.

- A contract claim can lead to an award of attorney fees to the prevailing party. *American Sales Corp. v Adventure Travel, Inc.* (ED Va 1994) 867 F Supp 378 (applying Virginia UTSA).

- On the basis of contract, a court can bar a former employee from raiding the employer's current employees. *Loral Corp. v Moyes* (1985) 174 CA3d 268, 278, 219 CR 836.

- A contract can cover someone's exclusive personal services if it satisfies CC §3423(e). See *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 862 n3, 27 CR2d 573.

Counsel must ensure that all appropriate parties are bound by any contract at issue; a confidentiality and noncompetition agreement signed by a company is unenforceable against its departing employees who did not personally sign the agreement. *Composite Marine Propellers, Inc. v Van Der Woude* (7th Cir 1992) 962 F2d 1263, 1265 (applying Illinois UTSA).

WARNING: Parties to a contract may not declare information to be a trade secret if, in fact, it is not. *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 265, aff'd (9th Cir 1960) 283 F2d 695. Furthermore, contractual protections of information may be subject to federal preemption arguments. See §1.16. Contractual remedies may not always be cumulative. At least one court enforced contractual remedies but declined to enforce remedies under the UTSA when both gave similar relief. *Nestle Food Co. v Miller* (D RI 1993) 836 F Supp 69, 76 n28 (nominal damages and injunction barring solicitation for 1 year).

PRACTICE TIP: Employers should take care not to include unenforceable terms in employment agreements. See, *e.g.*, *D'Sa v Playhut, Inc.* (2000) 85 CA4th 927, 102 CR2d 495 (employee wrongfully terminated for refusing to sign confidentiality agreement that contained unenforceable 1-year, noncompetition agreement). Employers should also exercise care when putting attorney fees clauses into these agreements, because unsuccessful suits initiated on marginal information can impose liability on the employer. *International Billing Servs., Inc. v Emigh* (2000) 84 CA4th 1175, 1180, 101 CR2d 532; see *Blickman Turkus, LP v MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 899, 76 CR3d 325 (party claiming fees under CC §1717 must establish that opposing party actually would have been entitled to receive fees if he or she was prevailing party). The liability accrues even if the agreement provides that only a prevailing employer can recover fees. CC §1717(a).

For further discussion of proof of breach of contract claims, see California Business Litigation, chap 9 (Cal CEB 2002).

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§11.39 2. Actions Arising From Assignment of Inventions

Many lawsuits involve former employees who are accused of both misappropriating trade secrets and using the secrets to develop an invention that should belong to the employer. Often, an employment agreement is involved.

California public policy prohibits employers from imposing contracts on employees that transfer to the employer ownership of inventions created with the employee's own time, money, and equipment when the inventions are unrelated to the employer's business. Lab C §2870.

PRACTICE TIP: The ownership of inventions can be altered or clarified by agreement. See generally chap 6. Written agreements prevent many problems such as the statute of frauds, consideration, or uncertainty about the agreement's terms. See *Eaton Corp. v Giere* (8th Cir 1992) 971 F2d 136, 139 (adequate consideration); *Aero Bolt & Screw Co. v Iaia* (1960) 180 CA2d 728, 740, 5 CR 53 (oral license and statute of frauds); *Ackerman v Kimball Int'l* (1995) 652 NE2d 507, 509 (noncompetition agreement enforceable despite lack of consideration). But if a written agreement specifies a fixed term of confidentiality, then no injunctive relief may be available after the fixed term expires, even though an implied duty of confidentiality may provide a longer term than the agreement. *Union Pac. R.R. v Mower* (9th Cir 2000) 219 F3d 1069.

An employer can enter into contracts with employees that require the disclosure of all inventions made during the course of employment, but the disclosure must be received in confidence. Any employment agreement requiring assignment of such inventions to the employer is unenforceable in California. Lab C §2871. Additionally, in *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084, the court held that employers may be liable for unfair business practices for requiring employees to execute overly broad inventions assignment agreements. An employer's right to inventions developed by employees is enforceable by injunctive relief when appropriate. *Cubic Corp. v Marty* (1986) 185 CA3d 438, 450, 229 CR 828 (assigning invention to employer); *Aero Bolt & Screw Co. v Iaia, supra* (employer not entitled to assignment). See §2.3.

Assignor estoppel is an equitable doctrine that prevents one who has assigned the rights to a patent (or patent application) from later contending that what was assigned is a nullity. *Diamond Scientific Co. v Ambico, Inc.* (Fed Cir 1988) 848 F2d 1220, 1224. The doctrine has broad implications. New employees are often hired because of their expertise in an area. If those new employees developed patented technology during their prior employment, the new employer must be especially careful of those patents because the new employer may be estopped from contesting the validity or enforceability of those patents. *Pandrol USA, LP v Airboss Ry. Prods. Inc.* (Fed Cir 2005) 424 F3d 1161, 1167 (inventor estopped from disputing patent validity). A company hiring an inventor to start operations that infringe a process previously patented by the inventor was in privity with the inventor and thus estopped the company and inventor not only from contesting the patent's validity but from asserting inequitable conduct as a defense. *Shamrock Technols., Inc. v Medical Sterilization, Inc.* (Fed Cir 1990) 903 F2d 789.

To preserve the ability to dispute patent validity requires express language reserving the right to challenge patent validity. A general disclaimer of any warranty of fitness is insufficient to avoid estoppel. The estoppel extends to those in privity with the assignor and can include a wholly owned subsidiary with common management personnel. *Mentor Graphics Corp. v Quickturn Design Sys., Inc.* (Fed Cir 1998) 150 F3d 1374, 1378.

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§11.40 3. Punitive Damages for Breach of Contract

California allows punitive damages only for "the breach of an obligation not arising from contract." CC §3294. Therefore, punitive damages can be awarded for breach of contract only if the breach was also a tort.

Punitive damages are not available for breach of a contractual trade secret obligation in California unless the defendant has violated an independent duty (other than bad faith denial of the existence of a contract). *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 102, 44 CR2d 420.

Punitive damages are available for other claims, including fraud and misappropriation of trade secrets, provided the defendant is guilty of oppression, fraud, or malice. CC §3294. Although these allegations must be pled specifically in state court, the state of mind can be averred generally in federal court even under Fed R Civ P 9(b). *Premiere Innovations, Inc. v IWAS Indus.,* LLC (SD Cal, Sept. 28, 2007, No. 07cv1083 BTM(BLM)) 2007 US Dist Lexis 72755.

NOTE: It is uncertain whether a plaintiff must prove by clear and convincing evidence that the defendant was guilty of "oppression, fraud, or malice" to obtain an award for "willful and malicious misappropriation" under CC §3426.3(c), which entitles the plaintiff to double the damages awarded. The Ninth Circuit found that a plaintiff suing under Montana's UTSA did not have such a requirement. See *Yeti by Molly, Ltd. v Deckers Outdoor Corp.* (9th Cir 2001) 259 F3d 1101, 1112. There is no specific statutory language that requires clear and convincing evidence to establish willful and malicious misappropriation, but there may be due process concerns.

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.41 D. Breach of Noncompetition Agreements

§11.41 D. Breach of Noncompetition Agreements

California public policy disfavors contracts that restrain business, trade, or the practice of a profession. Bus & P C §16600. Thus, although some states enforce agreements not to compete regardless of whether trade secrets are involved (see *Norand Corp. v Parkin* (ND Iowa 1990) 785 F Supp 1353 (applying Iowa UTSA)), California courts generally deny injunctions enforcing such broad agreements (*Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573; *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 47, 6 CR2d 602). See generally §§1.2, 2.32-2.32D, 10.16, 12.13. The public policy favoring employee mobility cannot be circumvented by using the "inevitable disclosure" doctrine to impose an after-the-fact covenant not to compete that restricts employee mobility. *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 1277, 95 CR3d 307; *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 1463, 125 CR2d 277. This policy has even barred enforcing injunctions issued by foreign courts (as in other states or countries). *Robinson v Jardine Ins. Brokers Int'l Ltd.* (ND Cal 1994) 856 F Supp 554, 559.

California courts have also ignored choice of law provisions specifying another state's rules as controlling when considering noncompetition agreements. See *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 908, 72 CR2d 73 (refusing to uphold choice of law clause in contract with Maryland resident hired by California company to telecommute). But out-of-state decisions enforcing a covenant not to compete against a California resident can be enforced. See *Jones v Humanscale Corp.* (2005) 130 CA4th 401, 411, 29 CR3d 881 (upholding arbitration award under New Jersey law where agreement authorized arbitrator to determine both applicable law and enforceability of covenant not to compete); *Estee Lauder Cos. v Batra* (SD NY 2006) 430 F Supp 2d 158 (enforcing New York forum selection clause in employment agreement and imposing 5-month preliminary injunction against California resident).

In *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, the California Supreme Court held that employee noncompetition agreements are invalid, even if narrowly drawn, unless the agreement falls within a statutory exception (see Bus & P C §§16601-16602, 16602.5) to Bus & P C §16600. In *Edwards,* the court rejected the narrow restraint doctrine followed by the Ninth Circuit, which excepted from the §16600 prohibition noncompetition agreements that barred an employee from pursuing only a small part or limited part of the business, trade, or profession. The court, however, expressly refrained from addressing whether a trade secret exception to §16600 exists that would permit nonsolicitation-of-customers clauses to the extent that such clauses are necessary to protect trade secrets such as qualifying customer lists. At least one appellate court has since cast doubt on whether there is a trade secret exception. *Dowell v Biosense Webster, Inc.* (2009) 179 CA4th 564, 577, 102 CR3d 1. See also *The Retirement Group v Galante* (2009) 176 CA4th 1226, 98 CR3d 585. For further discussion of this issue, see §2.32B. Thus, to attempt to enforce a nonsolicitation-of-customers clause, companies will need to demonstrate that their customer lists and related customer information are genuine trade secrets and that a breach of the clause has occurred. Those circumstances may also provide grounds for claims for trade secret misappropriation and breach of any nondisclosure provisions in the employment agreement.

By statute, noncompetition agreements are enforceable in several contexts, as when they are executed in connection with the sale of a business or its goodwill (Bus & P C §16601; *John F. Matull & Assocs. v Cloutier* (1987) 194 CA3d 1049, 240 CR 211); the dissolution of, or the departure of partners from, a partnership (Bus & P C §16602; see *Howard v Babcock* (1993) 6 C4th 409, 419, 25 CR2d 80); the dissolution of, or sale of an interest in, a limited liability company (Bus & P C §16602.5); and a merger agreement (Bus & P C §16601; *Hilb, Rogal & Hamilton Ins. Servs. of Orange County, Inc. v Robb* (1995) 33 CA4th 1812, 1824, 39 CR2d 887).

Further, noncompetition agreements may possibly be enforceable when necessary to protect trade secrets (*Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442 (citing *Edwards v Arthur Andersen LLP* (2008) 44 C4th 937, 81 CR3d 282, for proposition that Bus & P C §16600 invalidates noncompete contracts unless they are necessary to protect an employer's trade secrets)); *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427; but see *Dowell,* 179 CA4th at 577 ("Although we doubt the continued viability of the common law trade secret exception to covenants not to compete, we need not resolve the issue here."); *The Retirement Group v Galante, supra*. See also §2.32B.

Sham attempts to fall within the statutory exceptions to noncompetition agreements are not likely to be successful. In *Hill Med. Corp. v Wycoff* (2001) 86 CA4th 895, 103 CR2d 779, a doctor was required to buy shares in a medical corporation with which he practiced medicine, but had no say in the corporation and was required to sell the shares at a scheduled price on departure; the price did not account for goodwill. In that case, the noncompetition agreement was unenforceable even though the doctor owned and sold his shares in the corporation.

WARNING: While there is some authority that nonsolicitation-of-customers covenants may be upheld if needed to protect employers' trade secrets, there has not been a detailed analysis of the nature of the trade secrets exception and what one must

show to make defensible use of it post-*Edwards*. Furthermore, at least one California appellate court has expressed doubt regarding the continued viability of the common law trade secret exception to covenants not to compete. See *Dowell v Biosense Webster, Inc., supra*. See also *The Retirement Group v Galante, supra;* §2.32B. Employers should be cautious in relying on the trade secrets exception when drafting nonsolicitation clauses in any employee contracts. If there is no genuine trade secret, nonsolicitation clauses are likely to be unenforceable, and the inclusion of such provisions opens the employer up to liability.

Noncompetition agreements are enforceable in the "specified geographic area in which the business so sold… has been carried on." Bus & P C §16601. That includes areas where all phases of the business are conducted, including production, promotion, marketing, and sales. *Alliant Ins. Servs., Inc. v Gaddy* (2008) 159 CA4th 1292, 72 CR3d 259 (entire state of California properly encompassed in preliminary injunction because clients were in all 58 counties). In *Alliant Ins. Servs., Inc.,* a preliminary injunction properly enforced a noncompetition agreement in the 58 counties of California because evidence showed that the company did business with insurance brokers in all 58 counties and the agreement was made when selling the company. A nonsolicitation covenant involving both the buyer's and seller's customers was also enforced. Because the sale agreement prohibited contacting the seller's customers and the seller accepted employment with the buying company, the seller was prohibited from contacting trade secret customers of the buying company. The court noted that the covenant prohibiting solicitation of the buyer's other customers related only to the seller's employment by the buying company, not the sale of the business.

Noncompetition agreements often arise in customer list settings, where they may be enforceable only to bar solicitation of (but not notification to) customers. *Gordon v Landau* (1958) 49 C2d 690, 321 P2d 456 (applying California common law); *Thompson v Impaxx, Inc.* (2003) 113 CA4th 1425, 7 CR3d 427 (agreement barring solicitation for 1 year was unenforceable to extent customer identity was not trade secret); *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 262 CR 92 (applying UTSA). In *Retirement Group v Galante* (2009) 176 CA4th 1226, 98 CR3d 585, the trial court granted a preliminary injunction that prevented former financial advisors from using information solely and exclusively on the plaintiff's databases, but made an exception for similar information found on servers, databases, and other resources owned and operated by other entities or businesses. However, the trial court's injunction went even further, prohibiting the former financial advisors from directly or indirectly soliciting any of the plaintiff's current customers. The appellate court overturned the solicitation portion of the preliminary injunction, finding that this aspect of the injunction violated Bus & P C §16600 and the reasoning of *Edwards*. The *Galante* decision reiterated the *Edwards* holding that noncompete clauses are unenforceable in California, and that injunctions that violate the *Edwards* ruling will be overturned. Furthermore, injunctions may be used to protect trade secrets, but should not be overextended to the point that they unlawfully restrict trade in violation of §16600.

Notwithstanding *Edwards,* carefully drafted nonsolicitation-of-employees clauses may still be enforceable, although they will be closely scrutinized by the courts. In *Loral Corp. v Moyes* (1985) 174 CA3d 268, 284, 219 CR 836, the court of appeal ruled that a contract may prohibit departing employees from directly soliciting fellow employees to join a new business. The court expressly found that the nonsolicitation or "anti-raiding covenant" did not constitute an impermissible covenant void under §16600; although such a covenant may restrict the former employee's business practices in a small way, the court determined it was enforceable as it had no overall impact on trade or business. 174 CA3d at 280. Furthermore, the court found that the duration of the covenant depends on its "reasonableness, evaluated in terms of the employer, the employee and the public." 174 CA3d at 280. The court found a 1-year restriction reasonable, but it declined to rule on whether a longer limitation would pass muster. 174 CA3d at 280. See also *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 859, 27 CR2d 573 (affirming denial of plaintiff's request for preliminary injunction to restrain defendant from soliciting plaintiff's employees). But see *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818 (holding no-hire clause unenforceable because it was much broader than necessary and would unfairly limit employees' mobility).

PRACTICE TIP: An attorney who drafts an agreement with post-termination restrictions on employees should ensure that the agreements identify the appropriate entities, or the agreements will be unenforceable and will fail to demonstrate reasonable efforts to maintain secrecy. See *Miller v Hehlen* (Ariz App 2005) 104 P3d 193 (contractual restrictions between employee and "Margaret Miller, doing business as H&R Block," were not binding on employee when Miller began doing business under a name other than H&R Block; disclosed customer information was not trade secret).

WARNING: Using a broad noncompetition agreement containing otherwise enforceable confidentiality and nonsolicitation provisions may result in a court's finding that the entire contract is void. *Kolani v Gluska* (1998) 64 CA4th 402, 408, 75 CR2d 257. Moreover, terminating employees for failing to sign employee agreements that contain statutorily proscribed noncompetition agreements may result in liability for wrongful termination. *D'Sa v Playhut, Inc.* (2000) 85 CA4th 927, 934, 102 CR2d 495 (court ignored severability and choice of law provisions).

PRACTICE TIP: If a prospective employee from outside California is bound by a noncompetition agreement, the new employer should consider filing a declaratory relief action challenging enforceability of the restrictive covenant. See *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73 (refusing to uphold choice of law clause in contract in which Maryland resident was hired by California company to telecommute). Filing first, however, does not necessarily mean that the employer will be barred from suing in another state, thus triggering a race to judgment. See *Advanced Bionics Corp. v Medtronic, Inc.* (2002) 29

C4th 697, 128 CR2d 172 (reversing trial court's injunction against sister-state proceeding).

Limitations on noncompetition agreements may apply to consultant agreements as well as employer-employee agreements. In *VL Sys., Inc. v Unisen, Inc.* (2007) 152 CA4th 708, 61 CR3d 818, a corporation and a computer consulting firm entered a no-hire agreement imposing a liquidated damages provision if the consultant hired any employee of the corporation within 1 year after the end of the consulting agreement. The no-hire clause was unenforceable under Bus & P C §16600 because it restrained employment of persons not involved with the consultant and those hired after the consultation was completed.

For further discussion of covenants not to compete, see California Law of Contracts §6.38 (Cal CEB 2007); California Business Litigation, chap 3 (Cal CEB 2002).

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§11.42 E. Civil Conspiracy

A civil conspiracy claim helps ensure that, if a judgment is obtained, sufficient resources are available to satisfy the judgment. The elements of an action for civil conspiracy are (1) formation and operation of the conspiracy and (2) damage resulting to the plaintiff (3) from a wrongful act done in furtherance of the common design. See *Rusheen v Cohen* (2006) 37 C4th 1048, 1062, 39 CR3d 516.

Conspiracy requires that each conspirator agree to do something to further the conspiracy while knowing of its improper purpose. *Powell Prods. v Marks* (D Colo 1996) 948 F Supp 1469, 1480 (applying Colorado UTSA). By participating in a civil conspiracy, a co-conspirator effectively adopts as his or her own the torts of other co-conspirators within the ambit of the conspiracy and thus incurs tort liability for the acts of all co-conspirators. Imposing this liability requires that two or more persons combine to achieve an unlawful purpose that damages the plaintiff. *Applied Equip. v Litton Saudi Arabia* (1994) 7 C4th 503, 511, 28 CR2d 475; 5 Witkin, Summary of California Law, *Torts* §44 (10th ed 2005); see *Saunders v Superior Court* (1994) 27 CA4th 832, 838, 33 CR2d 438 (civil conspiracy). A conspirator cannot be held liable unless he personally owed the duty that was breached. *Champlaie v BAC Home Loans Servicing, LP* (ED Cal, Oct. 22, 2009, No. CIV S-09-1316 LKK/DAD) 2009 US Dist Lexis 102285, *62 (party may not be vicariously liable for conspiracy to breach fiduciary duty) (citing *Applied Equip. v Litton Saudi Arabia* (1994) 7 C4th 503, 511, 514, 28 CR2d 475). There is no separate tort for civil conspiracy. *Yulaeva v Greenpoint Mortgage Funding, Inc.* (ED Cal, Sept. 3, 2009, No. CIV. S-09-1504 LKK/KJM) 2009 US Dist Lexis 79094, *14.

A corporation may qualify as a person involved in a conspiracy, and a corporate officer's knowledge can be imputed to the officer's corporation for purposes of establishing that the corporate conspirator knew of the improper purpose; however, a corporation cannot conspire with its officers or employees acting within their appropriate corporate capacity. *Davis & Cox v Summa Corp.* (9th Cir 1985) 751 F2d 1507, 1526, citing *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 576, 108 CR 480; *Powell Prods. v Marks, supra*. Counsel for a party is not liable as that party's co-conspirator for filing lawsuits on the party's behalf unless counsel personally violates a duty or acts not as an agent but for personal gain. *Doctors' Co. v Superior Court* (1989) 49 C3d 39, 260 CR 183. A contingency fee is not deemed a sufficient interest in the outcome of the litigation to make counsel liable as a co-conspirator. *Cooper v Equity Gen. Ins. Co.* (1990) 219 CA3d 1252, 1261, 268 CR 692.

The limitations period itself is determined by the gravamen of the claim furthered by the conspiracy, which will vary with the specific facts. *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 786, 157 CR 392 (last overt act was collecting last payment on fraudulently induced loan). If the wrong committed in the conspiratorial acts is a continuing tort, the limitations period for all co-conspirators may be extended to the commission of the last overt act of the conspiracy. *Wyatt v Union Mortgage Co., supra*.

PRACTICE TIP: Because the limitations period for civil conspiracy runs from the last overt act of the conspiracy, the period of time in which to pursue otherwise time-barred claims is effectively extended.

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§11.43 F. Conversion and Trespass to Chattels

Conversion was originally a remedy for the wrongful taking of another's lost goods, so historically it has been applied only to tangible property. Under this view, conversion of intangible property such as ideas or information would occur only if the intangible property were represented by documents or were contained in tangible items. This view is reflected in the Restatement (Second) of Torts, §242 (1965), and early California cases. See, *e.g., Olschewski v Hudson* (1927) 87 CA 282, 287, 262 P 43 (misappropriating intangible secret customer route list not actionable in conversion); *Palm Springs-La Quinta Dev. Co. v Kieberk Corp.* (1941) 46 CA2d 234, 240, 115 P2d 548 ("lead cards" containing trade secret information on customer lists were tangible items giving rise to conversion claim). To the extent that a trade secret misappropriator takes documents, drawings, computer disks, equipment, secret components, or sample ingredients, a claim for conversion exists under this restrictive version of conversion.

California, however, no longer follows the Restatement requirement that some tangible document must represent the owner's intangible property right. Conversion is now routinely applied to intangibles without inquiring whether they are merged in a document. *Kremen v Cohen* (9th Cir 2003) 337 F3d 1024, 1031. Conversion requires the following:

- An ownership interest or a right to possession of property at the time of the conversion;
- A defendant's conversion by a wrongful act or dispossession of plaintiff's property rights; and
- Damages.

Miles, Inc. v Scripps Clinic & Research Found. (9th Cir 1991) 951 F3d 361, citing *Hartford Fin. Corp. v Burns* (1979), 96 CA3d 591, 598, 158 CR 169. See *Moore v Regents of Univ. of Cal.* (1990) 51 C3d 120, 136, 271 CR 146. To show that a property right exists, a plaintiff must allege an interest that is "capable of precise definition" and may be exclusively possessed or controlled, and that the putative owner of the interest has "established a legitimate claim to exclusivity." *Tethys Bioscience, Inc. v Mintz, Levin, Cohn, Ferris, Glovsky & Popeo, PC* (ND Cal, Dec. 9, 2009, No. C 09-5115 CW) 2009 US Dist Lexis 114992, *8 (citing *Kremen v Cohen* (9th Cir 2003) 337 F3d 1024, 1030). If the trade secret allegations coincide with allegations for conversion, there is some risk of preemption under CCP §3426.7. *MDTV Med. News, Inc. v Weinstock* (SD Cal, Feb. 6, 2007, No. 03CV371-BEN) 2007 US Dist Lexis 8806 (claims for conversion and breach of duty of confidence preempted). See also *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27 (claims for unlawful business practices and conspiracy preempted). But see *Ali v Fasteners for Retail, Inc.* (CD Cal 2008) 544 F Supp 2d 1064, 1072 (at motion to dismiss juncture, court found it was still unclear how much of allegedly misappropriated information was trade secret and therefore held it would be premature to hold that UTSA preempted plaintiff's conversion claim). If the property was stolen, criminal theft remedies may also be available. See chap 13.

Problems arise if the trade secret owner has copies of the same documents held by the alleged converter. Several courts have recognized that the owner is not deprived of the beneficial use of the documents if the owner kept usable copies. For example, a news agency in possession of stolen documents was liable for conversion only to the extent the owner had no copy of the stolen documents. *FMC Corp. v Capital Cities/ABC, Inc.* (7th Cir 1990) 915 F2d 300, 304 (applying California law); *Pearson v Dodd* (DC Cir 1969) 410 F2d 701, 707 (no conversion when reporters surreptitiously copied documents from United States senator's files). Recovery of property is likely to be the primary benefit of conversion, because the remedy for conversion if the property is destroyed is the value of the property at the time of its conversion and fair compensation for the time and money properly expended in pursuit of the property. *Lueter v State* (2002) 94 CA4th 1285, 1302, 115 CR2d 68 (affirming $1.50 for destroying partial tire tread arising from car accident). Thus, the conversion claim may be best suited when the misappropriator has a unique version or the only tangible embodiment of the trade secret. *ViChip Corp. v Lee* (ND Cal 2006) 438 F Supp 2d 1087 (summary judgment of conversion involving designs and provisional patent application).

Trespass to chattels, the little brother of conversion, can arise if intangibles are used without authorization but are not converted in the sense of depriving the owner of their use. *Thrifty-Tel, Inc. v Bezenek* (1996) 46 CA4th 1559, 1566, 54 CR2d 468 (upholding damages for trespass involving computer access codes and imposing liability on parents for their children's computer hacking). Determining what constitutes a trespass can be tricky. In *Intel Corp. v Hamidi* (2003) 30 C4th 1342, 1 CR3d 32, the court found that sending six e-mails to large numbers of Intel employees did not interfere with the use or possession of Intel's computers, and any lost employee productivity arising from reading the e-mails did not damage the computers, so no trespass occurred.

Claims for conversion of tangible assets must be brought within 3 years (CCP §338(c); *Minsky v City of Los Angeles* (1974) 11 C3d 113, 119 n6, 113 CR 102), but claims for conversion of intangible interests have a 2-year limitations period (CCP §339).

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§11.44 G. Fraud and Constructive Fraud

Misappropriation includes wrongful acquisition of a trade secret. CC §§3426.1(b)(1), (b)(2)(B)(i)-(ii). Claims for fraud may arise if the nature of the acquisition is sufficiently egregious, but theft or unethical acquisition does not constitute misappropriation if the purloined materials contain no trade secrets. *Buffets, Inc. v Klinke* (9th Cir 1996) 73 F3d 965, 970 (applying Washington UTSA; no trade secrets in recipes for buffet dishes). Fraud focuses on misrepresentation rather than on the existence of a trade secret. Thus, fraud claims can provide separate relief whether or not misappropriation or the existence of a trade secret is found.

Because misappropriation often involves implied or express contracts, CC §1572 becomes relevant as it defines fraud in connection with contracts. Under §1572, such fraud may involve:

- The suggestion of a fact that is not true by one who does not believe it to be true;
- A positive assertion that something is not true that is unwarranted by the information of the person making the assertion, even if the person believes the assertion to be true;
- The suppression of the truth by someone with knowledge or belief of the truth;
- A promise made without intent of keeping it; or
- Any other act intended to deceive.

Constructive fraud encompasses actions that might otherwise not be fraudulent and consists of any act or omission specifically declared to be fraudulent, whether or not there is actual fraud. CC §1573(2). It also exists "[i]n any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him." CC §1573(1).

Constructive fraud can arise from any confidential or fiduciary relationship that induces a person's justifiable reliance with resulting prejudice. *Tyler v Children's Home Soc'y* (1994) 29 CA4th 511, 548, 35 CR2d 291. See *General Am. Life Ins. Co. v Rana* (ND Cal 1991) 769 F Supp 1121, 1127 (relationship need not satisfy formal requirements of fiduciary relationship). See also CC §1573. The constructive fraud statute can also impose liability for nondisclosure of material facts within the knowledge of a fiduciary. *Estate of Gump* (1991) 1 CA4th 582, 601, 2 CR2d 269. If counsel is involved in the fraud, even unknowingly, the attorney-client privilege may be waived. *In re Grand Jury Proceedings* (9th Cir 1996) 87 F3d 377, 381; *Laser Indus. v Reliant Technol.* (ND Cal 1996) 167 FRD 417.

Fraud claims have a 3-year limitations period accruing on discovery of the fraud or on reasonable notice of facts giving rise to the fraud. CCP §338(d). Fraud claims are not preempted by the 1976 Copyright Act. *Gladstone v Hillel* (1988) 203 CA3d 977, 987, 250 CR 372.

A plaintiff who successfully proves a constructive fraud claim can obtain punitive damages above the treble damages permitted under the UTSA. CC §3426.3(c). See §11.40 (punitive damages).

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§11.45 H. Breach of Fiduciary Duty

Common law imposes a fiduciary duty on an employee to protect the employer's trade secrets, even in the absence of a written agreement and even if the employee participated in development of the trade secret during employment. *Norand Corp. v Parkin* (ND Iowa 1990) 785 F Supp 1353, 1355 (applying Iowa UTSA); *Components for Research, Inc. v Isolation Prods.* (1966) 241 CA2d 726, 729, 50 CR 829. Fiduciary duties can also arise when persons put their confidence in the integrity of others who voluntarily accept the confidence. *Tri-Growth Centre City Ltd. v Sillodorf, Burdman, Duignan & Eisenberg* (1989) 216 CA3d 1139, 1150, 265 CR 330 (partners owe fiduciary duty to copartners). See *GAB Bus. Servs., Inc. v Lindsey & Newsom Claim Servs., Inc.* (2000) 83 CA4th 409, 420, 99 CR2d 665, overruled on other grounds in *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289 (defining who is fiduciary for purposes of claim of breach of fiduciary duty). But fiduciary duties do not arise merely because the other party to an agreement has information critical to the agreement. In *Wolf v Superior Court* (2003) 107 CA4th 25, 130 CR2d 860, the author of the novel on which the movie *Who Framed Roger Rabbit?* was based sued Disney for breach of fiduciary duty because Disney had all the financial records but paid no money under a royalty agreement and would not allow an audit of the records. The claims were dismissed because a fiduciary duty did not arise from a contractual right to contingent compensation within the control of another.

Fiduciary duties include loyalty and confidentiality, resulting in obligations to assign any invention to the employer and in liability for damages proximately caused by the breach of duty for the loss of key employees. *Eaton Corp. v Giere* (8th Cir 1992) 971 F2d 136, 141; *Bancroft-Whitney Co. v Glen* (1966) 64 C2d 327, 49 CR 825. An employee or officer who attempts during employment to misappropriate trade secrets, or who solicits other employees to leave, violates these fiduciary duties. 64 C2d at 350; *Alexander & Alexander Benefit Servs. v Benefit Brokers & Consultants, Inc.* (D Or 1991) 756 F Supp 1408, 1411 (applying Oregon UTSA and Restatement of Agency). Employees have a duty of loyalty not to assist potential competitors in any way (see *Fowler v Varian Assocs., Inc.* (1987) 196 CA3d 34, 41, 241 CR 539), but this duty terminates on their leaving the business. *John F. Matull & Assocs. v Cloutier* (1987) 194 CA3d 1049, 1053 n3, 240 CR 211. California statutes provide additional liability for, and remedies against, corporate officers. See Corp C §§300-318.

When fiduciary duties are not based on a written instrument or statute, a 2-year limitations period applies. See CCP §339. But one California court has found that claims for breach of fiduciary duty based on misappropriation have a 3-year limitations period. CC §3426.6; *Intermedics, Inc. v Ventritex, Inc.* (ND Cal 1993) 822 F Supp 634, 640. Claims for fraudulently conspiring to breach fiduciary duties have a 3-year limitations period. CCP 338(d); *Wyatt v Union Mortgage Co.* (1979) 24 C3d 773, 787 n2, 157 CR 392.

A plaintiff is also entitled to traditional remedies for fraud, most notably rescission or increased damages, even if the relationship is less than the traditional fiduciary relationship. CC §1573; *Estate of Gump* (1991) 1 CA4th 582, 601, 2 CR2d 269 (probate matter).

Although California courts have held that §301 of the 1976 Copyright Act does not preempt actions for breach of fiduciary duties arising in trade secret contexts, federal courts have reached various conclusions, depending on whether acts in addition to those needed for a copyright violation are alleged. *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1351, 267 CR 787 (discussing federal cases). Further, the fiduciary duty claim could also be preempted by the UTSA. See *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247. But see *Ali v Fasteners for Retail, Inc.* (CD Cal 2008) 544 F Supp 2d 1064 (UTSA did not preempt California fiduciary duty claim alleging that defendant's business secretly designed, developed, and tested competing product while nondisclosure agreement was in effect with plaintiff inventor and owner of patent on inventory control system).

For further discussion on breach of fiduciary duties, see California Business Litigation, chap 4 (Cal CEB 2002).

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§11.46 I. Common Law Misappropriation

Common law misappropriation requires that "(1) the plaintiff has invested substantial time and money in development of its … 'property'; (2) the defendant has appropriated the [property] at little or no cost; and (3) the plaintiff has been injured by the defendant's conduct." *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1342, 267 CR 787, quoting *International News Serv. v Associated Press* (1918) 248 US 215, 63 L Ed 211, 39 S Ct 68. The elements of this tort are difficult to establish and are limited to the "hot news" situation of *INS*. See *National Basketball Ass'n v Motorola, Inc.* (2d Cir 1997) 105 F3d 841 (transmission of real time sports information on Motorola beepers and through America On Line had no adverse competitive effect on NBA and no free riding, because information was independently collected).

Patent and copyright statutes preempt many claims for this form of misappropriation so that the claims seldom survive attacks on pleadings. *Summit Mach. Tool Mfg. Corp. v Victor CNC Sys.* (9th Cir 1993) 7 F3d 1434 (unfair competition and INS misappropriation claims preempted under patent and copyright law); *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 1353, 267 CR 787 (preempted by Copyright Act of 1976); *Sammons & Sons v Ladd-Fabb, Inc.* (1982) 138 CA3d 306, 187 CR 874 (preempted by federal patent and copyright laws).

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.47 J. Interference With Prospective Business Advantage

§11.47 J. Interference With Prospective Business Advantage

The elements of intentional interference with prospective economic advantage are that (*Della Penna v Toyota Motor Sales, U.S.A.* (1995) 11 C4th 376, 45 CR2d 436):

- Plaintiff had an economic relationship with a third party with probable future economic benefit;
- Defendant knew of the existence of that relationship;
- Defendant intentionally interfered with that relationship by independent tortious means or wrongful acts;
- Actual disruption occurred; and
- Plaintiff was damaged as a result of defendant's acts.

NOTE: California courts are narrowing the "intent" element. A plaintiff need not plead that the defendant acted with specific intent to interfere with the plaintiff's business expectancy in order to state a claim for interference with prospective economic advantage. *Korea Supply Co. v Lockheed Martin Corp.* (2003) 29 C4th 1134, 1154, 131 CR2d 29 (agent representing losing bidder in sale of defense equipment could sue winning bidder for lost commissions without specific allegations of wrongful intent related to agent's lost commissions). See *Quelamine Co. v Steward Title Guar. Co.* (1998) 19 C4th 26, 55, 77 CR2d 709 (no independent act for interference with existing contract as opposed to interference with prospective relationship).

Parties to an economic relationship cannot commit or conspire to commit a tortious interference of that relationship. *Kasparian v County of Los Angeles* (1995) 38 CA4th 242, 266, 45 CR2d 90.

Negligent interference with prospective business advantage imposes liability for negligent action, but not all negligent actions suffice. To impose liability, a wrongful negligent act is required, along with consideration of six other factors, which are (*DeVoto v Pacific Fid. Life Ins. Co.* (9th Cir 1980) 618 F2d 1340, 1349 n8, citing *J'Aire Corp. v Gregory* (1979) 24 C3d 799, 804, 157 CR 407):

- The extent to which the transaction was intended to affect the plaintiff;
- The foreseeability of harm to the plaintiff;
- The degree of certainty that the plaintiff suffered injury;
- The closeness of the connection between the defendant's conduct and the injury suffered;
- The moral blame attached to the defendant's conduct; and
- The policy of preventing future harm.

The imposition of economic damages for negligent interference with prospective business advantage is limited and does not extend to areas such as the sale of goods under the UCC. *Livermore Amador Valley Wastewater Mgmt. Agency v Northwest Pipe & Casing Co.* (ND Cal 1995) 915 F Supp 1066, 1073.

Claims for interference with prospective business advantage have a 2-year limitations period in California. CCP §339; *Stutz Motor Car of Am. v Reebok Int'l* (CD Cal 1995) 909 F Supp 1353, 1361, aff'd (Fed Cir 1997) 113 F3d 1258. See *Sade Shoe Co. v Oschin & Snyder* (1990) 217 CA3d 1509, 266 CR 619 (dismissal affirmed for 2-year delay).

Courts have enjoined former employees from using confidential information to interfere with the prospective business advantage of their former employer. See *Ernst & Ernst v Carlson* (1966) 247 CA2d 125, 55 CR 626. The same requirements apply to interference with at-will employment relationships caused by competing employers. See *Reeves v Hanlon* (2004) 33 C4th 1140, 17 CR3d 289 (attorneys leaving without notice, after destroying status reports and lists of pending matters, committed independent wrongful acts in hiring at-will employees). Injunctions have even issued for threatened interference. See *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262 (enjoined disclosure of marketing plans pursuant to Illinois UTSA). However, courts seldom issue injunctions barring customer solicitation or solicitation of employees to change jobs in the absence of an enforceable contract or the use of trade secret information. See *Hollingsworth Solderless Terminal Co. v Turley* (9th Cir 1980) 622 F2d 1324, 1337; *Alexander & Alexander Benefit Servs. v Benefit Brokers & Consultants, Inc.* (D Or 1991) 756 F Supp 1408, 1414 (preliminary injunction

granted). See §11.41 (noncompetition agreements) and Bus & P C §16600 (contracts restraining trade are invalid).

For further discussion of interference with prospective business advantage, see California Business Litigation, chap 9 (Cal CEB 2002).

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§11.48 K. Trade Libel

Trade libel is the "intentional disparagement of the quality of property, which results in pecuniary damages to plaintiff." *Erlich v Etner* (1964) 224 CA2d 69, 73, 36 CR 256. An injunction, damages, and punitive damages are available, but actual damages specifically caused by the disparaging statements must be proved. *Polygram Records v Superior Court* (REGE) (1985) 170 CA3d 543, 549, 216 CR 252; *Erlich v Etner, supra*. The difficulty in proving damages has limited successful applications of this cause of action. Moreover, claims for trade libel in California are governed by a relatively short, 2-year limitations period. CCP §339; *Guess, Inc. v Superior Court* (1986) 176 CA3d 473, 478, 222 CR 79.

PRACTICE TIP: Be careful of claiming that a statement is libelous, because if it relates to a matter of public interest that may impinge someone's First Amendment rights, the client may face an anti-SLAPP suit. *Troy Group, Inc. v Tilson* (CD Cal 2005) 364 F Supp 2d 1149 ("Are these guys the biggest crooks on the planet or what?" was protected speech warranting dismissal of complaint and SLAPP sanctions); *Dealertrack, Inc. v Huber* (CD Cal 2006) 460 F Supp 2d 1177 (libel counterclaim based on one sentence in complaint that was protected by litigation privilege led to anti-SLAPP motion and sanctions); see also *Neville v Chudacoff* (2008) 160 CA4th 1255, 1261, 73 CR3d 383 (affirming anti-SLAPP dismissal of defamation claims based on prelitigation letters notifying customers of fired employee's alleged misappropriation).

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.49 L. Unfair Competition

§11.49 L. Unfair Competition

California recognizes claims for both common law unfair competition and statutory unfair competition. See *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 10 CR2d 538 (discussing both in insurance coverage context). Common law unfair competition has been said to encompass only torts involving palming off, deceit, and, possibly, likelihood of confusion. *Bank of the W. v Superior Court, supra; Keating v National Union Fire Ins. Co.* (9th Cir 1993) 995 F2d 154. A claim for common law or even statutory unfair competition may be preempted under CC §3426.7 if it relies on the same nucleus of facts as the misappropriation claim. *Silvaco Data Sys. v Intel Corp.* (2010) 184 CA4th 210, 109 CR3d 27 (conversion, unlawful business practices, and conspiracy claims preempted); *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247; *AccuImage Diagnostics Corp. v Terarecon, Inc.* (ND Cal 2003) 260 F Supp 2d 941, 955 (common law claims preempted); *Airdefense, Inc. v Airtight Networks, Inc.* (ND Cal, July 26, 2006, No. C 05-04615JF) 2006 US Dist Lexis 55364 (claims for conversion, unjust enrichment, unfair competition, and intentional interference preempted). Statutory unfair competition under Bus & P C §17200 is extremely broad, encompassing any practice forbidden by law, whether civil, criminal, federal, state or municipal, statutory, regulatory, or court made. "Unfair conduct" is any practice whose harm to the victim outweighs its benefits. *Saunders v Superior Court* (1994) 27 CA4th 832, 838, 33 CR2d 438; *Ojala v Bohlin* (1960) 178 CA2d 292, 2 CR 919 (claims under common law and CC §3369 (predecessor to Bus & P C §17200)). Statutory unfair competition requires no intent to injure anyone and "borrows" violations of other statutes and regulations to serve as a basis for action under Bus & P C §17200. *State Farm Fire & Cas. Co. v Superior Court* (1996) 45 CA4th 1093, 53 CR2d 229, abrogated by *Cel-Tech Comm. v L.A. Cellular Tel. Co.* (1999) 20 C4th 163, 83 CR2d 548.

A claim for statutory unfair competition provides a separate remedy for misappropriation. Bus & P C §§17200, 17205 (cumulative remedy unless otherwise expressly provided); *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1291, 272 CR 352; *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 1018, 24 CR3d 720 (court may also enjoin use or disclosure of trade secrets under unfair competition provisions, particularly Bus & P C §17203). Other courts, however, have found that if claims are based on the same facts as trade secret misappropriation, then the §17200 claim may be preempted, so that the outcome of a preemption dispute is currently uncertain. See *Silvaco Data Sys. v Intel Corp., supra* (UTSA preempts conversion and unfair business practice claims based on misappropriation of trade secrets); *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc., supra* (statutory unfair competition claim preempted by California UTSA when based on same conduct giving rise to trade secrets claim); *Aversan USA, Inc. v Jones* (ED Cal, June 24, 2009, No. 2:09-cv-00132-MCE-KJM) 2009 US Dist Lexis 53660 (statutory unfair competition claim not based on same nucleus of facts as claim for trade secrets misappropriation not preempted by California UTSA); *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025, 1034 (all state law claims based on same nucleus of facts as trade secrets claim are preempted under California UTSA).

Generally, only injunctive relief is available for civil litigants under the unfair competition statutes, but monetary recovery may be available as restitution (*not* as compensation or punitive damages). *Kates v Crocker Nat'l Bank* (9th Cir 1985) 776 F2d 1396, 1398 (citing *Chern v Bank of America* (1976) 15 C3d 866, 127 CR 110, and other cases); *Newport Components, Inc. v NEC Home Elec.* (CD Cal 1987) 671 F Supp 1525, 1551. Disgorgement of profits obtained by an unfair business practice is not an authorized remedy in an individual action under Bus & P C §17200. Restitution is a remedy, but is limited to restoring property in which the plaintiff has an ownership interest. *Korea Supply Co. v Lockheed Martin Corp.* (2003) 29 C4th 1134, 1149, 131 CR2d 29. See Bus & P C §17203.

Abuse of Bus & P C §17200 to extract settlements from large numbers of businesses resulted in the passage in 2004 of Proposition 64, which narrows the standing requirements to require actions by public prosecutors or persons suffering injury in fact and loss of money or property as a result of the unfair competition.

Injunctive relief, damages, and punitive damages are available for common law unfair competition. See *Duncan v Stuetzle* (9th Cir 1996) 76 F3d 1480, 1489; *Ojala v Bohlin, supra*. Although a bond is normally required for interlocutory injunctions, Bus & P C §17200 creates an exemption from this requirement. See Bus & P C §17081. If, however, the unfair competition claim is based on the same facts as the trade secret misappropriation claim, it may be preempted by California's UTSA. *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025, 1033 (common law claims preempted).

Claims for statutory unfair competition have a 4-year limitations period. Bus & P C §17208.

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§11.50 M. Unjust Enrichment

"Unjust enrichment" arises when one party accepts something of benefit without paying for it. A true contract is not created, and instead of being based on the parties' intention, liability is based on the theory that a duty or an obligation is created for reasons of fairness or justice. *County of Santa Clara v Robbiano* (1960) 180 CA2d 845, 848, 5 CR 19. See CACI 305. This quasi-contract claim may be pleaded in state court by a common count. *Frank v Tavares* (1956) 142 CA2d 683, 689, 298 P2d 887. Because claims for unjust enrichment include an element of bad faith, they may not be preempted by federal patent laws. See *Zenith Electronics Corp. v Elgo Touchsystems, Inc.* (Fed Cir 1999) 182 F3d 1340, 1355. State law claims of fraud and unjust enrichment are preempted to the extent they attempt to define who is the inventor of a patented combination or to grant patent-like rights that limit the public's use of the patented invention. *University of Colo. Found., Inc. v American Cyanamid Co.* (Fed Cir 2003) 342 F3d 1298 (unjust enrichment not preempted by patent laws when used as a contract remedy and not to enforce intellectual property rights; damages limited to disgorgement of incremental profits wrongfully made from the improperly obtained patent). But a claim for unjust enrichment will be preempted under CC §3426.7 if it relies on the same facts as the misappropriation claim. *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025, 1035.

The elements of proof usually contain the same requirements as an implied-in-fact contract (see §11.38 on breach of implied-in-fact or written contracts), and, in addition, the following:

- The defendant received benefits from the plaintiff;
- The plaintiff did not give the benefits gratuitously;
- The defendant accepted the benefits without paying for them; and
- The defendant has been unjustly enriched, so it is inequitable to retain the benefits without compensating the plaintiff. *Truestone, Inc. v Simi W. Indus. Park II* (1984) 163 CA3d 715, 724, 209 CR 757.

Unjust enrichment claims have a 2-year limitations period running from the date of injury. CCP §339.

NOTE: If the unjust enrichment claim is based on the same facts as the trade secret misappropriation claim, it may be preempted by California's UTSA. *Digital Envoy, Inc. v Google, Inc.* (ND Cal 2005) 370 F Supp 2d 1025, 1033 (common law claims preempted).

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§11.51 N. Civil Writ of Possession for Stolen Property

If a misappropriator has taken tangible personal property that embodies trade secrets, California's claim and delivery law enables the sheriff to help recover that property. CCP §§511.010-516.050. Recovery requires that the plaintiff has a right to immediate possession of tangible personal property and that the defendant is wrongfully withholding that property. *Englert v IVAC Corp.* (1979) 92 CA3d 178, 185, 154 CR 804. A prejudgment writ of possession may issue if the plaintiff (1) establishes the probable validity of its claim to possession of the personal property, (2) provides an undertaking, and (3) establishes the probable location of the property. CCP §512.020(b)(1). An ex parte writ of possession is available if a court also finds that the defendant gained possession of the property feloniously. CCP §512.060.

Although this action offers the assistance of law enforcement officials, few reported cases have applied it for recovery of trade secrets. One court applied this section to affirm an injunction requiring counsel to return confidential information improperly acquired from employees of the opposing party. *Pillsbury, Madison & Sutro v Schectman* (1997) 55 CA4th 1279, 64 CR2d 698.

NOTE: Counsel may be able to get a court order permitting the immediate deposition of the alleged misappropriator and to serve him or her with a subpoena requiring that he or she bring to the deposition all property of the trade secret owner and all tangible things embodying the trade secret, as identified in the subpoena. For example, counsel might be able to obtain a daily transcript of the deposition and, with the transcript and the knowledge obtained about the property in the misappropriator's possession, obtain interim equitable relief.

Claims for recovery of stolen property have a 3-year limitations period. CCP §338(c).

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§11.52 O. Copyright Act of 1976

A copyright protects the expression of an idea against copying that would result in works substantially similar to the copyrighted work. The Copyright Act of 1976 preempts "all legal or equitable rights that are equivalent to any of the exclusive rights" specified in the Act. 17 USC §301. These exclusive rights include the right to reproduce the work, make derivative works, distribute copies of it, perform the work, or display it publicly. 17 USC §106.

Claims for trade secret misappropriation and breach of confidentiality and fiduciary duty are not usually preempted by the Copyright Act, but a claim for misappropriation is preempted to the extent it encompasses potentially copyrightable software. *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 267 CR 787. See chap 16 for discussion of trade secrets involving computer technology.

Preemption most often occurs if the same facts are alleged to give rise to both a claim of copyright infringement and a claim of trade secret misappropriation. *Relational Design & Technol., Inc. v Data Team Corp.* (D Kan 1992) 23 USPQ2d 1074 (applying Kansas UTSA). If an extra element is required to constitute trade secret misappropriation, however, either instead of or in addition to an act that violates one or more of the exclusive rights of a copyright holder, then there is no preemption. *Computer Assocs. Int'l v Altai, Inc*. (2d Cir 1992) 982 F2d 693, 716.

If a state court claim pleads a copyright claim as a state trade secret claim, the action can be removed to federal court. *Rosciszewski v Arete Assocs.* (4th Cir 1993) 1 F3d 225, 232 (applying Virginia UTSA; claim in software removed to federal court); *Enhanced Computer Solutions, Inc. v Rose* (SD NY 1996) 927 F Supp 738 (remanding claim improperly removed as preempted by Copyright Act). See §11.8.

To the extent a copyrighted work embodies information that is not subject to copyright protection, the work may be subject to trade secret protection. *Gates Rubber Co. v Bando Chem. Indus.* (10th Cir 1993) 9 F3d 823, 848. A copyrighted work may be maintained as a trade secret until it is published, giving rise to potential recovery under both trade secret and copyright liability. The court may allow a party to waive its copyright claims if it loses the originally copyrighted program and then to pursue only trade secret claims. *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1529 (applying Colorado UTSA).

Copyright claims have a 3-year rolling limitations period on damages, which means that damages are recoverable for the three-year period before the complaint was filed. 17 USC §507(b); *Roley v New World Pictures, Ltd.* (9th Cir 1994) 19 F3d 479, 481. Although the limitations period for an accounting by a copyright co-owner is governed by state law (*Goodman v Lee* (5th Cir 1996) 78 F3d 1007, 1013), a claim of co-ownership must be brought within 3 years after an express repudiation of co-ownership (*Zuill v Shanahan* (9th Cir 1996) 80 F3d 1366, 1369).

For further discussion of copyrights, see §§16.43-16.46; California Business Litigation, chap 7 (Cal CEB 2002).

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Source: Business Law/Trade Secrets Practice in California/11 Litigation Issues/§11.53 P. Lanham Act

§11.53 P. Lanham Act

Section 43(a) of the Lanham Act (15 USC §1125(a)) encompasses trademark infringement, false designations of origin, false advertising, and numerous other claims that may be characterized as unfair competition. One purpose of the Lanham Act is to "protect commercial parties against unfair competition." *Abdul-Jabbar v General Motors Corp.* (9th Cir 1996) 85 F3d 407, 410 (false endorsement claim). Common law unfair competition and unfair competition under Bus & P C §17200 are "substantially congruent" to claims made under the Lanham Act. *Cleary v News Corp.* (9th Cir 1994) 30 F3d 1255, 1265 (claim for misattribution of authorship). The breadth of §43(a) has led to the removal of poorly drafted misappropriation claims from state to federal court. *Duncan v Stuetzle* (9th Cir 1996) 76 F3d 1480, 1491 (remanding claims for misappropriation, unfair competition, and civil conspiracy that were improperly removed under the Lanham Act).

For many years, a defendant who published information under the name of a person who was not the author of that information was liable for falsely designating the origin of the information under Lanham Act §43(a) (15 USC §1125(a)). These claims were characterized as "reverse palming off." See, *e.g., Smith v Montoro* (9th Cir 1981) 648 F2d 602, 607 (omitting director's name from movie credits). That is no longer the law. In 2003, the Supreme Court stated that the requirement in §1125(a) for "origin of goods" "refers to the producer of the tangible goods that are offered for sale, and not to the author of any idea, concept, or communication embodied in those goods." *Dastar Corp. v Twentieth Century Fox Film Corp.* (2003) 539 US 23, 37, 156 L Ed 2d 18, 26, 123 S Ct 2041. In *Dastar,* the defendant was the origin of the product it sold (a video series compiled from prior television shows in which the copyright had expired), so the claim for reverse palming off was dismissed.

A successful plaintiff in a Lanham Act action may recover the defendant's profits or the plaintiff's damages, which may be trebled in the court's discretion. Attorney fees may be awarded in exceptional cases. See 15 USC §1117; *FASA Corp. v Playmates Toys, Inc.* (7th Cir 1997) 108 F3d 140 (on remand, attorney fees denied at discretion of trial court; see *FASA Corp. v Playmates Toys, Inc.* (ND Ill 1998) 1 F Supp 2d 859). There is concurrent federal and state jurisdiction for Lanham Act claims, making a choice of forums possible. *Silvaco Data Sys. v Technology Modeling Assocs.* (ND Cal 1995) 896 F Supp 973, 977 (staying federal suit pending conclusion of parallel state court action).

The Lanham Act, including 15 USC §1125(a), has no statute of limitations. Federal law provides a general 4-year statute of limitations for any civil law enacted by Congress that lacks a specific statute of limitations (see 28 USC §1658), but the 4-year statute applies only if the civil law was enacted after December 1, 1990. The Lanham Act was enacted long before that date, so §1658 is inapplicable. California's statutes of limitation apply to federal Lanham Act claims brought in California federal or state courts, because the state statutes of limitation are applied to any federal cause of action that lacks an express statute of limitations. *Ragan v Merchants Transfer & Warehouse Co.* (1949) 337 US 530, 93 L Ed 1520, 69 S Ct 1233 (affirming summary judgment dismissal based on statute of limitations of forum state); *Turner v Lundquist* (9th Cir 1967) 377 F2d 44, 46 (Securities Exchange Act violation); *Fox Chem. Co. v Amsoil, Inc.* (D Minn 1978) 445 F Supp 1355, 1357 (Lanham Act claim). See *Tandy Corp. v Malone & Hyde, Inc.* (6th Cir 1985) 769 F2d 362, 365 (trademark/unfair competition case). California's state trademark statute has no limitations period, so the 4-year default provision of CCP §343 is the longest period that could apply. Other potential analogous and applicable statutes are the 4-year period of the unfair competition statute. Bus & P C §17208. See California Business Litigation, chap 4 (Cal CEB 2002). The 4-year period also applies to false advertising. Bus & P C §17500.

NOTE: The Lanham Act incorporates international treaties, including the Paris Convention for the Protection of Industrial Property (available at http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html), which arguably invokes the broad, European action for unfair competition under which anything inconsistent with honest business practice is actionable as unfair competition. 15 USC §1126; *General Motors Corp. v Ignacio Lopez de Arriortua* (ED Mich 1996) 948 F Supp 670 (applying 15 USC §1126(h)-(i) to trade secret case).

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§11.54 Q. Patents

A United States patent gives the owner the right to exclude others from making, using, selling, offering to sell, or importing the inventions defined in one or more claims of the patent. 35 USC §271. A plaintiff may recover only for acts of patent infringement that occurred within 6 years before the infringement suit is filed. 35 USC §286. Although United States patent applications are kept secret until an application is published or a patent is issued (35 USC §122), the disclosure of a trade secret in an issued patent prospectively destroys the trade secret to the extent of the disclosure. A misappropriator cannot defend against liability for misappropriation, however, by patenting and thus publishing ill-gotten trade secrets. *Syntex Ophthalmics, Inc. v Tsuetaki* (7th Cir 1983) 701 F2d 677, 683.

The United States patent laws, 35 USC §§1-376, do not preempt trade secret protection. *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 474, 40 L Ed 2d 315, 94 S Ct 1879. Patent law requires adequate disclosure of the best mode of a claimed invention, however, and thus limits an inventor who attempts to enjoy both patent protection and trade secret protection on the same invention. If everything is disclosed in the patent, there may well be no remaining trade secrets, but if some know-how is not included in the patent, the inventor risks having the patent denied for inoperability or insufficient disclosure. 35 USC §112; *Ocean Science & Eng'g v U.S.* (Ct Cl 1979) 595 F2d 572, 582; *Flick-Reedy Corp. v Hydro-Line Mfg. Co.* (7th Cir 1965) 351 F2d 546. Moreover, if information is intentionally withheld, the patent may be found unenforceable for inequitable conduct. *Consolidated Aluminum Corp. v Foseco Int'l* (Fed Cir 1990) 910 F2d 804. Therefore, a patent clearly limits what a party can claim as trade secrets and effectively estops a party from seeking trade secret relief for some aspects of the patent. *American Can Co. v Mansukhani* (7th Cir 1984) 742 F2d 314, 329.

A patent applicant need only disclose the best mode contemplated by the inventor. 35 USC §112. See *Glaxo Inc. v Novopharm Ltd.* (Fed Cir 1995) 52 F3d 1043. In *Glaxo,* the corporation disclosed in the patent application only an inferior manufacturing method known to the inventor of a claimed chemical compound and shielded the inventor from knowledge of a better process to make the compound that was known to the corporation. The corporation was thereby able to maintain the best manufacturing process as a trade secret without jeopardizing the patent. But the trial court recognized the tension between the disclosure obligations of patents and the secrecy requirements for trade secrets; that tension flavored the ultimate finding that *Glaxo* had no trade secrets and that the accused misappropriator developed its process independently. *Glaxo Inc. v Novopharm Ltd.* (ED NC 1996) 931 F Supp 1280, aff'd (Fed Cir 1997) 110 F3d 1562.

Not all elements of a patented invention need be disclosed. Disclosure of firmware that embodies a computer program to implement a specific task may satisfy the best mode and enabling requirements, even if the specific program used by the inventor is maintained as a trade secret. *In re Hayes Microcomputer Prods.* (Fed Cir 1992) 982 F2d 1527, 1534. Similarly, trade secrets can exist in the tolerances for mass-produced items, even if portions of those items are patented. *Christianson v Colt Indus. Operating Corp.* (7th Cir 1989) 870 F2d 1292, cert denied (1989) 493 US 822; see *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, 975 (specifications material and manufacturing processes). Thus, trade secret protection may supplement patent protection.

Because publication of a patent discloses the trade secrets, the patent publication date is crucial. See *Penalty Kick Mgmt. Ltd. v Coca Cola Co.* (11th Cir 2003) 318 F3d 1284 (beverage label marketing and production process qualified for trade secret status, but most "concepts" of production process were disclosed in prior art utility patents and were not protectable as trade secrets). For patent applications filed on or after March 15, 2001, in the United States or most foreign countries, the application will be published 18 months from its earliest priority date. 35 USC §122. There is one exception for United States applicants by which an applicant can certify at the time of filing that no foreign applications will be sought, in which case the application will be maintained in secret until issued or until the applicant voluntarily publishes the application. The applicant can change its position and file foreign patent applications by complying with Patent Office procedures. Access to issued United States patents or published United States patent applications is available at http://www.uspto.gov. That website has links to websites of patent offices in other countries, some of which also publish issued and pending patents.

Maintaining patentable material as a trade secret rather than seeking patent protection can limit the options available to the inventor of the material. A process practiced in secret will not invalidate a later-issued patent obtained by another inventor. *W.L. Gore & Assocs. v Garlock* (Fed Cir 1983) 721 F2d 1540, 1550. If an inventor practices a process in secret and sells the resulting product for more than 1 year without filing for a patent, the inventor forfeits the right to a United States patent. *Metallizing Eng'g Co. v Kenyon Bearing & Auto Parts Co.* (2d Cir 1946) 153 F2d 516. Further, if a trade secret is misappropriated and placed on sale more than 1 year before a patent application is filed, the 1-year on-sale bar of 35 USC §102(b) prevents a patent from issuing. *Evans Cooling Sys. v General Motors, Inc.* (Fed Cir 1997) 125 F3d 1448.

A committee of the American Bar Association, examining the rights of a previous user of a trade secret relative to a later patentee,

concluded that the cases reflect the courts' tendency to stretch 35 USC §102(g) to avoid holding a prior inventor liable to a later inventor patentee. ABA Section of Patent, Trademark and Copyright Law, 1980 Committee Reports 217. The committee found no cases in which a second inventor/patentee obtained a remedy against a first inventor/trade secret user. See *Dunlop Holdings, Ltd. v Ram Golf Corp.* (7th Cir 1975) 524 F2d 33; *Grain Prods. v Lincoln Grain, Inc.* (SD Ind 1976) 191 USPQ 177; *Westwood Chem. v Dow Corning Corp.* (ED Mich 1975) 189 USPQ 649. Thus, under two different analyses, the first inventor is not liable to a second inventor.

NOTE: Congress has made first inventor protection explicit for "business method" patents. 35 USC §273.

For further discussion of patents, see California Business Litigation, chap 8 (Cal CEB 2002); §§16.60-16.62.

While the test for the existence of a trade secret (see §§1.3-1.10) is different from the standards for determining patentability, courts have nonetheless considered patentability in evaluating various aspects of trade secret protection. See *Weins v Sporleder* (SD Sup Ct 1997) 569 NW2d 16, 22 (patent office rejection for obviousness relevant to claim asserting "combination-of-known-elements" secret). Expert testimony opining that a trade secret was patentable can be substantial evidence that the device was not generally known and not readily ascertainable by proper means. *Olson v Nieman's, Ltd.* (Iowa Sup Ct 1998) 579 NW2d 299, 313 (applying Iowa UTSA). However, it is not appropriate to request an attorney to testify regarding what constitutes a trade secret or an act of misappropriation. *Bausch & Lomb, Inc. v Alcon Labs., Inc.* (WDNY 2000) 79 F Supp 2d 252, 258.

If a misappropriation and unauthorized disclosure result in loss of patent rights, then damages may be based on a reasonable royalty that would have been derived from the putative patent. *Olson v Nieman's, Ltd.* (Iowa Sup Ct 1998) 579 NW2d 299, 310 (applying Iowa UTSA). See §12.1. But the unauthorized disclosure must be the cause of the loss of patent rights. *Russo v Baxter Healthcare Corp.* (1st Cir 1998) 140 F3d 6 (applying Rhode Island UTSA).

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§11.55 R. Racketeer Influenced and Corrupt Organizations Act

The Racketeer Influenced and Corrupt Organizations Act (RICO) (18 USC §§1961-1968) makes it unlawful to engage in a pattern of racketeering activity in interstate commerce, to conspire to do so, or to acquire or invest money from that pattern of racketeering activity. Violations such as mail fraud or wire fraud can constitute a pattern of racketeering activity. Use of mail to establish mail fraud need not be an essential element of the scheme; it need only be "incidental to an essential part of the scheme," or "a step in the plot." *Schmuck v U.S.* (1989) 489 US 705, 710, 103 L Ed 2d 734, 109 S Ct 1443. The requirements for establishing RICO claims are still evolving, and the statute's reach is very broad. See *Sedima S.P.R.L. v IMREX Co.* (1985) 473 US 479, 87 L Ed 2d 346, 105 S Ct 3275.

RICO has been applied to an alleged conspiracy involving a close-ended scheme to steal trade secrets from an automobile company. *General Motors Corp. v Ignacio Lopez de Arriortua* (ED Mich 1996) 948 F Supp 670. In this case, the continued use of the trade secrets was also alleged to constitute an open-ended scheme or pattern of continuing racketeering activity. The trade secret misappropriators allegedly gave the secrets to Volkswagen, which was held to constitute the ongoing enterprise. That the underlying misappropriation occurred in the United States provided jurisdiction over the foreign defendants.

A RICO claim may not lie if confidential information is disclosed to or withheld from a government agency. In *University of W. Va. v VanVoorhies* (Fed Cir 2002) 278 F3d 1288, a patent owner was accused of intentionally withholding material from the Patent Office in order to improperly obtain a patent. The court found that, even if true, the allegation did not adequately state a predicate racketeering act under RICO, because such inequitable conduct does not defraud the Patent Office of something of value, as required by the mail fraud statute under 18 USC §1341.

RICO claims offer the possibility of recovering treble damages and attorney fees. To state a claim under civil RICO, the plaintiff is required to show that a RICO predicate offense was not only a "but for" cause of its injury, but was the proximate cause as well. *Hemi Group, LLC v City of New York* (2010) ___ US ___, 175 L Ed 2d 943, 130 S Ct 983 (citing *Holmes v Securities Investor Protection Corp.* (1992) 503 US 258, 117 L Ed 2d 532, 112 S Ct 1311). Proximate cause, for RICO purposes, requires some direct relation between the asserted injury and the alleged injurious conduct. *Anza v Ideal Steel Supply Corp.* (2006) 547 US 451, 457, 164 L Ed 2d 720, 728, 126 S Ct 1991 (citing *Holmes;* RICO plaintiff cannot circumvent proximate-cause requirement simply by claiming that defendant intended to increase market share at competitor's expense). See also *Hemi Group, LLC v City of New York, supra*. Further, personal jurisdiction is very broad under RICO, authorizing service of process wherever a defendant "resides, is found, has an agent, or transacts his affairs." Those liberal service requirements make it appropriate to assert pendent personal jurisdiction over state law claims arising from a common nucleus of operative fact, such as RICO predicate acts of trade secret misappropriation and interference with business advantage. *ESAB Group, Inc. v Centricut, Inc.* (4th Cir 1997) 126 F3d 617, 628; *Armstrong v American Pallet Leasing Inc.* (ND Iowa 2009) 678 F Supp 2d 827.

State courts have concurrent jurisdiction over RICO claims. *Tafflin v Levitt* (1990) 493 US 455, 107 L Ed 2d 887, 110 S Ct 792. RICO actions have a 4-year statute of limitations, which is analogous to the Clayton Act limitation. *Agency Holding Corp. v Malley-Duff & Assocs.* (1987) 483 US 143, 97 L Ed 2d 121, 107 S Ct 2759.

For discussion of criminal liability under RICO, see §13.7.

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12

Remedies for Trade Secret Misappropriation

Lowell Anderson

I. SUMMARY OF REMEDIES AVAILABLE §12.1

II. INJUNCTIVE RELIEF

A. Availability of Injunctive Relief §12.1A

B. Illustrative Injunction Remedies §12.2

C. Preliminary Injunctions §12.3

1. Standards for Preliminary Injunctions in California Courts §12.4

2. Standards for Preliminary Injunctions in Federal Courts §12.5

D. Temporary Restraining Orders §12.6

E. Permanent Injunctions

1. Standards for Permanent Injunctions §12.7

2. Specificity and Scope §12.8

3. Duration

a. General Rule §12.9

b. Variable Termination Date §12.10

4. Ordering Affirmative Acts to Protect Trade Secrets §12.11

5. Royalty in Lieu of Injunction §12.12

F. Threatened Misappropriation §12.13

G. Orders; Findings of Fact and Law §12.14

H. Bond for Interlocutory Injunctions §12.15

1. California State Courts §12.16

2. Federal Courts §12.17

I. Appellate Review

1. California State Court §12.18

2. Federal Court §12.19

III. DAMAGES AND OTHER MONETARY AWARDS

A. Basis for Relief: Actual Loss or Unjust Enrichment §12.20

B. Reasonable Royalty §12.21

C. Punitive Damages §12.22

D. Attorney Fees §12.23

E. Costs §12.24

IV. REMEDIES NOT BASED ON UTSA §12.25

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§12.1 I. SUMMARY OF REMEDIES AVAILABLE

Under the California Uniform Trade Secrets Act (UTSA) (CC §3426-3426.11), a trade secret owner can obtain both affirmative and prohibitory injunctive relief (CC §3426.2; see §§12.2-12.19) as well as monetary damages (CC §3426.3; see §§12.20-12.21). The court has the discretion to award treble damages (CC §3426.3(c); see §12.22) and attorney fees and costs, including reasonable fees for independent experts (CC §3426.4; see §12.23). Imprisonment and fines may also be imposed (see, *e.g.,* Pen C §499c; see chap 13).

Remedies under contract law and other related statutes may provide additional injunctive and damage relief, as well as constructive trusts and assignments of patents derived from misappropriated trade secrets. CC §3426.7. See §§11.35-11.54 for discussion of related causes of action. If the dispute involves electronically stored evidence that is easily destroyed, counsel should consider requesting expedited discovery in addition to preliminary injunctive relief. See, *e.g., Physicians Interactive v Latham Sys. Inc.* (ED Va 2003) 69 USPQ2d 1981 (Virginia UTSA). If a computer or Internet access device was involved in acquiring the misappropriated information, remedies under the federal Computer Fraud and Abuse Act (18 USC §1030) may be available.

One remedy that is not available in California is reformation of contracts that violate Bus & P C §16600, since narrowing contracts to define the outer limits permitted by §16600 would undermine the policy behind the statute and could unfairly favor employers. *Applied Materials, Inc. v Advanced Micro-Fabrication Equip. (Shanghai) Co.* (ND Cal 2009) 630 F Supp 2d 1084 (refusing to reform an employment agreement assigning all inventions related to the business for 1 year after termination). On the remedy of reformation generally, see California Law of Contracts §§11.62-11.64 (Cal CEB 2007).

Ownership of trade secrets at the time of trial is not required to recover damages. A trade secret owner has standing to sue for misappropriation of trade secrets owned when suit was filed even though the company assets were sold afterwards in a bankruptcy sale, with the plaintiff retaining rights to the trade secret claim, but not the trade secrets. *Jasmine Networks, Inc. v Superior Court (Marvell Semiconductor, Inc.)* (2009) 180 CA4th 980, 103 CR3d 426. The accused party can join the current owner to avoid repeated suits. Ownership of the trade secret at the time of trial should be required for injunctive relief in order to establish irreparable injury, as discussed below.

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II. INJUNCTIVE RELIEF

§12.1A A. Availability of Injunctive Relief

A trade secrets plaintiff can obtain three types of injunctions. The most common is an injunction against ongoing, actual misappropriation of a trade secret. A plaintiff may also obtain an injunction against "threatened" misappropriation, discussed in §12.13 below. See CC §3426.2(a).

Less common but still available is the so-called "head start" injunction. See §12.9. This remedy is appropriate for situations in which a defendant misappropriated a trade secret while it was secret, but the trade secret subsequently entered the public domain. In such cases, a court can craft an injunction to take away the advantage the defendant obtained from predisclosure use of the trade secret. See *Winston Research Corp. v Minnesota Mining & Mfg. Co*. (9th Cir 1965) 350 F2d 134 (applying concept under California law); Barclay, *Trade Secrets: How Long Should An Injunction Last?,* 26 UCLA L Rev 203 (1978) (collecting cases). See also *Internet Inc. v Tensar Polytechnols., Inc.* (D Minn 2005) 77 USPQ2d 1122 (preliminary injunction denied after accused party retracted sales quotations and purged computers of information provided by plaintiff's personnel).

NOTE: There is a fourth situation for which injunctive relief is not available. If the defendant has ceased using the trade secret, there is no injunctive relief available for past misappropriation. No reported California case has addressed this issue, but the basic principle that injunctions do not reach past conduct is sound. See *Campbell Soup Co. v Conagra, Inc*. (3d Cir 1992) 977 F2d 86, 92 (applying rule); *Lemmon v Hendrickson* (Iowa 1997) 559 NW2d 278, 279 (same). Because an injunction for trade secrets may be limited to take away the "head start" advantage obtained by misappropriation of trade secrets (see §§12.1A, 12.9), the duration of a preliminary injunction may be limited. In *Estee Lauder Cos. v Batra* (SD NY 2006) 430 F Supp 2d 158, the court granted a preliminary injunction to enforce a 1-year noncompetition agreement against a California resident but limited the preliminary injunction to 5 months.

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§12.2 B. Illustrative Injunction Remedies

A wide variety of misconduct has been enjoined under common and statutory trade secret law. Since 1915, when the earliest reported California case issuing an injunction for trade secret misappropriation was decided, courts applying California law have issued, affirmed, or remanded for, injunctions in at least 40 published decisions. The breadth of available injunctive relief is illustrated by the following examples:

- *Dodge, Warren & Peters Ins. Servs., Inc. v Riley* (2003) 105 CA4th 1414, 130 CR2d 385 (applying California common law): Preliminary injunction preventing defendants from destroying, deleting, or secreting from discovery any electronic storage media and allowing immediate copying of information at issue and computer hard drives for analysis by a computer expert.

- *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 66 CR2d 731 (applying UTSA): Permanent injunction with leave to seek termination of injunctive relief against defendants' use of plaintiff's customer list found to be trade secret.

- *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 272 CR 352 (applying UTSA): Injunction barring the use of a list of employers actually hiring temporary employees and the "negative know-how" indicating those that did not.

- *ISC-Bunker Ramo Corp. v Altech, Inc*. (ND Ill 1990) 765 F Supp 1310, 1333 (applying Illinois version of Uniform Act): Injunction barring use of utilities programs, operating systems programs, technical bulletins, and service manuals.

- *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 262 CR 92 (applying UTSA): Injunction barring the use of an elite customer list prepared by a former employer, which identified the businesses that used the service at issue.

- *Den-Tal-Ez, Inc. v Siemens Capital Corp.* (Pa Super Ct 1988) 9 USPQ2d 1932, aff'd (9th Cir 2002) 35 Fed Appx 450 (unpublished opinion) (applying Pennsylvania common law to preliminary and permanent injunctions): Injunction barring acquisition of a company by a competitor to prevent disclosure of confidential information disclosed during failed acquisition discussions. See also *Phillips v Frey* (5th Cir 1994) 20 F3d 623 (applying Texas common law to permanent injunction in similar case).

- *Imi-Tech Corp. v Gagliani* (SD Cal 1986) 691 F Supp 214, 231 (applying California common law): Injunction barring disclosure, use, and licensing of information and patents developed under government contracts.

- *Cubic Corp. v Marty* (1986) 185 CA3d 438, 229 CR 828 (applying California common law): Injunction barring exploitation of a patent and assigning the patent to a former employer.

- *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 960 (applying California common law): TRO procedure forcing an alleged misappropriator to clear all disclosures with its competitor.

- *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 24 CR3d 720. The court upheld a preliminary injunction that prohibited a former employee from soliciting employees and customers of a temporary nurse staffing business because the identity of the company's employees and customers was secret. The former employee's right to compete did not, in this case, overcome the "concomitant right to have the ingenuity and industry one invests in the success of the business or occupation protected from the gratuitous use of that 'sweat-of-the-brow' by others."

- *Smith Barney v Burrow* (ED Cal 2008) 558 F Supp 2d 1066. A preliminary injunction enforced a 1-year covenant not to solicit customers brought to an employer by other financial advisors but allowed servicing and solicitation of customers previously serviced by the departing financial advisors.

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§12.3 C. Preliminary Injunctions

Preliminary injunctions preserve the status quo by stopping acts of misappropriation until a decision of the action is made on the merits. *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 961 (preliminary injunction would maintain post-TRO status quo). The court has discretion to grant or deny injunctive relief to enjoin actual or threatened misappropriation. CC §3426.2(a). See *Lakeview Technol., Inc. v Robinson* (7th Cir 2006) 446 F3d 655 (plaintiff not required to prove misappropriation has occurred; defendant's "history of deceit" suggests substantial risk for plaintiff absent injunction); *Capital Tool & Mfg. v Maschinenfabrik Herkules* (4th Cir 1988) 837 F2d 171, 173 (applying Virginia version of Uniform Act; "actual or threatened misappropriation *may,* not must, be enjoined"). If the requested injunction would have a significant adverse impact on the defendant, however, a reasonable royalty could be imposed in lieu of an injunction. CC §3426.2(b); see §12.12. Conversely, if the accused misappropriator is not disseminating the trade secrets and has an incentive to keep the misappropriated information secret in order to maintain a competitive advantage, there may be no presumption of irreparable injury from the misappropriation. *Faiveley Transp. Malmo AB v Wabtec Corp.* (2d Cir 2009) 559 F3d 110 (reversing preliminary injunction).

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/§12.4 1. Standards for Preliminary Injunctions in California Courts

§12.4 1. Standards for Preliminary Injunctions in California Courts

California state courts consider two interrelated factors in deciding whether to issue a preliminary injunction: (1) likelihood of success on the merits and (2) interim harm. *Hilb, Rogal & Hamilton Ins. Servs. of Orange County, Inc. v Robb* (1995) 33 CA4th 1812, 1819, 39 CR2d 887. The first factor examines the likelihood that the trade secret owner will prevail on the merits at trial. The second examines the interim harm that the plaintiff trade secret owner is likely to sustain if the injunction is denied, balanced against the harm that the defendant is likely to suffer if the preliminary injunction is issued. 33 CA4th at 1822. Statutory factors are listed in CC §3422 and CCP §526. Issuance of an injunction under California's UTSA requires the court to balance the harms, even though an injunction is expressly authorized by statute (CC §3426.2). See *DVD Copy Control Ass'n, Inc. v Bunner* (2003) 31 C4th 864, 4 CR3d 69 (free speech rights were not violated in enjoining publication of DeCSS decryption program, because injunction was content neutral and no broader than needed to protect trade secrets in decryption program). The court balances the equities and decides whether, pending a trial on the merits, the defendant should be restrained from exercising the right he or she claims. *ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 17, 286 CR 518. See *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 637, 262 CR 92 (goal "is to minimize the harm which an erroneous interim decision may cause").

PRACTICE TIP: Because injunctions are equitable in origin and application, many judges will not grant injunctive relief without a showing of irreparable injury. Therefore, counsel should always submit evidence of such injury.

The trial court may consider additional factors in deciding whether to grant or deny an injunction, such as diligence (*Tustin Community Hosp. v Santa Ana Community Hosp. Assocs.* (1979) 89 CA3d 889, 894, 153 CR 76) and the public interest in national security (*Republic Aviation Corp. v Schenk* (NY Sup Ct 1967) 152 USPQ 830 (armament and control systems for jet fighters)). But see *Continental Group, Inc. v AMOCO Chem. Corp.* (3d Cir 1980) 614 F2d 351, 357 (general and abstract expression of public policy insufficient to support preliminary injunction under common law).

No permanent injunction is appropriate if the trade secret is no longer a secret. *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064, 1069.

NOTE: Secrecy can be lost quickly if information is posted on the Internet. Thus, a plaintiff trade secret holder should make certain that the secrecy required for protection has not been destroyed before the time an accused misappropriator is said to have committed the acts of misappropriation. See *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 10 CR3d 185.

An injunction is also inappropriate if money damages are awarded over a period long enough to accommodate any head start. *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 64 n44, 37 CR3d 221. In *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 1017, 24 CR3d 720, the court found trade secrets are "fundamental to the preservation of our free market economic system," and thus outweighed a former employee's right to compete; the employee's right did not overcome the "concomitant right to have the ingenuity and industry one invests in the success of the business or occupation protected from the gratuitous use of that 'sweat-of-the-brow' by others."

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/§12.5 2. Standards for Preliminary Injunctions in Federal Courts

§12.5 2. Standards for Preliminary Injunctions in Federal Courts

Federal courts apply federal procedural rules to determine whether a preliminary injunction or a TRO is warranted. Thus, rules such as the standards for issuing a preliminary injunction and the requirements for a hearing are governed by federal law. *Granny Goose Foods, Inc. v Brotherhood of Teamsters, Etc.* (1974) 415 US 423, 39 L Ed 2d 435, 94 S Ct 1113. See 28 USC §§1332 (diversity jurisdiction), 1338 (jurisdiction over patent, copyright, and sufficiently related unfair competition cases), 1367 (supplemental jurisdiction); Fed R Civ P 65 (injunctions). The courts apply state law, however, to determine the substantive issue of trade secret misappropriation. *Imi-Tech Corp. v Gagliani* (SD Cal 1986) 691 F Supp 214, 229. Even if a trade secret suit initiated in federal court in California is joined with a claim arising under federal patent law so that appellate jurisdiction lies with the Court of Appeals for the Federal Circuit (see 28 USC §§1292(c), 1295), the procedural rules governing the preliminary injunction to enjoin misappropriation are those of the Ninth Circuit Court of Appeals, and California law governs the substantive aspects of the suit. *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 955. California law also governs personal jurisdiction through California's long-arm statute (CCP §410.10). *Electronics for Imaging Inc. v Coyle* (Fed Cir 2003) 340 F3d 1344.

Before November 2008, the party seeking a preliminary injunction in the Ninth Circuit had to show either (1) a combination of probable success on the merits and the possibility of irreparable injury or (2) that serious questions are raised and the balance of hardships tips sharply in the moving party's favor. *Imi-Tech Corp. v Gagliani, supra; Litton Sys. v Sundstrand Corp., supra*. The court examined these factors on a continuum. *Johnson Controls, Inc. v Phoenix Control Sys.* (9th Cir 1989) 886 F2d 1173, 1174.

In November 2008, however, the Supreme Court rejected the "possibility" standard in *Winter v Natural Resources Defense Council, Inc.* (2008) 555 US ___, 172 L Ed 2d 249, 256, 129 S Ct 365. As a result, preliminary injunction cases decided before November 2008 are no longer controlling. In *Winter*, the Court found that "the Ninth Circuit's 'possibility' standard is too lenient. Our frequently reiterated standard requires plaintiffs seeking preliminary relief to demonstrate that irreparable injury is *likely* in the absence of an injunction." 172 L Ed 2d at 262. Under the current applicable standard (172 L Ed 2d at 261),

[a] plaintiff seeking a preliminary injunction must establish that he is likely to succeed on the merits, that he is likely to suffer irreparable harm in the absence of preliminary relief, that the balance of equities tips in his favor, and that an injunction is in the public interest.

Irreparable injury can take a variety of forms in trade secret cases. In addition to initial or further disclosure of the trade secret, exemplary injuries may include disclosure or licensing beyond the court's jurisdiction to enjoin the use of a trade secret and harm to a party's competitive position. *Imi-Tech Corp. v Gagliani* (SD Cal 1986) 691 F Supp 214, 230 (pending disclosure in Japan). The courts examine whether the impact of an injunction on the enjoined party would be more severe than the injury the moving party would suffer were it not granted. *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 959 (noting "devastating" effect on alleged misappropriator). Intangible interests can tip the balance. For example, in *CBS, Inc. v Davis* (1994) 510 US 1315, 127 L Ed 2d 358, 114 S Ct 912, the Supreme Court stayed a preliminary injunction enjoining an alleged trade secret violation because it constituted a prior restraint causing irreparable harm to the defendant news organization; such harm was "intolerable under the First Amendment." However, a preliminary injunction would be appropriate if a strong showing were made of probable success on the merits and of irreparable harm, despite an unfavorable balance of the hardships.

NOTE: Do not assume that irreparable injury will be presumed to arise once misappropriation is shown. An injunction requires that an irreparable injury exists for which monetary damages are inadequate, that the balance of hardships warrants an equitable remedy, and that the public interest is not disserved by an injunction. See *eBay Inc. v MercExchange, LLC* (2006) 547 US 388, 164 L Ed 2d 641, 126 S Ct 1837 (reversing injunction that presumed irreparable injury upon finding of patent infringement).

Like California state courts, the federal trial court may consider additional factors such as public interest, any diligence that affects the irreparable injury, and the relative size of the companies. See *Robinson v Jardine Ins. Brokers Int'l Ltd.* (ND Cal 1994) 856 F Supp 554, 559 n20 (size and strength of parties relevant in determining respective hardships); *ISC-Bunker Ramo Corp. v Altech, Inc.* (ND Ill 1990) 765 F Supp 1310 (public interest). In the Ninth Circuit, federal district courts must expressly consider on the record any public policy at stake when balancing the hardships on a request for preliminary injunction. See *Northern Cheyenne Tribe v Hodel* (9th Cir 1988) 851 F2d 1152, 1157.

A court may delay the preliminary injunction hearing to narrow or specifically identify the alleged trade secrets and to allow the defendant time to investigate their validity. *Albion Labs. v Seroyal Brands, Inc.* (ND Cal 1979) 209 USPQ 511; *Lee Pharms. v Den-Mat, Inc.* (CD Cal 1976) 197 USPQ 62, 63.

The steps to avoid preliminary injunctions are illustrated in *Internet Inc. v Tensar Polytechnols., Inc.* (D Minn 2005) 77 USPQ2d

1122, in which the defendant promptly ended its agreement with the consultant accused of misappropriating information, retracted the consultant's sales quotations, and purged its computers of any consultant-derived information. The court found that the harm from the requested overly broad injunction outweighed the potential harm to the plaintiff stemming from its denial. *Internet Inc. v Tensar Polytechnols., Inc., supra* (Minnesota UTSA; court noted that issues existed as to whether customer information was secret and known to defendant, and that plaintiff had high burden as to customer lists because they do not ordinarily rise to level of trade secret).

For further discussion of preliminary injunctive requirements and procedures, see California Business Litigation, chap 2 (Cal CEB 2002).

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§12.6 D. Temporary Restraining Orders

A temporary restraining order (TRO) is used to preserve the status quo only pending the preliminary injunction hearing. See CCP §527. A party seeking a TRO must show immediate and irreparable harm (due to the inadequacy of legal remedies). CCP §526(a)(2); *Triple A Mach. Shop v State* (1989) 213 CA3d 131, 138, 261 CR 493. If the harm is not immediate, *i.e.,* if no injury will result before the preliminary injunction can be heard, a judge is likely to wait until the preliminary injunction hearing to determine whether to grant injunctive relief.

In California courts, a TRO differs from a preliminary injunction in several ways. A California state court can issue a TRO (but not a preliminary injunction) without notice to the opposing party, provided that irreparable injury will result and that counsel either informed the opposing party of when and where the TRO application would be made, attempted but was unable to so notify the opposing party, or shows that notice should not be given for specifically stated reasons. CCP §527(a), (c). If a TRO is granted without notice, a hearing on an order to show cause why an injunction should not be granted must be held within 15 days after issuance of the TRO (or on good cause within 22 days after the TRO). CCP §527(d)(1). The defendant can obtain a continuance to prepare for the preliminary injunction, if appropriate. CCP §527(d)(4).

In federal court, a TRO (but not a preliminary injunction) may be obtained ex parte. Fed R Civ P 65(a)-(b). An ex parte TRO generally may be issued when the defendant's identity is unknown, when a known defendant cannot be located in time for the hearing, or when notice to the defendant would render fruitless the further prosecution of the action (typically through destruction or secretion of evidence). *American Can Co. v Mansukhani* (7th Cir 1984) 742 F2d 314, 322. A TRO must expire by its own terms within 14 days in the absence of consent to or good cause for a limited extension. Fed R Civ P 65(b)(2). These rules also apply to restraining orders issued by state courts when a case is removed to federal court. *Granny Goose Foods, Inc. v Brotherhood of Teamsters, Etc.* (1974) 415 US 423, 39 L Ed 2d 435, 94 S Ct 1113. The TRO may be modified or dissolved on 2 days' notice, or on less notice if the court prescribes. Fed R Civ P 65(b)(4).

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E. Permanent Injunctions

§12.7 1. Standards for Permanent Injunctions

Generally, a court may grant a permanent injunction after trial in four situations (CC §3422):

- When monetary compensation is inadequate;
- When monetary relief is extremely difficult to ascertain;
- To avoid a multiplicity of proceedings; or
- When an obligation arose from a trust.

Depending on the specific facts, trade secret misappropriation may give rise to any or all of these four situations. See *Ernst & Ernst v Carlson* (1966) 247 CA2d 125, 55 CR 626 (confidential information disclosed in breach of trust).

None of the statutory bases for permanent injunctions expressly require irreparable injury. However, CCP §526(a)(2) provides that an injunction may be granted if the defendant's acts during litigation would cause irreparable injury. Thus, irreparable injury may be relevant to granting permanent injunctive relief only to the extent that it falls within one of the bases for injunctive relief stated in CC §3422, such as inadequate monetary compensation or inability to determine monetary compensation.

Irreparable injury is not necessary for a court to enjoin trade secret misappropriation if a statute authorizes this remedy; all that is needed is a violation of the statute. *Capital Tool & Mfg. v Maschinenfabrik Herkules* (4th Cir 1988) 837 F2d 171 (applying Virginia version of Uniform Act); see *Richardson v Suzuki Motor Co.* (Fed Cir 1989) 868 F2d 1226, 1247 (applying California law). The UTSA does specifically authorize injunctive relief for trade secret misappropriation. CC §3426.2.

The U.S. Supreme Court applied the traditional four-part test for permanent injunctions in a case holding that this test applies to patents even though patent law gives the patentee the right to exclude others from infringement. *eBay Inc. v MercExchange, LLC* (2006) 547 US 388, 164 L Ed 2d 641, 645, 126 S Ct 1837 (nothing in Patent Act indicated that Congress intended major departure from long tradition of equity practice and such departure should not be lightly implied). For a permanent injunction, a claimant must prove (1) that the plaintiff has suffered an irreparable injury; (2) that remedies at law, including monetary damages, are inadequate to compensate for that injury; (3) that the balance of hardships warrants an equitable remedy; and (4) that the public interest is not disserved by an injunction. *eBay Inc. v MercExchange, LLC, supra* (approach was consistent with Court's treatment of injunctions under Copyright Act). The *eBay* rejection of presumed irreparable injury and the requirement to focus on four traditional factors is being applied in nonpatent contexts (*Metro-Goldwyn-Mayer Studios, Inc. v Grokster, Ltd.* (CD Cal 2007) 518 F Supp 2d 1197 (copyright)) and in the preliminary injunction context. *Hologic, Inc. v SenoRx, Inc.* (ND Cal, Apr. 25, 2008, No. C-08-00133 RMW) 2008 US Dist Lexis 36693 (denying preliminary injunction in patent case).

Because an injunction is an equitable remedy, courts have discretion in framing the scope of injunctive relief, in implementing the injunction, and in deciding whether to disclose the request for injunctive relief to the jury. *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1531 (jury not told of request for injunctive relief). An award of damages sufficient to compensate for any injury effectively acts as a paid-up license to the misappropriator, removing the need for a permanent injunction. *DSC Communications Corp. v Next Level Communications* (5th Cir 1997) 107 F3d 322. See *Whiteside Biomechanics, Inc. v Sofamor Danek Group, Inc.* (ED Mo 2000) 88 F Supp 2d 1009, 1020 (court refused to enjoin defendants' future use of patents when jury had already awarded future damages, so injunction would duplicate plaintiffs' legal relief). Pre-Uniform Act decisions transferred rights to patents that were developed with misappropriated trade secrets. However, in an unpublished decision, the Ninth Circuit held that the Uniform Act only authorized injunctive relief to protect a trade secret so there was no basis for transferring patent ownership. The pre-Uniform Act cases were no longer applicable. *B. Braun Med., Inc. v Rogers* (9th Cir 2006) 163 Fed Appx 500, cert denied (2006) 549 US 824.

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§12.8 2. Specificity and Scope

A direct trade secret misappropriator, and those in active concert or participation with such misappropriator, may be enjoined from continued trade secret misappropriation. CC §3426.2; *General Elec. Co. v Sung* (D Mass 1994) 843 F Supp 776, 781; *Components for Research, Inc. v Isolation Prods.* (1966) 241 CA2d 726, 729, 50 CR 829 (injunction included corporation and officers who received notice of misappropriation and continued to use trade secrets). The identification of potentially enjoined persons begins with the complaint, which identifies the direct misappropriators or any party using agents to achieve the misappropriation, and ends with a contempt motion for those who have notice of the enjoined acts and violate the order. *Magnecomp Corp. v Athene Co.* (1989) 209 CA3d 526, 257 CR 278 (personal jurisdiction over Japanese corporation for misappropriation of trade secrets based on agency theory; identification of defendants in complaint); *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 146 (defendant corporation held in contempt for substantial duplication of trade secrets in developing second machine during life of injunction). An injunction must enjoin only guilty parties, and only specific harms may be enjoined: A court abuses its discretion by enjoining entities for which there is no evidence of solicitation or use of trade secret information. *Gallagher Benefit Servs., Inc. v De La Torre* (9th Cir 2008) 283 Fed Appx 543 (unpublished).

Interlocutory and permanent injunctive orders prohibit conduct under threat of judicial punishment. Therefore, the parties enjoined must be given explicit notice of exactly what conduct is enjoined, even if doing so requires precisely defining the trade secrets in a confidential appendix. Fed R Civ P 65(d); *Henry Hope X-Ray Prods. v Marron Carrel, Inc.* (9th Cir 1982) 674 F2d 1336, 1343 (injunctive terms in confidential appendix); *International Molders & Allied Workers v Superior Court* (1977) 70 CA3d 395, 411, 138 CR 794 ("party cannot be held in contempt if he had neither knowledge nor notice of an order for the violation of which the contempt is sought").

But despite the need for specificity, an injunction can encompass large volumes of material. In *3M v Pribyl* (7th Cir 2001) 259 F3d 587, the court found that an injunction was not impermissibly vague in enjoining disclosure of the secrets contained in 500 pages of manuals when the manuals also contained some public information, because the secrets comprised a unified and unique compendium of public information. A preliminary injunction prohibiting "using, copying, disclosing, converting, appropriating, retaining, selling, transferring, or otherwise exploiting [plaintiff's] copyrights, confidential information, trade secrets, or computer files" lacked the specificity required by Fed R Civ P 65(d) because the trade secrets and confidential information were not specified and FOIA requests showed much information was not confidential or secret. *Patriot Homes, Inc. v Forest River Hous., Inc.* (7th Cir 2008) 512 F3d 412, 414.

Injunctions against contacting customers and employees need not list the proscribed entities. The enjoined party can always ask if someone is on the list. *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 24 CR3d 720. But injunctions barring contact with entities having "association" or unknown contractual ties may be too broad and stricken. *ReadyLink Healthcare v Cotton, supra* (striking "or anyone" under contract "or associated" with plaintiff).

PRACTICE TIP: Because an action for contempt requires notice of the enjoined activities, counsel should disseminate copies of an injunction to any interested persons to broaden the effective protection granted by the injunction. See *Tracer Research Corp. v National Envtl. Servs. Co.* (D Ariz 1993) 843 F Supp 568, 581, rev'd on other grounds (9th Cir 1994) 42 F3d 1292 (order sent not only to defendant but also to defendant's distributors and licensees).

Plaintiffs that fail to identify trade secrets with reasonable specificity during motions, discovery, or trial risk being denied injunctive relief. See *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511, 522 (applying UTSA); *AMP, Inc. v Fleischhacker* (7th Cir 1987) 823 F2d 1199, 1203 (applying Illinois common law); *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 956, 958 n3 (applying California common law). For discussion of litigation issues relating to identification of trade secrets, see §§11.21-11.24. Appellate courts have also found injunctions fatally indefinite when generic trade secret categories rather than specific trade secrets were identified. *E.W. Bliss Co. v Struthers-Dunn, Inc.* (8th Cir 1969) 408 F2d 1108, 1114. See also CCP §2019.210; *Roton Barrier, Inc. v Stanley Works* (Fed Cir 1996) 79 F3d 1112, 1122, aff'd without opinion (Fed Cir 1997) 108 F3d 1394 (permanently enjoining use of any "trade secret business and technical information in any manner whatsoever" was found overbroad for failing "to describe in reasonable detail the acts sought to be restrained"); *SI Handling Sys., Inc. v Heisley* (3d Cir 1985) 753 F2d 1244, 1265 (court reversed injunction enjoining "concepting" further systems that would use trade secrets); *American Can Co. v Mansukhani* (7th Cir 1984) 742 F2d 314, 332 (court reversed injunction enjoining inks "compositionally similar" to protected inks). See also §11.24.

An injunction can bar not only the *direct use* of the trade secrets, but also *derivations* (*i.e.,* indirect use) based on trade secret information. *General Elec. Co. v Sung* (D Mass 1994) 843 F Supp 776, 778; *Superior Flux & Mfg. Co. v H&S Indus.* (ND Ohio 1980) 210 USPQ 669, 672 (enjoining modification or improvement derived from knowledge of trade secret). The penumbra of

knowledge or variations surrounding a particular trade secret are difficult to define, however, and receive variable protection. Although enjoining the use of a trade secret is usually sufficient, if the trade secret is inextricably intertwined with a product then its production must also be enjoined. *General Elec. Co. v Sung* (D Mass 1994) 843 F Supp 776, 781 (7-year injunction on production of diamonds). In addition to enjoining use of specific trade secrets, a court may apply the doctrine of equivalents from patent law to enjoin use of materials equivalent to trade secret compounds. *Syntex Ophthalmics, Inc. v Tsuetaki* (7th Cir 1983) 701 F2d 677, 684. But see *Square Liner 360°, Inc. v Chisum* (8th Cir 1982) 691 F2d 362, 378 (injunction enjoining "infringing equivalents" in patent context fatally indefinite).

An injunction cannot bar the use of general knowledge or principles. *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 139. See *Syntex Ophthalmics, Inc. v Tsuetaki* (7th Cir 1983) 701 F2d 677, 679 n1 (injunctions expressly excepting information in published patents or other publications). Absent enforceable contractual restrictions, injunctions also cannot bar conduct otherwise permitted by law, such as notifying (but not soliciting) those listed on a trade secret customer list of one's change of employment or accepting unsolicited business from such customers. *Aetna Bldg. Maintenance Co. v West* (1952) 39 C2d 198, 246 P2d 11; *John F. Matull & Assocs. v Cloutier* (1987) 194 CA3d 1049, 1056, 240 CR 211.

Pre-UTSA law was inconsistent on the ability to enjoin the person who developed a trade secret from using it. Compare *Futurecraft Corp. v Clary Corp.* (1962) 205 CA2d 279, 23 CR 198 (developing employee can use), with *Components for Research, Inc. v Isolation Prods., supra* (developing employee cannot use). Part of this uncertainty resulted from the courts' reluctance to enjoin the use of negative know-how and to separate such information from the general skill, knowledge, and experience employees are entitled to use. *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 143; *Knudsen Corp. v Ever-Fresh Foods, Inc.* (CD Cal 1971) 336 F Supp 241, 245.

Under the UTSA, however, negative information can be a protectable trade secret. Legislative Committee Comment to CC §3426.1. See §1.6. The UTSA does not distinguish trade secrets developed by an employee from those given to the employee by an employer. See CC §3426.1(d). The UTSA clarifies the public policy balance to include both the interests of the developer of the trade secrets and the interests of the owner of the trade secrets. *Courtesy Temp. Serv. v Camacho* (1990) 222 CA3d 1278, 1287, 272 CR 352 (employer's customer list contained protectable negative information by screening out unlikely clients); *Dionne v Southeast Foam Converting & Packaging, Inc.* (Va 1990) 397 SE2d 110 (person developing trade secret can be enjoined under Virginia UTSA); *3M v Pribyl* (7th Cir 2001) 259 F3d 587 (Wisconsin UTSA; party developing trade secret was enjoined from disclosing secret, but could use it after damages were paid).

The court's personal jurisdiction over misappropriators is limited only by due process. *Integral Dev. Corp. v Weissenbach* (2002) 99 CA4th 576, 122 CR2d 24 (personal jurisdiction over German citizen hired by California company to manage German subsidiary). Trade secret protection is potentially of unlimited geographic scope as long as damage can be shown and other legal concepts, such as antitrust implications, do not restrict such scope. See §§7.25-7.31 for discussion of antitrust considerations in licensing trade secrets. The court has considerable discretion in fashioning relief. For example, in *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, 974 (applying Oregon UTSA), the court issued a worldwide injunction even though the trade secret owner sold in only a few countries. The purpose of the injunction was to eliminate the head start improperly obtained by the misappropriator.

NOTE: The value of a worldwide injunction is limited by the California court's ability to enforce an injunction only against in-state persons and assets, the need to register the judgment in other jurisdictions for enforcement, and comity to the judicial systems of foreign countries.

The geographic scope of an injunction may be limited by contract. For example, an enforceable noncompetition agreement under Bus & P C §16601 is limited to the "specified geographic area in which the business so sold … has been carried on." That includes areas where all phases of the business are conducted, including production, promotional, marketing, and sales. *Alliant Ins. Servs., Inc. v Gaddy* (2008) 159 CA4th 1292, 72 CR3d 259 (entire state of California properly encompassed in preliminary injunction because clients were in all 58 counties).

A trade secret defendant might resist an application for preliminary injunctive relief as a "prior restraint" that violates the First Amendment of the United States Constitution. If the court finds evidence of an actual misappropriation, such claims should be rejected. *DVD Copy Control Ass'n, Inc. v Bunner* (2003) 31 C4th 864, 4 CR3d 69. But it is unclear what treatment will be applied to claims of purely "threatened" misappropriation, in which there is no showing of an improper use or disclosure. (See *DVD Copy Control Ass'n, Inc. v Bunner, supra,* in which a concurring opinion suggested a higher standard of proof as a method of meeting the constitutional issue.)

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3. Duration

§12.9 a. General Rule

A permanent injunction relating to trade secrets generally terminates once the trade secret has been made public, but it may continue for an additional time sufficient to eliminate any head start or commercial advantage improperly obtained by the misappropriator. CC §3426.2(a). See *Stampede Tool Warehouse, Inc. v May* (Ill App Ct 1995) 651 NE2d 209 (applying Illinois UTSA). Thus, an injunction may continue past the date a patent disclosing the trade secret issues. *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, 975 (applying Oregon version of Uniform Act); *Electro Scientific Indus., Inc. v General Scanning, Inc.* (Fed Cir 2001) 247 F3d 1341 (unauthorized publication of trade secret in patent could not be asserted by discloser as destroying secret). In appropriate circumstances, the injunction may also be terminated on payment of damages. *3M v Pribyl* (7th Cir 2001) 259 F3d 587 (Wisconsin UTSA) (no proof of future damages). The UTSA's limited-duration injunction follows pre-UTSA California decisions that limited injunctions to the time needed to reverse engineer or independently develop the trade secrets. *K-2 Ski Co. v Head Ski Co.* (9th Cir 1974) 506 F2d 471 (cited in Commissioners' Comments to Uniform Act §2(a)); *Gordon v Landau* (1958) 49 C2d 690, 321 P2d 456.

NOTE: Such a head start can mean the time necessary to reverse engineer the trade secret, because reverse engineering alone does not constitute trade secret misappropriation. CC §3426.1(a).

The duration of noncompetition agreements as actually enforced can also affect the duration of injunctive relief. In *Estee Lauder Cos. v Batra* (SD NY 2006) 430 F Supp 2d 158, the court granted a preliminary injunction to enforce a 1-year noncompetition agreement against a California resident but limited the preliminary injunction to 5 months because other similar agreements were enforced for less than the contractual time.

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/§12.10 b. Variable Termination Date

§12.10 b. Variable Termination Date

Although the duration of a permanent injunction is limited, the court's order need not necessarily specify a calendar date on which the injunction will cease. The injunction may be terminated on application to the court, as long as the enjoined party can prove that the trade secret has ceased to exist. CC §3426.2(a). See *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 66 CR2d 731; *Cook Group, Inc. v Wilson (In re Wilson)* (MD NC 2000) 248 BR 745 (misappropriator has burden of proving trade secret is no longer secret or was derived independently by third party). See also CC §3424 (modification or dissolution of injunction on material change in facts or law, or to serve ends of justice). Thus, seemingly perpetual injunctions have been upheld. See *Morlife, Inc. v Perry, supra* (applying UTSA and affirming permanent injunction terminable by motion under CC §3426.2); *Boeing Co. v Sierracin Corp.* (Wash App 1986) 716 P2d 956 (applying Washington version of Uniform Act).

PRACTICE TIP: If the duration of the injunction is not finite or if the order contains no express expiration date, counsel should ask the court to specifically reserve jurisdiction so that it may later modify the injunction. *Components for Research, Inc. v Isolation Prods.* (1966) 241 CA2d 726, 50 CR 829.

Courts have considerable discretion in fashioning the duration of injunctive relief. *Lamb-Weston, Inc. v McCain Foods, Ltd.* (9th Cir 1991) 941 F2d 970, 974 (applying Oregon version of Uniform Act); *Surgidev Corp. v Eye Technol., Inc.* (8th Cir 1987) 828 F2d 452, 456 (applying Minnesota version of Uniform Act and UTSA). A court is more likely to include a specific time limit if it has information on the amount of head start achieved by the defendant or the ascertainability and independent development of the trade secret, because it then has the information necessary to determine an appropriate expiration date. Thus, the defendant should produce such evidence if it is likely to shorten the injunction.

WARNING: Counsel must be realistic in its requests regarding duration. In *Boeing Co. v Sierracin Corp.* (Wash App 1986) 716 P2d 956, the court gave the defendant an opportunity to show that it could independently develop the trade secrets in 120 days, as defendant had represented to the court, with a permanent injunction taking effect after that time if the defendant was unable to do so.

The duration of an injunction may be extended by several types of agreements:

- By consent decree. See *Motorola, Inc. v Computer Displays Int'l* (7th Cir 1984) 739 F2d 1149 (but pertinent discussion did not appear in officially reported decision at 739 F2d 1149).

- By settlement agreements or contracts. See *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 116 CR 654 (licensing agreement valid even though product embodying trade secret was marketed and in public domain).

- By a person's agreement not to use trade secrets for a time period longer than the time needed to reverse engineer the trade secrets. See *Aronson v Quick Point Pencil Co.* (1979) 440 US 257, 59 L Ed 2d 296, 99 S Ct 1096 (parties can contractually bind themselves for longer periods of time than the law provides).

- By a person's agreement not to use information even after it becomes public. *Aronson v Quick Point Pencil Co., supra; Warner-Lambert Pharmaceutical Co. v John J. Reynolds, Inc.* (SD NY 1959) 178 F Supp 655, aff'd (2d Cir 1960) 280 F2d 197.

Agreements to extend the length of an injunction do not violate public policy because they affect only the contracting parties, leaving the public free to use the information once it is no longer secret. *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 222, 116 CR 654. Consistent with this approach, the UTSA does not affect contractual remedies based on trade secret misappropriation or otherwise. CC §3426.7(b). However, such agreements may need to be limited to the trade secret rights at issue; otherwise, they may be ruled invalid on other policy grounds, such as an improper extension of patent rights. See *Bonito Boats, Inc. v Thunder Craft Boats, Inc.* (1989) 489 US 141, 103 L Ed 2d 118, 109 S Ct 971 (state law providing protection to boat hull design preempted by patent law); *Kewanee Oil Co. v Bicron Corp.* (1974) 416 US 470, 40 L Ed 2d 315, 94 S Ct 1879 (trade secret law not preempted by patent law); *Brulotte v Thys Co.* (1964) 379 US 29, 13 L Ed 2d 99, 85 S Ct 176 (license invalid for impermissibly extending patent rights beyond 17-year period); *Sinclair v Aquarius Elecs.* (1974) 42 CA3d 216, 116 CR 654 (enforcing royalty agreement on trade secrets in patented item after secret ceased to exist); *Zila, Inc. v Tinnell* (9th Cir 2007) 502 F3d 1014 (perpetual 5-percent royalty unenforceable after patent expired).

Courts may imply a reasonable term commensurate with the parties' intention to enforce a potentially perpetual injunction. See *Consolidated Theaters, Inc. v Theatrical Stage Employees Union, Local 16* (1968) 69 C2d 713, 73 CR 213 (enforceability of labor contract without specific expiration date); *Loral Corp. v Moyes* (1985) 174 CA3d 268, 279, 219 CR 836 (enforceability of noninterference

agreement without specific expiration date).

PRACTICE TIP: Counsel can reduce the risk of disputes based on the duration of a potentially perpetual injunction by providing an ascertainable event that triggers termination of the injunction, such as the defendant's establishing that the trade secret no longer exists or plaintiff's stopping its use of the trade secret. See CC §3426.2(a) (injunction ceases when trade secret ceases to exist); *Superior Flux & Mfg. Co. v H&S Indus.* (ND Ohio 1980) 210 USPQ 669, 672 (injunction ceases when trade secret released to public, becomes generally available, or is obtained from source having legal right to convey information); *Lura v Multaplex* (1982) 129 CA3d 410, 414, 179 CR 847 (commissions paid as long as defendant serviced and billed customers).

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§12.11 4. Ordering Affirmative Acts to Protect Trade Secrets

The court may issue affirmative injunctions to protect a trade secret. CC §3426.2(c). Such affirmative actions may include the following:

- Ordering the return of materials containing trade secrets. See *Tracer Research Corp. v National Envtl. Servs. Co.* (D Ariz 1993) 843 F Supp 568, 580, rev'd on other grounds (9th Cir 1994) 42 F3d 1292.
- Ordering that trial records be sealed. However, the court must balance the public right of access to information and documents introduced into evidence at trial against compelling interests in maintaining the confidentiality of the information and documents. See *In re Adobe Sys. Secs. Litig.* (ND Cal 1992) 141 FRD 155. See also §11.33.
- Ordering the destruction of materials containing or embodying trade secrets. See *Gladstone v Hillel* (1988) 203 CA3d 977, 988, 250 CR 372 (common law trade secret).
- Ordering the alleged misappropriator to mail to customers copies of preliminary injunction orders. See *Tracer Research Corp. v National Envtl. Servs. Co.*, *supra*.
- Ordering the alleged misappropriator to assign to the alleged trade secret owner the rights to inventions derived from misappropriated trade secrets. See *Cubic Corp. v Marty* (1986) 185 CA3d 438, 229 CR 828.
- A court may impose a protective order governing the treatment of trade secret information during litigation. A model protective order is being developed by the Trade Secrets Committee of the State Bar of California, Intellectual Property Section, and will be available at http://www.calbar.ca.gov when finalized.

PRACTICE TIP: In California courts, an affirmative injunction is automatically stayed by an appeal. Thus, it is best to couch injunction language in prohibitory rather than affirmative terms, if possible.

In a trademark counterfeiting case, the Second Circuit Court of Appeals affirmed a preliminary injunction requiring the defendant to bring all enjoined products from China to the United States and to keep them in the U.S. as a proper extraterritorial extension of the Lanham Act as applied to a U.S. corporate defendant. *Fun-Damental Too, Ltd. v Gemmy Indus.* (2d Cir 1997) 111 F3d 993. Such relief might also be an excellent remedy for limiting distribution of articles that embody trade secrets in order to prevent loss of trade secret protection. See 15 USC §1126; *General Motors Corp. v Ignacio Lopez de Arriortua* (ED Mich 1996) 948 F Supp 670 (applying "unfair competition" definition under Paris Convention for the Protection of Industrial Property (available at http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html) to trade secret case under 15 USC §1126(h)-(i)). The UTSA does not state any standard for granting affirmative injunctive relief, and no trade secret cases have discussed the heightened standards normally required for this relief, which alters the status quo. *Stanley v University of S. Cal.* (9th Cir 1994) 13 F3d 1313, 1320 (mandatory injunction goes beyond maintaining status quo and is therefore subject to heightened scrutiny).

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§12.12 5. Royalty in Lieu of Injunction

If it would be unreasonable for the court to prohibit future use, it may impose a royalty for a time no longer than that during which use could be enjoined. CC §3426.2(b). This remedy is similar to the pre-UTSA imposition of damages in lieu of an injunction. *Clark v Bunker* (9th Cir 1972) 453 F2d 1006, 1011.

Situations in which it is unreasonable to prohibit future use may include:

- When the use benefits the public interest. See *Republic Aviation Corp. v Schenk* (NY Sup Ct 1967) 152 USPQ 830 (armament and control systems for jet fighters); *Weinberger v Romero-Barcelo* (1982) 456 US 305, 72 L Ed 2d 91, 102 S Ct 1798 (Navy's use of land for training pilots).

- When "too much time has passed and too many events had occurred to turn back the clocks." *Kilbarr Corp. v Business Sys., Inc., B.V.* (D NJ 1988) 679 F Supp 422, 426, aff'd (3d Cir 1989) 869 F2d 589.

NOTE: In an unusual application of this royalty principle, one court entered a permanent injunction, and then stayed the injunction for 120 days on payment of a royalty because the defendant said that it could reverse engineer the trade secrets within that time. *Boeing Co. v Sierracin Corp.* (Wash App 1986) 716 P2d 956.

For discussion of the calculation of reasonable royalties as a means of determining a damages award, see §12.21.

The use of secrets to reduce research and manufacturing costs and avoid developing software supported a reasonable royalty in *Mid-Mich. Computer Sys., Inc. v Marc Glassman, Inc.* (6th Cir 2005) 416 F3d 505 (Ohio UTSA; royalty amount based on liquidated damages amount multiplied by number of misuses).

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/§12.13 F. Threatened Misappropriation

§12.13 F. Threatened Misappropriation

California courts may issue temporary and permanent injunctions for either "actual" or "threatened" acts of misappropriation. CC §3426.2(a); see §12.1A. Four variations of threatened misappropriation have been identified, three of which may be enjoined, not including the "inevitable disclosure" variation that has been rejected by California courts. *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 75 CR3d 771 (vacating injunction after court trial when hospital received confidential patient information under nondisclosure agreement and refused to return information after buy-out was repudiated). The three variations that may be enjoined include:

- The actual possession of a trade secret by someone who has misused or disclosed the secret so as to establish a threat of future disclosure;
- The actual possession of a trade secret by someone who intends to improperly use or disclose the secret; and
- The wrongful refusal to return materials containing trade secrets.

A fourth variation, mere knowledge of a properly acquired trade secret, without more, is not subject to injunction. 162 CA4th at 527. Although *Central Valley Gen. Hosp.* discussed these variations, the court found insufficient findings to support a preliminary injunction.

Central Valley Gen. Hosp. found two limitations on injunctions under CC §3426.2(c). First, §3426.2(c) should not be construed to render subsection (a) superfluous; subsection (c) must be narrower than subsection (a) and requires a "threatened misappropriation" satisfying subsection (a). In other words, "a remote threat of misuse or disclosure is not an 'appropriate circumstance' that justifies enjoining the possible misuse or disclosure" under §3426.2(c). 162 CA4th at 530. Second, based on comments to the Uniform Act, §3426.2(c) authorizes mandatory injunctions such as the return of materials containing trade secrets, and does not authorize prohibitory injunctions. The court found the portion of the preliminary injunction requiring the return of material containing trade secret information proper under §3426.2(c), but found insufficient factual findings to support the injunction. The court vacated the portion of the injunction prohibiting the defendant from using information in its possession. 162 CA4th at 531. *Central Valley Gen. Hosp.* reiterates that mere possession of secrets by a departing employee is not enough. See *Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 107, 148 P2d 9, discussed below; *Universal Analytics, Inc. v MacNeal-Schwendler Corp.* (CD Cal 1989) 707 F Supp 1170, 1177 (granting defendant summary judgment on claim based on "speculation that since the former … employees are working in similar areas," the defendant must have misappropriated trade secrets). Further, even if physical documents bearing trade secrets are actually taken, a change of position accompanied by destruction of the documents and nonuse of the secrets may avoid liability for even nominal damages. See *News Am. Mktg. In-Store, Inc. v Marquis* (Conn 2005) 885 A2d 758 (Connecticut UTSA).

The central issue usually involves the interplay between Bus & P C §16600, which prohibits noncompetition agreements (see §§1.2, 2.32-2.32D, 11.41), and a company's need to enjoin a former employee who has evidenced an intention to misuse the company's trade secrets. In other jurisdictions (where noncompetition agreements are permitted), courts for decades have enjoined employees under what has become known as the "inevitable disclosure" theory. Under that theory, a company can prevent a former employee from going to work for a competitor, merely on the basis of speculation about the employee's possible future misconduct. See *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262. The rules for "inevitable disclosure" injunctions vary from state to state.

Because of California's public policy in favor of employee mobility, however, the inevitable disclosure theory has never been law in California. In 1944, the state supreme court reversed an injunction barring a former employee who knew an allegedly secret formula from joining a competitor. The court held that (*Continental Car-Na-Var Corp. v Moseley* (1944) 24 C2d 104, 107, 148 P2d 9)

[t]he mere fact that [defendant] was employed for 22 months by plaintiff, and as a result of that employment knew the formulae for plaintiff's products when he left plaintiff's employ in 1936 was not sufficient evidence from which an inference could be drawn that he was using or intended to use such formulae on behalf of defendants.

Numerous California courts since *Moseley* have refused to accept speculative theories about future misappropriation, whether or not framed as "inevitable disclosure." Some have held that allowing "inevitable disclosure" injunctions would amount to judicially created noncompetition agreements. See *Whyte v Schlage Lock Co.* (2002) 101 CA4th 1443, 125 CR2d 277 (incorrectly assuming that it was the first court to reject the theory); *GlobeSpan, Inc. v O'Neill* (CD Cal 2001) 151 F Supp 2d 1229, 1235 (rejecting the

theory under California law as conflicting with Bus & P C §16600); *Del Monte Fresh Produce Co. v Dole Food Co.* (SD Fla 2001) 148 F Supp 2d 1326 (California and Florida law) (absent actual or threatened disclosure, inevitable disclosure doctrine should not be used as noncompetition agreement); *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1120 (rejecting "inevitable disclosure" as California law); *Universal Analytics, Inc. v MacNeal-Schwendler Corp*. (CD Cal 1989) 707 F Supp 1170, 1177 (holding that plaintiffs could not avoid summary judgment on a claim "based purely on the speculation that since the former UAI employees are working in similar areas at MSC and that after the employees began working for MSC, MSC announced improvements in its Nastran products, therefore MSC must be misappropriating UAI trade secrets," a theory the court rejected as having "no logic"). See also *Mayview Corp. v Rodstein* (9th Cir 1973) 480 F2d 714, 718 n7 (applying California law, reversing injunction based only on "opportunity" that defendant might disclose trade secrets, and holding that "[i]njunctive relief on such grounds should issue only on convincing proof of harm").

As a corollary, California courts have held that a former employee's mere possession of trade secrets is not a basis for an injunction. See *Gibson-Homans Co. v Wall-Tite, Inc.* (CD Cal 1992) 26 USPQ2d 1867 (finding that employee's possession of notebook containing former employer's trade secrets not a "threat" of misappropriation under California law, even though former employee was competing, and holding that "[i]f in the future the threat of misappropriation becomes real, plaintiff will have a remedy under CC §3426.2"). See also *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 1279, 95 CR3d 307 (employer acted with subjective bad faith in bringing action absent actual threat of misappropriation).

But if an employee has misappropriated trade secrets and told others of an intent to use those secrets, then even employment in an unrelated field will not necessarily avoid an injunction. See *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 24 CR3d 720. Moreover, restrictions on future solicitation and competition may be able to avoid the strictures of §16600 if the employment agreement says the customer and employee information is a secret. *ReadyLink Healthcare v Cotton, supra* (contract language was supported by evidence of actual secrecy and actual misappropriation of other information).

Here lies the controversy: On one hand, speculative injunctions are not permitted, and an employee remains free to go to work for a competitor. On the other hand, California's UTSA expressly contemplates that something less than actual misuse is required to obtain an injunction. The debate will no doubt continue until California courts provide further guidance on the issue. But since the doctrine of "inevitable disclosure" of trade secrets is not the law in California, evidence of imminent misuse should exist or a party risks a finding of bad faith. *FLIR Sys., Inc.,* 174 CA4th at 1279.

WARNING: The choice of forum may be crucial to the outcome of a case. Courts may not always apply the law that the parties specify as controlling in the agreement. In *Scott v Snelling & Snelling* (ND Cal 1990) 732 F Supp 1034, a franchisor tried to enforce a noncompetition agreement against a California franchisee. The agreement was valid under Pennsylvania law (the governing law designated in the agreement) but not under California law. See Bus & P C §16600. The court held that California's strong public policy against restraint of trade invalidated the noncompetition provision to the extent it did not apply to trade secrets, and refused to grant the injunction. See *Frame v Merrill Lynch* (1971) 20 CA3d 668, 97 CR 811 (forfeiture provision invalid under Bus & P C §16600 could be enforced because agreement expressly stated that New York law governed); *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73 (refusing to uphold choice of law clause in contract with Maryland resident hired by California company to telecommute). But see *Baxter Int'l v Morris* (8th Cir 1992) 976 F2d 1189, aff'd (8th Cir 1993) 11 F3d 90 (court applied Illinois law because California had no materially greater interest in controversy than did Illinois forum that parties selected). The general rules on enforceability of choice of law clauses in California are set forth in *Nedlloyd Lines B.V. v Superior Court* (1992) 3 CA4th 459, 465, 11 CR2d 330. See also *Hambrecht & Quist Venture Partners v American Med. Int'l, Inc.* (1995) 38 CA4th 1532, 46 CR2d 33; California Law of Contracts §§5.44-5.55 (Cal CEB 2007).

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§12.14 G. Orders; Findings of Fact and Law

A California court need not state its reasons for denying a preliminary injunction or a temporary restraining order (TRO), and it need not enter detailed, formal findings of fact or conclusions of law when granting a preliminary injunction or a TRO. CCP §632. See *Metro Traffic Control, Inc. v Shadow Traffic Network* (1994) 22 CA4th 853, 857, 27 CR2d 573 (affirming denial of preliminary injunction).

Federal courts, however, must specifically state in the order why preliminary injunctive relief or a TRO is granted and must provide findings of fact and conclusions of law for either granting or denying such relief. Fed R Civ P 52(a), 65(d). Local court rules may require the prevailing party to prepare proposed findings of fact and conclusions of law or the order, including the reasons for the order. Fed R Civ P 65(d); CD Cal Local R 52-2; ED Cal Local R 52-290; ND Cal Local R 7-2, 65-1.

Typically, the plaintiff's attorney wants to make sure that the court properly satisfies its requirements under Fed R Civ P 52 and 65 lest a federal district court victory be lost on interlocutory appeal. In preparing moving papers, the plaintiff's attorney should include a proposed order with the findings of fact and conclusions of law.

If trial is to the court instead of a jury, then the judgment must contain sufficient findings of fact and conclusions of law to allow an appellate court to review the judgment and the findings must support the full scope of any injunctive relief granted. In *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 75 CR3d 771, a judgment by a referee under CCP §638 was vacated and remanded for further findings because of inadequate findings to support either a mandatory injunction or prohibitory injunction.

PRACTICE TIP: Even if the client is the prevailing party, if the court's Statement of Decision (CCP §632 or §638) or the court's Findings of Fact and Law (FRCP 52) are inadequate, counsel should consider filing a motion to modify the Statement of Decision, a motion for further findings, or a motion to amend the findings to avoid problems on appeal.

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§12.15 H. Bond for Interlocutory Injunctions

The bond is a crucial weapon in a defendant's arsenal. The defendant generally argues for a very high bond because the consequential harm from an improper injunction is enormous. The bond may also prove to be prohibitive for the plaintiff, preventing the plaintiff from obtaining relief even if it wins on the merits of preliminary relief. However, because the cost of obtaining a bond may be recoverable as part of the plaintiff's court costs, the defendant must use some judgment before requesting a high bond. Conversely, the plaintiff generally argues for a low bond. See §§12.16-12.17 for discussion of bond requirements in state and federal courts.

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§12.16 1. California State Courts

An undertaking or a bond must be posted as a condition for issuing a preliminary injunction in California courts. CCP §529(a); *ABBA Rubber Co. v Seaquist* (1991) 235 CA3d 1, 10, 286 CR 518. See CCP §§995.710-996.560. Whether to require an undertaking or bond for a temporary restraining order (TRO) is usually left to the court's discretion, although it is considered the better practice to do so. *Biasca v Superior Court* (1924) 194 C 366, 228 P 861. See also *Allen v Pitchess* (1973) 36 CA3d 321, 329, 111 CR 658. If a TRO is granted, the terms of the bond determine whether the surety's liability is limited to the TRO, or whether the same bond may be continued for the preliminary injunction. *Greenly v Cooper* (1978) 77 CA3d 382, 143 CR 514 (TRO bond covered preliminary injunction).

The injunction does not take effect until the bond is furnished, and the injunction is dissolved if the bond is not filed within the time set by statute. CCP §529(a); *ABBA Rubber Co. v Seaquist, supra*. The bond can be waived, however, if the parties stipulate to an injunction (*Greenly, 77* CA3d at 386) or, as has been held in non-trade-secret cases, if a party is indigent and cannot post bond (*Brown v Pitchess* (1975) 13 C3d 518, 527 n4, 119 CR 204).

The bond amount must be sufficient to pay such damages as the enjoined party might sustain if the court decides that the applicant was not entitled to an injunction. Damages include reasonably foreseeable harm proximately caused by the wrongfully issued injunction. Damages that may be recovered by a wrongfully enjoined party are limited by the amount of the bond. CCP §529(a); *ABBA Rubber Co.,* 235 CA3d at 11. As a case progresses, the enjoined party may seek to have the amount of the bond altered to reflect changing circumstances. CCP §§995.960(c) (changed circumstances), 996.010 (insufficiency). The *ABBA Rubber* court held that the bond must consider the attorney fees and expenses incurred in prosecuting an appeal of the preliminary injunction or defending at trial against the causes of action on which preliminary injunctive relief has been granted. 235 CA3d at 14 ($1000 bond inadequate, warranting reversal of preliminary injunction). The probability that the enjoined party may ultimately prevail either through trial or appeal is "irrelevant in determining the likely amount of those damages" for the bond. 235 CA3d at 16 n8.

Failure to affirmatively request a bond does not necessarily waive a party's right to the statutorily mandated bond. 235 CA3d at 10. If a party objecting to the bond as insufficient does not file a written motion within ten days after service of a copy of the bond on the beneficiary, stating the precise grounds for the objection, the objection will be waived. CCP §§995.930(b). However, substantial compliance is sufficient to avoid waiver. 235 CA3d at 9, 13.

A party may recover on the bond by motion, but recovery against the bond cannot occur until after final termination (including appeals) of the action in which the injunction was issued and proof of the amount of damages incurred. CCP §996.440; *Satinover v Dean* (1988) 202 CA3d 1298, 249 CR 277. See also *Nuclear Elec. Lab. v William C. Cornell Co.* (1965) 239 CA2d 8, 12, 48 CR 416.

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§12.17 2. Federal Courts

Federal rules require a bond (except from the United States government, its officers, or its agencies) for temporary or preliminary injunctive relief. Fed R Civ P 65(c). The bond amount should be sufficient to pay costs and damages if the party is found to have been wrongfully enjoined. See *Curtis 1000, Inc. v Youngblade* (ND Iowa 1995) 878 F Supp 1224, 1280; *Imi-Tech Corp. v Gagliani* (SD Cal 1986) 691 F Supp 214, 232. The court "costs" include reasonable fees for independent expert witnesses. CC §3426.4. The amount of the bond is "in such amount as the court deems proper," and the court's discretion is given substantial deference on appellate review. 878 F Supp at 1279.

Failure to request a bond in federal court does not waive the statutory bond requirement, and an injunction will not take effect until a bond is posted. Fed R Civ P 65(c); *Zambelli Fireworks Mfg. Co. v Wood* (3d Cir 2010) 592 F3d 412 (absent specific findings of unusual circumstances, bond required even when no party requests one). Counsel should consult local court rules to ensure that the proper procedures are followed in posting the bond or appropriate security. See CD Cal Local R 65-3—65-10; ED Cal Local R 65.1-151; ND Cal Local R 65.1-1; SD Cal Local R 65.1.2.

The court's decision to execute on the bond is reviewed de novo in federal court, but the computation of damages is reviewed under a clearly erroneous standard. *Nintendo of Am. v Lewis Galoob Toys, Inc*. (9th Cir 1994) 16 F3d 1032, 1036, 1038 (wrongfully enjoined in copyright matter). There is a rebuttable presumption that a wrongfully enjoined party is entitled to execute on the bond and can recover provable damages up to the amount of the bond; a plaintiff's good faith is irrelevant to the amount of damages a defendant may recover against the bond. *Nintendo of Am. v Lewis Galoob Toys, Inc., supra*. See *W.R. Grace & Co. v Local Union 759* (1983) 461 US 757, 770 n14, 76 L Ed 2d 298, 309 n14, 103 S Ct 2177. As the case progresses, the enjoined party may seek to have the amount of the bond altered to reflect changing circumstances. Fed R Civ P 65.1; see *Nintendo of Am.,* 16 F3d at 1034 (bond amount increased twice); *Curtis 1000, Inc. v Youngblade* (ND Iowa 1995) 878 F Supp 1224, 1279 (increasing bond).

Recovery on the bond is obtained in federal court by filing a motion with the court clerk, proving the amount of damages incurred. Fed R Civ P 65.1.

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I. Appellate Review

§12.18 1. California State Court

Review of all orders granting or denying a preliminary injunction are available by writ as well as by appeal in California courts. CCP §904.1(a)(6). Writs move much faster than appeals and are an indispensable form of appellate relief.

The grant of a preliminary injunction is reviewed on appeal to determine whether the trial court abused its discretion on *either* of the two factors to be considered: likelihood of success on the merits, and interim harm. See §12.4. If a preliminary injunction is denied, the trial court will be reversed only if it abused its discretion on *both* factors, because both must favor the plaintiff in order to warrant a preliminary injunction. *Hilb, Rogal & Hamilton Ins. Servs. of Orange County, Inc. v Robb* (1995) 33 CA4th 1812, 1819, 39 CR2d 887. The party challenging the preliminary injunction has the burden of making a clear showing of an abuse of discretion. 33 CA4th at 1819.

An abuse of discretion occurs only if the court "exceeded the bounds of reason or contravened the uncontradicted evidence." *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 629, 262 CR 92. The appellate court must not reweigh conflicting evidence or determine the credibility of witness, because those issues are the province of the trial court. *Hilb, Rogal & Hamilton Ins. Servs. of Orange County, Inc. v Robb, supra.* To the extent the evidence is conflicting, the facts are interpreted in the light most favorable to the prevailing party and all reasonable inferences are drawn in support of the trial court's order. 33 CA4th at 1820.

Some courts have stated that whether the information qualifies as a trade secret is a question of law, not a finding of fact, and conclusions of law do not bind a reviewing court. See, *e.g., ALRB v Richard A. Glass Co.* (1985) 175 CA3d 703, 713, 221 CR 63. But see *Tele-Count Eng'rs v Pacific Tel. & Tel. Co.* (1985) 168 CA3d 455, 465, 214 CR 276 (question of whether information was substantially secret was submitted to jury).

PRACTICE TIP: In California courts, an affirmative injunction is automatically stayed by an appeal. Thus, it is best to couch injunction language in prohibitory rather than affirmative terms, if possible.

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§12.19 2. Federal Court

The denial of a temporary restraining order (TRO) is generally not appealable because of the TRO's short duration, its expiration after the preliminary injunction hearing, and a desire to avoid piecemeal litigation. An appeal from a TRO denial can sometimes be obtained if the denial would effectively rule on the merits or foreclose further interlocutory relief. *Environmental Defense Fund, Inc. v Andrus* (9th Cir 1980) 625 F2d 861; *Kimball v Commandant, Twelfth Naval Dist.* (9th Cir 1970) 423 F2d 88, 89. Even if not immediately appealable, the issue of a TRO's validity remains even after it expires, and it continues as long as there is a possibility of recovering on the TRO bond. *Northern Stevedoring & Handling Corp. v International Longshoremen's & Warehousemen's Union* (9th Cir 1982) 685 F2d 344, 346. In contrast, orders granting or denying a preliminary injunction in federal court are immediately appealable. 28 USC §1292(a)(1), (c)(1).

On appeal, the grant or denial of a preliminary injunction or a TRO is reviewed to determine whether the trial court abused its discretion or based its decision on an erroneous legal standard or clearly erroneous findings of fact. Fed R Civ P 52(a). See *Religious Technol. Ctr. v Scott* (9th Cir 1989) 869 F2d 1306, 1309; *Litton Sys. v Sundstrand Corp.* (Fed Cir 1984) 750 F2d 952, 955; *American Can Co. v Mansukhani* (7th Cir 1984) 742 F2d 314 (TRO). Generally, the type of information that qualifies as a trade secret is a question of state law reviewed de novo (*Religious Technol. Ctr. v Wollersheim* (9th Cir 1986) 796 F2d 1076, 1079), although whether the requirements for a trade secret are met in a particular instance is a question of fact (*Gates Rubber Co. v Bando Chem. Indus.* (10th Cir 1993) 9 F3d 823, 848 (applying Colorado version of Uniform Act); *K-2 Ski Co. v Head Ski Co.* (9th Cir 1974) 506 F2d 471, 474).

Under Ninth Circuit rules, an expedited hearing can be requested. Fed R App P 2. Such a hearing may be essential because time is sometimes of the essence in getting appellate review.

PRACTICE TIP: As in the state courts, it is also desirable to couch injunction language in prohibitory terms in federal courts because some federal courts impose a greater evidentiary burden for an affirmative injunction.

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/ III. DAMAGES AND OTHER MONETARY AWARDS/§12.20 A. Basis for Relief: Actual Loss or Unjust Enrichment

III. DAMAGES AND OTHER MONETARY AWARDS

§12.20 A. Basis for Relief: Actual Loss or Unjust Enrichment

A plaintiff may recover for the actual loss caused by misappropriation and for any unjust enrichment to the defendant (*e.g.,* savings attributable to defendant's not having to independently develop the trade secret) that was not taken into account in computing damages for actual loss. CC §3426.3(a); *Sokol Crystal Prods. v DSC Communications Corp.* (7th Cir 1994) 15 F3d 1427, 1433 (applying Wisconsin UTSA). The cost of investigating even an actual misappropriation may not be recoverable if the trade secrets are not actually used. *News Am. Mktg. In-Store, Inc. v Marquis* (Conn 2005) 885 A2d 758 (Connecticut UTSA) (no liability and not even nominal damages awarded when former employee recanted theft, destroyed relevant documents, and did not use trade secrets).

If the misappropriated information is profitably used by the misappropriator, the unjust enrichment can be substantial. See, *e.g., University of Colo. Found., Inc. v American Cyanamid Co.* (D Colo 2002) 216 F Supp 2d 1188 ($53,106,066 for unjust enrichment when company chemist filed patent application using information developed by independent researchers). Because the common law of trade secrets has been displaced to the extent it conflicts with the UTSA, a plaintiff has no common law damage claims beyond those described in §3426.3. *Cacique Co. v Robert Reiser & Co.* (9th Cir 1999) 169 F3d 619. Nevertheless, liability for lost profits can be imposed on intermediaries who did not profit personally from sales made by a company but disclosed the trade secret that resulted in the lost sales and lost profits. *Mangren Research & Dev. Corp. v National Chem. Co.* (7th Cir 1996) 87 F3d 937, 945.

Although the Uniform Act states that an unauthorized disclosure constitutes misappropriation of a trade secret, at least one court has required that the unauthorized disclosure be the cause of the damage to the trade secret owner. In *Russo v Baxter Healthcare Corp.* (1st Cir 1998) 140 F3d 6 (applying Rhode Island version of Uniform Act), the invention in a patent application was disclosed without authorization. The inventor was incorrectly advised that foreign patents were not available because of the unauthorized disclosure and thus no foreign patents were filed. The court found that the cause of injury was the incorrect legal advice, not the unauthorized disclosure, and dismissed trade secret claims based on the unauthorized disclosure.

Other defenses to tort damages may apply to limit recovery of trade secret damages; *e.g.,* the economic loss doctrine. *Bell Helicopter Textron v Tridair Helicopters, Inc.* (D Del 1997) 982 F Supp 318 (applying Delaware version of Uniform Act).

Damages can be substantial (see *Kilbarr Corp. v Business Sys., Inc., B.V.* (D NJ 1988) 679 F Supp 422, 426, aff'd (3d Cir 1989) 869 F2d 589 (damage award of $221 million)) or negligible, especially if plaintiff refuses to realistically identify trade secrets during discovery (see *Winston Research Corp. v Minnesota Mining & Mfg. Co.* (9th Cir 1965) 350 F2d 134, 145 (refusal was basis for denying damages)).

This rule continues the law established by pre-UTSA California decisions. See *Clark v Bunker* (9th Cir 1972) 453 F2d 1006. Some courts have allowed proof of damages at trial under both lost profits and unjust enrichment theories. See *Pioneer Hi-Bred Int'l v Holden Found. Seeds* (8th Cir 1994) 35 F3d 1226 (applying Iowa common law).

Although the plaintiff must prove damages, complete precision is not required. *American Loan Corp. v California Commercial Corp.* (1963) 211 CA2d 515, 524, 27 CR 243. See *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064, 1076 ("reasonable basis" required for damages). Evidence of speculative profits, speculative lost profits, or speculation as to the existence of damages are improper, but once the *existence* of damages or lost profits has been established, the courts are much more lenient in determining the *amount* of damages. *Tri-Tron Int'l v Velto* (9th Cir 1975) 525 F2d 432, 436 (applying Restatement of Torts §757 (1939)); *Monroe v Owens* (1946) 76 CA2d 23, 172 P2d 110 (applying California common law). Nevertheless, proof that the damages are tied to an actionable misappropriation is required. *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064, 1072 (internal experimentation with trade secret information not resulting in market product; employing confidential information in manufacturing, production, research, or development; marketing goods that embody trade secret; and soliciting customers through use of trade secret information all constitute use). In *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc., supra,* the only damage testimony was for unjust enrichment based on all trade secrets lumped together, so a $12 million jury verdict was overturned on a motion for judgment as a matter of law when some of the trade secrets were found not to be misappropriated.

NOTE: See *Computer Print Sys. v Lewis* (Pa Super Ct 1980) 422 A2d 148, 212 USPQ 626, 632, which rejected the defendant's contention that the owner of misappropriated computer software was not actually deprived of the programs and therefore suffered no loss. The court held that this argument was meritless, stating (212 USPQ at 632):

[I]t ignores the fact that the value to [plaintiff] in its exclusive possession of the programs was as a protection for the time and expense it had invested in developing the completed programs. Because of this investment, [plaintiff] had a valuable product that it presumably could have sold to other parties, in this case [defendant].

When seeking damages for unjust enrichment, the plaintiff cannot simply show the general value of the trade secret to the plaintiff and assume that the defendant's gain matches the plaintiff's alleged loss. Evidence of the defendant's enrichment must be presented in the form of specific amounts of the defendant's profits or reasonable royalties for the defendant's use of the trade secrets. *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 12 CR2d 741 (nonsuit for lack of proof on enrichment and reasonable royalty on computer software). Damages experts may be used to determine matters such as the defendant's marginal gain from use of the plaintiff's information compared with publicly available alternatives the defendant might otherwise have used. See, *e.g., University of Colo. Found., Inc. v American Cyanamid Co.* (Fed Cir 2003) 342 F3d 1298, 1312 (expert economist calculated damages for disgorgement of incremental profits wrongfully made from a patent wrongfully obtained by misuse of confidential information). The defendant has the burden to prove the amount of appropriate deductions for its profits that are not attributed to misappropriation. *Jet Spray Cooler, Inc. v Crampton* (Mass 1979) 385 NE2d 1349. The court can award damages based on defendant's profit from diverted sales if the award takes into account the reasonable value of defendant's office management and bookkeeping services, even if those services were not paid for. *Klamath-Orleans Lumber, Inc. v Miller* (1978) 87 CA3d 458, 151 CR 118. The role trade secrets played in a product's commercial success may also be considered in evaluating profits. *Softel, Inc. v Dragon Med. & Scientific Communications, Ltd.* (SD NY 1995) 891 F Supp 935, 943. The measure of "actual damages" under the Uniform Act includes lost profits arising from the sale of defective products embodying the misappropriated secret. *World Wide Prosthetic Supply, Inc. v Mikulsky* (Wis 2002) 640 NW2d 764 (applying Wisconsin UTSA).

Damages under the UTSA appear to be recoverable independently of recoveries for violations of other legal rights. Non-California courts, however, have made successful plaintiffs elect among damage theories (see *DSC Communications Corp. v Next Level Communications* (5th Cir 1997) 107 F3d 322, 325 (applying Texas law)), have awarded damages for misappropriation contingent on denial of a damage award for infringement of a patent on a product embodying the trade secret (see *Minnesota Mining & Mfg. Co. v Johnson & Johnson Orthopaedic, Inc.* (D Minn 1991) 22 USPQ2d 1401, 1417 (applying Minnesota version of Uniform Act)), and have found that liability for misappropriation does not necessarily require damages in addition to those for copyright infringement (see *Softel, Inc. v Dragon Med. & Scientific Communications* (2d Cir 1997) 118 F3d 955).

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§12.21 B. Reasonable Royalty

If neither the plaintiff's actual damages nor the defendant's unjust enrichment are provable, the court may award a reasonable royalty for a time not to exceed the duration of any potential injunction. CC §3426.3(b). *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064 (awarding $900,000 as reasonable royalty for paid-up license based on hypothetical negotiations). (Royalties cannot be awarded as damages if actual damages or unjust enrichment are provable. *Cacique Co. v Robert Reiser & Co.* (9th Cir 1999) 169 F3d 619; *Robert L. Cloud & Assocs., Inc. v Mikesell* (1999) 69 CA4th 1141, 1150, 82 CR2d 143.) The reasonable royalty cannot be combined with other damage valuation methods, such as the cost of creating the trade secret. *American Sales Corp. v Adventure Travel, Inc.* (ED Va 1994) 862 F Supp 1476, 1480, reconsidered on other grounds (ED Va 1994) 867 F Supp 378. Some courts have said that the reasonable royalty is more commonly applied than other damage formulations. See *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1527 (discussing Colorado version of Uniform Act in common law action).

Although damages may include lost profits based on future sales, they may not include royalties for future sales when an injunction is issued barring future use of the trade secrets. *Robert L. Cloud & Assocs., Inc. v Mikesell* (1999) 69 CA4th 1141, 82 CR2d 143.

Evidence of actual royalties is persuasive in these cases, but without such evidence the royalty may be based on the plaintiff's sales data rather than the defendant's actual profits. 831 F Supp at 1527. Courts have analogized this royalty provision to the reasonable royalty decisions in patent infringement cases, which base the award on the results of a hypothetical negotiation occurring at the time the infringement began. *Vermont Microsystems, Inc. v Autodesk, Inc.* (2d Cir 1996) 88 F3d 142 (applying California law (UTSA) and identifying several factors to consider in determining a reasonable royalty in lieu of damages); *American Sales Corp. v Adventure Travel, Inc.* (ED Va 1994) 862 F Supp 1476, 1479, reconsidered on other grounds (ED Va 1994) 867 F Supp 378 (applying Virginia version of Uniform Act). See *Georgia-Pacific Corp. v United States Plywood Corp.* (SD NY 1970) 318 F Supp 1116, 1120, for a list of 15 factors examined in setting a reasonable royalty after patent infringement. Such a negotiation does not contemplate any increase in royalty to compensate for the cost of infringement nor does it allow a double recovery. *Vermont Microsystems, Inc. v Autodesk, Inc., supra*. Without evidence that the defendant actively uses the trade secret, however, only nominal damages may be available. *All W. Pet Supply Co. v Hill's Pet Prods. Div.* (D Kan 1993) 840 F Supp 1433, 1440 (applying Kansas version of Uniform Act).

One court awarded damages based on the lost royalties from a hypothetical patent that was lost because of the misappropriation and unauthorized disclosure of a patentable idea. *Olson v Nieman's, Ltd.* (Iowa Sup Ct 1998) 579 NW2d 299 (applying Iowa version of Uniform Act). Other courts have required a more direct showing of causation and resulting damages. *Russo v Baxter Healthcare Corp.* (1st Cir 1998) 140 F3d 6 (applying Rhode Island version of Uniform Act; court found cause of injury based on incorrect legal advice rather than unauthorized disclosure).

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§12.22 C. Punitive Damages

Under the UTSA, punitive damages are permitted if "willful and malicious misappropriation exists." CC §3426.3(c). This standard replaces a state's more stringent requirements for punitive damages. See *Yeti by Molly, Ltd. v Deckers Outdoor Corp.* (9th Cir 2001) 259 F3d 1101 (Montana version of Uniform Act) (remanded to determine misappropriation under "willful and malicious" standard rather than "clear and convincing" standard of Montana's general punitive damages statute). This requirement includes intentional misappropriation as well as misappropriation resulting from the conscious disregard of the rights of another. *Mangren Research & Dev. Corp. v National Chem. Co.* (7th Cir 1996) 87 F3d 937, 946. Punitive damages are limited to twice the damages awarded. CC §3426.3. This limit on punitive damages falls within the Fourteenth Amendment's due process requirements. "[A]n award of more than four times the amount of compensatory damages might be close to the line of constitutional impropriety." *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 425, 155 L Ed 2d 585, 123 S Ct 1513. But "[w]hen compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee." 538 US at 425, 155 L Ed 2d at 606.

NOTE: The preemptive clause of California's UTSA may limit punitive damages for other claims by preempting those claims. *K.C. Multimedia, Inc. v Bank of America Technol. & Operations, Inc.* (2009) 171 CA4th 939, 90 CR3d 247. See §§11.35, 11.50 on preemption.

Moreover, punitive damage awards should punish a party for specific harm related to the plaintiff, rather than punishing for generally unsavory business practices not specifically related to the plaintiff. *Campbell,* 538 US at 422, 155 L Ed 2d at 604.

Evidence of the defendant's financial condition is relevant to punitive damages in California, although it may not be in other states. See *Computer Assocs. Int'l v American Fundware, Inc.* (D Colo 1993) 831 F Supp 1516, 1529.

In California courts, the plaintiff must provide meaningful evidence of the defendant's financial condition or show why the lack of such evidence is excused. *Robert L. Cloud & Assocs., Inc. v Mikesell* (1999) 69 CA4th 1141, 1151, 82 CR2d 143. In federal courts, the defendant has the burden of proving any financial considerations that it wants considered in awarding punitive damages, including proof that the requested punitive damages would cause undue harm. *Clark v Bunker* (9th Cir 1972) 453 F2d 1006, 1012 n11; see *Chavez v Keat* (1995) 34 CA4th 1406, 41 CR2d 72.

By giving the court discretion to award exemplary damages, the UTSA parallels patent law (35 USC §284), which also grants the court discretion to award treble damages even if the case is tried before a jury. Commissioners' Comment to Uniform Act §3. Yet *Trandes Corp. v Guy F. Atkinson Co.* (4th Cir 1993) 996 F2d 655, 666 (applying Maryland version of Uniform Act), held that any award of punitive damages in federal court is a factual question for the jury. The Ninth Circuit, however, held that a court may award exemplary damages under Montana's trade secrets statute even if a jury has decided that punitive damages are not available under the state's general punitive damages statute. *Yeti by Molly, Ltd. v Deckers Outdoor Corp.* (9th Cir 2001) 259 F3d 1101. See also *02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064 (doubled reasonable royalty for punitive award of $1,800,000 under Cal UTSA).

Note that although the Seventh Amendment might mandate that the issue of willfulness be submitted to the jury in federal cases, there is a lack of case law on whether the entire issue of punitive damages must be decided by the judge. Reference to patent law on willfulness may be useful; in patent cases, the issue of the party's willful conduct can be for the jury to decide, but the court has discretion to grant or deny increased damages. *Delta-X Corp. v Baker Hughes Prod. Tools* (Fed Cir 1993) 984 F2d 410, 414 (upholding district court ruling denying enhanced damages after jury found willful infringement).

NOTE: Other states have lower standards for punitive damages than California. For example, in South Carolina, no malice or aggravation standard is required to find "willful, wanton or reckless disregard" in order to enhance damages under that state's version of the Uniform Act. Thus, increased damages were proper even though the misappropriator believed there was no trade secret. *BBA Nonwovens Simpsonville v Superior Nonwovens* (Fed Cir 2002) 303 F3d 1332.

See also *Roby v McKesson Corp.* (2009) 47 C4th 686, 719, 101 CR3d 773 (one-to-one ratio was federal constitutional limit based on facts of this case).

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Source: Business Law/Trade Secrets Practice in California/12 Remedies for Trade Secret Misappropriation/§12.23 D. Attorney Fees

§12.23 D. Attorney Fees

The court may award reasonable attorney fees to the prevailing party in a trade secrets lawsuit if it finds sufficient bad faith or willful and malicious trade secrets misappropriation (CC §3426.4), and as part of the "costs" award (see CCP §1032) may award reasonable fees for costs actually incurred and reasonably necessary independent expert witnesses incurred in pretrial, trial, or arbitration proceedings. Civil Code §3426.4 is intended to deter specious claims of misappropriation, such as when a plaintiff commences and maintains a lawsuit for previously disclosed trade secrets. *Stilwell Dev. v Chen* (CD Cal 1989) 11 USPQ2d 1328, 1330; *VSL Corp. v General Technol., Inc.* (ND Cal 1998) 46 USPQ2d 1356 (Cal UTSA). The fees may be fixed by the court in a posttrial motion and recovered as part of the prevailing party's costs. *Vacco Indus. v Van Den Berg* (1992) 5 CA4th 34, 54, 6 CR2d 602. The discretionary power to award attorney fees under the UTSA differs from California common law, which had denied such fees. *Pachmayr Gun Works, Inc. v Olin Mathieson Chem. Corp.* (9th Cir 1974) 502 F2d 802, 809.

A trade secrets defendant may recover attorney fees under the UTSA if the plaintiff brought the trade secret claim in bad faith. CC §3426.4. Any reliance on an expert's advice to excuse personal liability for misappropriation must be reasonable, and reliance is unreasonable if the person has reason to know of the misappropriation. *PMC, Inc. v Kadisha* (2000) 78 CA4th 1368, 93 CR2d 663, modified at 79 CA4th 1144A. A defendant cannot recover fees unless a claim for "trade secret misappropriation" was alleged. A claim for misappropriation of patents and trademarks is not based on CC §3426.4, even though attorney fees under §3426.4 were alleged. *Cytodyn of New Mexico, Inc. v Amerimmune Pharms., Inc.* (2008) 160 CA4th 288, 72 CR3d 600 (reversing award of fees under §3426.4).

To establish bad faith, courts apply a two-part, subjective and objective analysis. A trade secret claim is deemed subjectively specious when the plaintiff knew or should have known that the claim had no basis. A trade secret claim is deemed objectively specious when there is a complete lack of evidence to support the claim. The standard for establishing bad faith is lower than the bar set for establishing that a lawsuit is frivolous. See *FLIR Sys., Inc. v Parrish* (2009) 174 CA4th 1270, 1279, 95 CR3d 307; *Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 116 CR2d 358 (setting forth rules). See also *Computer Econs., Inc. v Gartner Group, Inc*. (SD Cal, Dec. 14, 1999, No. 98-CV-0312) 1999 US Dist Lexis 22204 (same). But see *Forcier v Microsoft Corp*. (ND Cal 2000) 123 F Supp 2d 520, 529 (applying different standard based on the "confidence" with which plaintiffs pursued their claim; this case appears to be incorrect in light of *Gemini*).

Courts applying California law have found bad faith in cases in which a plaintiff claimed secrets in information it had previously released into the public domain (*VSL Corp. v General Technol., Inc.* (ND Cal 1998) 46 USPQ2d 1356); a plaintiff failed to identify the alleged secrets after being repeatedly asked to do so (*Computer Econs., Inc.,* 1999 US Dist Lexis 22204, *19); a plaintiff knew that the information lacked economic value and there was no injury to the plaintiff (*Gemini Aluminum Corp. v California Custom Shapes, Inc.* (2002) 95 CA4th 1249, 1263, 116 CR2d 358); the statute of limitations had run (*Alamar Biosciences, Inc. v Difco Labs., Inc.* (ED Cal 1995) 40 USPQ2d 1437); the plaintiff failed to identify any trade secret, failed to produce evidence of independent economic value, and failed to show the information was not readily ascertainable (*Berry v Dillon* (9th Cir 2008) 291 Fed Appx 792). Making demands that violate Bus & P C §16600 or knowingly making inflammatory settlement demands may support a finding of bad faith maintenance of a lawsuit. Denial of a summary judgment motion does not preclude a finding of bad faith. *FLIR Sys., Inc.,* 174 CA4th at 1281.

In considering bad faith, the court can also award attorney fees to the plaintiff for a defendant's bad faith motion to terminate an injunction or to the defendant for a plaintiff's bad faith resistance to a motion to terminate an injunction. *Boeing Co. v Sierracin Corp.* (Wash 1987) 738 P2d 665.

The fee amount is determined by considering many factors that may vary with the forum's law. Compare *Stilwell Dev. v Chen* (CD Cal 1989) 11 USPQ2d 1328, 1334 (novelty and difficulty affect fees), with *Boeing Co. v Sierracin Corp.* (Wash 1987) 738 P2d 665 (novelty not basis for reducing fee award). Illustrative factors considered by California courts include the following:

- Time, labor, and skill required;
- Novelty and difficulty of the issues;
- Counsel's special skill and experience;
- Counsel's professional relationship with the client;
- Reasonableness of counsel's rate and the customary rate;

- Time limitations;
- The amount involved and the results obtained; and
- Awards in similar cases.

Stilwell Dev. v Chen (CD Cal 1989) 11 USPQ2d 1328, 1332 n9, citing *Kerr v Screen Extras Guild, Inc*. (9th Cir 1975) 526 F2d 67, 70, and *Johnson v Georgia Highway Express, Inc.* (5th Cir 1974) 488 F2d 714, 717. See 11 USC §330 (codifying *Johnson* factors for compensating attorneys representing debtors in bankruptcy proceedings). See also *Vacco Indus. v Van Den Berg, supra* (affirming fee award). But see *Stewart v Gates* (9th Cir 1993) 987 F2d 1450 (not permissible to consider whether rate was fixed or contingent, which was *Kerr-Johnson* factor included in *Stilwell* discussion); *In re Activision Sec. Litig.* (ND Cal 1989) 723 F Supp 1373 (criticizing application of *Kerr-Johnson* factors). If the trade secret claims are inextricably intertwined with other claims, then the court has discretion to apportion fees. *VSL Corp. v General Technol., Inc.* (ND Cal 1998) 46 USPQ2d 1356 (Cal UTSA).

NOTE: When a party does not prevail and is found to have acted in bad faith, the prevailing party may recover not only counsel fees incurred at the trial level but also those incurred in a successful defense of the trial court's final judgment on appeal. *Trident Perfusion Assocs. v Lesnoff* (WD Va 1998) 992 F Supp 829 (applying Virginia version of Uniform Act).

In appropriate circumstances, attorney fees may be sought under other theories, such as the following:

- CCP §128.7: Bad faith actions that are frivolous, intended solely to delay, or based on insufficient prefiling investigation. *Computer Prepared Accounts, Inc. v Katz* (1991) 235 CA3d 428, 286 CR 556 (fees for forged documents supporting preliminary injunction for trade secrets misappropriation; counsel and client jointly liable).
- CCP §907: Frivolous appeals or appeals taken for purposes of delay. *Millennium Corp. Solutions v Peckinpaugh* (2005) 126 CA4th 352, 23 CR3d 500 (action for unfair competition and misappropriation of trade secrets, attorney fees granted when party frivolously appealed preliminary injunction it had not opposed). See *Computer Prepared Accounts, Inc. v Katz, supra* (counsel and client jointly liable for fees for appealing sanctions imposed for seeking injunction based on forged documents).
- Improper summary judgment: *Monex Int'l v Peinado* (1990) 224 CA3d 1619, 274 CR 667 (co-conspirator in alleged misappropriation improperly sought dismissal; counsel and client jointly liable).
- Attorney fee provision in a contract: *American Sales Corp. v Adventure Travel, Inc.* (ED Va 1994) 867 F Supp 378 (applying Virginia version of Uniform Act).
- Pursuing trade secret claims in bad faith to violate antitrust laws: *CVD, Inc. v Raytheon Co.* (1st Cir 1985) 769 F2d 842, 859.

Courts have rejected fee awards under the third party tortfeasor doctrine and the court's equitable power to award fees for breach of confidence. *Vacco Indus. v Van Den Berg, supra* (cannot single out one of multiple joint tortfeasors in two-party suit); see *Monolith Portland Midwest Co. v Kaiser Aluminum & Chem. Corp.* (9th Cir 1969) 407 F2d 288, 297 (no fee award for common law trade secret efforts intermingled with patent efforts for which fees can be recovered).

NOTE: To avoid a motion for fees, trade secret plaintiffs should investigate whether information is easily available in the public domain before claiming it as a trade secret. By the same token, trade secret defendants should, on receipt of a CCP §2019.210 statement, inform the plaintiff when any alleged secrets can be easily located in the public domain, such as on the Internet.

If a party is fortunate enough to be awarded fees, it will be necessary to submit a detailed disclosure of the fees and how they were incurred in relation to the relevant claims in order to establish that the fees were reasonable. A conclusory declaration without supporting documents is insufficient to establish the reasonableness of the claimed fees. *Ajaxo, Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 65, 37 CR3d 221 (plaintiff failed to establish reasonableness of attorney fees by not submitting evidence detailing services that each attorney provided and counsels' qualifications and experience to support requested billing rates).

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§12.24 E. Costs

Code of Civil Procedure §1032 generally allows a court to award "costs" to the prevailing party in a lawsuit, but arbitrators generally cannot do so unless the arbitration agreement provides otherwise. See CCP §1284.2. By a 2006 amendment to CC §3426.4, however, a court may now award costs, including fees of independent expert witnesses, to the prevailing party in a lawsuit or arbitration under the Uniform Trade Secrets Act. Fees are appropriate only if misappropriation is brought in bad faith, if a motion to terminate an injunction is resisted in bad faith, or if willful and malicious misappropriation exists. CC §3426.4.

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§12.25 IV. REMEDIES NOT BASED ON UTSA

The UTSA expressly allows contractual and criminal remedies, whether or not based on trade secret misappropriation, and other civil remedies not based on misappropriation. CC §3426.7. Non-UTSA civil remedies are discussed in §§11.35-11.54; criminal penalties are discussed in chap 13.

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13

Criminal Liability for Trade Secret Misappropriation

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I. CRIMINAL LIABILITY FOR TRADE SECRET MISAPPROPRIATION §13.1

II. CRIMINAL STATUTES PROTECTING TRADE SECRETS §13.2

A. Penal Code §499c: Theft of Trade Secret §13.3

B. Penal Code §496: Receiving Stolen Property §13.4

C. Penal Code §502: Unauthorized Access to Computers, Computer Systems, and Computer Data §13.5

D. 18 USC §§1341, 1343: Mail Fraud and Wire Fraud §13.6

E. 18 USC §1962: RICO §13.7

F. 18 USC §§2311-2322: National Stolen Property Act §13.8

G. 18 USC §1029: Fraud and Related Activity in Connection With Access Device §13.9

H. 18 USC §§1831-1839: Economic Espionage Act of 1996 (EEA) §13.9A

I. Avoiding Exposure to EEA Liability §13.9B

III. DECIDING WHETHER TO PURSUE CRIMINAL OR CIVIL ACTION

A. Advantages of Criminal Action §13.10

B. Disadvantages of Criminal Action §13.11

IV. INITIATING A CRIMINAL ACTION

A. Evidence Memorandum §13.12

B. Contacting Proper Authorities §13.13

C. Advice for Alleged Misappropriator §13.14

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§13.1 I. CRIMINAL LIABILITY FOR TRADE SECRET MISAPPROPRIATION

Most trade secret cases are brought in civil court by the wronged party. However, the California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) does not limit a wronged party to civil actions. The UTSA "does not affect … criminal remedies, whether or not based upon misappropriation of a trade secret." CC §3426.7(b).

Several criminal statutes protect trade secrets and their owners. If a client's trade secrets have been misappropriated, counsel should carefully consider contacting the proper authorities to bring a criminal action against the defendants. See §§13.10-13.11. Although an attorney has a privilege to contact the authorities, report a crime, and provide evidence of a crime without incurring personal liability (see CC §47(b)), counsel may not threaten criminal action to gain an advantage in a civil action (Cal Rules of Prof Cond 5-100). An attorney who violates this rule may be subject to state bar penalties, ranging from a letter of censure to disbarment. See Cal Rules of Prof Cond 1-100; Bus & P C §§6077-6078. Criminal extortion charges may also be filed against the attorney. See Pen C §519.

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§13.2 II. CRIMINAL STATUTES PROTECTING TRADE SECRETS

Numerous criminal statutes prohibit improper use of another's trade secret. Both state law (see §§13.3-13.5) and federal law (see §§13.6-13.9) protect trade secrets. If the facts support a claim in both jurisdictions, plaintiff's counsel can approach federal and state authorities simultaneously. For further discussion, see §13.13.

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§13.3 A. Penal Code §499c: Theft of Trade Secret

Trade secret misappropriators and persons conspiring with them are subject to criminal penalties, including fines, imprisonment, probation, and restitution, if they appropriated trade secrets by wrongful or dishonest methods or if they offered anyone a bribe to do so. Pen C §499c; see *People v Gopal* (1985) 171 CA3d 524, 217 CR 487. The defendant must have acted with intent. Pen C §499c(b). Violation is punishable by a fine of up to $5000, imprisonment of up to one year, or both. Pen C §499c(c). If the trade secret's value is proved to be over $400, the criminal act is a felony; if the value is $400 or less, it is a misdemeanor. See *People v Pribich* (1994) 21 CA4th 1844, 1849 n1, 27 CR2d 113 (three-year probation, $1000 fine, $400 restitution for misdemeanor petty theft of item worth $400 or less). The prosecution has the burden of proving the value of the trade secret and hence whether the alleged crime is a felony or a misdemeanor. Criminal sentences under this statute can be consecutive and can include sentences for related criminal offenses such as conspiring to commit a crime, offering a bribe to acquire a trade secret, receiving stolen property, and possessing stolen property. *People v Gopal* (1985) 171 CA3d 524, 549, 217 CR 487. The statute of limitations is three years if the offense is found to be a felony (Pen C §801) and one year if it is found to be a misdemeanor (Pen C §802).

When a client is charged with violating Pen C §499c, the two key issues are whether the property involved meets this definition of a trade secret and the means by which the client acquired the information. The definition of a trade secret in Pen C §499c(a)(9) was amended in 1996 to conform with the definition in the UTSA. See §§1.3-1.10 for discussion of the definition of a trade secret under the UTSA. The current definition marks a radical change from the prior law, which, in accordance with the approach of most other large states, punished only the theft of "scientific or technical" information.

If the information is not found to be a trade secret, no liability is incurred under Pen C §499c. *People v Laiwala* (2006) 143 CA4th 1065, 1072, 49 CR3d 639 ("absence of evidence that information was a trade secret negates a requisite element of the crime"). If the information is found to be a trade secret, the attorney must ask whether the client acquired the property by legitimate means. Such means include independent discovery, reverse engineering, license, public observation, or published literature. See §§1.13-1.14. See also general discussion of sources of information in §§10.29-10.48.

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§13.4 B. Penal Code §496: Receiving Stolen Property

No one may acquire or conceal property that he or she knows was stolen from another. Pen C §496(a). The elements of this crime are as follows:

- The property was stolen;
- The defendant knew that the property was stolen; and
- The defendant had possession of the stolen property (which possession need not be exclusive).

People v Land (1994) 30 CA4th 220, 223, 35 CR2d 544. Section 496(a) can be used to prosecute competitors who buy or receive trade secrets (or copies of trade secrets), knowing that they have been stolen, or who conceal, sell, or withhold or aid in concealing, selling, or withholding trade secrets from the owner if the competitor knows that trade secrets were stolen. *People v Gopal* (1985) 171 CA3d 524, 217 CR 487. Any act prohibited by Pen C §496(a) is punishable by imprisonment for up to one year. One who is convicted of violating §496(a) cannot also be convicted of the theft. Pen C §496(a). As with violations of Pen C §499c (see §13.3), the statute of limitations is three years if the offense is found to be a felony (Pen C §801) and one year if it is found to be a misdemeanor (Pen C §802).

NOTE: The injured party may bring an action for treble damages, attorney fees, and court costs. Pen C §496(c). A defendant may argue, however, that this provision is preempted by the UTSA. See §1.16.

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§13.5 C. Penal Code §502: Unauthorized Access to Computers, Computer Systems, and Computer Data

It is illegal to gain access to and without permission use any computer data or other computer hardware or software. Pen C §502(c); *People v Gentry* (1991) 234 CA3d 131, 285 CR 591 (defendant gained access to and altered credit reporting company computer files). See also *People v Hawkins* (2002) 98 CA4th 1428, 121 CR2d 627 (statute not void for vagueness). Depending on the defendant's conduct, a violation of §502(c) may be punishable by a fine of up to $12,000, imprisonment for up to 3 years, or both. Pen C §502(d). In addition, any hardware or software used in violating Pen C §502 is subject to forfeiture. Pen C §§502(g), 502.01. Thus, if the trade secret is in the form of computer data, software, or hardware, this statute may apply.

The statute of limitations under this section is 3 years if the crime is charged as a felony and 1 year if it is charged as a misdemeanor. Pen C §§801-802.

A victim of this crime may bring a civil action for compensatory damages and attorney fees, in addition to other remedies. Pen C §502(e).

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§13.6 D. 18 USC §§1341, 1343: Mail Fraud and Wire Fraud

Mail fraud includes using the United States Postal Service in connection with a scheme to defraud or to obtain money or other property by false or fraudulent pretenses. Such actions are punishable by a fine, imprisonment for up to 20 years, or both. The fine increases up to $1 million, imprisonment up to 30 years, or both, if the violation affects a financial institution. 18 USC §1341.

Wire fraud is similar to mail fraud except that it involves the use of wire, radio, or television communications, or writings, signs, signals, pictures, or sounds in the scheme to defraud. 18 USC §1343. Under the White-Collar Crime Penalty Enhancement Act of 2002 (Pub L 107-204, 116 Stats 806), it is also a crime to attempt or conspire to commit mail or wire fraud. 18 USC §1349.

Trade secrets and other confidential information may qualify as property under these statutes. *Carpenter v U.S.* (1987) 484 US 19, 26, 98 L Ed 2d 275, 108 S Ct 316. See also *U.S. v Louderman* (9th Cir 1978) 576 F2d 1383, 1387, in which the Ninth Circuit upheld the trial court's jury instruction that "property" encompasses "confidential and nonpublic commercial information such as customer lists, customer credit data, lists of services provided customers, and accounting data, as well as services of employees and customers goodwill." But see §13.8.

The statute of limitations for both mail and wire fraud is 5 years after the last offense is committed. 18 USC §3282. If the alleged fraud affects a financial institution, the period is extended to 10 years. 18 USC §3293.

Breach of a fiduciary duty alone does not constitute mail fraud. A defendant with a fiduciary duty must have concealed material information that a fiduciary has a duty to disclose when nondisclosure would result in harm. The defendant must also have had an intent to defraud or deceive by affirmative misrepresentation or by silence. *U.S. v Lemire* (DC Cir 1983) 720 F2d 1327. Thus, because a mobile employee need not tell the employer of plans to change jobs unless it is inimical to the employer's interests, an employee's decision to misappropriate the former employer's trade secrets after changing employment does not form the basis of mail fraud liability. A decision to misappropriate before changing employment, however, could lead to such liability. *Celpaco, Inc. v MD Papierfabriken* (D Conn 1988) 686 F Supp 983, 993.

For further discussion of the application of mail fraud and wire fraud statutes to trade secret information, see Toren, *The Prosecution of Trade Secrets Thefts Under Federal Law,* 22 Pepp L Rev 59, 85 (1994). See also Hostetler, *Intangible Property Under the Federal Mail Fraud Statute and the Takings Clause,* 50 Duke LJ 589 (2000).

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§13.7 E. 18 USC §1962: RICO

The federal government may bring criminal proceedings under the Racketeer Influenced and Corrupt Organizations Act (RICO) (18 USC §§1961-1968), alleging that stealing trade secrets constitutes forming an "enterprise" that engaged in "a pattern of racketeering activity" in violation of 18 USC §§1961, 1962(c)-(d), and 1963(a). See *Rockwell Graphic Sys. v DEV Indus.* (7th Cir 1991) 925 F2d 174, 175. The "pattern" factor of this crime requires continuity of the illegal activity. *Celpaco, Inc. v MD Papierfabriken* (D Conn 1988) 686 F Supp 983. In *Celpaco,* the plaintiff alleged that several of its former employees tried to put the plaintiff out of business and form a new company using plaintiff's trade secrets (customer lists). The court found no RICO violation, because the scheme lasted no longer than the time needed to steal the plaintiff's lists, *i.e.,* the defendants' scheme lacked the requisite continuity. But see *General Motors Corp. v Ignacio Lopez de Arriortua* (ED Mich 1996) 948 F Supp 670, 676 (civil action; pattern of trade secret misappropriation can be established by multiple acts within "single scheme").

A RICO violation is punishable by a fine, imprisonment of up to 20 years, or both, and by forfeiture of all interests, rights, and claims in the proceeds of the racketeering activity. 18 USC §1963. Because RICO has no statute of limitations, the general 5-year limitation for noncapital offenses under 18 USC §3282 applies. See *U.S. v Bethea* (5th Cir 1982) 672 F2d 407.

The injured party may also bring a civil action for treble damages, attorney fees, and costs. 18 USC §1964. See §11.55.

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§13.8 F. 18 USC §§2311-2322: National Stolen Property Act

Criminal trade secret misappropriation cases have been prosecuted under the National Stolen Property Act (18 USC §§2311-2322) on the theory that the stolen secret was "goods, wares, [or] merchandise" valued at more than $5000 and moved in interstate commerce. 18 USC §§2314-2315. See *U.S. v Riggs* (ND Ill 1990) 739 F Supp 414, in which the defendant was charged with violating 18 USC §2314 (interstate transportation of stolen property) for downloading, copying, and distributing data taken from another's computer. The court rejected the defendant's argument that only electronic impulses crossed state lines, and focused on the information in the stolen file. The court analogized the stolen file to an imperceptible gas, stored and moved across state lines. Using this reasoning, the court concluded that the file in question fell within the statutory definition of goods, wares, or merchandise.

In contrast, the Tenth Circuit rejected the *Riggs* analysis. *U.S. v Brown* (10th Cir 1991) 925 F2d 1301. The defendant in *Brown* was charged with transporting computer programs and source code across state lines. Relying on *Dowling v U.S.* (1985) 473 US 207, 87 L Ed 2d 152, 105 S Ct 3127, in which the Supreme Court acknowledged a physical embodiment requirement, the *Brown* court stated that the stolen property must have a tangible form to fall under 18 USC §2314, holding that "purely intellectual property" was not covered by the statute. Some tangible property, no matter what its value, had to be involved (*e.g.,* a file containing diagrams of trade secrets). Thus, transporting a stolen computer disk containing trade secret information across state lines could trigger application of the statute, but not downloading the same information onto a computer located across state lines. See Toren, *The Prosecution of Trade Secrets Thefts Under Federal Law*, 22 Pepp L Rev 59, 67 (1994). On the other hand, two district courts have rejected *Brown* and applied the statute to information transmitted across state lines by e-mail. See *U.S. v Alavi* (D Ariz, May 2, 2008, No. CR 07-429-PHX-NVW) 2008 US Dist Lexis 38682; *U.S. v Farraj* (SD NY 2001) 142 F Supp 2d 484. See also *U.S. v Wirtz* (D Minn 2005) 357 F Supp 2d 1164, 1168 (citing *Carpenter v U.S.* (1987) 484 US 19, 26, 98 L Ed 2d 275, 108 S Ct 316, and holding statute applicable to pricing information that was secret before release to customers).

This crime is punishable by fine, up to 10 years' imprisonment, or both. 18 USC §2314. The statute of limitations is 5 years. 18 USC §3282.

It is also a federal crime to receive or sell stolen property. 18 USC §2315. The government must prove that the defendant knew that the goods at issue were stolen. See *U.S. v Rugendorf* (7th Cir 1963) 316 F2d 589. The penalties and statute of limitations for this crime are the same as for violation of 18 USC §2314.

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§13.9 G. 18 USC §1029: Fraud and Related Activity in Connection With Access Device

It is illegal to use counterfeit devices, such as credit cards or access codes, to obtain money, goods, services, or any other thing of value. 18 USC §1029(a), (e)(1). If a trade secret was obtained in such a manner, this statute may apply. Punishment under this statute depends on the value of the goods obtained and previous offenses. The punishment for this crime is a fine, imprisonment for up to 10 or 15 years for a first offense or up to 20 years for offenders with prior convictions, or both. 18 USC §1029(c). The statute of limitations is 5 years. 18 USC §3282. See also *U.S. v Martin* (1st Cir 2000) 228 F3d 1 (use of e-mail to entice employee to reveal secrets can be prosecuted as wire fraud).

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§13.9A H. 18 USC §§1831-1839: Economic Espionage Act of 1996

The Economic Espionage Act of 1996 (EEA) (18 USC §§1831-1839) applies to all forms of trade secret misappropriation and is similar to Pen C §499c (see §13.3). It treats separately acts of theft committed to benefit a foreign government, which are punished more harshly. The general theft section of the EEA requires (18 USC §1832):

- An intent to "convert" the trade secret, and
- That the secret be "related to or included in a product" (casting doubt on coverage of research information and service-related data).

A violation is punishable by a fine or imprisonment up to 15 years, or both. An organization that commits a violation receives a fine of up to $5 million. 18 USC §1832(b). In addition, property used in or resulting from the theft is subject to forfeiture to the government.

The EEA permits the United States Attorney General to initiate a civil action to obtain injunctive relief protecting against violations and requires the courts in criminal cases to make appropriate orders to protect trade secret information from disclosure through the proceeding.

The EEA may dramatically change the availability of criminal enforcement because the other federal statutes described in this chapter were not designed to apply to trade secrets. See Pooley, Lemley & Toren, *Understanding the Economic Espionage Act of 1996,* 5 Tex Intell Prop LJ 177 (1997). See also Moohr, *The Problematic Role of Criminal Law in Regulating Use of Information: The Case of the Economic Espionage Act,* 80 NC L Rev 853 (2002).

The first reported decision under the EEA underscores the trade secret owner's risks in referring a matter to the authorities. In *U.S. v Hsu* (3d Cir 1998) 155 F3d 189 (*Hsu I*), the district court rejected a government request for a protective order prohibiting access by the defendant to the victim's trade secret information that was the subject of the alleged crime. The court of appeals reversed, explaining that the defendants had been charged only with conspiracy and attempted misappropriation, and that the trade secret status of the material was therefore irrelevant. (Following remand, Hsu unsuccessfully moved to dismiss on the ground that the statutory elements of "not generally known to the public" and "reasonable efforts" were unconstitutionally vague. *U.S. v Hsu* (ED Pa 1999) 40 F Supp 2d 623.) However, the appeals court left open the question whether, in a case charging completed theft, the defense would have to be given access to the information so as to satisfy Sixth Amendment concerns. Therefore, in criminal proceedings, it is not safe to assume that the protective order typical in civil cases (see §11.28) will be entered.

U.S. v Lange (7th Cir 2002) 312 F3d 263 calls into question the broad holding of *Hsu I* that attempted theft of secrets can be charged regardless of the material that was taken. In dictum, the *Lange* court suggested that, if the material hadn't been substituted with a fake but in its original state could not be considered a trade secret, the "impossibility" defense might apply. "Selling a copy of *Zen and the Art of Motorcycle Maintenance* is not attempted economic espionage, even if the defendant thinks that the tips in the books are trade secrets; nor is sticking pins in voodoo dolls attempted murder." 312 F3d at 269.

An 74-year-old aerospace engineer who acted as an espionage agent for the Peoples Republic of China for 30 years was sentenced to 15 years in prison after he was convicted of six counts of violating the EEA. See *U.S. v Chung* (CD Cal 2009) 633 F Supp 2d 1134. The defendant, Dongfan Chung, was found to have stored more than 300,000 pages of his employer's trade secret and proprietary information at his home.

In a prosecution under the EEA, the defendant may not depose witnesses before trial for clarification of the trade secrets involved. *U.S. v Ye* (9th Cir 2006) 436 F3d 1117, 1123.

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§13.9B I. Avoiding Exposure to EEA Liability

Chapter 8 of the Federal Sentencing Guidelines (see United States Sentencing Commission, *Guidelines Manual* (Nov. 2008), available at http://www.ussc.gov/guidelin.htm) (USSG), generally applicable to the issue of how the courts should approach sentencing, is also employed widely by the government in deciding whether to seek an indictment in an EEA action. When a company has established a preventive plan and has managed and enforced it well, the company and its management are much less likely to face criminal charges if, for example, a rogue employee brings unauthorized material into the organization.

Largely in response to the Sarbanes-Oxley Act of 2002 (Pub L 107-204, 116 Stat 745), the USSGs have been toughened and made more specific regarding the expected content of compliance plans. There are seven criteria designed to encourage ethical conduct and compliance with the law. They include (features in response to the Sarbanes-Oxley Act are in bold) (see USSG §8B2.1):

(1) The company must establish "standards and procedures to prevent and detect criminal conduct," including "**internal controls** that are reasonably capable of reducing the likelihood of criminal conduct."

(2) The **Board of Directors and senior management** must be knowledgeable about and **oversee** the compliance program. Although responsibility for operation may be delegated, the person in charge must have "**direct access" to the Board,** which must provide **adequate resources** and receive reports at least annually.

(3) Individuals involved in management of the program should be free of any relevant record of criminal behavior.

(4) The Board of Directors and senior management must receive compliance and ethics training.

(5) The plan must include **auditing and monitoring systems** and must guarantee the right of individuals to come forward without fear of retribution.

(6) The program must provide both **incentives** for individual compliance and disciplinary measures for noncompliance.

(7) Once criminal conduct has been detected, the company must take reasonable steps to respond to it and to prevent further similar conduct.

In addition to these seven basic features, the USSGs require that a company "**periodically assess the risk** of criminal conduct" and take steps to modify its program to reduce that risk. USSG §8B2.1.

Unquestionably, the intersection of trade secrets, criminal law, and corporate compliance has marked a new and serious challenge for management. At the same time, following these strengthened requirements will provide value to the enterprise by raising the visibility of its intangible (but increasingly valuable) assets and by making theft or contamination of those assets less likely.

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III. DECIDING WHETHER TO PURSUE CRIMINAL OR CIVIL ACTION

§13.10 A. Advantages of Criminal Action

There are several advantages to a criminal action, primarily that:

- The government bears the cost of the prosecution.
- The government has significant investigative powers, such as search warrants and telephone wiretaps, that are not available to companies or their counsel.
- Once the authorities are involved, counsel has gone a long way toward recovering the client's trade secrets and mitigating the damages caused by the misappropriation. The authorities can often completely recover all trade secrets in a short period of time. When contacted by the authorities, many defendants return trade secrets with the hope that doing so will end the criminal investigation.
- In many cases, the government essentially does the discovery for the client and "tests" the case. If the authorities obtain a confession or other evidence of misappropriation, counsel may be able to use that evidence in a subsequent civil action.
- Insurance occasionally covers liability in a civil case, but it rarely covers a criminal action. Thus, the defendant must personally pay any attorney fees as well as fines or other penalties.
- As a general rule, criminal cases are disposed of more quickly than civil matters because of the constitutional requirement of a speedy trial. US Const amend VI.

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§13.11 B. Disadvantages of Criminal Action

There are certain disadvantages to bringing a criminal action:

- The owner of the trade secret loses control over how the action is prosecuted, which may result in information being revealed, and loses control over settlement, because federal and state authorities represent the *people* rather than the victim (the trade secret owner).

- Federal and state authorities are sometimes overburdened and have limited resources to prosecute cases. Unless the actual monetary loss is significant, the industry is crucial to national defense, or a foreign power is involved, the case is generally not prosecuted.

PRACTICE TIP: A key to triggering investigation and prosecution of a case is to make the job easy for the authorities. Counsel should prepare a detailed evidence memorandum giving the authorities as much information as possible. See §13.12.

- Even though the authorities may be able to recover the client's property quickly once it prosecutes the case, it may take counsel some time and effort to convince the authorities to undertake the case.

- Criminal sanctions punish the defendant but do not otherwise protect the rights of the trade secret owner (but see Economic Espionage Act of 1996 (18 USC §§1831-1839), discussed in §13.9A).

- Once the criminal action begins, the defendant can move to stay the civil action. If there is no stay, the civil case typically grinds to a halt because the defendant witnesses refuse to testify on Fifth Amendment grounds. Such a delay can harm the trade secret owner, especially if the criminal action is eventually unsuccessful.

- A criminal conviction can have the effect of canceling the defendant's insurance in the civil case. "An insurer is not liable for a loss caused by the willful act of the insured." Ins C §533. This language is used as an exclusionary clause in every insurance contract. See *Ubrich v State Farm Fire & Cas. Co.* (2003) 109 CA4th 598, 135 CR2d 131. Civil Code §1668 parallels §533:

All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.

- If during the criminal trial the defendant's actions are found to be willful, the insurance company may rightfully withhold indemnity in a subsequent civil suit. *Evans v Pacific Indem. Co.* (1975) 49 CA3d 537, 122 CR 680. For further discussion of availability of insurance for trade secret misappropriation claims, see chap 14.

- In criminal matters, the prosecution must prove beyond a reasonable doubt that the defendant misappropriated the trade secret. Because this is a much higher burden of proof than the mere preponderance of the evidence required in civil actions, it is more difficult to get a conviction in a criminal action than to prevail in a civil suit.

- Once the authorities have brought charges against the defendant, the client, like any witness to a crime, will be subject to subpoena, which may involve testifying at a preliminary hearing and trial.

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IV. INITIATING A CRIMINAL ACTION

§13.12 A. Evidence Memorandum

If the trade secret owner or its counsel has evidence of a trade secret misappropriation, counsel should prepare an evidence memorandum and send it to the proper authorities. The memorandum should contain at a minimum the following information:

- Copies of the statutes that were violated;
- Analysis of the statutory elements and the value of the trade secrets;
- Admissible evidence of the violations;
- A list of witnesses, including names, addresses, and telephone numbers; and
- Detailed information about the defendants, which should be checked thoroughly for accuracy.

NOTE: Civil Code §47(b) gives an absolute privilege to all communications relating to misappropriation of trade secrets made to the Attorney General's office or to local law enforcement agencies. The privilege is not defeated by any ulterior motive of the communicant. *Forro Precision, Inc. v International Bus. Mach. Corp.* (9th Cir 1984) 745 F2d 1283; *Forro Precision, Inc. v International Bus. Mach. Corp.* (9th Cir 1982) 673 F2d 1045, 1055. But see *People v Eubanks* (1996) 14 C4th 580, 59 CR2d 200 (upholding recusal of district attorney office for soliciting reimbursement of investigation expenses).

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§13.13 B. Contacting Proper Authorities

Deciding whether to contact the state authorities, the federal authorities, or both depends on the specific facts of each case. If both state and federal laws are violated, the attorney should contact both. The United States Attorney's office and the District Attorney's office are usually overburdened and will generally initiate proceedings only if a strong case is made and a significant amount is involved or certain interests are involved. See §13.11. If one jurisdiction prosecutes the case, the other generally will not because of double jeopardy concerns.

If the crimes were committed in more than one jurisdiction, the attorney, along with the client, must determine where the strongest case can be brought. As a rule, the greater the local nexus to the crime, the greater the interest local authorities have in prosecuting the case. Logistical considerations, such as travel time and expense, should also be considered.

Clients may be hesitant to file charges out of fear of further disclosure of the trade secret. The California Legislature has addressed this concern by providing various protections for trade secrets disclosed during trial. The trade secret owner may assert a privilege "if the allowance … will not tend to conceal fraud or otherwise work injustice." Evid C §1060. Thus, the party seeking discovery of a trade secret must make a particularized showing that the information sought is relevant, necessary, and essential to a fair resolution of the lawsuit. *Bridgestone/Firestone, Inc. v Superior Court* (1992) 7 CA4th 1384, 9 CR2d 709. The court has discretion to issue a protective order limiting the use and dissemination of the trade secret, which may limit dissemination only to counsel for the parties, allow the defendant to view the trade secret only in counsel's presence, and require anyone with access to the trade secret to sign and be bound by the protective order. Evid C §1061(b)(4). The court may also exclude the public from criminal trials on a motion of the trade secret owner. Evid C §1062. The Economic Espionage Act of 1996 (18 USC §§1831-1839) (see §13.9A) protects trade secrets during a criminal proceeding in federal court. The UTSA affords similar protection in civil cases (CC §3426.5): "a court shall preserve the secrecy of an alleged trade secret by reasonable means." See chap 11 for further discussion of litigation issues.

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§13.14 C. Advice for Alleged Misappropriator

When a client is charged with a crime, counsel should immediately retain an experienced criminal attorney and, if not already part of the litigation team, an experienced trade secret attorney. Together they should analyze the specific facts of the case in conjunction with the required elements of each crime charged and the possible defenses. Counsel should also ascertain whether insurance coverage is available. See chap 14. Persons cannot insure themselves against their own willful acts. However, if intent is not an element of the crime charged, the act in question may not fall within the willful act exclusion.

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14

Insurance Coverage for Misappropriation Claims

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I. PRINCIPLES OF INSURANCE COVERAGE

A. Importance of Insurance Coverage §14.1

B. Basis of Insurance Coverage §14.2

C. Insurance Coverage Generally §14.3

II. COVERAGE UNDER ADVERTISING INJURY PROVISIONS OF GENERAL LIABILITY POLICIES §14.4

A. Definition of "Advertising Injury"

1. 1973 ISO Form §14.5

2. 1986, 1998, 2001, and 2004 ISO Forms §14.6

B. Application of Advertising Injury Provisions to Trade Secret Litigation §14.7

1. Misconduct Must Constitute "Covered Offense" §14.8

a. Misappropriation of Advertising Ideas or Style of Doing Business §14.9

b. Infringement of Title §14.10

c. Piracy and Unfair Competition §14.11

2. Was Insured Engaged in Advertising Activity? §14.12

3. Causal Nexus Between Advertising Injury and Advertising Activity §14.13

III. COVERAGE STRATEGY FOR TRADE SECRET CASES

A. Plaintiff's Strategies §14.14

B. Insured's Strategies

1. Insurance Policy Review §14.15

2. Declaratory Relief §14.16

3. Bad Faith Denial of Insurance Coverage §14.17

4. Procedural Issues §14.18

5. Choice of Law §14.19

C. Counsel's Professional Responsibilities §14.20

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I. PRINCIPLES OF INSURANCE COVERAGE

§14.1 A. Importance of Insurance Coverage

The costs of trade secret misappropriation lawsuits, and intellectual property disputes in general, can be exorbitant. For a defendant, the availability of insurance to defend a trade secret case can make the difference between winning (or being in a position of sufficient strength to get to a successful settlement) and losing the case. From a plaintiff's perspective, the loss caused by trade secret misappropriation can be disastrous for a company. Businesses seeking recompense for theft of trade secrets may look to the deep pockets of the insurance company for recovery of their damages.

Courts have held that general liability insurance policies may provide coverage for claims of trade secret misappropriation. See, *e.g., Sentex Sys. v Hartford Acc. & Indem. Co.* (9th Cir 1996) 93 F3d 578. But see *Avery Dennison Corp. v Allendale Mut. Ins. Co.* (9th Cir 2002) 310 F3d 1114 (theft of trade secrets by employee not covered under policy issued to cover losses to tangible property resulting from employee dishonesty).

However, recent judicial decisions narrowly interpreting the scope of coverage available under the "advertising injury" provisions of Commercial General Liability (CGL) insurance policies and the addition of exclusions for infringement of trade secrets in CGL policies have limited the availability of coverage for claims of trade secret misappropriation.

This chapter discusses the general procedures for obtaining coverage for misappropriation of trade secrets and cites specific cases discussing such coverage.

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§14.2 B. Basis of Insurance Coverage

Coverage for trade secret claims may arise from the "advertising injury" provisions of CGL insurance policies purchased by most businesses. See §§14.4-14.6. These provisions trigger both a duty to defend and a duty to indemnify for a variety of intellectual property claims. The 1986 Insurance Services Office "advertising injury" provision of the CGL Policy (see §14.6) expressly covers claims based on copyright infringement and misappropriation of advertising ideas or style of doing business. Examples of the types of claims potentially covered under the advertising injury provisions of CGL policies include:

- Trade secret use or misappropriation: *Sentex Sys. v Hartford Acc. & Indem. Co.* (9th Cir 1996) 93 F3d 578.
- Trademark infringement: *Lebas Fashion Imports, Inc. v ITT Hartford Ins. Group* (1996) 50 CA4th 548, 59 CR2d 36, modified at 50 CA4th 1949a.
- Trade dress infringement: *Dogloo, Inc. v Northern Ins. Co.* (CD Cal 1995) 907 F Supp 1383.
- Copyright infringement: *Poof Toy Prods. v U.S. Fid. & Guar. Co.* (ED Mich 1995) 891 F Supp 1228.
- Unfair competition and piracy: *Rymal v Woodcock* (WD La 1995) 896 F Supp 637.
- Patent infringement: *Hyundai Motor Am. v National Union Fire Ins. Co.* (9th Cir 2010) 600 F3d 1092; *Elan Pharm. Research Corp. v Employers Ins. Co. of Wausau* (11th Cir 1998) 144 F3d 1372.

Case law confirms that the issue of advertising injury coverage for intellectual property claims is complex. Numerous courts have found advertising injury coverage for claims of trade secret misappropriation, trademark infringement, and copyright infringement. See *Sentex Sys. v Hartford Acc. & Indem. Co., supra* (affirming that advertising injury provisions provide coverage for trade secret misappropriation). Other California and federal decisions, however, have refused to extend the reach of advertising injury provisions to claims of patent infringement or inducing patent infringement. See, *e.g., Everett Assocs., Inc. et al. v Transcontinental Ins. Co.* (ND Cal 2001) 159 F Supp 2d 1196, aff'd in part and rev'd in part without published opinion (9th Cir 2002) 2002 US App Lexis 8583 (policy holder cannot reasonably read policy's "misappropriation of style of doing business" language to include *patent* infringement if patented invention in question cannot reasonably be considered a "style of doing business." Court found "unique cradle locks" of a massage table not a "style of doing business"). *Maxconn Inc. v Truck Ins. Exch.* (1999) 74 CA4th 1267, 88 CR2d 750; *Simply Fresh Fruit, Inc. v Continental Ins. Co.* (9th Cir 1996) 94 F3d 1219; *Everest & Jennings, Inc. v American Motorists Ins. Co.* (9th Cir 1994) 23 F3d 226, 229; *Iolab Corp. v Seaboard Sur. Co.* (9th Cir 1994) 15 F3d 1500, 1505 (patent infringement "not an act of piracy arising out of or committed in advertising" and therefore not covered by CGL policies' advertising injury provisions). But see *Hyundai Motor Am. v National Union Fire Ins. Co., supra*. In *Hyundai,* the court held that third party patent infringement claims constituted allegations of "misappropriation of advertising ideas" when the advertising itself was the improper use of the patented method. 600 F3d at 1104. See also *Elan Pharm. Research Corp. v Employers Ins. Co. of Wausau, supra*. In *Elan,* the CGL policy, as modified by endorsement, defined "advertising injury" to include injury arising from patent infringement committed in the course of advertising activities. 144 F3d at 1375. Allegations that the insured infringed the patent by disseminating clinical studies for the purpose of commercializing a drug constituted advertising activity within the meaning of CGL and commercial umbrella liability policies covering "advertising injury."

WARNING: Trade secret cases differ from patent cases, however, in that the misappropriation of proprietary advertising and marketing ideas and the use of misappropriated trade secrets to advertise and market a product seem to constitute the very essence of advertising injury.

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§14.3 C. Insurance Coverage Generally

Any coverage analysis begins with a determination of whether a duty to defend exists. This duty obligates insurance companies to defend their policyholders at the insurer's expense when third parties sue the policyholders. For this reason, liability insurance is frequently described as "litigation insurance." In contrast, a separate duty to indemnify obligates insurers to pay all sums that policyholders are legally obligated to pay to third parties for actions that fall within the scope of the liability insurance policies. An insurance company's duty to defend exists independently of and is much broader than its duty to indemnify: "[A]n insurer may owe a duty to defend its insured in an action in which no damages ultimately are awarded." *Horace Mann Ins. Co. v Barbara B.* (1993) 4 C4th 1076, 1081, 17 CR2d 210. Whether the insurer has a duty to defend "turns not upon the ultimate adjudication of coverage under its policy of insurance, but upon those facts known by the insurer at the inception of a third party lawsuit.... Hence, the duty 'may exist even where coverage is in doubt and ultimately does not develop.'" *Montrose Chem. Corp. v Superior Court* (1993) 6 C4th 287, 295, 24 CR2d 467.

An immediate duty to defend all potentially covered claims is part of an insured's reasonable expectations. If there is a potential or possibility for coverage, the insurer's duty arises. Thus, "the insured need only show that the underlying claim *may* fall within the policy coverage; the insurer must prove it *cannot*." 6 C4th at 300. See *Horace Mann Ins. Co. v Barbara B.* (1993) 4 C4th 1076, 1086, 17 CR2d 210; *Northland Ins. Co. v Briones* (2000) 81 CA4th 796, 803, 97 CR2d 127.

If the complaint against the insured contains allegations of liability that might be covered by the policy, or if the complaint could be amended to include such allegations, a duty to defend exists. *Montrose Chem. Corp. v Superior Court, supra*. But see *Waller v Truck Ins. Exch.* (1995) 11 C4th 1, 44 CR2d 370 (uncovered claim does not trigger defense obligation). Courts look to all facts available to the insurer at the time the insured tenders its claim for a defense in deciding whether a duty to defend exists. Even facts extrinsic to the complaint may demonstrate a possibility of coverage. *Gray v Zurich* (1966) 65 C2d 263, 276, 54 CR 104; *Wausau Underwriters Ins. Co. v Unigard Sec. Ins. Co.* (1998) 68 CA4th 1030, 80 CR2d 688. If a complaint is silent regarding advertising and marketing allegations but discovery discloses that a plaintiff is contending that misappropriated trade secrets were advertised or marketed, the duty to defend is triggered. *Merchants Co. v American Motorists Ins. Co.* (SD Miss 1992) 794 F Supp 611, 617 (deposition testimony revealed use of customer list to solicit).

Any doubts about a duty to defend are resolved in the insured's favor. *Horace Mann Ins. Co. v Barbara B.* (1993) 4 C4th 1076, 1081, 17 CR2d 210; *Ringler Assocs., Inc. v Maryland Cas. Co.* (2000) 80 CA4th 1165, 1186, 96 CR2d 136. When a duty to defend does exist, the insurer must defend against all covered and noncovered claims "until the insurer produces undeniable evidence supporting an allocation of a specific portion of the defense costs to a non-covered claim." *Horace Mann Ins. Co. v Barbara B., supra*.

Most advertising injury provisions include language that may be characterized as ambiguous by courts. Ambiguities are typically resolved against the insurer whose policy language is responsible for the uncertainty. *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1265, 10 CR2d 538. Accordingly, the coverage provided may be broader than that expressly stated on the face of the policy.

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§14.4 II. COVERAGE UNDER ADVERTISING INJURY PROVISIONS OF GENERAL LIABILITY POLICIES

Virtually all CGL policies include advertising injury provisions. Because the language in these provisions is vague and is seldom defined, insurance companies and policyholders are in conflict over the breadth and meaning of these provisions. Insurers urge a narrow, limited interpretation while insureds advocate a broad, comprehensive reading. Complicating matters further is that the standardized Insurance Services Office (ISO) forms, which include the definition of advertising injury, have been amended on several occasions. See §§14.5-14.6.

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A. Definition of "Advertising Injury"

§14.5 1. 1973 ISO Form

Advertising injury coverage was created by a 1976 endorsement to the 1973 ISO Comprehensive General Liability Insurance Policy. The 1976 endorsement, labeled the Broad Form Comprehensive General Liability Endorsement, defines advertising injury as follows:

"Advertising Injury" means injury arising out of an offense committed during the policy period occurring in the course of the named insured's advertising activities, if such injury arises out of libel, slander, defamation, violation of right of privacy, *piracy, unfair competition* or infringement of copyright, title or slogan. [Emphasis added.]

Neither the term "advertising activities" nor the underlying advertising injury offenses were defined in the 1973 ISO Form.

An Explanatory Memoranda filed in 1976 by the ISO with state insurance regulators in many states explained the ISO's interpretation of the extent of coverage:

We believe that the coverage afforded under [the advertising injury] endorsement is the *broadest package of coverage available* to the average insured.… Advertising injury covers the insured for various types such as piracy, unfair competition, infringement of copyright, etc., arising out of the insured's advertising, promotional or publicity activities. [Emphasis added.]

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§14.6 2. 1986, 1998, 2001, and 2004 ISO Forms

In 1986, the insurance industry changed from the Comprehensive General Liability policy form to the Commercial General Liability form, resulting in a major change to the definition of "advertising injury." The 1986 ISO Form deletes the terms "unfair competition" and "piracy" and defines advertising injury as follows (emphasis added):

"Advertising Injury" means injury arising out of one or more of the following offenses:

a. Oral or written communication of material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services;

b. Oral or written publication of material that violates a person's right of privacy;

c. *Misappropriation of advertising ideas or style of doing business*; or

d. *Infringement of copyright, title or slogan*.

The language of the 1986 CGL Form is broad enough to describe a variety of conduct, which may include trade secret misappropriation, trade name, trade dress, and trademark infringement.

In 1998 the form was changed again. The 1998 ISO Form combines the definitions of personal injury and advertising injury and defines "personal and advertising injury" as follows (emphasis added):

"Personal and advertising injury" means injury, including consequential "bodily injury", arising out of one or more of the following offenses:

a. False arrest, detention or imprisonment;

b. Malicious prosecution;

c. The wrongful eviction from, wrongful entry into, or invasion of the right of private occupancy of a room, dwelling or premises that a person occupies, committed by or on behalf of its owner, landlord or lessor;

d. Oral or written publication of material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services;

e. Oral or written publication of material that violates a person's right of privacy.

f. The use of another's advertising idea in your "advertisement"; or

g. Infringing upon another's copyright, trade dress or slogan in your "advertisement".

The 1998 ISO Form defines "advertisement" as follows:

"Advertisement" means a notice that is broadcast or published to the general public or specific market segments about your goods, products or services for the purpose of attracting customers or supporters.

The 2001 ISO Form kept the definitions of "personal and advertising injury" and "advertisement" from the 1998 ISO Form, and made it clear that personal and advertising injury offenses that "take place through the Internet or similar electronic means of communication" are covered, provided the insured's liability is determined in a suit in the coverage territory or in a settlement to which the insurer consents.

The 2001 ISO Form, however, also added exclusions for personal and advertising injury arising out of the following:

- Infringement of copyright, patent, trademark, or trade secret, but not infringement in the insured's "advertisement" of copyright, trade dress, or slogan;
- Insureds in media and Internet-type businesses;

- Electronic chat rooms or bulletin boards the insured hosts, owns, or over which the insured exercises control; and
- Unauthorized use of another's name or product in the insured's e-mail address, domain name, or metatag or similar tactics.

The 2004 ISO Form slightly changed the definitions of the "personal and advertising injury" offenses of slander or libel and invasion of privacy, as follows:

d. Oral or written publication, in any manner, of material that slanders or libels a person or organization or disparages a person's or organization's goods, products or services;

e. Oral or written publication, in any manner, of material that violates a person's right of privacy.

Although the 2001 CGL Form and 2004 CGL Form exclude coverage for infringement of trade secret and trademark, they still provide coverage for infringement of copyright, trade dress, and slogan, if such infringement occurred in the insured's "advertisement."

For discussion of misappropriation of advertising ideas or style of doing business, see §14.9; for discussion of infringement of copyright, title, or slogan, see §14.10.

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§14.7 B. Application of Advertising Injury Provisions to Trade Secret Litigation

The advertising injury provision provides coverage for damages that occur in the course of the insured's advertising activities, arise from one of the offenses enumerated in the policy, and occur during the policy period. *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1276, 10 CR2d 538. Thus, in addition to the general criteria for an insurance claim, such as timely notice to the insurer and the existence of an "occurrence" within the policy period, three elements must be satisfied to obtain defense, indemnity, or both for trade secret misappropriation claims under the 1986 ISO Form advertising injury provisions:

- The misappropriation of trade secrets must constitute a "covered offense," *e.g.,* misappropriation of advertising ideas or style of doing business, infringement of title, or, for earlier insurance policies, piracy or unfair competition. See §§14.8-14.11.
- The insured must be engaged in an "advertising activity" when the alleged advertising injury occurred. See §14.12.
- A causal connection must exist between the plaintiff's alleged injuries and the defendant's "advertising activity." See §14.13.

The "advertising injury" clause applies only when the insured engages in "widespread promotional activities." *Hameid v National Fire Ins. of Hartford* (2003) 31 C4th 16, 24, 1 CR3d 401. See §14.12.

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§14.8 1. Misconduct Must Constitute "Covered Offense"

The "covered offenses" in the 1998 ISO Form and later ISO forms are use of another's advertising idea in the insured's advertisement and infringing on another's copyright, trade dress, or slogan in the insured's "advertisement."

The 1986 ISO Form outlines four general "covered offenses": Trade secret misappropriation allegations potentially constitute misappropriation of advertising ideas or style of doing business, or infringement of title. See §§14.9-14.10. Coverage may also be available under the 1973 ISO Form for unfair competition or piracy. See §14.11. Whether analyzed under the pre-1986 language of "unfair competition" or the post-1986 language of "misappropriation," allegations of trade secret misappropriation usually satisfy the first requirement for obtaining defense or indemnity under the advertising injury provisions of a CGL policy.

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Source: Business Law/Trade Secrets Practice in California/14 Insurance Coverage for Misappropriation Claims/§14.9 a. Misappropriation of Advertising Ideas or Style of Doing Business

§14.9 a. Misappropriation of Advertising Ideas or Style of Doing Business

Trade secret misappropriation cases frequently involve the alleged theft of confidential customer lists, marketing techniques, bidding and sales procedures, and confidential knowledge about shortcomings of a manufacturer's product. The issue is whether this proprietary information should be characterized as advertising ideas or style of doing business. The use of the word "or" indicates that these provisions cover two separate offenses: The misappropriation of advertising ideas *and* the misappropriation of style of doing business.

Most CGL policies do not define "misappropriation," "advertising ideas," or "style of doing business." Applying contract interpretation principles, however, if the misappropriated trade secrets are confidential marketing and advertising ideas, such as proprietary customer lists, they should be deemed "advertising ideas." See *Sentex Sys. v Hartford Acc. & Indem. Co.* (9th Cir 1996) 93 F3d 578. Similarly, trade secrets of the most intimate aspects of a company's operations, strategies, and policies are characterized as "style of doing business." See *PepsiCo, Inc. v Redmond* (7th Cir 1995) 54 F3d 1262 (affirming preliminary injunction based on employee's intimate knowledge of former employer's pricing and marketing strategy). However, California's public policy favoring employee mobility caused a federal district court in *Danjaq, LLC v Sony Corp.* (CD Cal 1999) 50 USPQ2d 1638 to note that *PepsiCo* is not the law in California or of the Ninth Circuit Court of Appeals.

The Ninth Circuit interpreted misappropriation of "advertising ideas" to include misappropriation of trade secrets. *Sentex Sys. v Hartford Acc. & Indem. Co., supra*. In *Sentex,* a company's former sales representative went to work for a competitor. The company sued, alleging that the competitor misappropriated its trade secrets and confidential information (*e.g.,* customer lists, methods of bidding jobs, billing methods and procedures, and marketing techniques) and that the representative used the former employer's trade secrets to solicit business from its customers and to promote and advertise the competitor's products. The *Sentex* court found that such allegations fell within the policy's coverage for the advertising injury, *i.e.,* for misappropriation of advertising ideas.

Similarly, *Merchants Co. v American Motorists Ins. Co.* (SD Miss 1992) 794 F Supp 611 held that a customer list may be an advertising idea and that allegations of trade secrets misappropriation were sufficiently similar to the "misappropriation of advertising ideas" language in the policy to give rise to a duty to defend, and *John Deere Ins. Co. v Shamrock Indus.* (D Minn 1988) 696 F Supp 434, aff'd (8th Cir 1991) 929 F2d 413, held that allegations of the policyholders' use of confidential and proprietary information to develop and sell a product to the former employer's customers constituted misappropriation of the former employer's advertising ideas or style of doing business.

In *Hameid v National Fire Ins. of Hartford* (2003) 31 C4th 16, 1 CR3d 401, however, the California Supreme Court held that the "advertising injury" clause applies only when the insured engages in "widespread promotional activities." In that case, two former employees of a competitor of the insured (a beauty salon) used their list of customers for direct solicitation of the customers to the employees' new location with the insured. The court held that this type of one-on-one solicitation did not give rise to the insurer's duty to defend the underlying lawsuit. See also *Hayward v Centennial Ins. Co.* (9th Cir 2005) 430 F3d 989, 990 (actionable advertising injury requires widespread promotion to public; one-on-one solicitation of few customers did not give rise to insurer's duty to defend); *We Do Graphics, Inc. v Mercury Cas. Co.* (2004) 124 CA4th 131, 138, 21 CR3d 9 (allegation that insured took trade secrets consisting of specific customer information did not constitute allegation of misappropriation of advertising ideas).

Allegations of trademark infringement in an underlying complaint are potentially covered "advertising injuries." *Lebas Fashion Imports, Inc. v ITT Hartford Ins. Group* (1996) 50 CA4th 548, 562, 59 CR2d 36, modified at 50 CA4th 1949a. The insurance policy in *Lebas,* the 1986 ISO Form, defined advertising injury as an injury arising from either (1) "[m]isappropriation of an advertising idea or style of doing business" or (2) "[i]nfringement of copyright, title, or slogan." 50 CA4th at 558. A trademark is (50 CA4th at 556, citing 15 USC §1127):

any word, name, symbol, or device, or any combination thereof (1) used by a person, or (2) which a person has a bona fide intention to use in commerce and applies to register on the principle register … to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown.

The definition of trademark infringement includes "advertising of goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive." 50 CA4th at 557, citing 15 USC §1114.

A trademark serves three separate purposes: (1) identification of a product's origin, (2) guaranty of the product's quality, and (3) advertisement of the product. *Lebas Fashion Imports, Inc. v ITT Hartford Ins. Group, supra*. "A trademark is but a species of advertising, its purpose being to fix the identity of the article and the name of the producer in the minds of people who see the

advertisement, so that they may afterwards use the knowledge themselves and carry it to others having like desires and needs for such article.'" 50 CA4th at 557, quoting *Northam Warren Corp. v Universal Cosmetic Co.* (7th Cir 1927) 18 F2d 774. In contrast to patent infringement cases, which usually involve the "making, using, or selling of the patented invention" and thus do not always occur in the course of the insured's advertising activities, trademark infringement often occurs in advertising. Thus, the court found that a nexus exists between the alleged infringement and the insured's advertising activity. 50 CA4th at 557.

The court further found that the term "misappropriation" of either an "advertising idea" or a "style of doing business" was ambiguous, and found that the objectively reasonable meaning of "misappropriation" was "to take wrongfully." 50 CA4th at 562. The court found support for its conclusion that allegations of trademark infringement are covered under either a "misappropriation of an advertising idea or a style of doing business" because the 1986 ISO form for "advertising injury" at issue in *Lebas* eliminated the trademark infringement exclusion in pre-1986 forms.

Allegations involving false or misleading descriptions or representations of a product under the Lanham Act (15 USC §1125) are potentially covered claims under a 1986 ISO form defining "advertising injury." *Decisionone Corp. v ITT Hartford Ins. Group* (ED Penn 1996) 942 F Supp 1038, 1043. In *Decisionone,* Bell Atlantic Business Systems Services allegedly made false or misleading factual representations about its maintenance of Storage Technology Corporation's (STK) library equipment as well as deceptive comparisons between itself and STK. 942 F Supp at 1042. See also *B.H. Smith, Inc. v Zurich Ins. Co.* (Ill App 1996) 676 NE2d 221 (allegation of trademark infringement involving advertisement of knock-off product covered under 1986 ISO Form definition of "advertising injury" as "misappropriation of style of doing business").

Alleged violations of the Lanham Act involving the infringement of trade dress are covered under an insurance policy's 1986 ISO definition of "advertising injury" as misappropriation of advertising ideas or style of doing business. *Dogloo, Inc. v Northern Ins. Co.* (CD Cal 1995) 907 F Supp 1383, 1388 (coverage for misappropriation of advertising ideas or style of doing business extends to claim for trade dress infringement). Infringement of trade dress is specifically defined as an "advertising injury" offense in the 1998 ISO Form and later ISO forms.

In *Homedics, Inc. v Valley Forge Ins. Co.* (9th Cir 2003) 315 F3d 1135, the Ninth Circuit ruled that defense of a third party patent infringement action was not covered under a policy insuring against advertising injuries. It held that the policy's "misappropriation of advertising ideas or style of doing business" clause could not be interpreted, under an objectively reasonable standard, to include a defense of a third party complaint of violation of a patent.

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§14.10 b. Infringement of Title

An alternative ground for finding coverage of trade secret claims is provided by the "infringement of copyright, title, or slogan" clause of the ISO forms. Few policies define "infringement of title." Insurers argue that "title" refers only to a business name and is thus limited to copyrights. Some courts, however, have adopted the Black's Law Dictionary (7th ed 1999) definition of title, which is a "mark, style or designation" or "name by which anything is known" or "formal right of ownership of property." See, *e.g., Merchants Co. v American Motorists Ins. Co.* (SD Miss 1992) 794 F Supp 611, which held that "title" also refers to ownership and includes trade secrets. The *Merchants* court found that, even when a policy fails to include "trade secret misappropriation" as an offense in its definition of advertising injury, the phrase "infringement of copyright, title or slogan" is vague enough to include theft of a trade secret customer list. The court stated (794 F Supp at 618):

While [the insurer] argues that infringement should be limited solely to the context of copyrights, that is not what the CGL and Catastrophe policies state. If [the insurer] had wished to limit infringement solely to copyrights, it had only to say so in its policy. Moreover, since the word "infringement" is not defined in either policy of insurance, the Court must give that term its plain, ordinary or popular sense definition. The popular sense definition of "infringement", as set forth in Black's Law Dictionary (5th ed 1979) is: "A breaking into; a trespass or encroachment upon; a violation of law, regulation, contract or right." Applying this definition to the allegation that [the insured] improperly utilized [the injured party's] customer list without any right or license to do so, the Court concludes that the Alabama action does contain an allegation that [the insured] has infringed [the injured party's] title to its customer list.

Thus, if the insurance policy contains no applicable limitation to coverage, it is reasonable for an insured to expect coverage for the alleged infringement of either a business name *or* property, as long as the advertising injury occurs in the course of advertising. See *Sentex Sys. v Hartford Acc. & Indem. Co.* (CD Cal 1995) 882 F Supp 930, 943, aff'd (9th Cir 1996) 93 F3d 578 (district court opinion relied on reasonable expectations of insured to find that allegations of trade secret misappropriation constituted advertising injuries arising from infringement of title claims; Ninth Circuit opinion stated that court need not consider this issue). Note, however, that the reasoning of *Merchants* and *Sentex* was rejected in *Precision Automation, Inc. v West Am. Ins. Co.* (9th Cir 1999) 203 F3d 832 (unpublished opinion).

Allegations of trademark and trade dress infringement fall within the definition of advertising injury for both "a misappropriation of advertising ideas" and the "infringement of title." *American Employers' Ins. Co. v DeLorme Publishing Co.* (D Me 1999) 39 F Supp 2d 64; *Energex Sys. Corp. v Fireman's Fund Ins. Co.* (SD NY) 1997 US Dist Lexis 8894. The *Energex* court also found a nexus between the advertising injury and the requirement that the offense be "committed in the course of [Energex's] advertising goods, products, or services." 1997 US Dist Lexis at 3. Even though the underlying complaint did not include the word "advertising," the court held that the confusion created by Energex's communications with its customers occurred in its advertising. 1997 US Dist Lexis at 4.

NOTE: The court rejected the insurer's contention that it had no duty to defend, because the underlying complaint sought only injunctive relief. The court noted that, although the prayer for relief did not specifically seek damages, the prayer for "whatever relief the court deems just and proper" included a potential claim for damages, requiring the insured to defend Energex. 1997 US Dist Lexis at 5.

See also *El-Com Hardware, Inc. v Fireman's Fund Ins. Co.* (2001) 92 CA4th 205, 111 CR2d 670 (unnecessary to determine causal connection between advertising activities and trade dress infringement if extrinsic facts known to insurer at outset gave rise to potential of such causal connection).

On the other hand, if a policy provides coverage for "infringement of title" but contains an exclusion for infringement of trademarks or trade names other than titles or slogans, a court may find that the word "title" means only the name of a literary or artistic work on the ground that the exclusion would be meaningless if the word "title" were interpreted broadly to include trademarks and trade names. See *Palmer v Truck Ins. Exch.* (1999) 21 C4th 1109, 1119, 90 CR2d 647.

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§14.11 c. Piracy and Unfair Competition

The "misappropriation of advertising ideas or style of doing business" language was added to most insurance policies after 1986, when the ISO revised the CGL standard form to replace the offense of unfair competition with misappropriation of advertising ideas or style of doing business.

The term "unfair competition" as used in pre-1986 policies refers to the common law tort of unfair competition. *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1263, 10 CR2d 538. The common law tort of unfair competition imposes liability for misappropriation and use of proprietary information and trade secrets. See *American Credit Indem. Co. v Sacks* (1989) 213 CA3d 622, 634, 262 CR 92 (citing cases holding that customer lists may be proprietary information worthy of trade secret protection). The tort of unfair competition also prohibits an employee from competing directly with a former employer in certain ways. For example, a former employee may be liable for unfair competition for using the former employer's confidential information and trade secrets to solicit the employer's customers. See *Rigging Int'l Maintenance Co. v Gwin* (1982) 128 CA3d 594, 606, 180 CR 451. See also 13 Witkin, Summary of California Law, *Equity* §§93-96 (10th ed 2005).

The policy term "unfair competition" indicates both passing off and the narrower tort of trademark infringement. The court noted in *Industrial Indem. Co. v Apple Computer, Inc.* (1999) 79 CA4th 817, 831, 95 CR2d 528, that when a potential passing-off claim might be based on advertising conduct not involving trademark infringement, the insurer would be required to provide coverage under the advertising liability coverage.

Accordingly, several cases have concluded that advertising injury provisions provide coverage for allegations of various intellectual property torts based on the coverage afforded claims of unfair competition. See, *e.g., Rymal v Woodcock* (WD La 1995) 896 F Supp 637 (advertising injury coverage existed for claims of patent infringement and common law unfair competition); *Kurisu v Michigan Millers Mut. Ins. Co.* (4th App Dist 1993) 28 USPQ2d 1430 (unpublished opinion; CAVEAT: Cal Rules of Ct 977 restricts citation of or reliance on this opinion) (advertising injury coverage for unfair competition allegations of trade secret misappropriation).

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§14.12 2. Was Insured Engaged in Advertising Activity?

Coverage under advertising liability language requires a showing that the alleged offense occurred in the course of the insured's advertising activities. *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 10 CR2d 538. Most policies do not define "in the course of advertising." Trade secrets such as confidential customer lists, marketing techniques, bidding and sales procedures, and product knowledge that are misappropriated by competitors are frequently used to solicit customers and to advertise, promote, and market products. Often, such marketing activities involve face-to-face solicitations or presentations. The issue is whether this use of misappropriated trade secrets to market and sell a product constitute "advertising activity" under the advertising injury provisions of CGL policies.

There are two views on what constitutes advertising. A strict interpretation requires a widespread distribution of promotional materials to the public at large. *International Ins. Co. v Florists' Mut. Ins. Co.* (Ill App 1990) 559 NE2d 7. See *Select Design, Ltd. v Union Mut. Fire Ins. Co.* (Vt 1996) 674 A2d 798; *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1276, 10 CR2d 538. See also *Zurich Ins. Co. v Amcor Sunclipse N. Am.* (7th Cir 2001) 241 F3d 605; *Murphy v Fed. Ins. Co.* (ND Cal 2001) 2001 US Dist Lexis 11578; *Peerless Lighting Corp. v American Motorists Ins. Co.* (2000) 82 CA4th 995, 98 CR2d 753. The broader interpretation requires that, barring exclusionary language to the contrary, the court must look to the nature of the insured's business to determine whether advertising activity occurred. See, *e.g., Farmington Cas. Co. v Cyberlogic Technol., Inc.* (ED Mich 1998) 996 F Supp 695; *New Hampshire Ins. Co. v R.L. Chaides Constr. Co.* (ND Cal 1994) 847 F Supp 1452, 1456 ("[a]dvertising activity must be examined in the context of the overall universe of customers to whom a communication may be addressed; to hold otherwise would effectively preclude small businesses such as Chaides from ever invoking their rights to coverage"); *New Hampshire Ins. Co. v Foxfire, Inc.* (ND Cal 1993) 820 F Supp 489, 494. See also *Amway Distrib. Benefits Ass'n v Federal Ins. Co.* (WD Mich 1997) 990 F Supp 936, 945:

Advertising comes in many forms and may differ in scope from business to business, depending on the product, the size of the company, the company's marketing system, or the size of the target market. For example, a company such as Microsoft might use television, radio, newspaper, and magazine advertisements to sell its software to a huge potential market, whereas a company that produces specialized software for the automotive industry, with only a handful of customers, might find it most effective to reach its target market directly by letter and an in-person meeting to explain the benefits of the product. In both instances, the businesses are promoting their products to their potential customers.

In *New Hampshire Ins. Co. v Foxfire, Inc., supra,* the court found that the advertising activity requirement is met, even if the audience is small, as long as the audience "comprises all or a significant number of a competitor's client base." 820 F Supp at 494. See also *John Deere Ins. Co. v Shamrock Indus.* (D Minn 1988) 696 F Supp 434, 440, aff'd (8th Cir 1991) 929 F2d 413 (dictionary definition of "advertise" encompasses any form of solicitation; three letters and one demonstration to potential buyer within coverage for duty to defend).

The California Supreme Court has adopted the strict approach in CGL policies that do not define the term "advertising," holding that "advertising injury," as used in the 1986 CGL Form, requires "widespread promotional activities usually directed to the public at large," and excludes personal solicitations. *Hameid v National Fire Ins. of Hartford* (2003) 31 C4th 16, 24, 27, 1 CR3d 401. Although the 1998 and 2001 CGL Forms define "advertisement" to include "a notice that is broadcast or published to … specific market segments," the court declined to address the issue of whether promotional activities directed at specific market segments constitute advertising under the 1986 CGL Form. 31 C4th at 24 n3. Therefore, under the 1986 CGL Form's definition of "advertising injury," an insured was not entitled to a defense from his insurer against a lawsuit for "advertising injury" when the insured's only activities consisted of the insured's employees' making telephone calls and sending mailers to a former employer's customers advising them of their new location and of the insured's lower prices. 31 C4th at 29.

In *Rombe Corp. v Allied Ins. Co.* (2005) 128 CA4th 482, 27 CR3d 99, the court addressed the definition of "advertisement" in the 1998 and 2001 CGL Forms and held that the definition did not expand the scope of the policy's advertising coverage to include personal promotion or solicitation of business. The court held that the term "specific market segments" in the definition of "advertisement" did not relieve the insured of the requirement of engaging in relatively wide dissemination of its advertisements. 128 CA4th at 492. See also *Hayward v Centennial Ins. Co.* (9th Cir 2005) 430 F3d 989, 991 ("advertising" and "solicitation" are mutually exclusive terms). But see *Nichols v Great Am. Ins. Cos.* (1985) 169 CA3d 766, 774, 215 CR 416 (insured's one-on-one solicitations constituted advertising, which barred coverage under "personal injury" provisions of insured's policy); *Ford Dealers Assoc. v DMV* (1982) 32 C3d 347, 359, 185 CR 453 (undefined term "advertising" in Veh C §11713 included one-on-one solicitations). The *Ford Dealers* court noted that historically "the terms advertising and 'advertisement' have been held broad enough to include oral representations made on a one-on-one basis." 32 C3d at 359.

Marketing activities also fall within the definition of "advertising activities." See *Sentex Sys. v Hartford Acc. & Indem. Co.* (9th Cir

1996) 93 F3d 578; *Poof Toy Prods. v U.S. Fid. & Guar. Co.* (ED Mich 1995) 891 F Supp 1228, 1235. The *Poof Toy* court defined marketing as "an aggregate of functions involved in transferring title and in moving goods from producer to consumer" and held that it includes advertising activities. The court declined to determine whether alleged promotional activities directed to retailers fell under the definition of advertising because that determination was unnecessary to the court's reaching an opinion. 891 F Supp at 1235 n6.

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§14.13 3. Causal Nexus Between Advertising Injury and Advertising Activity

There must be a causal connection between the alleged advertising injury and the advertising activity for the insured to have a reasonable expectation of coverage for advertising injury. *Simply Fresh Fruit, Inc. v Continental Ins. Co.* (9th Cir 1996) 94 F3d 1219; *Microtec Research, Inc. v Nationwide Mut. Ins. Co.* (9th Cir 1994) 40 F3d 968, 971; *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1274, 10 CR2d 538 (court rejected insured's argument that "any connection, however remote," triggers coverage). Because "advertising" encompasses such a wide range of activities, "a great many acts may fall within the ambit of advertising, extending advertising injury coverage far beyond the reasonable expectations of the insured." *National Union Fire Ins. Co. v Siliconix, Inc.* (ND Cal 1989) 729 F Supp 77, 80.

However, the advertising activities need not be the only cause of the advertising injuries. See *John Deere Ins. Co. v Shamrock Indus.* (D Minn 1988) 696 F Supp 434, 440, aff'd (8th Cir 1991) 929 F2d 413. Nor is the insured required to conclusively establish causation at the duty-to-defend stage. 696 F Supp at 440. Rather, in determining whether a causal connection exists, courts examine whether there is a potential for liability, *i.e.,* the insured "need only arguably fall within the coverage of the policies." 696 F Supp at 440. See also *Bank of the W. v Superior Court* (1992) 2 C4th 1254, 1275, 10 CR2d 538. See §14.3.

Trade secret misappropriation requires improper acquisition, disclosure, or use of a trade secret. *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 1523, 66 CR2d 731; *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511, 521. See §§1.11-1.14 for discussion of what constitutes misappropriation. In many trade secret misappropriation cases, disclosure or use occurs in advertising or marketing efforts, and thus the injury to the plaintiff in many trade secret cases is specifically caused by the defendant's advertising and marketing activities. The defendant's use of the misappropriated trade secrets in advertising and marketing—the public dissemination of formerly confidential and private information—causes the injury to the plaintiff. The plaintiff is not injured by the trade secret misappropriation until the secrets are used in marketing or advertising. See *Sentex Sys. v Hartford Acc. & Indem. Co.* (9th Cir 1996) 93 F3d 578. When the defendant misappropriated confidential customer lists, the act of contacting the customers and marketing the defendant's products is an inherent advertising injury; *i.e.,* the customer list is an "advertising idea" that has been misappropriated. The claimed advertising injury is caused by the insured's advertising activities; *i.e.,* the marketing and solicitation of customers through advertising using the misappropriated trade secrets. 93 F3d at 581.

In the context of trade secret misappropriation, courts generally find that a causal connection exists between the advertising activity and the plaintiff's injury sufficient to trigger coverage. See, *e.g., Sentex Sys. v Hartford Acc. & Indem. Co.* (CD Cal 1995) 882 F Supp 930, 945, aff'd (9th Cir 1996) 93 F3d 578. Use of a misappropriated customer list by the insured as part of its direct mail campaign, an advertising activity, satisfies the requirement for a causal connection between the injury and the advertising activities. *Merchants Co. v American Motorists Ins. Co.* (SD Miss 1992) 794 F Supp 611. Addressing the "causal connection" requirement, *Kurisu v Michigan Millers Mut. Ins. Co.* (4th App Dist 1993) 28 USPQ2d 1430, 1434 (unpublished opinion; CAVEAT: Cal Rules of Ct 977 restricts citation of or reliance on this opinion), concluded that the plaintiff's injuries resulted from the solicitation of the customers from the trade secret customer list and the offer of a service using the trade secret formula (the advertising activity).

Some trade secret cases allege that the defendant misappropriated trade secrets only in the making of a product and not in marketing or advertising. Under such facts, some courts have found that there is arguably no duty to defend. See *Simply Fresh Fruit, Inc. v Continental Ins. Co., supra*. In *Simply Fresh Fruit*, a competitor brought patent infringement and trade secret misappropriation claims against Simply Fresh Fruit in connection with its secret automated process for slicing fruit. There were no allegations in the complaint or in extrinsic evidence presented to the court concerning any advertising activities or the use of misappropriated trade secrets during advertising. The court found that there was no potential liability for advertising injury, because the plaintiff in the underlying action did not produce any evidence that it suffered any damage as a result of advertising by Simply Fresh Fruit. See also *Winklevoss Consultants, Inc. v Federal Ins. Co.* (ND Ill 1998) 991 F Supp 1024 (allegations of trade secret misappropriation limited solely to the insured's development of a competing software product); *Frog, Switch & Mfg. Co., Inc. v Travelers Ins. Co.* (3d Cir 1999) 193 F3d 742 (third party's injury caused by misappropriation of dipper-bucket designs, not by insured's advertisement of its buckets); *Microtec Research, Inc. v Nationwide Mut. Ins. Co., supra* (no coverage if harm allegedly caused by misappropriation rather than advertising itself).

The California Court of Appeal addressed the issue of whether a causal connection existed between the advertising and the trade dress infringement at issue in evaluating whether an insurer has a duty to defend in *El-Com Hardware, Inc. v Fireman's Fund Ins. Co.* (2001) 92 CA4th 205, 111 CR2d 670. In *El-Com,* the insurer argued that there was simply no causal connection between the trade dress infringement (*i.e.,* a unique "handle" manufactured by the plaintiff in the underlying action) and the advertising in question (*i.e.,* images of the insured's product in a catalog). The insurer argued the advertising had no connection to the insured's use of the "handle." It merely portrayed it. However, the court found a causal connection, holding that it would not be possible to have

"palmed off" the plaintiff's handles or to otherwise cause customer confusion concerning the identity of the manufacturer of the handles without the advertising in question. 92 CA4th at 217.

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III. COVERAGE STRATEGY FOR TRADE SECRET CASES

§14.14 A. Plaintiff's Strategies

Although this chapter analyzes insurance coverage for trade secret litigation primarily from the perspective of a policyholder-defendant, the articulated principles apply equally to an individual or entity whose trade secrets have been misappropriated. The coverage analysis is identical for both parties, albeit with different goals in mind.

The plaintiff in a trade secret case must decide whether it desires to trigger defense, indemnity, or both by the defendant's insurance carrier. In most cases, when settlement and payment of damages is the goal, the plaintiff wants to trigger coverage and involve the insurer so that there is a dependable resource for obtaining compensation for damages. Once coverage is triggered and the insurance company is involved, plaintiff's chances of settlement may increase dramatically. To increase the likelihood of coverage, the allegations in the complaint should highlight the advertising aspects of the misappropriated trade secrets by focusing on the advertising and marketing ideas that were misappropriated and the resulting advertising use of the ideas. The complaint should also allege a causal connection between the defendant's advertising and the plaintiff's injuries.

On the other hand, the plaintiff may not want the insurer to defend or indemnify the defendant. The defendant (rather than the insurance company) is then forced to pay for the defense, which may become prohibitively expensive and compel the defendant to settle early on unfavorable terms. Early settlement would also save the plaintiff significant attorney fees. Such settlement is more likely if there is no insurance coverage because such coverage in a trade secret case can result in an expensive and protracted legal "war" against an insurer-funded defendant. To decrease the likelihood of coverage, the complaint should not allege any advertising or marketing use of the trade secrets. The plaintiff should not allege trade secret misappropriation involving advertising ideas, customer lists, or marketing techniques. See *Simply Fresh Fruit, Inc. v Continental Ins. Co.* (9th Cir 1996) 94 F3d 1219, and *Microtec Research, Inc. v Nationwide Mut. Ins. Co.* (9th Cir 1994) 40 F3d 968, 971 (see discussion in §14.13), in which plaintiffs intentionally elected not to allege advertising injury and therefore did not trigger insurance coverage or defense for the defendants for the costly intellectual property litigation.

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B. Insured's Strategies

§14.15 1. Insurance Policy Review

All businesses should periodically review their existing insurance coverage to make sure their policies protect them from liability arising from existing operations. Consultation with knowledgeable insurance coverage counsel as part of a "litigation audit" can help policyholders to analyze their insurance needs. Having policies that guard against the costs of defending an intellectual property lawsuit is well worth the minimal effort necessary to conduct a litigation audit.

In light of the exclusion for infringement of trade secrets in the ISO Form since 2001, businesses seeking liability coverage for misappropriation of trade secrets need to find an insurer that uses its own CGL form that provides this coverage, or an insurer that uses the pre-2001 ISO Form and does not add an exclusion for infringement of trade secrets via endorsement. Directors and officers liability policies usually contain an exclusion for claims arising out of the misappropriation of trade secrets, but businesses seeking liability coverage for misappropriation of trade secrets may want to find an insurer that is willing to delete such an exclusion.

Businesses should retain all insurance policies, even expired policies. The courts may hold that each act falling within the advertising injury provisions results in a new cause of action and a new "offense" committed within the meaning of the insurance policies' advertising injury provisions. Therefore, to obtain full reimbursement from the insurer, a policyholder may have to rely on all policies, dating back to the first advertising injury.

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§14.16 2. Declaratory Relief

Rather than agreeing to provide coverage or issue a reservations letter (see §14.18), an insurer may bring a declaratory relief action asking for a determination by the court that no coverage is available for a specific claim if coverage is disputed. Conversely, if the insurer denies defense and indemnity, the first and most direct legal remedy available to the insured is an action for declaratory relief, asking the court for a declaration as a matter of law that the insurer owes a defense obligation under the terms of the policy. After waiting the requisite time period after the responding party's appearance, the insured generally files a motion for summary judgment on the legal interpretation of the policy.

Probable cause is required to bring a declaratory relief action. An insurer may be liable for malicious prosecution for bringing a declaratory relief action against an insured, even if the insurer is not found to have acted in bad faith. *George F. Hillenbrand, Inc. v Insurance Co. of N. Am.* (2002) 104 CA4th 784, 128 CR2d 586.

Interpretation of an insurance contract is a question of law. *Hendrickson v Zurich Am. Ins. Co.* (1999) 72 CA4th 1084, 85 CR2d 622; *California Shoppers, Inc. v Royal Globe Ins. Co.* (1985) 175 CA3d 1, 38, 221 CR 171. The duty to defend is contractual in nature. *Isaacson v California Ins. Guar. Ass'n* (1988) 44 C3d 775, 791, 244 CR 655. Judicial determination of the duty to defend is a matter of law appropriate for summary adjudication. If summary adjudication of the duty to defend is made in a declaratory relief action, the entire action is effectively terminated. *Montrose Chem. Corp. v Superior Court* (1993) 6 C4th 287, 295, 24 CR2d 467.

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§14.17 3. Bad Faith Denial of Insurance Coverage

In any tender of coverage to an insurer, a potential for breach of the implied covenant of good faith and fair dealing by the insurer exists. California law is among the most liberal in the United States with regard to tort liability for bad faith denial of insurance benefits. To the extent that an insurance company unreasonably denies coverage, bad faith liability exists. *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 573, 108 CR 480. On the other hand, a mistaken but honest and reasonable denial of policy benefits is a breach of contract but is not a tort. *Shade Foods, Inc. v Innovative Prods. Sales & Mktg., Inc.* (2000) 78 CA4th 847, 879, 93 CR2d 364; *Congleton v National Union Fire Ins. Co.* (1987) 189 CA3d 51, 59, 234 CR 218.

What may initially appear to be a routine dispute over the interpretation of a contract may, in certain circumstances, give the insured a viable bad faith action for unreasonable denial of benefits.

PRACTICE TIP: In an action against the insurer for bad faith denial of coverage, the insured should consider also naming as a defendant the agent or broker if the agent or broker failed to obtain requested coverage. See *Third Eye Blind, Inc. v Near N. Entertainment Ins. Serv., LLC* (2005) 127 CA4th 1311, 26 CR3d 452. Bringing suit against a resident agent or broker in the bad faith action will often defeat federal diversity jurisdiction. See *Briano v Conseco Life Ins. Co.* (CD Cal 2000) 126 F Supp 2d 1293, 1296.

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§14.18 4. Procedural Issues

Counsel should review all of the client's current and prior insurance policies (and any homeowners' or other individual polices issued to the client's agents and employees who have been named in the lawsuit) to ascertain potential coverage and to identify the steps that need to be taken to give the insurer notice. Most insurers take the position that they are not liable for costs incurred before they have notice of the action unless the delay is involuntary.

PRACTICE TIP: Although an insurer may often be liable for pre-tender fees (see, *e.g.*, *Shell Oil Co. v National Union Fire Ins. Co.* (1996) 44 CA4th 1633, 52 CR2d 580; *Vann v Travelers Cos.* (1995) 39 CA4th 1610, 1619 n6, 46 CR2d 617), prudent counsel will provide timely notice so that the client will not have the additional burden of proving this entitlement.

The insured's counsel generally makes an initial tender of a defense by sending to the insurer:

- A copy of the complaint filed in the action and any settlement demand,
- A description of the date and manner of its service,
- A reference to the policy under which coverage is sought, and
- A request for confirmation of coverage.

If the source of coverage is not clear from the pleadings, counsel should provide any further information, such as facts outside the complaint, that may affect coverage.

PRACTICE TIP: An insured must take immediate action if it wants to involve the insurer but complaint does not trigger advertising injury coverage. If the omission of advertising injury allegations was unintentional, the insured can often negotiate with the plaintiff to have the complaint amended to trigger coverage. If the plaintiff deliberately drafted the complaint to not trigger coverage and therefore refuses to amend the complaint, the insured should aggressively conduct discovery to obtain factual evidence of the plaintiff's contentions that would trigger advertising injury coverage. For example, the plaintiff's deposition may reveal that the misappropriated trade secrets constitute advertising ideas or were disseminated by advertising, or interrogatories and requests for admissions may cause the plaintiff to admit that the trade secret misappropriation constitutes advertising injury. Once the facts extrinsic to the complaint are obtained through discovery, counsel should forward such evidence to the insurance company with an immediate demand for a defense.

After tender has been made, the insurer must respond. An insurer who accepts the tender with no reservation of rights defends the case with its own regular "panel" counsel and indemnifies for all damages (except punitive damages). If there is no reservation of rights, the insurer controls defense strategy and settlement issues. If the insurer agrees to defend but with a reservation of rights, it pays for the defense of the lawsuit until it concludes unequivocally there is no potential for coverage. The insurer also agrees to indemnify only for covered damages. This limitation may create a conflict of interest, entitling the insured to independent counsel. See CC §2860. If the insurer refuses to defend altogether, the insured may decide to institute a declaratory relief action (see §14.16) or a breach of contract and bad faith action (see §14.17).

WARNING: An insurer's denial of the duty of defense is fraught with peril. The insurer loses the ability to control defense and settlement, and liability for bad faith denial of insurance coverage can be high. Most insurers faced with an ambiguous or vague policy agree to provide a defense subject to a reservation of rights and seek declaratory relief. See §14.16.

For further discussion of procedural issues concerning coverage, see California Liability Insurance Practice: Claims & Litigation (Cal CEB 1991) and California Business Litigation, chap 1 (Cal CEB 2002).

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§14.19 5. Choice of Law

Proper selection of forum is an important part of a coverage determination. An insured who brings an action to obtain insurance coverage must make a decision on the choice of law. If the dispute involves multiple parties in numerous states, an insured may have some flexibility in choosing the appropriate forum in which to bring a coverage or bad faith action. Before filing, counsel should review the laws of the various states at issue to evaluate which venue has the most advantageous interpretation of advertising injury provisions specifically and insurance and coverage principles in general.

The choice of law may be significant in the trade secret misappropriation case. See *Atlantic Mut. Ins. Co. v Badger Med. Supply* (Wis App 1995) 528 NW2d 486, which was brought under Wisconsin law. Unlike California, Wisconsin has adopted the "four corners" rule: An insurer's duty to defend is determined solely from the allegations in the complaint, and no extrinsic facts are considered. The *Badger* complaint *did not allege* that the former employee had given Badger the plaintiff's trade secret (the customer list). 528 NW2d at 491. Consequently, the insured's contention that a trade secret customer list was an "advertising idea" was not within the four corners of the complaint and the court could not rule on the issue. Significantly, if the court had been allowed to consider the extrinsic facts (*i.e.,* misappropriation of a confidential customer list), it may have followed the majority law to hold that the insured was entitled to coverage for misappropriation of advertising ideas or style of doing business. See also *Professional Office Bldgs. v Royal Indem. Co.* (Wis App 1988) 427 NW2d 427, 429.

In the patent infringement area, California cases holding that patent infringement is not covered under the advertising injury provisions rely on *Aetna Cas. & Sur. Co. v Superior Court* (1993) 19 CA4th 320, 23 CR2d 442, and *Iolab Corp. v Seaboard Sur. Co.* (9th Cir 1994) 15 F3d 1500. *Aetna* noted that Ins C §533 prohibits indemnification of an insured for the willful violation of the law. Thus, this decision (and the cases following it) found that, regardless of whether there would be coverage under the policy, it was against California public policy to insure intentional conduct and, as such, found Ins C §533 to be an absolute bar to coverage for patent infringement. Not all states have an analog to §533 or follow this reasoning, however. In *Union Ins. Co. v Land & Sky, Inc.* (Neb 1995) 529 NW2d 773, the court declined to follow the *Aetna* line of cases, noting that the rulings in those cases were based on a California statute that had no parallel in Nebraska law and was therefore irrelevant to the case before the court. *Land & Sky* held that inducing patent infringement was included in the coverage for "piracy" and that the inducement occurred in the course of the insured's advertising activities, thus resulting in coverage.

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§14.20 C. Counsel's Professional Responsibilities

Defense counsel representing businesses and clients who are sued for trade secret misappropriation should consider tendering defense of the lawsuit to the insurer under all circumstances for their own professional liability purposes. See *Ross v Briggs & Morgan* (Minn App 1994) 520 NW2d 432, rev'd on other grounds (Minn 1995) 540 NW2d 843. In the lower court, the law firm representing the insured was found liable for malpractice for failing to tender a defense to the insurer. On appeal, the state supreme court reversed, holding that because the underlying action was for breach of contract, there was no insurance coverage and therefore no malpractice liability for failing to tender a defense. See §14.18 for discussion of tendering a defense.

Counsel may also have a duty to engage the services of experienced coverage counsel for assistance in persuading the insurer to provide the coverage required by law. Cal Rules of Prof Cond 3-110(C).

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15

Taxation of Trade Secrets

James G. Roberts
Walter R. Turner

I. INTRODUCTION

A. Scope of Chapter §15.1

B. Tax Law and Trade Secrets §15.2

II. COSTS INCURRED IN ACQUIRING TRADE SECRETS AND RIGHTS TO TRADE SECRETS §15.3

A. Purchaser's Tax Treatment of Cost of Purchased Trade Secrets: Amortization Under IRC §197 §15.4

1. Section 197 Intangibles Defined §15.5

2. Amortization Period §15.6

3. Effective Dates §15.7

4. Exceptions to Application of §197 for Related Party and Churning Transactions §15.8

5. Subsequent Transfers of §197 Property §15.9

B. Licensee's Tax Treatment of Licensed Trade Secrets

1. Treatment of Consideration Paid for License §15.10

2. Timing of Deduction §15.11

3. Method of Depreciation Under IRC §167 §15.12

III. OWNER'S TAX TREATMENT OF SELF-DEVELOPED TRADE SECRETS §15.13

A. Deduction, Capitalization of, or Credit for Development Costs §15.14

B. Deduction Under IRC §174

1. Electing §174(a) Treatment §15.15

2. Electing §174(b) Treatment §15.16

3. Interplay Between §174(a) and §174(b) Elections §15.17

4. Amortization Period Under §174 §15.18

5. Trade or Business Requirement §15.19

6. Research and Experimental Expenses §15.20

a. Management and Operating Expenses §15.21

b. Land and Depreciable Assets §15.22

c. Literary and Similar Projects §15.23

d. Contracted Services §15.24

7. Reasonableness Requirement §15.25

8. Research and Experimental Expenditures and Alternative Minimum Tax §15.26

C. Amortization of Development Costs Under IRC §167

1. Must Costs Be Capitalized? §15.27

2. Determining Ascertainable Useful Life §15.28

3. Goodwill and Related Mass Assets Not Depreciable §15.29

4. Method of Depreciation §15.30

IV. EXPLOITATION OF TRADE SECRETS

A. Manner of Trade Secret Exploitation §15.31

B. Sale or License: Capital Gains Treatment on Recognized Gain §15.32

1. Trade Secrets Constitute Property §15.33

2. Capital Asset or IRC §1231 Asset §15.34

3. "Sale or Exchange" Requirement: The "All Substantial Rights" Test §15.35

a. Transfers in Form of Sale §15.36

b. Exclusive Licenses §15.37

c. Limited Exclusive Licenses §15.38

4. Holding Period §15.39

5. Limitation on Capital Gain Treatment; Installment Sale Reporting; Imputed Interest §15.40

6. Limitation on Losses on Transfer of Acquired Trade Secrets Subject to IRC §197 §15.41

C. Taxation of License Payments Received by Licensor §15.42

D. Tax Consequences of Internal Use §15.43

V. OTHER DISPOSITIONS OF TRADE SECRETS

A. Abandonment and Worthlessness §15.44

1. Abandonment §15.45

2. Worthlessness §15.46

B. Transfers to Legal Entities §15.47

C. Transfer on Death §15.48

D. Transfer by Gift §15.49

E. Transfer on Liquidation or Sale of Business §15.50

VI. TRADE SECRETS VALUATION §15.51

VII. TAX CONSEQUENCES OF TRADE SECRET LITIGATION §15.52

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I. INTRODUCTION

§15.1 A. Scope of Chapter

The two principal tax objectives often sought by holders of trade secrets are obtaining (1) deductions for the acquisition or development costs of trade secrets as early as possible and (2) capital gains treatment on the sale or disposition of trade secrets. The practitioner must understand the tax consequences of a proposed transaction and identify any tax planning opportunities or pitfalls to help the client reach these goals.

This chapter outlines the federal income tax treatment of trade secrets. It follows the general life cycle of a trade secret in the hands of a taxpayer, from acquisition (by purchase, license, or self-development; see §§15.3-15.30), to exploitation (by license or use; see §§15.31-15.43), to sale, abandonment, or other transfer (see §§15.44-15.50). Trade secret valuation for tax purposes (see §15.51) and the tax treatment of litigation damages for misappropriation of trade secrets (see §15.52) are also discussed.

The purpose of this chapter is to provide the conceptual framework and references to sources of authority for achieving these goals; it is not an exhaustive treatment of the subject. The practitioner must consult the relevant sources of tax law before rendering advice.

WARNING: Because of the highly technical nature of this area of the law, the practitioner may need to consult a specialist in the field. See Cal Rules of Prof Cond 3-110.

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§15.2 B. Tax Law and Trade Secrets

One of the more challenging aspects of the taxation of trade secrets is the threshold issue of defining "trade secrets" or "know-how" for tax purposes. Neither term is defined in either the Internal Revenue Code (Title 26, USC) or the Treasury Regulations (Title 26, CFR). In general, favorable tax treatment depends on a determination that the particular "trade secret" or "know-how" constitutes "property" within the meaning of various tax provisions, including, *e.g.,* (1) the Code sections that provide capital gain treatment of the sale or exchange of capital assets (IRC §1221) and IRC §1231 assets and (2) the provisions that provide nonrecognition treatment on the transfer of "property" to a corporation or partnership in exchange for stock or an interest in the partnership under certain conditions (see IRC §§351, 721).

Because a taxpayer's services are often instrumental in creating a particular process, invention, technique, trade secret, or know-how, a determination that the item in question does not rise to the level of "property" for tax purposes will often mean that any consideration received by a taxpayer with respect to such item will be characterized as payments for services. In such event, the attendant tax consequences typically will be less favorable to the taxpayer.

The distinction between the "property" and "services" classifications is not always clear. In *Ofria v Commissioner* (1981) 77 TC 524, 535, involving a determination regarding whether certain technical data transferred to the Air Force was property for purposes of IRC §1221, the Tax Court described the challenge as follows:

The difficulty in determining whether payments to a creator of an invention or valuable commercial process are compensation for services or payments for the sale of a patent or other capital assets stems from the fact that an invention is merely the fruit of the inventor's labor, and that the payment for the invention itself necessarily compensates the inventor for his services in creating the invention.

The Tax Court went on to note that the difficulty increases when the invention or process in question has not been patented and is not, therefore, governed by the provisions of IRC §1235. 77 TC at 541. The issue of "property" versus "services" is discussed further in §15.33.

In a series of pronouncements, the IRS has enunciated a position with respect to the definitions of "trade secrets" and "know-how" for tax purposes. The IRS's position indicates that (1) the terms "trade secrets" and "know-how" are essentially identical for this purpose, and (2) in order to be considered a trade secret or know-how for tax purposes, the information in question must be secret and must be afforded substantial legal protection against unauthorized disclosure and use under applicable state or federal law. See Rev Rul 55-17, 1955-1 Cum Bull 388; Rev Rul 64-56, 1964-1 Cum Bull 133; Rev Proc 69-19, 1969-2 Cum Bull 301; Rev Rul 71-564, 1971-2 Cum Bull 179.

Case law is generally consistent with the IRS definitions. The Court of Claims established the following definition in *E.I. du Pont de Nemours & Co. v U.S.* (Ct Cl 1961) 288 F2d 904, 911:

A trade secret is any information not generally known in a trade. It may be an unpatented invention, a formula, pattern, machine, process, customer list, customer credit list, or even news.... It is truly valuable only so long as it is a secret, for only so long does it provide an advantage over competitors. It follows that the essential element of a trade secret which permits ownership and which distinguishes it from other forms of ideas is the right in the discoverer to prevent unauthorized disclosure of the secret.

In general, it would appear that any information that qualifies as a trade secret under the California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) (see §1.3) should satisfy the foregoing requirements of the IRS and case law and will therefore be considered "property" for income tax purposes.

PRACTICE TIP: Although the law appears to be largely settled with regard to the nature of trade secrets as "property" for income tax purposes, there is a dearth of case law and agency rulings that deal specifically with the tax treatment of trade secrets beyond this threshold determination. Accordingly, the practitioner must often apply other law developed for similar types of property, such as patents, or law applicable to categories of property that may include trade secrets. See, *e.g., Pickren v U.S.* (5th Cir 1967) 378 F2d 595 (trade secrets sufficiently similar to patents to apply decisions on patents in cases involving trade secret transfers). In advising a client who uses or owns trade secrets, the practitioner must have a general understanding of the framework of tax law relevant to a particular situation and evaluate the various possible sources of law that may apply. Many laws that apply to classes of property not defined as "trade secrets" or "know-how" may apply to some trade secrets but not others.

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§15.3 II. COSTS INCURRED IN ACQUIRING TRADE SECRETS AND RIGHTS TO TRADE SECRETS

Rights to use a trade secret owned by a third party may be acquired either by outright purchase and transfer of the trade secret (see §§15.4-15.9) or by a license to use the trade secret (see §§15.10-15.12). Rather than acquiring a trade secret from a third party, the taxpayer may develop the trade secret (see §§15.13-15.30). In any event, the transferee's principal tax issue is whether and when it may recover its cost, either through amortization, business expense deductions, tax credits, or depreciation.

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§15.4 A. Purchaser's Tax Treatment of Cost of Purchased Trade Secrets: Amortization Under IRC §197

Before adoption of the Revenue Reconciliation Act of 1993 (RRA 1993) (Pub L 103-66, 107 Stat 416), a taxpayer could recover the cost of an intangible asset through depreciation deductions under IRC §167 if the asset had a limited useful life, the length of which could be determined with reasonable accuracy. Treas Reg §1.167(a)-3(a). See §§15.27-15.30 for discussion of IRC §167. Trade secrets were generally not considered to have an "ascertainable useful life," however, and thus were not depreciable under §167 unless the taxpayer could prove that the trade secret *did* have an ascertainable useful life. Disputes between the IRS and taxpayers who attempted to prove an ascertainable useful life were common, with the IRS often successfully challenging taxpayers who claimed that their trade secret had an ascertainable useful life. See, *e.g., Yates Indus.* (1972) 58 TC 961, aff'd (3d Cir 1973) 480 F2d 920. But see *Liquid Paper Corp. v U.S.* (Cl Ct 1983) 83-1 USTC ¶9305, 51 AFTR2d 1166 (taxpayer proved that technological advances would render Liquid Paper obsolete within specified period of time).

Congress swept away most of this uncertainty in the 1993 RRA by enacting IRC §197, which provides for 15-year amortization of "§197 intangibles." The legislative history to the 1993 RRA indicates that Section 197 was intended to reduce the number of disputes between the IRS and taxpayers and to reduce the need for appraisals. Most trade secrets purchased after August 10, 1993, qualify as §197 intangibles. See §15.5 for definition of §197 intangibles. For trade secrets developed by the taxpayer or purchased before August 10, 1993 (or before July 25, 1991, if the taxpayers elects to apply IRC §197 beginning on that date), IRC §167, requiring proof of an ascertainable useful life for depreciation, still applies.

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Source: Business Law/Trade Secrets Practice in California/15 Taxation of Trade Secrets/§15.5 1. Section 197 Intangibles Defined

§15.5 1. Section 197 Intangibles Defined

The Internal Revenue Code defines certain categories of intangible property as IRC §197 intangibles. Most trade secrets fall within one of the following two of those categories:

- Business books and records, operating systems, or any other information base (including lists or other information on current or prospective customers). IRC §197(d)(1)(c)(ii).
- Any patent, copyright, formula, process, design, pattern, know-how, format, or similar item. IRC §197(d)(1)(c)(iii).

A contract for the use of a trade secret, such as a license, is treated as a §197 intangible. Treas Reg §1.197-2(b)(11). This rule is designed to prevent taxpayers from avoiding §197 by licensing rather than purchasing §197 intangibles.

Three of the exclusions from the definition of "§197 intangible" may exclude certain trade secrets, however, unless they are acquired in the acquisition of a trade or business:

Self-created intangibles. Section 197 generally does not apply if the intangible is created by the taxpayer (with certain exceptions inapplicable to trade secrets). The purpose of this exception is to avoid an overlap of §197 with the deduction of business expenses under IRC §162 and research and experimental expenses under IRC §174(a). See §§15.15-15.26 for discussion of research and experimental expenses under IRC §174. If §197 did apply to such self-created assets, business expenses otherwise currently deductible under IRC §162 that contributed to the creation of an intangible asset might have to be capitalized and amortized over 15 years. Section 197 will apply, however, if the trade secret is created by the taxpayer in connection with the acquisition of assets constituting all or substantially all of a trade or business. IRC §197(c)(2).

Certain computer software. Computer software is not a §197 intangible if it (1) is readily available for purchase by the general public, is distributed subject to a nonexclusive license, and has not been substantially modified (*i.e.,* is not custom software), or (2) was not acquired in a transaction or series of transactions involving the acquisition of assets constituting all or a substantial portion of a trade or business. IRC §197(e)(3)(A). Thus, only custom software acquired in the purchase of a business is subject to §197. All other *purchased* software, including "off the shelf" and separately acquired software, is depreciable over 36 months as long as it has an ascertainable limited useful life under IRC §167(a). However, if the software is bundled with computer hardware without a separately stated price, it is treated as part of the cost of the hardware. IRC §167(f)(1); Rev Proc 2000-50, 2000-2 Cum Bull 601, modified by Rev Proc 2004-11, 2004-3 Int Rev Bull 311. The costs for developing software may be currently deducted, may be amortized over a period of 60 months (Rev Proc 2000-50), or may be amortized over a period of 36 months (IRC §167(f)(1)). Note, however, that §167(f) was amended by the American Jobs Creation Act (AJCA) (Pub L 108-357, §847, 118 Stat 1418) to provide special rules for computer software that is tax-exempt use property subject to a lease.

The IRS has provided comprehensive guidance regarding recovery of the cost of acquiring or developing computer software in Rev Proc 2000-50, 2000-2 Cum Bull 601, modified by Rev Proc 2004-11, 2004-3 Int Rev Bull 311. The term "computer software" is defined as (Rev Proc 2000-50, modified by Rev Proc 2004-11, 2004-3 Int Rev Bull 311, and modified, superseded, clarified, and amplified by Rev Proc 2007-16, 2007-4 Int Rev Bull 358):

any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic or otherwise. Computer programs of all classes … are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Computer software does not include any data or information base described in [26 CFR] §1.197-2(b)(4) … (for example, data lists, customer lists, or client files) unless the data base or item is in the public domain and is incidental to a computer program. Nor does it include any cost of procedures that are external to the computer's operation.

Certain enumerated intangible assets. Certain enumerated intangible assets (including any interests in "a film, sound recording, video tape, book, or similar property"), patents, and copyrights are §197 intangibles only if they are acquired as part of an acquisition of assets constituting all or a substantial portion of a trade or business. IRC §197(e)(4).

Internal Revenue Code §197(e)(4)(D) provides that contract rights or certain rights granted by governmental agencies, and rights of fixed duration and amount, would be excluded from the definition of §197 intangibles to the extent provided in the regulations. Final regulations track IRC §197 and its legislative history for the most part (previously, these regulations were in

proposed form). The regulations provide that the aforementioned rights are not §197 intangibles if they are (1) acquired in the ordinary course of business and (2) have a fixed duration of less than 15 years (Treas Reg §1.197-2(f)(3)(ii), (iii)) or are fixed as to amount and would, other than §197, be recoverable under the unit-of-production method. Treas Reg §1.197-2(c)(13).

WARNING: The regulations provide that contracts for the use of a trade secret not acquired as part of a trade or business will be closely scrutinized to determine whether the transfer should be treated as a sale. Treas Reg §1.197-2(f)(3)(iii). See IRC §1235.

Another exclusion exists for licenses of certain intangible assets (generally information base (other than a customer-related information base), know-how, patents, copyrights, and similar assets) if the taxpayer shows that the license is not a sale of the underlying intangible (see IRC §1235) and the payments constitute arm's length consideration. See Treas Reg §1.197-2(f)(3)(ii)(B).

Because the exclusion for intangible assets is narrowly drawn, §197 may extend by implication to licenses of trade secrets for terms greater than 15 years or in perpetuity. In several areas, the regulations provide additional guidance:

Software readily available to the public. Software is "readily available to the public" if it may be obtained on substantially the same terms by a significant number of people who would be expected to use it. A system of retail distribution is not required. Treas Reg §1.197-2(c)(4)(i).

Substantial modification. The regulations provide a safe harbor for the definition of "substantial modification" of certain software. Software will not be considered to have been substantially modified if its cost does not exceed the greater of 25 percent of the price for the unmodified version or $2000. Integrated programs from a single source are considered to be a single program. Treas Reg §1.197-2(c)(4)(i).

Trade or business. The acquisition of a franchise, trademark, or trade name constitutes the acquisition of a trade or business (potentially rendering more of the assets as IRC §197 intangibles), unless the trademark or trade name (1) is included in certain types of property (including computer software), (2) is of nominal value, or (3) is immediately disposed of by the taxpayer. Any group of assets to which goodwill or going-concern value could attach constitutes a trade or business. Treas Reg §1.197-2(e).

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§15.6 2. Amortization Period

Internal Revenue Code §197 intangibles are amortized ratably over 15 years, beginning with the month in which the asset was acquired. IRC §197(a).

Any amount paid for a §197 intangible after the first month of a 15-year amortization (*e.g.,* contingent payment of purchase price) is amortized ratably over the remainder of the period. Amounts paid after the end of the 15-year period may be amortized in full immediately. Treas Reg §1.197-2(f)(2).

Internal Revenue Code §56 does not require a longer recovery period for amortizable §197 intangible assets for alternative minimum tax (AMT) purposes. Accordingly, no AMT adjustment is generally required for those assets. Individual taxpayers will be subject to adjustment for research and development expenditures for AMT purposes if they do not materially participate in the research activity. See §15.26.

NOTE: Regulations under IRC §§338(b)(5) and 1060 contain purchase price allocation rules that apply to asset acquisitions and deemed asset acquisitions under IRC §338 (*i.e.,* when a corporation acquires all of the stock of another corporation and elects to treat the transaction as an asset acquisition). All §197 intangibles except goodwill and going-concern value are placed in Class VI; the residual class, Class VII, consists of goodwill and going-concern value. Treas Reg §1.338-6(b)(2)(vi), (vii). The deemed purchase price is allocated among the assets under the residual method, with the adjusted grossed-up basis and aggregate deemed sales price allocated among the seven asset classes in priority order, with Class VII being the last one. Treas Reg §§1.338-6(b), 1.1060-1(c). These regulations revised the asset classifications effective March 16, 2001. Class II was modified to exclude stock of target affiliates other than certain actively traded stock described in IRC §1504(a)(4). Treas Reg §1.338-6(b)(2)(ii).

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§15.7 3. Effective Dates

Rules regarding IRC §197 intangibles apply to asset acquisitions after August 10, 1993. Taxpayers may elect to apply them to assets acquired after July 25, 1991. Temp Treas Reg §1.197-1T.

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§15.8 4. Exceptions to Application of §197 for Related Party and Churning Transactions

Congress did not want to permit taxpayers to convert previously nonamortizable assets into IRC §197 intangibles by making transfers or other arrangements with related parties. Thus, §197 does not apply to goodwill and other assets acquired after August 10, 1993, and not amortizable before §197 was enacted if (1) the intangible was held or used by the taxpayer or a related person at any time between July 25, 1991, and August 10, 1993; (2) the intangible is acquired from a person who held it at any time between July 25, 1991, and August 10, 1993, and the user of the intangible does not change; or (3) the taxpayer grants a right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time between July 25, 1991, and August 10, 1993. IRC §197(f)(9).

To qualify as an amortizable IRC §197 intangible, the intangible must have been acquired after the applicable date (July 25, 1991, if the acquiring taxpayer made a valid retroactive election under Temp Treas Reg §1.197-1T; August 10, 1993, in all other cases). Treas Reg §1.197-2(h)(1)(ii).

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§15.9 5. Subsequent Transfers of §197 Property

No loss is available on the sale, exchange, or worthlessness of a §197 intangible acquired as part of the acquisition of a trade or business until the taxpayer disposes of *all* §197 intangibles that were acquired in the same transaction. Assets are deemed not disposed of if they are held by a member of the same controlled group. The amount of the unrecognized loss on any early disposition is added to the basis of the remaining §197 intangibles and is amortized over the remainder of the 15-year period. This rule prevents taxpayers who acquire several assets as part of the acquisition of a trade or business from allocating more basis to assets that would be disposed of before expiration of the 15-year amortization period and thereby obtaining faster amortization. On the other hand, gain on the sale or exchange of a §197 intangible is recognized even if the taxpayer has not yet disposed of the other §197 intangibles acquired in the same transaction. IRC §197(f)(1).

When §197 intangibles are transferred in certain specified nonrecognition transactions, including those described in IRC §§332, 351, 361, 721, 731, 1031, or 1033 (corporate reorganizations and formations, contributions to and distributions from partnerships, like-kind exchanges, and involuntary conversions), the transferee treats the carryover basis of the §197 intangible the same as that basis was treated by the transferor to the extent of the transferor's basis in the intangible. Any new basis is treated as a new §197 intangible. IRC §197(f)(2).

The regulations under IRC §1031 provide that an exchange of intangible personal property does not qualify for nonrecognition treatment under §1031 if the exchanged properties are not of like kind. Whether intangible assets are of like kind to other intangible assets generally depends not only on the type of property involved (for example, a patent or a copyright) but also on the type of underlying property to which the intangible asset relates. This is sometimes referred to as the "two-prong test" or, less frequently, the "double whammy." The goodwill or going-concern value of a business is never of like kind to the goodwill or going-concern value of another business. Treas Regs §1.1031(a)-2(c)(1)-(2).

In a private letter ruling, the IRS stated that the first prong of the two-prong test set forth in §1.1031(a)-2(c)(1) may be satisfied by the commonality of legal protections available to unregistered intangible property generally, *e.g.,* designs and drawings, trade secrets and secret know-how, and software. IRS Letter Ruling 200602034. The second prong can generally be satisfied only if the underlying property is of the same General Asset Class (see Treas Reg §1.1031(a)-2(b)(2)) or the same Product Class (see Treas Reg §1.1031(a)-2(b)(3)). The IRS did recognize, however, that this may not be relevant to some types of unregistered intellectual property.

Treasury Regulation §1.1031-(a)(2)(c)(3) illustrates the foregoing provisions with the following examples:

- Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.
- Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

For further discussion of the tax consequences of the disposition of a trade secret, see §§15.44-15.50.

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B. Licensee's Tax Treatment of Licensed Trade Secrets

§15.10 1. Treatment of Consideration Paid for License

A licensee may obtain rights to a trade secret by exclusive or nonexclusive license. An *exclusive* license in perpetuity generally grants all rights to the licensee, is economically equivalent to a sale, and is typically treated as a purchase and sale for tax purposes. Section 197 applies to licenses of intangibles unless the license is for a fixed term of less than 15 years. See IRC §197(e)(4)(D). Therefore, a perpetual license would be subject to 15-year amortization under §197, although there is no authority on point as yet.

On the other hand, if §197 does not apply (*e.g.,* in the case of a *nonexclusive* trade secret license for a term of less than 15 years), the tax treatment of the royalty or license payments would be analogous to the rules that apply to the rental of tangible property. If the licensee makes periodic royalty or license payments evenly over the term of the license, the payments would be deductible as business expenses under IRC §162, as long as they are incurred in carrying on a trade or business and are "ordinary and necessary."

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§15.11 2. Timing of Deduction

If license payments are not made in equal annual or more frequent installments over the term of the license, the timing of deductions becomes an issue of tax accounting and is mainly a function of whether (1) the taxpayer is on the cash or accrual basis and (2) the payments are paid in advance or paid in arrears. The most common question is how to treat prepayments by a cash basis taxpayer. Such payments resulting "in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" must be capitalized rather than being currently deducted. Treas Reg §1.461-1(a)(1). The broad language of the regulation, while focusing on acquisitions of property that must be capitalized, also encompasses prepaid expenses. Thus, the licensee's cash prepayments must be capitalized and amortized over a period of years, usually over the time for which the licensee has licensed the property. See Treas Reg §1.162-11(a) (real property rentals); *Zaninovich v Commissioner* (9th Cir 1980) 616 F2d 429. For full discussion of these issues, see Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts (3d ed 2005).

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§15.12 3. Method of Depreciation Under IRC §167

Trade secrets subject to depreciation under IRC §167 are depreciated by the straight-line method over the useful life of the property. Treas Reg §1.167(b)-1(a). A series of well-known cases allowed taxpayers who acquired patents or trade secrets from third parties and paid periodic royalties based on revenues to deduct the amount of their royalty payments each year as §167 depreciation. See *Associated Patentees, Inc*. (1945) 4 TC 979, acq 1946-1 Cum Bull 1, acq 1959-2 Cum Bull 3 (patents); *Liquid Paper Corp. v U.S.* (Cl Ct 1983) 83-1 USTC ¶9305, 51 AFTR2d 1166 (trade secrets). These cases have little application to trade secrets after the adoption of IRC §197, however, because it governs the depreciation of most acquired trade secrets.

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§15.13 III. OWNER'S TAX TREATMENT OF SELF-DEVELOPED TRADE SECRETS

The cost of acquired trade secrets may often be capitalized and amortized over 15 years under IRC §197. See §15.4. However, §197 does not apply to self-developed assets. IRC §197(c)(2). A taxpayer who develops a trade secret, rather than purchasing or licensing it, is often permitted to deduct the expenses currently under IRC §162, especially if the trade secrets arise in the course of operation of the business, such as customer lists, business strategies, and insurance expirations (*i.e.*, information about the nature of insurance coverage for a client and the renewal data, allowing an insurance broker to solicit a renewal or new coverage at the most opportune time). On the other hand, expenses incurred in developing other types of trade secrets, most typically those that are or contribute to new products or that result in a tangible asset, may have to be capitalized under general tax law principles.

The question of whether development expenses must be capitalized was made more difficult by the Supreme Court's decision in *INDOPCO Inc. v Commissioner* (1992) 503 US 79, 117 L Ed 2d 226, 112 S Ct 1039. In *INDOPCO,* the Court held that legal and investment banking fees incurred in a takeover had to be capitalized because the benefits of the takeover would be realized over a number of years and the future benefits of the takeover were not "incidental" to benefits in the current year. The Court refused to require that expenditures had to create or improve a separate and distinct asset in order to be capitalized. See IRC §461; Treas Reg §1.461-1(a)(1). The taxpayer's principal concern therefore is how rapidly development costs may be deducted or amortized. Unlike a trade secret purchaser, a trade secret developer cannot amortize the development cost under §197; that section does not apply to self-developed assets. IRC §197(c)(2).

If the development work qualifies as "research and experimental" work as defined in IRC §174, the taxpayer may be able to deduct the development expenditures as incurred under §174. See §§15.15-15.26. The taxpayer may also qualify for a tax credit under IRC §41. See §15.14. If the development work does not qualify under §174 or §41, costs may be recovered through deductions only if the trade secret qualifies for depreciation under IRC §167. See §§15.27-15.30.

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§15.14 A. Deduction, Capitalization of, or Credit for Development Costs

Before 1954, the only statutory authority for deduction of research and experimental expenses was IRC §162, which allows deduction of ordinary and necessary expenses of an existing trade or business. Section 162 posed problems for many taxpayers. Businesses in the start-up phase had difficulty meeting the "trade or business" requirement. In addition, expenses resulting in assets with a useful life beyond one year generally had to be capitalized and could be recovered only through depreciation under IRC §167; they could not be currently deducted under §162. However, the taxpayer could depreciate the asset under §167 only if the trade secret had a provable limited useful life that could be determined with reasonable certainty. Thus, the cost of an asset for which a useful life could not be determined could be recovered only on the sale or abandonment of the asset. See §§15.44-15.50.

These problems are addressed by the research expenditures deductions allowed under IRC §174. Expenses need be incurred only "in connection with" a trade or business. IRC §174(a). To resolve the depreciation problem, the taxpayer may elect to currently deduct qualifying expenses, even if they result in an asset with a useful life longer than one year. IRC §174(a). In the alternative, the taxpayer may elect to capitalize the expenditures and amortize them over a period selected by the taxpayer of at least 60 months. IRC §174(b).

The provisions of §174 are elective; the taxpayer must elect to be treated under §174(a) or §174(b). In the absence of an election, the expenses are subject to rules applicable before the adoption of §174, *i.e.*, deductibility under §162 or capitalization and depreciation under §167.

A tax credit for incremental research expenses is available under IRC §41. The credit terminates for amounts paid or incurred after December 31, 2005. IRC §41(h)(1)(B). The credit is determined as the sum of (1) 20 percent of the amount that the taxpayer's qualified research expenditure for the year exceeds the base amount for that year and (2) 20 percent of the basic research payments paid to educational or scientific research organizations.

Taxpayers may also elect to compute the research credit by using the alternative incremental research credit (IRC §41(c)(4)), which uses a three-tiered credit schedule that utilizes reduced credit rates and fixed-base percentages. An election to use the alternative incremental credit may be revoked only with the IRS's consent. The tier one amount is equal to 1.65 percent of qualified research expenditures in excess of 1 percent of the base amount (base amount is average gross receipts for the last 4 tax years) but not more than 1.5 percent of the base amount. The tier two amount is equal to 2.2 percent of qualified research expenditures in excess of 1.5 percent of the base amount but not in excess of 2 percent of the base amount. The amount for tier three is equal to 2.75 percent of qualified research expenditures in excess of 2 percent of the base amount.

For any taxable year beginning after 1989, the deduction for research and experimental costs under IRC §174 is reduced by the previously allowed credit under IRC §41, if applicable. If research and experimental costs are capitalized under §174, the amount capitalized is reduced by the amount of the credit.

NOTE: The criteria for eligible research expenses are more restrictive for the credit under §41 than for the deduction under §174. Expenses must meet the following requirements: (1) They must qualify for the deduction under §174; (2) they must be undertaken to discover information that is technological; (3) they must be useful in developing a new or improved taxpayer business component; and (4) substantially all of the activities must constitute a process of experimentation. Treas Reg §1.41-4(a)(2)(i)-(iii).

A major issue has been whether and on what terms internal use software qualifies for the credit. *United Stationers, Inc. v U.S.* (7th Cir 1998) 163 F3d 440 (development of bookkeeping and administrative use software in-house by taxpayer not eligible for credit, because it was internal use software, expenses were not technological, and activities were not process of experimentation). Proposed Treas Reg §1.41-4(e) would impose three additional requirements for most internal use software to qualify for the increased research expenditure credit:

- The software must be "innovative";
- The development must involve significant economic risk for the taxpayer; and
- The software must not be commercially available.

Effective January 2, 2004, the IRS issued final regulations for the credit, making some changes to the regulations that had been propounded in 2001. The IRS specifically stated, however, that the section of the regulations published in 2001 that dealt with internal use software was not being finalized, and the IRS reserved Treas Reg §1.41-4(c)(6) for future regulations for internal use

software. See 69 Fed Reg 22 (Jan. 2, 2004). See also *Wicor, Inc. v U.S.* (7th Cir 2001) 263 F3d 659; *Norwest Corp. v Commissioner* (1998) 110 TC 454 (Tax Court stringently applied additional requirements); Barton, Jackson, and Wong, *Recent Developments Significantly Affect All Taxpayers Claiming Research Credit,* 90 J Tax 166 (1999).

The IRS has taken the position that new software must represent an advance of the state of the art to qualify for the credit. Two courts have agreed with the IRS position, holding that it was sufficient that the software developed was an innovation for the taxpayer and not freely available to the public. See *Tax & Accounting Software Corp. v U.S*. (10th Cir 2002) 301 F3d 1254, cert denied (2003) 539 US 903; *Wicor, Inc. v U.S.* (ED Wis 2000) 116 F Supp 2d 1028, aff'd (7th Cir 2001) 263 F3d 659.

PRACTICE TIP: The law concerning the tax credit has become increasingly complicated as a result of a steady flow of new enabling and extension statutes, legislative history, cases, and a number of releases of IRS regulations. A practitioner giving advice in this area must study these sources carefully to apply the law to a particular situation.

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B. Deduction Under IRC §174

§15.15 1. Electing §174(a) Treatment

A taxpayer may elect IRC §174(a) treatment by claiming a deduction for research and experimental expenditures on the income tax return for the first tax year in which such expenditures are made or incurred. Treas Reg §1.174-3(b)(1). Once a §174(a) election is made, it governs all such expenditures in the current and subsequent years, unless the taxpayer obtains IRS consent to a change. Treas Reg §1.174-3(a), (b)(3) (request for consent). If a taxpayer fails to adopt the §174(a) method for the first year in which research and experimental expenditures are made or incurred, IRS consent is required in order to adopt it for a later year. Treas Reg §1.174-3(b)(1)-(2).

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§15.16 2. Electing §174(b) Treatment

A taxpayer may elect IRC §174(b) treatment by attaching a statement to the return for which the election is made, stating whether the election applies to all eligible expenditures or only to a particular project or projects, and specifying the amounts of all eligible expenditures for the year and the period of amortization for each project. Treas Reg §1.174-4(b)(1). Different amortization periods may be selected for different projects. Treas Reg §1.174-4(a)(3). The election and selected amortization period will apply to that year and all later tax years, unless the IRS consents to a later change. Treas Reg §1.174-4(a)(5), (b)(2) (request for consent).

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§15.17 3. Interplay Between §174(a) and §174(b) Elections

A taxpayer who previously elected to deduct expenditures under IRC §174(a) may not elect to capitalize and amortize under IRC §174(b) without IRS consent. Treas Reg §1.174-4(a)(1), (b)(2) (request for consent). A taxpayer may not capitalize part of the expenditures for a project in a tax year under §174(b) and adopt a different method for the balance of the project's expenditures for that year. Treas Reg §1.174-4(a)(5). Thus, in the absence of IRS consent, a taxpayer has three options (Treas Reg §1.174-1):

(1) Elect §174(a), and deduct all research and experimental expenses;

(2) Elect §174(b) for all projects or certain projects, and capitalize and amortize expenses for elected projects and treat expenses for any nonelected projects under pre-§174 law; or

(3) Elect neither §174(a) nor §174(b), and treat all expenses under pre-§174 law.

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§15.18 4. Amortization Period Under §174

If the taxpayer elects to capitalize research and experimental expenditures under IRC §174(b) (see §15.16), these expenditures may be deferred and amortized over the period selected by the taxpayer, which period may not be less than 60 months. IRC §174(b). The taxpayer may not capitalize and then amortize expenses under §174(b) if the expenses contribute to an asset that is subject to depreciation or depletion under §167. Because depreciation applies to assets with an ascertainable useful life, §174(b) amortization applies only to expenditures that result in an asset with *no* ascertainable useful life. Treas Reg §1.174-4(a)(2). Thus, the development costs of most trade secrets can be amortized under §174(b) if they otherwise qualify. If the §174(b) election is made, (1) regular depreciation rules apply to depreciable property, and (2) amortization under §174(b) applies to nondepreciable property resulting from the expenditures. Amortization begins with the first month in which the taxpayer realizes benefits from the asset, which is deemed to be the month in which the taxpayer first puts the asset to an income-producing use, unless a showing is made of a different applicable date. Treas Reg §1.174-4(a)(3).

If the taxpayer elects §174(b) treatment and over a period of time the expenditures result in the development of depreciable property, then deductions for unrecovered expenses, beginning at the time the asset becomes depreciable in character, are calculated under regular depreciation rules. Treas Reg §1.174-4(a)(4). For example, assume that a taxpayer developed a secret process at a cost of $60,000, elected to amortize the costs under §174(b) over 60 months, and first realized benefits on July 1, 1986. On July 1, 1988, the taxpayer obtains a patent for the process. Because patents have an ascertainable useful life equal to the term of legal protection, they are depreciable under IRC §167. Thus, between July 1, 1986, and June 30, 1988, the taxpayer is entitled to amortization deductions of $1000 per month, or $24,000. Commencing July 1, 1988, the taxpayer is entitled to depreciation deductions for the unrecovered expenses ($36,000) ratably over the term of the patent. Treas Reg §1.174-4(a)(4).

PRACTICE TIP: Taxpayers should evaluate whether the protection given by the patent is worth the delayed cost remedy.

NOTE: Counsel should remember that IRC §197 does not apply to self-developed patents. See §15.5.

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§15.19 5. Trade or Business Requirement

Under IRC §174, the expenses must be incurred "in connection with" a trade or business, a lower standard than the IRC §162 requirement that expenses be incurred "in carrying on" a trade or business. *Snow v Commissioner* (1974) 416 US 500, 40 L Ed 2d 336, 94 S Ct 1876; *Harold J. Green* (1984) 83 TC 667. Under this lower standard, the taxpayer's efforts need not have reached the stage of an active trade or business; there need only be a "realistic prospect" that the taxpayer's efforts will result in a trade or business at some time. *Harris v Commissioner* (5th Cir 1994) 16 F3d 75.

PRACTICE TIP: Partnerships formed for the purpose of conducting research and experimentation, if a third party has the right to exploit the inventions commercially, are most often denied §174 deductions. In such cases, the partnership is often found to be a passive investor in the invention, and the expenses are thus not incurred "in connection with" a trade or business. *United Fibertech Ltd.,* TC Memo 1991-445, aff'd (8th Cir 1992) 976 F2d 445; *Louis H. Diamond* (1989) 92 TC 423, aff'd (4th Cir 1991) 930 F2d 372. But see *Scoggins v Commissioner* (9th Cir 1995) 46 F3d 950 (partnership deductions allowed for technology licensed to corporation majority owned by partners); *LDL Research & Development II Ltd. v Commissioner* (10th Cir 1997) 124 F3d 1338, 1972-2 USTC ¶50643, 80 AFTR 2d 97-6548 (partnership passive investor with respect to development of electronic devices).

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§15.20 6. Research and Experimental Expenses

Most of the authority on the definition of research and experimental expenses is in the regulations, which state that qualifying expenditures are those that represent "research and development costs in the research or laboratory sense." Treas Reg §1.174-2(a)(1). Usually, research and experimental expenses incurred in developing or improving a product qualify as research and experimental expenses if they are intended to *eliminate uncertainty* about achieving the development or improvement of the product. Treas Reg §1.174-2(a)(1) (effective for tax years beginning after October 3, 1994). "Uncertainty" exists if the taxpayer does not have available information establishing the ability to design, develop, or improve the product.

Qualification of the expenditures depends on the nature of the taxpayer's activity (*i.e.,* eliminating uncertainty about the development of the product), and not on the nature of the product or improvement being developed or the level of technological advancement. Treas Reg §1.174-2(a)(1). Products include not only commercial products for sale, but also pilot models, processes, formulas, inventions, techniques, patents, and similar property, whether developed for sale, lease, or use by the taxpayer in his or her trade or business. Treas Reg §1.174-2(a)(2).

The regulations specifically exclude certain types of expenditures from current research and experimental expense deductions. See §§15.21-15.24.

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§15.21 a. Management and Operating Expenses

The regulations specifically exclude certain operating and management expenses from current research and experimental expense deductions: ordinary quality control testing, efficiency surveys, management studies, consumer surveys, and advertising and promotion. Treas Reg §1.174-2(a)(3).

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§15.22 b. Land and Depreciable Assets

Expenditures to acquire land or depreciable or depletable property are not deductible under IRC §174. IRC §174(c); Treas Reg §1.174-2(b). For example, the cost of a microscope for use in research is not deductible but must be capitalized and depreciated.

Deductible expenses also do not include the cost of materials or labor to construct and install depreciable property or costs attributable to acquisition or improvement of depreciable property. For example, if a taxpayer develops a new machine, spending $10,000 on the actual cost of materials and labor to build it and $20,000 on research that is not attributable to the machine itself, the $20,000 is deductible under §174(a) but the $10,000 to build the machine must be capitalized and depreciated. Treas Reg §1.174-2(b)(4).

If the depreciable property is constructed for the taxpayer by a third party, costs are deductible as research and experimental expenses only (1) to the extent that they do not consist of the direct cost of construction or acquisition of the asset and (2) if the work is done on the taxpayer's order and at the taxpayer's risk. Treas Reg §1.174-2(a)(8), (b)(3). See §15.24.

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§15.23 c. Literary and Similar Projects

Research for literary, historical, or similar projects is not deductible. Treas Reg §1.174-2(a)(3)(vii). "Similar projects" include films, sound recordings, videotapes, and books. Treas Reg §1.174-2(a)(5).

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§15.24 d. Contracted Services

Amounts paid to third parties such as research institutes and contractors for research and experimentation qualify for deduction under IRC §174. Treas Reg §1.174-2(b)(8). But costs of acquisition, construction, or improvement of land or depreciable property to which the taxpayer acquires title are not deductible. See §15.22.

Similarly, no deduction is available if the taxpayer purchases another's product under a performance guarantee or if the product is in regular production. Treas Reg §1.174-2(b)(3). For example, if the taxpayer contracts for the construction of a new type of chemical processing plant that the contractor guarantees will produce a certain level of annual production at a given level of raw materials and price, none of the expenses are deductible. If there are no guarantees and there is real doubt as to whether the performance requirements of the plant will be met, expenses for research are deductible. If the third party retains the asset, none of the acquisition or construction costs should be capitalized by the taxpayer, and all of the taxpayer's costs are deductible. Treas Reg §1.174-2(a)(8), (b)(3).

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§15.25 7. Reasonableness Requirement

Only expenses that are reasonable in amount are deductible. IRC §174(e). An expenditure is reasonable if "the amount would ordinarily be paid for like activities by like enterprises under like circumstances." Treas Reg §1.174-2(a)(6).

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§15.26 8. Research and Experimental Expenditures and Alternative Minimum Tax

If a taxpayer who is an individual materially participates in the conduct of the research activity within the meaning of the passive activity loss rules, no alternative minimum tax (AMT) adjustment is necessary for tax years beginning after 1990. IRC §56(b)(2)(D).

For taxpayers other than corporations, in computing alternative minimum taxable income (the amount on which alternative minimum tax is imposed; see IRC §56), amounts allowable as a deduction under IRC §174(a) must be capitalized and amortized over 10 years, beginning when the expenditures are made. IRC §56(b)(2)(A)(ii). Thus, if a taxpayer elects IRC §174(a), AMT liability may result.

Corporations may use the election methods in IRC §174(a) or §174(b) for computing AMT income. See IRC §56(c).

The AMT provisions also allow a taxpayer to amortize IRC §174(a) research and experimental expenditures over 10 years for regular tax purposes. IRC §59(e). This election is open to all taxpayers and makes no distinction for taxpayers who have elected IRC §174(b) treatment for other expenditures in the same or other years.

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C. Amortization of Development Costs Under IRC §167

§15.27 1. Must Costs Be Capitalized?

If development costs cannot be deducted under IRC §162 or IRC §174(a) or capitalized and amortized on favorable terms under IRC §174(b), and if, as in most instances, the trade secret has a useful life greater than one year, the development costs must be capitalized under general tax law. Such costs can be recovered only through depreciation under IRC §167, if allowed, or on sale, exchange, abandonment, or worthlessness of the trade secret.

Depreciation of capitalized trade secret development costs must be under IRC §167, which governs both tangible and intangible property. Accelerated depreciation, permitted for certain types of tangible property under IRC §168, does not apply to intangible property.

A taxpayer may claim as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) … of property used in the trade or business." IRC §167(a)(1). For trade secret costs to be depreciated under §167, the trade secret asset must have a limited useful life that can reasonably be determined. Treas Reg §1.167(a)-3(a). See §15.28.

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§15.28 2. Determining Ascertainable Useful Life

The "ascertainable useful life" requirement is set forth in Treas Reg §1.167(a)-3(a):

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.

Unlike patents and copyrights, trade secrets have no term set by statute; they expire when they become public, but such time cannot be estimated in advance. Because trade secrets are not subject to physical wear and tear and are not consumed in use, the courts have long held that trade secrets have no limited useful life and are not subject to depreciation under IRC §167 unless the taxpayer can prove that in the particular circumstances the trade secret does have a limited useful life that is ascertainable with reasonable accuracy. *Yates Indus.* (1972) 58 TC 961, aff'd (3d Cir 1973) 480 F2d 920 (treatment for copper foil not shown to have limited life that could be determined); *Graham v U.S.* (ND Tex 1979) 79-1 USTC ¶9274, 43 AFTR2d 79-1013 (taxpayer failed to show that formula had ascertainable useful life); *Kaltenbach v U.S.* (1929) 66 Ct Cl 581 (weighting silk process not subject to wear and tear or exhaustion).

Although trade secrets are generally not subject to physical wear and tear or obsolescence, they can lose their value through passage of time, technological advances, changes in public taste, or independent discovery by or disclosure to others. Proof of an ascertainable useful life usually imposes a heavy factual burden on the taxpayer, generally requiring expert testimony. See *Newark Morning Ledger Co. v U.S.* (1993) 507 US 546, 123 L Ed 2d 288, 113 S Ct 1670 (taxpayer proved through expert testimony that paid subscriber list acquired in purchase of newspaper had ascertainable limited useful life); *Liquid Paper Corp. v U.S.* (Cl Ct 1983) 83-1 USTC ¶9305, 51 AFTR2d 1166 (taxpayer proved that formula would become obsolete because of technological advances in ascertainable period).

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§15.29 3. Goodwill and Related Mass Assets Not Depreciable

Goodwill has long been held not to be depreciable under the "mass asset" or "indivisible asset" rule. *Houston Chronicle Publishing Co. v U.S.* (5th Cir 1973) 481 F2d 1240. Under this rule, goodwill is considered to be indivisible and self-generating. Although some customers discontinue their patronage, others come to take their places. Thus, goodwill has an indefinite life. Customer lists, insurance expirations, subscriber lists, and similar intangibles, referred to as "customer-based intangibles," often constitute trade secrets. These customer-based intangibles pose special depreciation problems because of the mass asset rule and their relationship to goodwill.

The IRS is likely to view customer-based intangibles as nondepreciable and in the nature of goodwill. In an "unusual case," however, they may be depreciable if the taxpayer can prove that the asset does not possess the characteristics of goodwill, is susceptible of valuation, and is of use in the trade or business for only a limited time. Rev Rul 74-456, 74-2 Cum Bull 65; *Newark Morning Ledger Co. v U.S.* (1993) 507 US 546, 123 L Ed 2d 288, 301, 113 S Ct 1670, 1677. The taxpayer will have a difficult time meeting this burden of proof. See, *e.g.,* 507 US at 547, 123 L Ed 2d at 306, 113 S Ct at 1681 (taxpayer met burden regarding paid subscriber list).

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§15.30 4. Method of Depreciation

Trade secrets subject to depreciation under IRC §167 are depreciated by the straight-line method over the useful life of the property. Treas Reg §1.167(b)-1(a).

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IV. EXPLOITATION OF TRADE SECRETS

§15.31 A. Manner of Trade Secret Exploitation

A trade secret owner may choose to exploit the trade secret commercially in one of four ways: (1) selling the trade secret, (2) licensing the use of the trade secret to one or more businesses, (3) using the trade secret itself for production of goods or services or otherwise in its business, or (4) transferring the trade secret to a corporation controlled by the trade secret owner for commercial exploitation. A trade secret licensee may choose to exploit the trade secret commercially in one of the latter three options available to the owner, if permitted by the license agreement.

See §15.9 for discussion of transfers of IRC §197 intangibles.

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§15.32 B. Sale or License: Capital Gains Treatment on Recognized Gain

The principal tax concern of an individual taxpayer who sells or licenses a trade secret is whether favorable long-term capital gains treatment is available for any gain recognized. Internal Revenue Code §1235 provides long-term capital gains treatment on the transfer of all substantial rights to a patent. The scope of §1235 extends beyond patents issued or applied for to all patentable assets. See Treas Reg §1.1235-2(a). Any trade secrets transferred with and closely related to property qualifying for long-term capital gains treatment will also qualify for long-term capital gains treatment under IRC §1235. See, *e.g., PPG Indus., Inc*. (1970) 55 TC 928, overruled on other grounds in *Thomas B. Fegan* (1979) 71 TC 791, aff'd (10th Cir, Apr. 27, 1081, No. 79-1890) 1981 US App Lexis 13888.

If property does not qualify under IRC §1235, long-term capital gains treatment may be available under IRC §1221, which contains the general definition of capital assets. There are five basic requirements for obtaining long-term capital gains treatment under IRC §1221:

(1) The asset must constitute property (see §15.33);

(2) The asset must be a capital asset under IRC §1221 or must be an IRC §1231 asset (see §15.34);

(3) The transfer must constitute a "sale or exchange" (see §§15.35-15.38);

(4) The asset must have been held for the required holding period (see §15.39); and

(5) The asset or transaction must not be subject to certain limitations under IRC §707(b)(2), §1239, §1245, or §1249 (see §15.40).

In connection with the requirement enumerated in (5) above, it should be noted that IRC §197 property is treated as property subject to an allowance for depreciation under IRC §167. As a result, on disposition, trade secrets and similar intangible assets that constitute §197 property will be subject to depreciation recapture under IRC §1245, and long-term capital gain treatment will not be available with respect to the depreciation recapture component of that gain. See IRC §197(f)(7) and the discussion in §15.40. In addition, all gain recognized on the sale of such assets will be treated as ordinary income if the sale is between related persons. IRC §1239. With the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub L 108-27, 117 Stat 752), capital gains treatment offers greater benefits than under prior law because the maximum tax rates on capital gains have been reduced for individuals, estates, and trusts. In general, for noncorporate taxpayers in taxable years ending after May 6, 2003, long-term capital gain is subject to a maximum rate of 15 percent (5 percent for individuals in the 10 percent or 15 percent tax brackets). The amount of ordinary income against which a noncorporate taxpayer may deduct a capital loss is the lower of $3000 (or for a married taxpayer filing a separate return, $1500) or the excess of losses of the taxpayer over the taxpayer's capital gain. A capital asset or Section 1231 asset must be held more than 12 months for the gain to be classified as long-term capital gain. IRC §§1222(3), 1223. See §§15.34, 15.39. Other rates and holding periods may apply, depending on the circumstances.

PRACTICE TIP: Because of fundamental changes to the capital gains rules in the last few years, the practitioner should carefully review the relevant Internal Revenue Code sections for any significant capital gain transaction. See IRC §1(h). The changes do not apply to corporations; therefore, capital gains to corporations are taxed at ordinary income rates. Capital gains treatment could be important to a corporation if it has capital losses.

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§15.33 1. Trade Secrets Constitute Property

There appears to be little doubt that information that qualifies as a trade secret under the Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) will constitute property for income tax purposes. See §15.2. However, in some situations it may not be clear whether a payment has been made for a trade secret or for the services that created or contributed to the creation of a trade secret. For example, if an employee or independent contractor is required to transfer any trade secrets to the employer under an employment agreement requiring transfer of inventions made in the course of the employment or contract, the payments are compensation for services and not payment for property. See Treas Reg §1.1235-1(c)(2) (patents). See *William Tiffin Downs* (1968) 49 TC 533, acq 1968-2 Cum Bull 2 (payments to employee working on inventions held ordinary income); *Thomas H. McClain* (1963) 40 TC 841, acq 1964-2 Cum Bull 6 (payments for inventions by employees held capital gain); *Roland Chilton* (1963) 40 TC 552 (same). Elements of both services and property often coexist; the determination is based on all the facts and circumstances.

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§15.34 2. Capital Asset or IRC §1231 Asset

Capital assets are defined by exclusion under IRC §1221 and include any property held by the taxpayer, whether or not connected with a trade or business, except (as relevant here):

- Stock in trade or property held primarily for sale to customers in the ordinary course of a trade or business (IRC §1221(a)(1));
- Certain copyrights and other literary property (*e.g.,* generally, such property if it is held by the person whose efforts created it or a carryover-basis transferee of such person (IRC §1221(a)(3)); or
- Property used in a trade or business of a character subject to depreciation under IRC §167, or real property used in a trade or business (IRC §1221(a)(2)).

Internal Revenue Code §197(f)(7) provides that §197 intangible assets will be treated as property that is of a character subject to depreciation as provided in IRC §167. Consequently, these assets generally will not constitute capital assets under IRC §1221. However, if held for more than 1 year, they may qualify for capital gains treatment as IRC §1231 property.

Copyrights include copyrightable property. Computer software is covered by Title 17 of the U.S. Code, which applies to copyrights. Consequently, even if transferred as a patent or a trade secret, computer software may fall within the exception of IRC §1221(a)(3), taking it out of the definition of "capital assets" if held by the creator. See *David D. Levy*, TC Memo 1992-471. In addition, copyrights and other literary property described in IRC §1221(a)(3) will not qualify as IRC §1231 property. IRC §1231(b)(1)(C).

If a taxpayer is an inventor in the business of inventing and selling trade secrets, such assets would not be §197 intangibles for reasons discussed above. See §15.5. However, such trade secrets would be property held for sale to customers, not capital assets.

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§15.35 3. "Sale or Exchange" Requirement: The "All Substantial Rights" Test

To qualify as a "sale or exchange," a trade secret transfer must transfer "all substantial rights" in the trade secret. *Pickren v U.S.* (5th Cir 1967) 378 F2d 595 (patent tax law test adopted for trade secrets); Rev Rul 64-56, 1964-1 Cum Bull 133, 135; Rev Rul 71-564, 1971-2 Cum Bull 179 (all substantial rights test met by transfer of exclusive right to use a trade secret in all territory of a country). A qualifying transfer may be in the form of a sale or an exclusive license. See §§15.36-15.38. Whatever the form, the most important right is the right to use the trade secret. The next most important right is the right to prevent unauthorized disclosure because it is the secret nature of the information that gives the owner a competitive advantage and thus gives the information particular value. *E.I. du Pont de Nemours & Co. v U.S.* (Ct Cl 1961) 288 F2d 904 (transfer not sale, because no right to prevent unauthorized use transferred). See Treas Reg §1.861-18 (classification of international transactions involving computer software as sales or licenses).

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§15.36 a. Transfers in Form of Sale

A trade secret may be sold; the sale is often referred to as an assignment. If a transfer is in the form of a sale or expressly provides that the owner transfers all rights to the trade secret, a court may find that by implication the right to prevent unauthorized disclosure has been transferred. If a transfer is in the form of a license or is not clearly in the form of a sale, a court is less likely to imply the transfer of that right. Compare *Franklin S. Speicher* (1957) 28 TC 938, acq 1958-2 Cum Bull 7 (agreement assigning "ownership" conveyed all required rights), with *Stalker Corp. v U.S.* (ED Mich 1962) 209 F Supp 30 (no transfer of right to prevent disclosure implied when agreement did not use sale language).

PRACTICE TIP: To assure that a transfer qualifies for capital gains treatment, it should be in the form of a sale and specifically transfer the right to prevent unauthorized disclosure.

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§15.37 b. Exclusive Licenses

An exclusive patent license to "make, use, and vend" a patented product for the full term of the patent constitutes a sale. *Waterman v MacKenzie* (1891) 138 US 252, 34 L Ed 923, 11 S Ct 334. An exclusive trade secret license under which the licensor conveys all rights the licensor ever had and does not retain any rights should also qualify as a sale or exchange. See *Commercial Solvents Corp.* (1964) 42 TC 455, acq 1965-1 Cum Bull 4 (trade secret agreement not treated as sale, because substantial right retained by owner); *Edward C. Myers* (1946) 6 TC 258, acq 1958-2 Cum Bull 6 (exclusive license of invention prior to patent application held to be sale); Rev Rul 64-56, 64-1 Cum Bull 133 (transfer of all substantial rights to trade secrets treated as transfer of property for IRC §351 purposes).

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§15.38 c. Limited Exclusive Licenses

The transferor's retention of any right raises the issue of whether all substantial rights have been transferred. Few cases dealing with such retention are trade secret cases; the practitioner must look to analogous patent law dealing with other intangible assets such as patents, trademarks, franchises, copyrights, and computer software.

An exclusive patent license for one or more countries, while the transferor retains rights in other countries, qualifies as a sale in the licensed countries. The same rule seems to apply for trade secrets. See Treas Reg §1.1235-2(b)(1)(i) (definition of "substantial rights" for patent licenses); *Commercial Solvents Corp.* (1964) 42 TC 455, acq 1965-1 Cum Bull 4 (trade secret license in Japan did not qualify as sale, because agreement neither granted exclusive right to sell in Japan nor transferred right to prevent unauthorized disclosure in Japan); Rev Rul 64-56, 1964-1 Cum Bull 133 (transfers of trade secrets under IRC §351); Rev Rul 71-564, 1971-2 Cum Bull 179 (applies sale or exchange test for transfers of patents to §351 transfers of trade secrets). In *Vision Info. Servs. v Comm'r,* TC Memo 2004-53, the Tax Court rejected the argument of the taxpayer/sublicensor that its transfer of the exclusive right to use the trade secrets and know-how embodied in certain software constituted a sale. The court held that the payments received by the taxpayer were for the licensed use of the software and not a sale.

WARNING: A trade secret owner seeking to sell or exclusively license the trade secret in one or more countries confronts a problem not faced by a patent owner. If the transferee in one country discloses the trade secret to parties not obligated to maintain confidentiality, the value of the trade secret in other countries may be reduced or destroyed. But if the transferor retains some control over disclosure, such as the right to approve third parties to whom disclosure may be made, the retained right may render the transfer a license rather than a sale. See *Eickmeyer v Commissioner* (10th Cir 1978) 580 F2d 395 (retained rights to patent defeated sale treatment). But see *Hooker Chem. & Plastics Corp. v U.S.* (Ct Cl 1979) 591 F2d 652, which permitted sale status for a transfer that included a confidentiality obligation while allowing the transferee to disclose information if necessary.

A patent sale or an exclusive license covering only a portion of a country will not qualify as a sale or exchange of the patent. *Kueneman v Commissioner* (9th Cir 1980) 628 F2d 1196; *Estate of Klein v Commissioner* (7th Cir 1974) 507 F2d 617, cert denied (1975) 421 US 991, 44 L Ed 2d 482, 95 S Ct 1998. Similarly, sales or exclusive licenses of patents for particular fields of use do not qualify as sales or exchanges. *Mros v Commissioner* (9th Cir 1974) 493 F2d 813; *Fawick v Commissioner* (6th Cir 1971) 436 F2d 655. These rules likely apply to trade secrets as well.

To qualify as a sale, an exclusive license must generally extend for the balance of the useful life of the property. Because most trade secrets do not have a determinable limited useful life, however, exclusive trade secret licenses must usually be in perpetuity to qualify. See Rev Rul 71-564, 71-2 Cum Bull 179 (transfer of trade secret, to qualify for IRC §351, must be for entire period trade secret remains secret). If the transferor retains a right to terminate the exclusive license at will, there is generally no sale. *Bell Intercontinental Corp. v U.S.* (Ct Cl 1967) 381 F2d 1004, 1011 (patents); *Taylor-Winfield Corp.* (1971) 57 TC 205, aff'd (6th Cir 1972) 467 F2d 483 (trade secrets). However, security interests in the trade secret and reversionary rights or default on conditions subsequent for security purposes probably do not disqualify an exclusive license from sale treatment. See Treas Reg §1.1235-2(b)(2) (such provisions not substantial rights for patent transfers). But see *Pickren v U.S.* (5th Cir 1967) 378 F2d 595 (no sale when default provisions included in license were found substantial).

If a trade secret owner had previously licensed some rights to the property, will a later sale or exclusive license of all remaining rights qualify as a sale? The Court of Claims held that the latter transaction will qualify as a sale. *Bell Intercontinental Corp. v U.S., supra*. However, in *Blake v Commissioner* (6th Cir 1980) 615 F2d 731, a patent case, the court held that the second transfer did not qualify.

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§15.39 4. Holding Period

To qualify for long-term capital gains treatment on the sale of a capital asset or a §1231 asset, the taxpayer must have held the asset for more than 12 months. See IRC §§1222(3), 1223, 1231(a)(3). The holding period for a patent begins when the taxpayer reduces the invention to practice (*i.e.,* completely conceives the invention and renders drawings sufficient for manufacture). See *Franklin S. Speicher* (1957) 28 TC 938, acq 1958-2 Cum Bull 7; *Edward C. Myers* (1946) 6 TC 258, acq 1958-2 Cum Bull 6. An analogous test may apply to the holding period for trade secrets. The general tacking and holding period rules under IRC §1223 also apply to trade secrets. See IRC §§1222(1)-(4), 1223(1)-(2).

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§15.40 5. Limitation on Capital Gain Treatment; Installment Sale Reporting; Imputed Interest

Before claiming long-term capital gain on the sale of a trade secret, the taxpayer must ascertain whether any limitation on the availability of such treatment applies under other sections of the Internal Revenue Code. The taxpayer should consider the following:

- IRC §707(b)(2): Gain on certain transfers by partner to partnership or between commonly owned partnerships is ordinary income.
- IRC §1239: Gain on sale of depreciable property between specified related parties is ordinary income.
- IRC §1245: Recapture of gain is ordinary income in certain circumstances.
- IRC §1249: Gain on sale to a controlled foreign corporation is ordinary income.

The determination of whether a trade secret is depreciable property under IRC §1239 is made at the time of sale. *Robert M. Graham* (1981) 76 TC 853. Any trade secret that is classified as a §197 intangible will be considered depreciable property for purposes of IRC §§1239 and 1245. See IRC §197(f)(3).

In general, if a disposition of property, including certain trade secrets, qualifies as an installment sale, the installment method of reporting allows a taxpayer to defer recognition of the gain on the disposition until the taxpayer actually receives the money. See IRC §453. However, two important exceptions to the application of the installment method may apply to sales of trade secrets. First, the installment method does not apply to any depreciation recapture under Section 1245. See IRC §453(i). Second, the installment method is not ordinarily available with respect to sales of depreciable property, including §197 property, to a related person as defined in IRC §1239(b) or §707(b)(1). See IRC §§197(f)(3), 453(g)(1)(A).

In most instances, an installment sale of trade secrets will be subject to the imputed interest rules of IRC §483 or §1274, meaning that if the parties fail to provide for adequate interest in the installment sale contract, interest at the minimum required rate will be imputed. (Depending on the magnitude of the transaction, minimum interest is required either under §1274 or §483. In general, §1274 will apply unless the total payment due and received for the sale is $250,000 or less.) The minimum interest that must be charged to avoid imputed interest is called the Applicable Federal Rate (or AFR) and is determined by tables promulgated on a monthly basis by the IRS based on the rate of certain government obligations. See IRC §1274(d).

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§15.41 6. Limitation on Losses on Transfer of Acquired Trade Secrets Subject to IRC §197

If IRC §197 intangibles obtained as part of an acquisition of a trade or business are disposed of or become worthless, the taxpayer may not recognize any loss until disposition of *all* §197 intangibles acquired in the same acquisition. IRC §197(f)(1). See §15.9.

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§15.42 C. Taxation of License Payments Received by Licensor

Exploitation of trade secrets short of sale is usually accomplished by (1) nonexclusive license to one or more producers who will use the trade secret to produce goods or deliver services using the trade secret or (2) nonexclusive licenses to many end-users, permitting them to use the trade secrets. For example, most commercial computer software contains trade secrets. Software copies are usually licensed to end-users under nonexclusive licenses. See §§15.10-15.12 for discussion of licensee's tax treatment of license payments. See chap 16 for discussion of computer technology.

Subject to the potential application of the personal holding company (PHC) tax discussed below, the tax treatment usually presents few tax issues to a licensor of intellectual property. The payments are ordinary income to the licensor, and the timing of income recognition is set by the general rules of tax accounting. Therefore, a cash-basis taxpayer generally recognizes income when the payments are made, and an accrual-basis taxpayer recognizes income when the "all events test" is met with respect to any payment (but not later than when the payment is actually received). For discussion of the "all events test," see Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts (3d ed 2005).

A licensor receiving a substantial portion of its gross income in the form of royalties may be subject to the personal holding company (PHC) tax. The PHC tax applies only to certain closely held non-S electing corporations. Section 542(a) of the Internal Revenue Code defines the term "personal holding company" to mean any corporation (other than an S corporation) that meets the following two criteria:

(1) At least 60 percent of its adjusted ordinary gross income must be personal holding company income; and

(2) At any time during the last half of the corporation's taxable year, more than 50 percent of the value of its stock must be owned directly or indirectly by or for not more than 5 individuals.

An analysis of the PHC tax is beyond the scope of this discussion. Accordingly, the practitioner should consult other sources for a more complete analysis or consult a tax specialist. See Cal Rules of Prof Cond 3-110.

Corporations often license or assign trade secrets to related corporations for commercial exploitation, the most common example of which is the practice of granting rights to foreign affiliate companies for overseas commercialization. Setting a low price or license fee for the trade secret would often have the effect of shifting income from the United States parent to the foreign affiliate. To deal with this and other methods of income shifting between related organizations, IRC §482 permits the IRS to reallocate gross income, deductions, and credits when necessary to prevent evasion of taxed or to clearly reflect income of any of the organizations. Thus, when two or more related entities engage in trade secrets transactions, the practitioner must be alert to the possibility of a reallocation of income or deductions, particularly if the license fee or purchase price is low in relation to the income generated by the trade secret.

If the license is exclusive and is essentially a transfer of substantially all of the transferor's rights, it is equivalent to a sale and is treated as such for tax purposes. Royalty and license fees for such a license can be treated as income from the transfer of property and may be given capital gains treatment. See §§15.32-15.41.

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Source: Business Law/Trade Secrets Practice in California/15 Taxation of Trade Secrets/§15.43 D. Tax Consequences of Internal Use

§15.43 D. Tax Consequences of Internal Use

The internal use of trade secrets by the taxpayer generally has no independent tax consequences.

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V. OTHER DISPOSITIONS OF TRADE SECRETS

§15.44 A. Abandonment and Worthlessness

The concepts of abandonment and worthlessness as events for the recognition of loss are often intertwined and confused. In general, IRC §165 controls for losses from abandonment or worthlessness of nondepreciable property, and IRC §167 controls for losses from abandonment or worthlessness of depreciable property. Treas Reg §§1.165-2(b)-(c), 1.167(a)-8. Trade secrets may be depreciable or nondepreciable property, depending on whether they have an ascertainable useful life.

As a general rule, a deduction for nondepreciable property is allowed under §165 for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." IRC §165(a). Such losses include those "arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein." Treas Reg §1.165-2(a).

Section 167 provides deductions for the wear and tear or exhaustion of intangible depreciable property. (Tangible depreciable property is covered in IRC §168.) Loss may be recognized under §167 when the asset is "retired," *i.e.,* permanently withdrawn "from use in the trade or business or in the production of income." Treas Reg §1.167(a)-8(a)(1). Withdrawal may be by actual physical abandonment or by permanent withdrawal from productive use. In appropriate circumstances, withdrawal from use may result not only from actual disposal but also by transferring the asset to a supplies or scrap account. "[T]he intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition." Treas Reg §1.167(a)-8(a)(4).

Both §165 and §167 include the concept of permanently taking the asset out of use in the business. Although the §165 regulations seem to impose a requirement not imposed under the §167 regulations (*i.e.*, that the asset suddenly become worthless) the courts have allowed abandonment losses of nondepreciable property under §165 without requiring worthlessness. See *Massey-Ferguson, Inc*. (1972) 59 TC 220, acq 1973-2 Cum Bull 2.

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§15.45 1. Abandonment

Whether abandonment has taken place depends on all the facts and circumstances; it is impossible to reduce the cases to rules or formulas. The courts often state, however, that the taxpayer must have both the *intention* to abandon the property, coupled with an *act* of abandonment. *Boston Elevated Ry.* (1951) 16 TC 1084, aff'd (1st Cir 1952) 196 F2d 923, 52-1 USTC ¶9336, 41 AFTR 1353.

The taxpayer in abandonment cases must show that the property was permanently retired or disposed of, rather than just temporarily withdrawn from use. This showing is particularly difficult for intangible assets, such as trade secrets, because (1) intangible assets cannot be *physically* abandoned and (2) nonuse, without more, does not preclude future use. It is also difficult to prove that the intangible asset is separable from ongoing activities.

PRACTICE TIP: Unless an entire business is abandoned, the business operation should be altered, if possible, so that the trade secret can no longer be a factor in producing income. *Massey-Ferguson, Inc.* (1972) 59 TC 220, acq 1973-2 Cum Bull 2 (some intangibles abandoned with move to new location). See also *Parmelee Transp. Co. v U.S.* (Ct Cl 1965) 351 F2d 619 (goodwill abandoned when entire line of business terminated); *Metropolitan Laundry Co. v U.S.* (ND Cal 1951) 100 F Supp 803 (customer routes abandoned when San Francisco laundry closed even though taxpayer kept Oakland routes).

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§15.46 2. Worthlessness

A trade secret may become worthless on a specific event, such as general public disclosure or issuance of a patent that discloses the secret. More often, however, the value of the trade secret slowly succumbs to technological advances or market changes. See, *e.g., Liquid Paper Corp. v U.S.* (Cl Ct 1983) 83-1 USTC ¶9305, 51 AFTR2d 1166 (taxpayer proved that Liquid Paper would become obsolete because of self-correcting typewriters and word processors).

A loss is deductible on the worthlessness of nondepreciable property under IRC §165. Rev Rul 54-581, 1854-2 Cum Bull 112; *Alice v Gordon* (1942) 46 BTA 1201, aff'd (4th Cir 1943) 134 F2d 685, acq 1951-1 Cum Bull 2 (real property worthless, and loss allowed even though title retained). The deduction must be taken in the year in which the property became worthless; it may not be taken in a later year, even if the taxpayer abandons the property in that year. Rev Rul 54-581.

A loss is allowed for depreciable property permanently retired from use under §167 if the retirement is an "abnormal retirement." Treas Reg §1.167(a)-8(a)(3)(i). "Abnormal retirement" includes retirement because of an asset's sudden loss of its usefulness "as the result of extraordinary obsolescence." Treas Reg §1.167(a)-8(b).

There is doubt in the Ninth Circuit about whether a taxpayer may claim a loss of a nondepreciable asset without an act of abandonment. See *A.J. Indus. v U.S.* (9th Cir 1974) 503 F2d 660. The *A.J. Industries* court held that under similar pre-§165 regulations, an act of abandonment was required and the proper year of the loss was the year in which the act of abandonment occurred, not the year in which the asset became worthless. 503 F2d at 668. The court distinguished Rev Rul 54-581, holding that a taxpayer may not delay an act of abandonment to a later year. 503 F2d at 672. Thus, the greatest problem for the taxpayer is often to determine the tax year in which the trade secret will actually become worthless in order to abandon the asset in that year.

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§15.47 B. Transfers to Legal Entities

Before enactment of the Tax Reform Act of 1986 (Pub L 99-514, 100 Stat 2085), a trade secret developer often transferred its trade secrets to one or more C corporations owned by the developer. This practice is now less likely to result in tax benefits, and is thus less common, for two reasons. First, the highest marginal tax rate for C corporations is close to the highest individual rate. Second, the Tax Reform Act of 1986 repealed the *General Utilities* doctrine, which enabled the taxpayer to avoid the double corporate tax on appreciated assets in a corporate liquidation. See *General Utils. & Operating Co. v Helvering* (1935) 296 US 200, 80 L Ed 154, 56 S Ct 185.

Developers may still wish to transfer trade secrets to a corporation or other legal entity for business reasons, such as limitation of liability. If a corporation is the preferred choice of entity, the developer may want to consider making an S election because income and losses of an S corporation are allocated directly to the shareholders in a manner similar to partnerships. IRC §1366. In general, this avoids the double corporate tax applicable to C corporations. However, unlike a partnership, an S corporation is required to recognize gain if it distributes appreciated property to its shareholders. IRC 311(b). Consequently, the developer may also want to consider transferring trade secrets to a limited liability company or a limited partnership. In general, a limited liability company is treated like a partnership for federal income tax purposes.

An important consideration in transferring a trade secret to a corporation, limited liability company, or limited partnership is whether the contribution will constitute a tax-free exchange of the trade secret for an ownership interest in the entity. A transfer of trade secrets to a corporation in exchange for corporate stock may qualify for tax-free exchange treatment under IRC §351. Failure to qualify as such a tax-free exchange could result in a large taxable gain on exchange because the developer often has a low basis in the trade secret. The most important issue under §351 is whether the trade secret rights constitute "property." The IRS has taken the position that if "all substantial rights" to the trade secret are transferred, the transfer constitutes a transfer of "property." Rev Rul 64-56, 1964-1 Cum Bull 133; Rev Rul 71-564, 1971-2 Cum Bull 179 (applies patent "all substantial rights" test to trade secrets; must be for full life of trade secret). At least one court has taken a less restrictive approach in analyzing a patent license. In *E.I. Du Pont de Nemours & Co. v U.S.* (Ct Cl 1973) 471 F2d 1211, Du Pont had granted a *nonexclusive* license to French patents for the remaining life of the patents. The court found that the license did not need to qualify as a sale for capital gain purposes and that it was sufficient to constitute property under §351. This issue is important in joint ventures because the transferor often wants to retain some right to get the trade secret back on termination of the joint venture.

NOTE: See IRC §721 for nonrecognition of gain or loss on contribution of property to a partnership (or limited liability company) in exchange for an interest in the partnership (or limited liability company).

The transferor often agrees to perform services for the corporation related to the trade secret, such as instructing the transferee in the use of the trade secret. If the services are only ancillary and subsidiary to the trade secret transfer, the entire transfer is tax free under IRC §351. See Rev Rul 64-56, 1964-1 Cum Bull 133. If the services are more extensive, however, a portion of the stock received is treated as compensation for services and is taxable as ordinary income. See *Arthur C. Ruge* (1956) 26 TC 138, acq 1958-2 Cum Bull 7 (patent sale).

NOTE: Because of the impact of state taxes, counsel may want to suggest that the client consider incorporating in a state with more favorable tax treatment than California, particularly if the income is generated outside of California and distributed to non-California entities. An offshore tax haven may even be appropriate if significant income is generated from outside the United States and does not subsequently have to enter this country.

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§15.48 C. Transfer on Death

If a trade secret owner sells or licenses the trade secret for royalty payments but dies while some payments remain unpaid, the royalty payments are income in respect of a decedent if the transfer constitutes a sale. The present value of the future payments is then includable in the decedent's estate and subject to possible estate tax, and the beneficiaries are subject to income tax on the payments. IRC §691. If the transfer constitutes a license and not a sale, the royalties are not income in respect of a decedent and are taxable as income to the recipient. Rev Rul 60-227, 1960-1 Cum Bull 262 (patent case).

The character of the income received by the beneficiaries, *i.e.,* ordinary income or capital gain, is the same as the character of the income in the hands of the decedent. There is no step-up in basis on the items constituting income in respect of a decedent, but the beneficiary is entitled to a deduction for the prorata portion of any estate tax attributable to the income or gain received by the beneficiary. IRC §691(c); Rev Rul 57-544, 1957-2 Cum Bull 361 (copyright case).

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§15.49 D. Transfer by Gift

An anticipatory assignment of income occurs when a donor attempts to transfer the right to receive income without transferring the source of the income. If a trade secret owner sells or licenses the trade secret in return for future royalty payments and the owner later gives the contract of sale or license to a third party, the gift may constitute an anticipatory assignment of income. If the transfer is such an assignment, the donor is liable for income tax on the future payments as well as gift tax on the gift. Two cases have held that assignments of exclusive patent licenses did not constitute anticipatory assignments of income. *Heim v Fitzpatrick* (2d Cir 1959) 262 F2d 887; *Franklin A. Reece* (1955) 24 TC 187, aff'd (1st Cir 1956) 233 F2d 30, acq 1960-2 Cum Bull 6. To avoid the problem of anticipatory assignment of income, the trade secret owner should transfer the interest in the trade secret before the sale or license, if possible.

WARNING: Gift transfers raise substantial estate planning issues and should be reviewed by practitioners familiar with estate planning.

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§15.50 E. Transfer on Liquidation or Sale of Business

Before 2003, whenever a corporation liquidated or its stock was sold, the collapsible corporation rules under IRC §341 were potentially applicable. Under those rules, if the corporation was a collapsible corporation, any gain was generally taxed as ordinary income.

The collapsible corporation rules were repealed for tax years beginning after December 31, 2002. However, the repeal is temporary, and the collapsible corporation rules are currently scheduled to become applicable again in 2009. The collapsible corporation rules are quite intricate. They were enacted to prevent taxpayers from contributing property to a corporation that would generate ordinary income on sale in their hands, in order to later sell the stock or liquidate the corporation and receive capital gains treatment while also avoiding corporate level gain.

If a trade secret is owned by a partnership or limited liability company and an interest in the partnership or limited liability company is sold or liquidated, counsel should consider whether the trade secret constitutes a substantially appreciated inventory item (see IRC §751(d)) or whether an exclusive license of the trade secret constitutes an unrealized receivable (see IRC §751(c)). The portion of the proceeds of the sale or liquidation allocable to substantially appreciated inventory of unrealized receivables generates ordinary income rather than capital gain.

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§15.51 VI. TRADE SECRETS VALUATION

Frequently, a critical factor in determining the income tax, gift tax, and estate tax consequences of a trade secret transfer is the valuation of the trade secret. In all instances, the burden of proving valuation is on the taxpayer. See *Estate of Gabriel Pascal,* TC Memo 1963-336.

Although there is no precise formula for valuation in the Internal Revenue Code or the Regulations, fair market value is defined as (Treas Reg §20.2031-1(b))

the price at which the property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or to sell and both having [a] reasonable knowledge of relevant facts.

The following are some of the factors that courts consider in valuing trade secrets:

- Anticipated royalties (*e.g.,* if the transferor is to receive guaranteed minimum royalties for a fixed number of years, the right to receive these royalties could be valued by discounting the right to receive periodic fixed royalty payments to its present value, in accordance with applicable discount tables);
- The advancing state of the art in the field of the trade secret;
- Market conditions for products produced through use or application of the trade secret; and
- The opinions of experts.

A properly drafted buy-sell agreement between trade secret co-owners (*e.g.,* one providing adequate restrictions on transferability during life coupled with an enforceable right to purchase at a fixed price at death) can be effective in fixing the value of the trade secret for estate-tax purposes in much the same manner that a properly drafted buy-sell agreement covering partnership interests or stock in a closely held corporation can be used in valuing a partnership or corporation.

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§15.52 VII. TAX CONSEQUENCES OF TRADE SECRET LITIGATION

Tax treatment of a settlement or judgment generally depends on the origin of the underlying claim that formed the basis for the lawsuit. The recovery is taxed in the same way as the item for which it is intended as a substitute. See *Raytheon Prods. Corp. v Commissioner* (1st Cir 1944) 144 F2d 110, 113 (recovery was compensation for injury to capital asset (goodwill) on basis of pleadings). The basic damages in trade secret cases are for lost profits. Damages for lost profits, as well as punitive damages, are taxable as ordinary income. See *Commissioner v Glenshaw Glass Co*. (1955) 348 US 426, 99 L Ed 483, 75 S Ct 473. See also *W.W. Sly Mfg. Co.* (1931) 24 BTA 65 (patent infringement damages). Damages for injuries to a capital asset, on the other hand, qualify for capital gains treatment. *Durkee v Commissioner* (6th Cir 1947) 162 F2d 184.

PRACTICE TIP: The complaint in the lawsuit is one of the principal factors that courts consider in deciding the taxability of litigation or settlement proceeds. Therefore, counsel should carefully draft the allegations and claims for damages with the ultimate tax consequences in mind. For example, if damages are claimed in excess of reasonable royalties for past wrongful use, the complaint could allege that the excess is intended to compensate the plaintiff for the current and prospective injury to the trade secret, rather than for lost profits or punitive damages. See Anno, *Damages for Business Tort as Subject to Federal Income Tax*, 99 L Ed 491 (1954).

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16

Protecting Computer Technology

Louis J. Knobbe
Ronald J. Schoenbaum

I. INTRODUCTION §16.1

II. TRADE SECRET PROTECTION §16.2
- A. Form: Confidential Notice and Copyright Notice for Software §16.3
- B. Sample Software License Agreement
  1. Form: Introduction §16.4
  2. Form: Definitions §16.5
  3. Form: Term of License §16.6
  4. Form: Nonexclusive License §16.7
  5. Form: Confidential Information §16.8
  6. Form: Copies §16.9
  7. Form: Security §16.10
  8. Form: License Fee §16.11
  9. Form: Termination §16.12
  10. Form: Title to Licensed Program §16.13
  11. Form: Disclaimer of Warranty §16.14
  12. Form: Assignment and Sublicensing §16.15
  13. Form: Remedies §16.16
  14. Form: Independent Contractor Status §16.17
  15. Form: Governing Law §16.18
  16. Form: Binding Effect §16.19
  17. Form: Export Controls §16.19A
  18. Form: Government Ownership §16.19B
  19. Form: Notices §16.20
  20. Form: Waiver of Breach §16.21
  21. Form: Attorney Fees and Costs §16.22
  22. Form: Severability §16.23
  23. Form: Headings §16.24
  24. Form: Entire Agreement §16.25
  25. Form: Concluding Clause and Signatures §16.26
- C. Preemption of Trade Secret Rights §16.27
- D. Proof Requirements §16.28

III. TRADE SECRET PROTECTION FOR MASS-MARKETED SOFTWARE §16.29
- A. By Use of Shrink-Wrap Licenses §16.30
- B. Using Shrink-Wrap License §16.31
  1. Form: Introduction §16.32
  2. Form: Confidentiality §16.33
  3. Form: License Grant §16.34
  4. Form: Term §16.35
  5. Form: Limited Warranty §16.36
  6. Form: Limitation of Remedies §16.37
  7. Form: Sublicensing, Assignment, and Transfer §16.38
  8. Form: Governing Law §16.39
  9. Form: Acceptance of License §16.40
- C. Click-Wrap and Browse-Wrap Licenses §16.41
- D. Additional Strategies for Maintaining Trade Secrets in Mass-Marketed Software §16.42
- E. Internet Publication of Trade Secrets §16.42A

IV. PROTECTION UNDER FEDERAL COPYRIGHT LAW
- A. Computer Programs §16.43
- B. Preserving Copyright Protection §16.44

C. Rights Against Infringers Under Copyright Law §16.45
D. Copyright Registration for Trade Secret Software §16.46
E. Contributory Infringement §16.46A

V. LIMITATIONS ON SCOPE OF COPYRIGHT PROTECTION
A. Statutory Limitations on Copyright Protection §16.47
B. Copying to Reverse Engineer §16.48
C. Protection for GUIs §16.49
D. Limitations on Protection of Object Code §16.50

VI. OWNERSHIP OF COPYRIGHTED SOFTWARE §16.51

VII. CONSULTANT'S COPYRIGHT ASSIGNMENT
A. Form: Introduction §16.52
B. Form: Agreement to Create Software §16.53
C. Form: Consultant's Warranties §16.54
D. Form: Confidentiality §16.55
E. Form: Consideration §16.56
F. Form: Ownership of Copyright §16.56
G. Form: Assignment of Copyright §16.58
H. Form: Signatures §16.59

VIII. PROTECTION UNDER DIGITAL MILLENNIUM COPYRIGHT ACT §16.59A

IX. PROTECTION UNDER THE COMPUTER ABUSE AND FRAUD ACT §16.59B

X. PATENT PROTECTION FOR COMPUTER TECHNOLOGY
A. Advantages and Disadvantages of Patent Protection §16.60
B. Sufficiency of Disclosure §16.61
C. Strategies for Mitigating Effect of 35 USC §112 Disclosure Requirements §16.62

XI. PATENTABLE SUBJECT MATTER
A. Interpretation of 35 USC §101 §16.63
B. Patent Office Position §16.64
C. Invention Must Have Some Practical Application §16.65
D. Doctrine of Obviousness §16.65A
E. Claims Directed to Computer Processes §16.66

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§16.1 I. INTRODUCTION

It is a rare business client who is not occasionally faced with the need to protect computer technology. Almost every home and small business either has a personal computer or is a potential customer for one, and the capability of these computers to handle complex, high-bandwidth tasks (such as the display and processing of full motion video) continues to grow at a high rate. In addition, businesses and individuals are rapidly becoming aware of the utility of the Internet and of private on-line services for handling communications-related tasks (*e.g.*, e-mail, voicemail, video conferences), information dissemination tasks (*e.g.*, advertising, online product support), and electronic commerce tasks (*e.g.*, software distribution, on-line banking, on-line shopping). As these trends continue, the production and marketing of software will continue to increase tremendously, as will the demand for practitioners who are knowledgeable about the various forms of protection for computer-related inventions.

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§16.2 II. TRADE SECRET PROTECTION

Trade secret protection may be available for all forms of computer technology, including hardware, firmware, and software. Thus, in *Cybertek Computer Prods. v Whitfield* (LA Super Ct 1977) 203 USPQ 1020, the superior court held that, although general computer software concepts are not per se protectable as trade secrets, their particular combination of concepts may be. The court stated that "while some of the concepts set forth are … general concepts not susceptible of protection, … the entire bundle or combination of these concepts as developed and utilized by plaintiff … do constitute the trade secrets which are protectable under the circumstances." 203 USPQ at 1024. See also *Tradescape.Com v Shivaram* (SD NY 1999) 77 F Supp 2d 408 (computer software may be subject of trade secret protection).

Several issues arising from claiming a combination of information as a trade secret are illustrated by *Architectronics, Inc. v Control Sys.* (SD NY 1996) 935 F Supp 425 (applying Minnesota version of Uniform Act). There, the defendant asked for summary judgment of noninfringement based on extensive expert testimony and trade articles that allegedly showed that each of several discrete aspects of a computer program were generally known basic computer graphics principles. Summary judgment was denied because fact issues remained on whether the combination of information was generally known, and on whether each disclosure was inferior in performance to the claimed trade secret. However, the court also outlined the plaintiff's burden of proving at trial that any protection resided in the implementation of the ideas rather than the generally known ideas themselves and that the defendant actually used the combination. Damages could be limited if the secret represented only a small improvement or if rapidly evolving technology rendered the secrets obsolete.

To qualify for the protections of trade secret laws, it is crucial that the holder take the necessary steps that are "reasonable under the circumstances" to keep the technology secret. The information cannot be published, nor can it be distributed to anyone who has no obligation of confidence to the owner. See *Integrated Cash Mgmt. Servs., Inc. v Digital Transactions, Inc.* (SD NY 1989) 732 F Supp 370; *Warrington Assoc. v Real-Time Eng'g Sys.* (ND Ill 1981) 522 F Supp 367. See also *Rivendell Forest Prods. v Georgia-Pacific Corp.* (10th Cir 1994) 28 F3d 1042 (whether computer program was trade secret was triable issue of fact). The *Rivendell* court stressed that novelty is not required for trade secret protection; a trade secret may consist of a combination of elements that are all in the public domain.

Even if use of the object code is unrestricted, protecting the confidentiality of the source code may protect the trade secrets in it. *Q-Co Indus. v Hoffman* (SD NY 1985) 625 F Supp 608. Similarly, disclosure of portions of a computer program does not necessarily disclose trade secrets in the structure and organization of the program. *Softel, Inc. v Dragon Med. & Scientific Communications* (2d Cir 1997) 118 F3d 955 (applying New York common law).

All other pertinent recommendations in chap 4 should be followed. See, *e.g.*, *Jostens, Inc. v National Computer Sys.* (Minn 1982) 318 NW2d 691 on the availability of trade secret protection for a computer system. If possible, trade secret information given to a third party should be communicated only under a written confidential disclosure agreement. See §16.42 for alternative procedures for mass-marketed software. In addition, software information should be communicated only under the terms of a written license agreement, if at all possible. See §§16.4-16.26 for a sample license agreement.

The vital importance of a written agreement is exemplified by *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, 758, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442, in which the court held that an "implied, unlimited license" was created when the independent contractor Gagnon delivered and installed custom software on Asset's computers with no expressed intent that continued use of the software was prohibited after Asset terminated Gagnon's services. The court further ruled that Asset could not have misappropriated Gagnon's trade secrets, because Asset "was entitled to use and modify the source code; the license included access to any trade secret embodied therein." 542 F3d at 758.

All software copies should contain both a confidential notice and a copyright notice, such as the one in §16.3. Because copyright protection does not preempt trade secret rights, providing for both types of protection allows the owner of the information to pursue copyright infringement remedies (including statutory damages) as well as trade

secret misappropriation remedies for wrongful use or disclosure of the information.

PRACTICE TIP: Consider using both copyright protection (see §§16.43-16.50) and patent protection (see §§16.60-16.66).

Customer lists, of course, are often the subject of trade secret litigation. The owners of such lists have an additional incentive to maintain the secrecy of these lists. Under CC §1798.29, the owner of a computerized customer list must notify any customer who is a California resident of a security breach in which "personal information" was or was reasonably believed to have been acquired by an unauthorized person. "Personal information" is defined as the individual's first name or first initial and last name in combination with a social security number, a driver's license number, California identification card number, credit or debit card access information, medical information, or health insurance information, when either the name or data elements are not encrypted. CC §1798.29(e)(1)-(5). For further discussion of these requirements, see Internet Law and Practice in California §§9.24-9.26 (Cal CEB 2004).

PRACTICE TIP: Encrypt all computerized personal data.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.3 A. Form: Confidential Notice and Copyright Notice for Software

§16.3 A. Form: Confidential Notice and Copyright Notice for Software

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

16.3-1 Confidential notice and copyright notice for software

This computer program is a proprietary trade secret of _ _[*name of company*]_ _. Possession and use of this program shall be strictly in accordance with a license agreement between user and _ _[*name of company*]_ _, and receipt or possession of this program does not convey any rights to divulge, reproduce, or allow others to use it without specific written authorization of _ _[*name of company*]_ _.

Copyright © _ _[*year*]_ _, an unpublished work by _ _[*name of company*]_ _. All rights reserved.

Comment: This notice should be used in the manner discussed in §§16.44, 16.46. See forms 6.8-1 through 6.8-3 for alternative forms of copyright notice.

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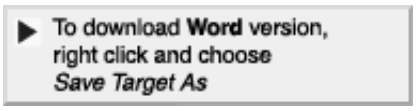
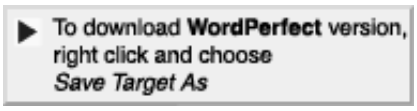
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/ B. Sample Software License Agreement/§16.4 1. Form: Introduction

B. Sample Software License Agreement

§16.4 1. Form: Introduction





SOFTWARE LICENSE AGREEMENT

BY THIS AGREEMENT, as of _ _[*date*]_ _, _ _[*name of licensor*]_ _ (referred to as "Licensor") agrees to grant, and _ _[*name of licensee*]_ _ (referred to as "Licensee") agrees to accept, on the following terms and conditions, for valuable consideration described in Paragraph 7 and Schedule A of this Agreement, a nonexclusive license to use each Licensed Program as set forth in this Agreement (including any schedules, exhibits, or appendixes).

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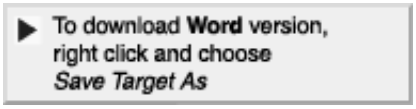
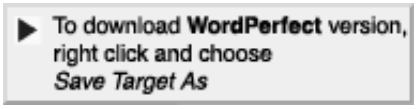
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.5 2. Form: Definitions

§16.5 2. Form: Definitions





1. *Definitions.* The following terms are defined for the purposes of this Agreement as follows:

a. "License Fee" means that fee, as defined in Paragraph 7, paid for the use of the Licensed Program.

b. "Licensed Program" means each program enumerated in Schedule A attached to this Agreement.

c. "Use" means (i) copying any portion of any Licensed Program only into Licensee's computer for processing, (ii) consulting any Licensed Program in printed form in support of this processing, and (iii) copying for archival or emergency restart purposes.

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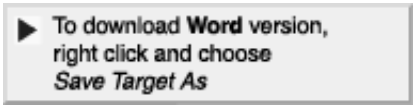
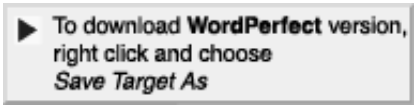
§16.6 3. Form: Term of License





2. *Term.* This Agreement is effective as of the date stated above. This Agreement and any license granted under it may be terminated by Licensor if Licensee fails to comply with any of its terms and conditions. Otherwise, the license granted to each Licensed Program remains in force until Licensee stops using that Licensed Program or until Licensor terminates this Agreement or any license because of Licensee's failure to comply with any of the terms and conditions of this Agreement.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.7 4. Form: Nonexclusive License

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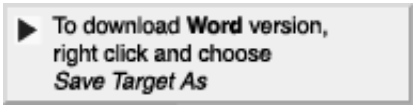

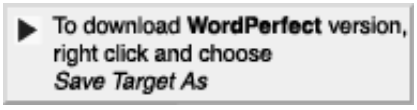

3. *Nonexclusive License.* Licensor hereby grants to Licensee a nonexclusive license to use the Licensed Program only on the premises of Licensee at _ _[*address of licensee*]_ _. This Agreement does not give Licensee a license or right to distribute or sell the Licensed Program or any modification of it or to use the Licensed Program or any portion of it for assistance in the preparation for sale or distribution of any computer program. This Agreement does not grant a license or right to use the Licensed Program on any computer or computer system other than Licensee's or to use the Licensed Program at any other location.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.8 5. Form: Confidential Information

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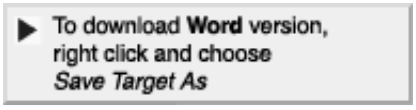

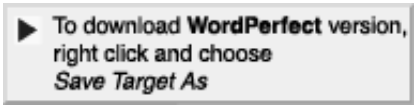

4. *Confidential Information*. Licensee shall treat the Licensed Programs as trade secrets and proprietary know-how belonging to Licensor that is being made available to Licensee in confidence solely on the basis of a confidential relationship between Licensor and Licensee. Licensee agrees to hold the Licensed Programs in trust and agrees not to use, print, copy, provide, or otherwise make available, in whole or in part, any portion of a Licensed Program or modifications of it or related material except in accordance with this Agreement. Licensee agrees that it will not reconstruct in whole or in part the object code, source code, or algorithms in the Licensed Programs. Licensee agrees to treat the confidentiality of the Licensed Programs with reasonable care, not less than that with which it treats its own confidential or proprietary information.

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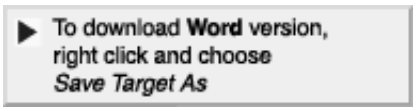
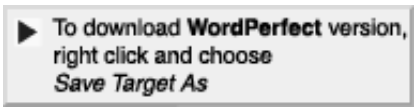
§16.9 6. Form: Copies





5. *Copies.*

a. Licensee shall make only those copies of the supplied software and documentation needed for backup or archival purposes. No more than _ _[*number*]_ _ printed copies and _ _[*number*]_ _ machine-readable copies shall be in existence at any one time _ _[*without the prior written consent of Licensor*]_ _.

b. Any copies of the Licensed Program are the property of the Licensor.

c. Licensee agrees to reproduce the following notice on all copies of the Licensed Program in any form:

> **This computer program is a proprietary trade secret of Licensor. Possession and use of this program must conform strictly to the license agreement between user and Licensor, and receipt or possession does not convey any rights to divulge, reproduce, or allow others to use this program without Licensor's specific written authorization.**

Copyright © _ _[*year*]_ _, an unpublished work by _ _[*name of company*]_ _. All rights reserved.

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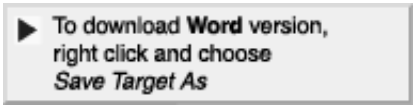
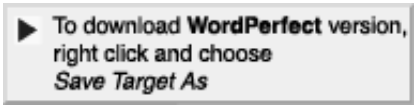
§16.10 7. Form: Security





6. *Security.* Licensee agrees not to provide or otherwise make available any Licensed Programs in any form to anyone other than permanent employees of the Licensee who are obligated by a written, executed agreement to maintain in confidence third party trade secrets and know-how, licensed or otherwise, in the possession of Licensee, without prior written consent of an officer of Licensor. Licensee agrees to advise all employees having access to the Licensed Program of the terms and conditions of this License, including the proprietary and confidential nature of the Licensed Program.

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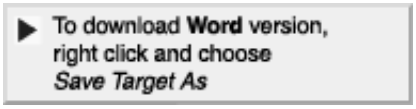
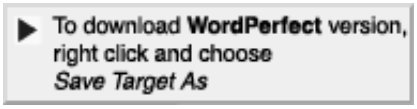
§16.11 8. Form: License Fee





7. *License Fee.*

a. As compensation for the License granted by this Agreement, Licensee shall pay to Licensor the license fee or fees stated in Schedule A, attached ("License Fee").

b. The License Fee specified in Schedule A is exclusive of any tariff, duty, or tax, however designated, levied or based, including, without limitation, any sales or use taxes in any state and local privilege or excise taxes based on gross revenue, on (i) either this Agreement, the Licensed Program and/or Licensee's use of it, or (ii) any materials or supplies agreed to be furnished by Licensor under this Agreement, Licensee agrees to pay and be responsible for any and all of those taxes and levies (exclusive, however, of taxes based on the Licensor's net income). Licensor shall have the right, but shall have no obligation, to pay any of those taxes or levies directly, in which event Licensee shall reimburse Licensor, on demand, the amount so paid by Licensor. In no event does the exercise or nonexercise by Licensor of the foregoing right relieve Licensee of its obligations under this Agreement or impose any liability whatsoever on Licensor.

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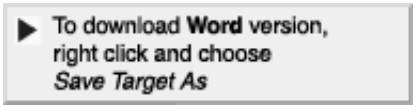
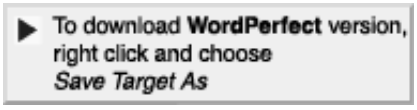
§16.12 9. Form: Termination





8. *Termination.*

a. *Grounds for Termination.* Licensor shall have the right to terminate this License immediately if:

(i) Licensee fails to perform any obligation required of Licensee under this License, and fails to cure such breach within 10 days of written notice of such breach;

(ii) Licensee makes any assignment of its business for the benefit of creditors;

(iii) A receiver, trustee in bankruptcy, or similar officer is appointed to take charge of all or part of Licensee's property;

(iv) Licensee files a petition in bankruptcy, or an involuntary petition in bankruptcy is filed against it that is not dismissed within 60 days; or

(v) Licensee is adjudged bankrupt.

b. *Effect of Termination.*

(i) Within 30 days after Licensee has discontinued the use of any Licensed Programs or within 5 days after Licensor has terminated any license because of Licensee's failure to comply with any terms of this Agreement, Licensee will certify, in writing, to Licensor that the original and all copies, in whole or in part, in any form, including partial copies and modifications, of the discontinued or terminated Licensed Program or Programs have been transmitted to Licensor or have been destroyed.

(ii) In the event of a termination by Licensor, Licensor or owner shall have the right to repossess all Licensed Programs and modifications of them and related materials and shall have the right to enter on Licensee's premises for the purpose of repossession, and Licensee hereby consents to that entry.

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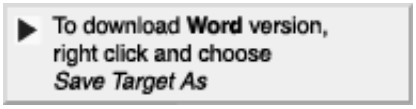
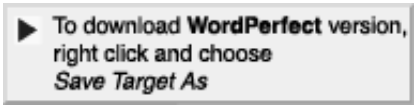
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.13 10. Form: Title to Licensed Program

§16.13 10. Form: Title to Licensed Program





9. *Title.* Licensor retains title to and ownership of the Licensed Program, including all portions and all copies of it at all times.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.14 11. Form: Disclaimer of Warranty

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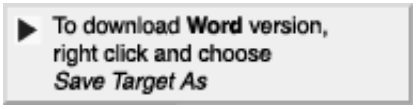

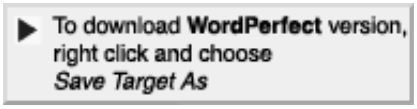

10. *DISCLAIMER OF WARRANTY.*

THE LICENSED PROGRAM IS PROVIDED "AS IS." LICENSOR DISCLAIMS ALL WARRANTIES WITH REGARD TO THE SOFTWARE LICENSED UNDER THIS AGREEMENT, INCLUDING, BUT NOT LIMITED TO, ALL WARRANTIES, EXPRESS OR IMPLIED, OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. REGARDLESS OF ANY OTHER PROVISION OF THIS AGREEMENT, LICENSOR ADDITIONALLY DISCLAIMS ALL OBLIGATIONS AND LIABILITIES ON THE PART OF LICENSOR FOR DAMAGES, INCLUDING, BUT NOT LIMITED TO, SPECIAL, INDIRECT, AND CONSEQUENTIAL DAMAGES, ATTORNEYS' AND EXPERTS' FEES, AND COURT COSTS (EVEN IF LICENSOR HAS BEEN ADVISED OF THE POSSIBILITY OF THESE DAMAGES), ARISING FROM OR IN CONNECTION WITH THE USE OF THE SOFTWARE LICENSED UNDER THIS AGREEMENT. SOME STATES DO NOT ALLOW THE EXCLUSION OF IMPLIED WARRANTIES, SO THE ABOVE EXCLUSION MAY NOT APPLY TO YOU. THIS WARRANTY GIVES YOU SPECIFIC LEGAL RIGHTS AND YOU MAY ALSO HAVE OTHER RIGHTS THAT VARY FROM STATE TO STATE.

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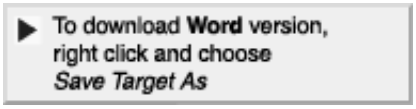
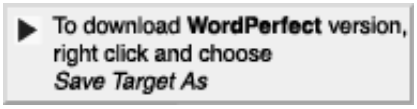
§16.15 12. Form: Assignment and Sublicensing





11. *Assignment and Sublicensing.* Licensee shall not (either directly or indirectly) sell, transfer, sublicense, assign in whole or in part, convey, pledge, or otherwise dispose of this Agreement, the Licensed Program, or any right, duty, or license granted under this Agreement, without first getting Licensor's express written consent, which may be refused in the sole and absolute discretion of Licensor. Any attempted assignment made without the prior express written consent of Licensor is null and void and is a material breach of this Agreement.

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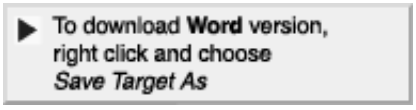
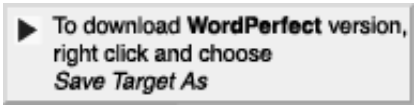
§16.16 13. Form: Remedies





12. ***Remedies.***

a. The parties acknowledge and agree that, if Licensee breaches any of its obligations under Paragraphs 4, 8, or 11 of this Agreement, Licensor would incur irreparable harm and damage that could not be fully compensated with monetary damages. Accordingly, if Licensee breaches any provision of paragraphs 4, 8, or 11 of this Agreement, Licensor, in addition to monetary damages, shall be entitled to specific performance of Licensee's obligations under those paragraphs and injunctive relief against any further violations of those paragraphs.

b. Licensor's sole obligation with respect to a breach by Licensor of any representation, warranty, or obligation under this Agreement is to correct that breach.

c. The parties to this Agreement understand and agree that fees to be received by Licensor under this Agreement are based solely on the value of the right to use the Licensed Program granted to Licensee and that it is impractical and extremely difficult to fix the actual damages, if any, that may result from any failure in connection with its intended use. It is therefore further agreed that if any liabilities are imposed on Licensor for any reason whatsoever, including, but not limited to, any liabilities resulting from Licensor's inability to correct any breach of this Agreement, the maximum aggregate amounts payable by Licensor for all liabilities under this Agreement will not exceed the aggregate amount of fees received by Licensor before that breach under Paragraph 7 for the portion of the software giving rise to that liability.

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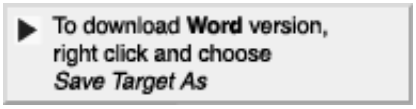
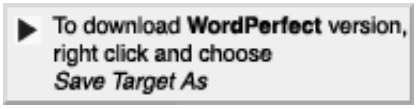
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.17 14. Form: Independent Contractor Status

§16.17 14. Form: Independent Contractor Status





13. *Independent Contractor Status.* Nothing in this Agreement is intended or to be construed to make Licensor and Licensee partners or joint venturers, or to make the employees, agents, or representatives of Licensor into employees, agents, or representatives of Licensee, or the employees, agents, or representatives of Licensee into employees, agents, or representatives of Licensor. The relationship of Licensor and Licensee to each other shall at all times be that of an independent contractor. No party to this Agreement shall have any express or implied right or authority to assume or create any obligations on behalf of or in the name of the other party or to bind the other party to any contract, agreement, or undertaking with any third party.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.18 15. Form: Governing Law

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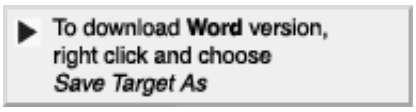

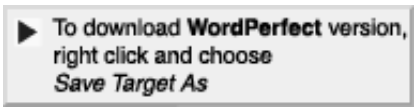

14. *Governing Law.* This Agreement, and any dispute arising from the relationship between the parties to this Agreement, shall be governed and determined by _ _[*e.g., California*]_ _ law, _ _[*excluding/including*]_ _ any laws that direct the application of the law of another jurisdiction. Any dispute that arises under or relates to this Agreement (whether contract, tort, or both) shall be resolved in _ _[*type of court, e.g., a superior court*]_ _ in _ _[*city, state*]_ _, and the parties expressly waive any right they may otherwise have to cause any such action or proceeding to be brought or tried elsewhere.

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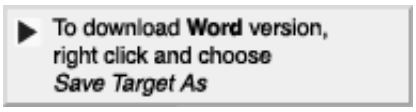
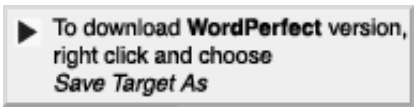
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.19 16. Form: Binding Effect

§16.19 16. Form: Binding Effect





15. *Binding Effect.* This Agreement is binding on and inures to the Licensor and its successors, assigns, and legal representatives. This Agreement is binding on and personal to Licensee and may not be assigned by Licensee without Licensor's prior written consent.

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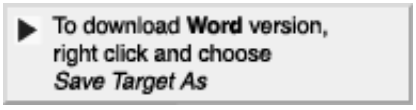
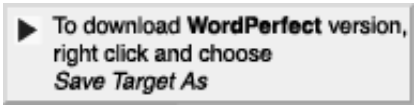
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.19A 17. Form: Export Controls

§16.19A 17. Form: Export Controls





16. *Export Controls*. The Licensed Program is subject to the export control laws of the United States, including the Export Administration Act of 1979 (EAA) (50 USC App §§2401-2420) and its related regulations. Licensee agrees to obey all such laws and to hold harmless Licensor for Licensee's failure to properly do so.

Comment: For an extensive discussion of the federal export controls on commercial software and technology, see Internet Law and Practice in California §§21.21-21.61 (Cal CEB 2004).

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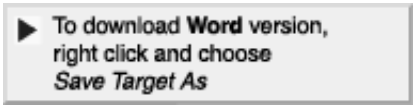
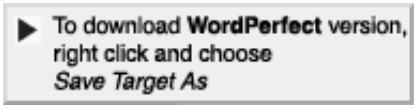
§16.19B 18. Form: Government Ownership





17. *Government Ownership*. The Licensed Program is provided with RESTRICTED RIGHTS. Use, duplication, or disclosure by the United States government is subject to restrictions set forth in FAR 52.227-14, Rights in Data—General (June 1987) and DFAR 252.227-7013, Rights in Technical Data—Non-Commercial Items (Nov 1995) or their successors.

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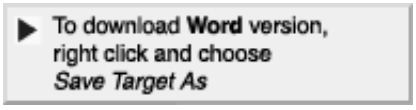
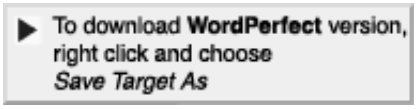
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.20 19. Form: Notices

§16.20 19. Form: Notices





18. *Notices.* Any notice required or permitted under this Agreement will be deemed given on delivery to the party to whom it is intended at its address of record. The record addresses of the parties are as follows:

Licensor:

_ _[*Name of licensor*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Attention: _ _[*Specify name or title*]_ _

Licensee:

_ _[*Name of licensee*]_ _

_ _[*Mailing address*]_ _

_ _[*Facsimile number, if appropriate*]_ _

_ _[*Electronic mail address, if appropriate*]_ _

Comment: Although the notice provision does not specifically require it, a prudent sender will obtain receipts for any notices sent.

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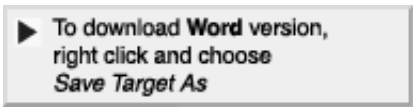
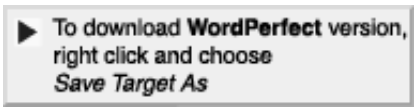
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.21 20. Form: Waiver of Breach

§16.21 20. Form: Waiver of Breach





19. *Waiver of Breach.* No waiver of a breach, failure of any condition, or any right or remedy contained in or granted by this Agreement will be effective unless it is in writing and signed by the party waiving the breach, failure, right, or remedy. No waiver of any breach, failure, right, or remedy will be deemed a waiver of any other breach, failure, right, or remedy, whether or not similar, nor will any waiver constitute a continuing waiver unless the writing so specifies.

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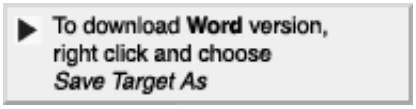
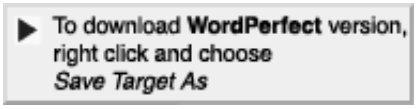
§16.22 21. Form: Attorney Fees and Costs





20. *Attorney Fees and Costs.* In any litigation, arbitration, or other proceeding by which one party either seeks to enforce its rights under this Agreement (whether in contract, tort, or both) or seeks a declaration of any rights or obligations under this Agreement, the prevailing party will be awarded reasonable attorney fees, together with any costs and expenses, to resolve the dispute and to enforce the final judgment.

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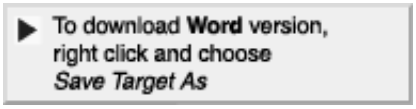
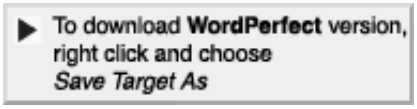
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.23 22. Form: Severability

§16.23 22. Form: Severability





21. *Severability.* If any provision of this Agreement contravenes any law or valid regulation of any regulatory agency or self-regulatory body having jurisdiction over either party, or if any provision is otherwise held invalid or unenforceable by a court or other body of competent jurisdiction, then each such provision shall be automatically terminated and performance of that provision by both parties waived. However, if that provision is reasonably considered by either party to be an essential element of this Agreement, and the parties are unable to agree on an alternative provision within 90 days after the invalidation of the provision in question, this Agreement may be terminated in its entirety at the option of the party reasonably considering the contravening provision to be an essential element of this Agreement. That termination shall be effective when that party gives notice of that termination to the other party.

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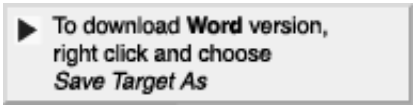
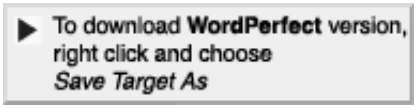
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.24 23. Form: Headings

§16.24 23. Form: Headings





22. *Headings.* The captions of the sections of this Agreement are inserted for convenience only and are not intended to be a part of this Agreement.

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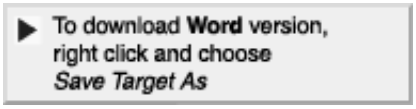
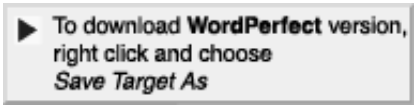
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.25 24. Form: Entire Agreement

§16.25 24. Form: Entire Agreement





23. *Entire Agreement.* This Agreement and all other agreements and exhibits referred to in this Agreement constitute the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this Agreement and supersede all prior and contemporaneous understandings or agreements of the parties. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation or warranty outside those expressly set forth in this Agreement.

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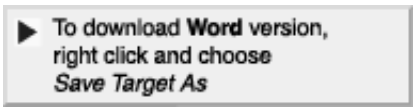
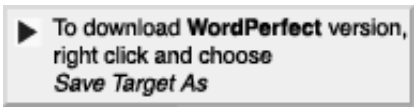
§16.26 25. Form: Concluding Clause and Signatures





IN APPROVAL OF THIS AGREEMENT, the parties' respective officers have duly executed this Agreement.

Licensee:	**Licensor:**
__[*Signature*]__	_ _[*Name of Company*]_ _
By: _ _[*Typed name*]_ _	**By:** __[*Signature*]__
Its: _ _[*Title*]_ _	**Name:** _ _[*Typed name*]_ _
	Its: _ _[*Title*]_ _

Comment: In representing a software licensee, the attorney should be aware that the licensee's rights to correct and maintain the software should be protected against the licensor's financial difficulty or bankruptcy. See *Computer Print Sys. v Lewis* (Pa Super Ct 1980) 422 A2d 148, 212 USPQ 626, in which a customer of the plaintiff innocently (but wrongfully) acquired the plaintiff's computer tapes to protect itself if the plaintiff went out of business. The court held that the defendants infringed the plaintiff's trade secrets by using the tapes after learning that their possession was wrongful.

It is customary to require the licensor to put its source code in escrow so that, if the licensor refuses or is otherwise unable to fulfill an obligation to maintain or update the software, the licensee will be able to obtain the source code and do its own maintenance and updating. For a form of source code escrow agreement, see Internet Law and Practice in California, chap 15 (Cal CEB 2004). The Bankruptcy Code was amended on October 1, 1988, by the Intellectual Property Bankruptcy Protection Act, to at least partially protect the interests of the licensee if the licensor files for bankruptcy and the trustee in bankruptcy rejects the license agreement. For further discussion of software licenses in bankruptcy, see Internet Law and Practice in California §§12.11-12.13 (Cal CEB 2004).

California law allows for disclaimers of implied warranties in certain circumstances. See CC §§1792-1793.02; Com C §2316; California UCC Sales and Leases, chap 3 (Cal CEB 2002).

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§16.27 C. Preemption of Trade Secret Rights

The sample agreement shown in §16.9 includes a copyright clause as well as a trade secret clause, because at least some forms of protection for software under trade secret law may be limited by future court rulings. The 1976 Copyright Act provides that "all legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright … and come within the subject matter of copyright … are governed exclusively by [the copyright law]." 17 USC §301. Certainly, some forms of protection are the same under both copyright and trade secret law. For example, if someone under an obligation of confidence wrongfully copies an unpublished program that is a trade secret onto a blank floppy disk and resells it, the injunctive relief under the Copyright Act is the same as that under the state trade secret laws. One court has held §301 to preempt state trade secret law. See *Avco Corp. v Precision Air Parts, Inc.* (MD Ala 1980) 210 USPQ 894, aff'd (11th Cir 1982) 676 F2d 494 (copying of drawings alleged to be trade secrets).

On the other hand, a significant difference between copyright and trade secret protection is the extension of trade secret (but not copyright) protection to wrongful "use" of the computer program's trade secrets to develop similar programs. In the author's opinion, although some rights in software are logically preempted by 17 USC §301, they are not necessarily lost, and the software owner should take care to maintain rights under both the Copyright Act and the state trade secret laws. See *Warrington Assoc. v Real-Time Eng'g Sys.* (ND Ill 1981) 522 F Supp 367 (software company successfully argued that trade secret misappropriation claim was not preempted by §301). See also *Bishop v Wick* (ND Ill 1988) 11 USPQ2d 1360 (damages awarded under claims for both misappropriation of trade secrets and copyright infringement). It is generally true that it is easier to create a protected interest in trade secrets than a protected interest in copyrighted material. Some of the prerequisites to protection are common to both interests, and if these requirements are not met, neither copyright nor trade secret protections are available. For example, claims for both copyright infringement and misappropriation of trade secrets will fail if proof of copying is insufficient. *Plains Cotton Coop. Ass'n v Goodpasture Computer Serv.* (5th Cir 1987) 807 F2d 1256.

The Tenth Circuit held that no federal preemption of trade secret protection occurred under 17 USC §301(a) when the trade secret was embodied in a program protected by United States copyright laws. *Gates Rubber Co. v Bando Chem. Indus.* (10th Cir 1993) 9 F3d 823. The *Gates* court pointed out that the Uniform Trade Secrets Act was not preempted, because the state cause of action required an extra element beyond the copyright infringement claim. This case applied Colorado law, which, like California law, requires that the plaintiff show the following to prove misappropriation of a trade secret: (1) The plaintiff possessed a valid trade secret, (2) the trade secret was used without the plaintiff's consent, (3) the defendant knew or should have known that the trade secret was acquired improperly, and (4) a breach of a relationship of trust or confidence occurred. Counsel should note that item (4) is not required under the Copyright Act. Because the defendant used the trade secrets and because their economic value could be established by the 25,000 man-hours and over $500,000 in investment in development and upgrading the program, the value and status of the trade secrets were clearly established. It is almost certain that a similar conclusion would be reached in the Ninth Circuit. On the other hand, for a case in which a contract claim was preempted by federal copyright law, see *Selby v New Line Cinema Corp*. (CD Cal 2000) 96 F Supp 2d 1053, discussed in §16.30.

California has supported software protection by enacting Pen C §499c. The definition of trade secrets in §499c incorporates computer programs and data bases, and "theft" includes unauthorized use of the trade secret.

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§16.28 D. Proof Requirements

Identification of specific items within a software program as trade secrets may not be necessary to prove misappropriation. *Data Gen. Corp. v Grumman Sys. Support Corp.* (D Mass 1993) 825 F Supp 340. The plaintiff in Data General alleged that the defendant misappropriated its software program. The defendant cited *MAI Sys. Corp. v Peak Computer, Inc.* (9th Cir 1993) 991 F2d 511 for the proposition that a plaintiff must specifically identify the trade secrets that were purportedly misappropriated. The defendant argued that it was entitled to a verdict in its favor because plaintiff produced proof only that major portions of the source code had been adopted and used by the defendant but never produced or identified the precise secret embodied in the source code. The court rejected this argument and held that identifying specific items within the software as trade secrets was unnecessary because (1) the software representative had made a substantial investment in it, (2) everyone who had access to the software had been required to sign a confidentiality agreement to preserve the secrecy, and (3) the defendant had appropriated the totality of the software. But if elements of the software are shown to be publicly known so that the protection resides in the combination of subprograms or in the details of the subprograms, then the plaintiff may have to prove use of the protected combination and the subprograms themselves. *Architectronics, Inc. v Control Sys.* (SD NY 1996) 935 F Supp 425 (applying Minnesota version of Uniform Act). Thus, disclosure of portions of a computer program does not necessarily disclose trade secrets in the structure and organization of the program. *Softel, Inc. v Dragon Med. & Scientific Communications* (2d Cir 1997) 118 F3d 955. In filtering out any expression that is not protected by copyright law, a jury must be instructed on the consequences of copying to achieve compatibility with preexisting hardware or software. Compatibility is evaluated at the literal level (verbatim copying) rather than at the nonliteral level (paraphrasing/structural). *Bateman v Mnemonics, Inc.* (11th Cir 1996) 79 F3d 1532.

In *Pioneer Hi-Bred Int'l v Holden Found. Seeds* (8th Cir 1994) 35 F3d 1226, the defendant was charged with misappropriating the genetic makeup of certain seed corn developed at great expense, and maintained in secret, by plaintiff. Although Pioneer could not prove a specific act of misappropriation, the court held that, in view of the complexity of the technology, misappropriation could be inferred because the secret was so unusual that duplication was probably improper. No similar case has been decided involving computer software, but, given the complexity of modern programming, a similar rule may well apply.

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§16.29 III. TRADE SECRET PROTECTION FOR MASS-MARKETED SOFTWARE

An open issue is the extent to which trade secret protection is available for mass-marketed software and software-based products. This issue is particularly important when the mass-marketed software includes significant functional features (*e.g.*, algorithms, communications protocols) that are not protected by copyright law. See *Sega Enters. v Accolade, Inc.* (9th Cir 1992) 977 F2d 1510, in which the court found that the software interface of Sega's video game system was unprotectable by copyright, and that Accolade's intermediate copying of the video game program in order to reverse engineer the interface was a "fair use" of Sega's copyrights in the program. See discussion of *Sega* in §16.48.

Wide distribution of a computer program does not alone preclude the possibility of maintaining trade secrets in the program. See, *e.g.*, *Data Gen. Corp. v Digital Computer Controls, Inc.* (Del Ch 1971) 297 A2d 433, aff'd (Del 1972) 297 A2d 437 (even with numerous copies sold, program still qualifies as a trade secret). The problem lies in the nature of the transaction between the vendor and the consumer. Specifically, because the consumer of mass-marketed software normally does not sign (let alone bargain for) a written contract, it is often difficult to establish that the consumer has a duty of confidentiality as to the software's trade secrets.

However, neither the California Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11) nor the model Uniform Act requires absolute secrecy. The onus is on the trade secret owner to prove that the software was the subject of efforts that were reasonable in the circumstances to maintain its secrecy. These efforts do not necessarily require a written contract between the buyer and the seller, because a contract is not a reasonable undertaking for mass-marketed software. Rather, a combination of other security measures is advisable (see §16.42) to be able to establish that the information qualifies as a trade secret as defined in the statute.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.30 A. By Use of Shrink-Wrap Licenses

§16.30 A. By Use of Shrink-Wrap Licenses

Most suppliers of mass-distributed software use a "shrink-wrap license" (referred to more generally as a "notice" license) on the exterior of the package to restrict consumer use of the software and maintain trade secrets in the software. Shrink-wrap licenses typically contain language that purports to require the purchaser to read the attached terms and conditions before opening the software and implies that opening the software is agreeing to the terms. Shrink-wrap licenses typically prohibit both reverse engineering and the transfer to others of the "licensed" program. A sample shrink-wrap license is provided in §§16.32-16.40.

Although shrink-wrap licenses have not been upheld in all jurisdictions, mainly because they have attributes of adhesive contracts, a recent Federal Circuit decision, *Bowers v Baystate Technols., Inc.* (Fed Cir 2003) 320 F3d 1317, cert denied (2003) 539 US 928, emphasizes the advisability of using shrink-wrap licenses. Applying First Circuit law, the court in *Bowers* upheld a prohibition against reverse engineering in a shrink-wrap license agreement. An amici curiae brief by Professor Mark A. Lemley of Boalt Hall on behalf of a number of interested associations and professors of intellectual property law argued that the Copyright Act preempted the anti-reverse-engineering clause. The Federal Circuit, however, relying on *Data Gen. Corp. v Grumman Sys. Support Corp.* (1st Cir 1994) 36 F3d 1147, 1164, and *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447, stated that "most courts to examine this issue have found that the Copyright Act does not preempt contractual constraints on copyrighted articles." *Bowers v Baystate Technols., Inc.* (Fed Cir 2003) 320 F3d 1317, 1324.

The *Bowers* court distinguished *Vault Corp. v Quaid Software Ltd*. (5th Cir 1988) 847 F2d 255, discussed below, by stating that "while the Fifth Circuit has held a state law prohibiting all copying of a computer program is preempted by the federal Copyright Act, no evidence suggests the First Circuit would extend this concept to include private contractual agreements *supported by mutual assent and consideration*." (Emphasis added.) *Bowers v Baystate Technols., Inc.* (Fed Cir 2003) 320 F3d 1317, 1325. Interestingly, the *Bowers* decision did not discuss the issue of whether *shrink-wrap* agreements are "supported by mutual assent and consideration." The omission is significant given that shrink-wrap licenses are typically imposed unilaterally by the licensor. See generally Karjala, *Federal Preemption of Shrink-wrap and On-Line Licenses*, 22 U Dayton L Rev 511 (1997) (preemption concerns heightened in shrink-wrap context).

Other decisions reflect differing opinions on the enforceability of shrink-wrap agreements. For example, in *Step-Saver Data Sys. v Wyse Technol.* (3d Cir 1991) 939 F2d 91, the court applied the UCC in finding that the shrink-wrap license accompanying software purchased by telephone order was an invalid attempt to modify the terms of a preexisting contract (created when Step-Saver responded to a magazine ad and placed an order by telephone). In reaching its conclusion, the court stressed that it was unreasonable to expect the consumer to have to return the product for a refund when the terms are unacceptable. 939 F2d at 102.

A decision that is particularly relevant to maintaining trade secret protection by shrink-wrap license is *Vault Corp. v Quaid Software Ltd.* (5th Cir 1988) 847 F2d 255. Vault sold a data security program called PROLOK, which enabled other software vendors to "lock" their respective programs to prevent consumer duplication. PROLOK was sold with a typical shrink-wrap license that, among other things, prohibited copying and reverse engineering its software. Quaid bought a copy of PROLOK, and reverse engineered the program to learn how to defeat its locking mechanism. Quaid then developed and sold a program that allowed users to defeat the PROLOK locking mechanism and thereby make copies of PROLOK-protected software.

Vault sued Quaid, claiming copyright infringement, misappropriation of trade secrets, and breach of the shrink-wrap agreement. On the breach of contract claim, the district court held that the shrink-wrap license was an unenforceable contract of adhesion unless it was saved by the Louisiana Software License Enforcement Act (LSLEA) (La Rev Stat Ann §§51:1961-51:1966), which specifically authorized contractual terms prohibiting the copying and reverse engineering of software. *Vault Corp. v Quaid Software Ltd.* (ED La 1987) 655 F Supp 750. On appeal, the Fifth Circuit agreed that the license was an unenforceable contract of adhesion and held that the relevant portions of the LSLEA were in direct conflict with §117 of the Copyright Act and were therefore preempted under 17 USC §301. (Copyright Act

§117, discussed in §16.47, grants the owner of a copy of a computer program the right to make archival copies and to adapt the program as necessary to run on the owner's computer.)

The Seventh Circuit has upheld shrink-wrap licenses in *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447, 1451, and dealt differently with many of the issues raised in *Step-Saver* and *Vault*. The court treated the license included with the ProCD product as an enforceable contract, citing instances in which the actual detailed terms of a transaction were disclosed after the conclusion of the transaction but were still binding (warranties, purchase of insurance policies, airline tickets). The court further held that copyright laws did not preempt state laws enforcing contract rights and that the license was an enforceable contract. *ProCD, Inc. v Zeidenberg, supra*. The Eastern District of California has favorably cited the Seventh Circuit's approach to shrink-wrap licenses (*Pollstar v Gigmania Ltd.* (ED Cal 2000) 170 F Supp 2d 974, 980 (browse-wrap license may be enforceable and valid), and the Northern District has also implicitly upheld the validity of shrink-wrap licenses. See *Adobe Sys. Inc. v Stargate Software Inc.* (ND Cal 2002) 216 F Supp 2d 1051. But see *Selby v New Line Cinema Corp.* (CD Cal 2000) 96 F Supp 2d 1053 (finding claim for breach of implied contract for use of screenplay was preempted by copyright law and distinguishing *ProCD* because examples cited there involved conduct other than copying). More recently, the Ninth Circuit has held that "[a] state law tort claim concerning the unauthorized use of the software's end product is not within the rights protected by the federal Copyright Act." *Altera Corp. v Clear Logic, Inc.* (9th Cir 2005) 424 F3d 1079, 1090 (citing *ProCD* and noting that most courts do not find preemption of Copyright Act). To survive preemption, the state law claim must include an "extra element" that makes the right asserted qualitatively different from those protected by the Copyright Act. 424 F3d at 1089. In *Meridian Project Sys. v Hardin Constr. Co.* (ED Cal 2006) 426 F Supp 2d 1101, 1106, the court found that an end-user license agreement (treated as a shrink-wrap license) was not invalid merely because the customer purchased plaintiff's software and then received the license after opening the package. To the extent that the agreement prohibited reverse engineering, the breach of contract claim was not preempted because the contract protected a qualitatively different right than those protected by the Copyright Act.

Some related decisions pertain to computer hardware contracts shipped in the box containing the computer. In *Hill v Gateway 2000, Inc.* (7th Cir 1997) 105 F3d 1147, cert denied (1997) 522 US 808, the Seventh Circuit upheld the terms of such an agreement, specifically following its *ProCD* decision. But see *Klocek v Gateway, Inc.* (D Kan 2000) 104 F Supp 2d 1332 (refusing to follow *Hill* or *ProCD*).

Although the California Supreme Court has yet to rule on the enforceability of a "shrink wrap"-type license, the Ninth Circuit in *Arizona Cartridge Remanufacturers Ass'n v Lexmark Int'l, Inc.* (9th Cir 2005) 421 F3d 981 had no problem in upholding a federal district court ruling that such a contract printed on a package containing an ink cartridge was an enforceable contract under California law. No California decision was cited; rather the court referred to the Uniform Commercial Code as establishing that a "contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." Com C §2204(1). Additionally, California law provides that an "agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined." Com C §2204(2).

PRACTICE TIP: In view of the *Sega* (discussed in §16.29), *Step-Saver*, and *Vault* decisions, and the nature of shrink-wrap licenses in general, practitioners should not rely solely on the combination of copyright protection and shrink-wrap licenses to protect against reverse engineering and use of software. This is especially true, for example, when the computer program includes important security-related features (*e.g.*, software interfaces, data encryption algorithms, cryptographic keys, passwords) that are crucial to the commercial viability of the vendor's product or product line (as in both the PROLOK data-locking algorithm of Vault and the game console interface of Sega), or that protect against tampering by computer hackers. In such cases, the practitioner should consider utility patent protection for the functional features of the program. (See discussion of patent protection in §§16.60-16.62.) In addition, the practitioner should consider taking measures (discussed in §§16.41-16.42) beyond merely including a shrink-wrap license in order to impose an obligation of confidentiality on the consumer.

For a thorough analysis of the enforceability of shrink-wrap licenses and a discussion of a proposed UCC provision designed to increase the enforceability of shrink-wrap licenses, see Lemly, *Intellectual Property and Shrinkwrap Licenses*, 68 S Cal L Rev 1239 (July 1995). See also Internet Law and Practice in California, chap 7 (Cal CEB 2004).

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§16.31 B. Using Shrink-Wrap License

The shrink-wrap license in §§16.32-16.40 is a representative shrink-wrap license that also incorporates a limited warranty. California law allows for disclaimer of implied warranties in certain circumstances. See CC §§1792-1793.02; Com C §2316; California UCC Sales and Leases, chap 3 (Cal CEB 2002). See also Com C §2719 and California UCC Sales and Leases §§18.35-18.42 (Cal CEB 2002) for discussion of limitation of liability for incidental and consequential damages in California.

Applicability of the terms in shrink-wrap agreements is quite limited. They are seldom applicable to agreements expressly negotiated and signed by parties. Thus, a negotiated and signed agreement prohibiting modification except by a writing signed by both parties could not be modified by a forum selection clause in a shrink-wrap agreement accompanying software covered by the agreement. *Morgan Labs. Inc. v Micro Data Base Sys. Inc.* (ND Cal 1997) 41 USPQ2d 1850.

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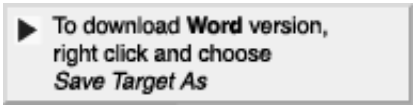
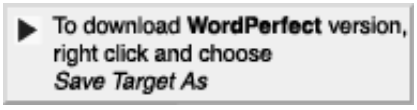
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.32 1. Form: Introduction

§16.32 1. Form: Introduction





_ _[*NAME OF LICENSOR*]_ _**'S PROGRAM LICENSE AGREEMENT**

YOU SHOULD CAREFULLY READ THE FOLLOWING TERMS AND CONDITIONS BEFORE OPENING THIS DISKETTE(S) OR CASSETTE(S) PACKAGE. OPENING THIS DISKETTE(S) OR CASSETTE(S) PACKAGE INDICATES YOUR ACCEPTANCE OF THESE TERMS AND CONDITIONS. IF YOU DO NOT AGREE WITH THEM, YOU SHOULD PROMPTLY RETURN THE PACKAGE UNOPENED, AND YOUR MONEY WILL BE REFUNDED.

_ _[*Name of licensor*]_ _ **provides this program and licenses its use in the United States and Puerto Rico. You assume responsibility for the selection of the program to achieve your intended results, and for the installation, use, and results obtained from the program.**

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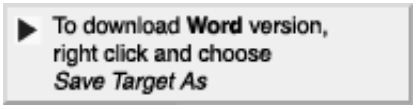
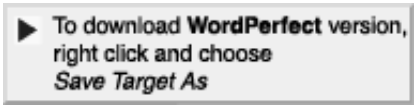
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.33 2. Form: Confidentiality

§16.33 2. Form: Confidentiality





CONFIDENTIAL DISCLOSURE

THIS PROGRAM CONTAINS TRADE SECRETS AND PROPRIETARY KNOW-HOW BELONGING TO LICENSOR, AND IT IS BEING MADE AVAILABLE TO YOU IN STRICT CONFIDENCE. ANY USE OR DISCLOSURE OF THIS PROGRAM, OR OF ITS ALGORITHMS, PROTOCOLS, OR INTERFACES, OTHER THAN IN STRICT ACCORDANCE WITH THIS LICENSE AGREEMENT, MAY BE ACTIONABLE AS A VIOLATION OF _ _[*NAME OF LICENSOR*]_ _'S TRADE SECRET RIGHTS.

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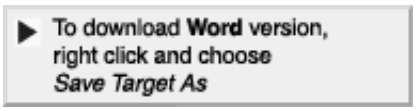
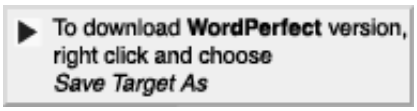
§16.34 3. Form: License Grant





LICENSE

You are licensed to use this program at any given time on only one machine, solely for the purpose of its intended use. Any attempt by you to reconstruct in whole or in part the program's object code, source code, or algorithms will automatically terminate this license.

YOU ARE PROHIBITED FROM REVERSE-ENGINEERING THIS PROGRAM.

IF YOU TRANSFER POSSESSION OF ANY COPY, MODIFICATION, OR MERGED PORTION OF THE PROGRAM TO ANOTHER PARTY, YOUR LICENSE IS AUTOMATICALLY TERMINATED.

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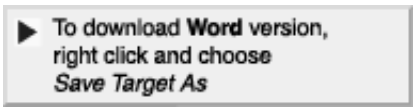
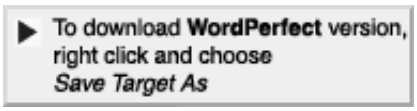
§16.35 4. Form: Term





TERM

The license is effective until terminated. You may terminate it at any other time by destroying the program together with all copies, modifications, and merged portions in any form. It will also terminate on conditions set forth elsewhere in this Agreement or if you fail to comply with any term or condition of this Agreement. You agree on termination of this license to destroy the program, together with all copies, modifications, and merged portions in any form.

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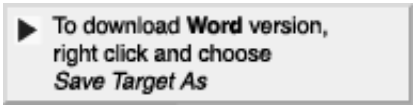
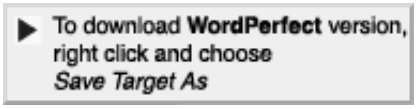
§16.36 5. Form: Limited Warranty





LIMITED WARRANTY

THIS PROGRAM IS PROVIDED "AS IS" WITHOUT WARRANTY OF ANY KIND, EITHER EXPRESSED OR IMPLIED, INCLUDING, BUT NOT LIMITED TO, THE IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. YOU BEAR THE ENTIRE RISK OF THE QUALITY AND PERFORMANCE OF THE PROGRAM. IF THE PROGRAM PROVES DEFECTIVE, YOU (AND NOT _ _[*NAME OF LICENSOR*]_ _ OR AN AUTHORIZED DEALER OR DISTRIBUTOR) ASSUME THE ENTIRE COST OF ALL NECESSARY SERVICING, REPAIR, OR CORRECTION. SOME STATES DO NOT ALLOW THE EXCLUSION OF IMPLIED WARRANTIES, SO THE ABOVE EXCLUSION MAY NOT APPLY TO YOU. THIS WARRANTY GIVES YOU SPECIFIC LEGAL RIGHTS AND YOU MAY ALSO HAVE OTHER RIGHTS THAT VARY FROM STATE TO STATE.

_ _[*Name of licensor*]**_ _ does not warrant that the functions in the program will meet your requirements or that operation of the program will be interruption-free or error-free.**

However, _ _[*name of licensor*]**_ _ warrants the diskette(s) or cassette(s) on which the program is furnished to be free from defects in materials and workmanship under normal use for a period of 90 days after the date of delivery to you, as evidenced by a copy of your receipt.**

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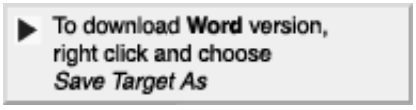
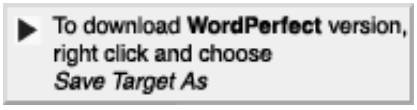
§16.37 6. Form: Limitation of Remedies





LIMITATION OF REMEDIES

_ _[*Name of licensor*]_ _**'s entire liability and your exclusive remedy shall be:**

1. The replacement of any diskette(s) or cassette(s) not meeting Licensor's "Limited Warranty," which is returned to Licensor or an authorized Dealer or Distributor with a copy of your receipt, or

2. If Licensor or an authorized Dealer or Distributor is unable to deliver a replacement diskette(s) or cassette(s) that is free of defects in materials or workmanship, you may terminate this Agreement by returning the program and your money will be refunded.

IN NO EVENT WILL _ _[*NAME OF LICENSOR*]_ _ BE LIABLE TO YOU FOR ANY DAMAGES, INCLUDING ANY LOST PROFITS, LOST SAVINGS, OR OTHER INCIDENTAL OR CONSEQUENTIAL DAMAGES ARISING FROM THE USE OF OR THE INABILITY TO USE THE PROGRAM (EVEN IF LICENSOR OR AN AUTHORIZED DEALER OR DISTRIBUTOR HAS BEEN ADVISED OF THE POSSIBILITY OF THESE DAMAGES), OR FOR ANY CLAIM BY ANY OTHER PARTY.

SOME STATES DO NOT ALLOW THE LIMITATION OR EXCLUSION OF LIABILITY FOR INCIDENTAL OR CONSEQUENTIAL DAMAGES, SO THE ABOVE LIMITATION OR EXCLUSION MAY NOT APPLY TO YOU.

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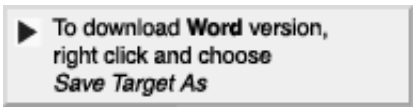
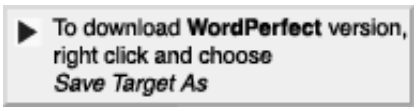
§16.38 7. Form: Sublicensing, Assignment, and Transfer





TRANSFERS

You may not sublicense, assign, or transfer the license or the program except as expressly provided in this Agreement. Any attempt to sublicense, assign, or transfer any of the rights, duties, or obligations under this Agreement will be void.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.39 8. Form: Governing Law

§16.39 8. Form: Governing Law

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

GOVERNING LAW

This Agreement will be governed by the laws of the State of California.

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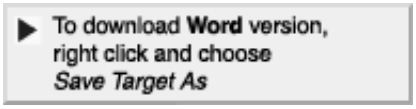
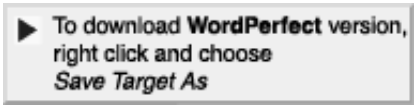
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.40 9. Form: Acceptance of License

§16.40 9. Form: Acceptance of License





ACCEPTANCE OF LICENSE

YOU ACKNOWLEDGE THAT YOU HAVE READ THIS AGREEMENT, UNDERSTAND IT, AND AGREE TO BE BOUND BY ITS TERMS AND CONDITIONS. YOU FURTHER AGREE THAT IT IS THE COMPLETE AND EXCLUSIVE STATEMENT OF THE AGREEMENT BETWEEN US THAT SUPERSEDES ANY PROPOSAL OR PRIOR AGREEMENT, ORAL OR WRITTEN, AND ANY OTHER COMMUNICATIONS BETWEEN US RELATING TO THE SUBJECT MATTER OF THIS AGREEMENT.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.41 C. Click-Wrap and Browse-Wrap Licenses

§16.41 C. Click-Wrap and Browse-Wrap Licenses

With the evolution of software distribution over the Internet (and over on-line services networks such as CompuServe and America Online), a new form of license, referred to by some as a "click-wrap" license, has become popular. With a click-wrap license, the purchaser is typically asked to read the terms of the license on the computer screen, and then click on an "accept" button (if the contract terms are acceptable) to initiate the download of the software.

An advantage of click-wrap licenses over shrink-wrap licenses from the viewpoint of enforceability, including an agreement to maintain confidentiality of the software, is that the purchaser must take an active step (other than simply opening a package) to accept the license terms. To increase the level of activity required by the consumer, the click-wrap license can be structured so that the purchaser must scroll through the license terms, and/or type in a phrase such as "I ACCEPT" to initiate the download. The click-wrap license overcomes the shrink-wrap requirement that the purchaser go back to the store to return the software if the terms are unacceptable.

In re RealNetworks, Inc. (ND Ill 2000) 2000 US Dist Lexis 6584, the court upheld an arbitration provision in a contract delivered over the Internet. The contract was contained in a download from the RealNetworks site on the World Wide Web. The party opposing arbitration argued that the contract was not a "written" contract as required by the Federal Arbitration Act. The court held that the contract's printable and storable nature was enough to cause it to be "written."

Cases to date seem to indicate that a properly structured click-wrap license is enforceable if actual assent by the recipient is shown. However, the cases reach differing conclusions about "browse-wrap" licenses, a third type of software license distinguished from click-wrap and shrink-wrap licenses. In *Specht v Netscape Communications Corp.* (2d Cir 2002) 306 F3d 17, the court applied California law and upheld a Southern District of New York court's refusal to compel arbitration based on Netscape's license terms covering a program downloaded from the Internet. The software program at issue, "Smart Download," was available from Netscape's website free of charge, and a user was not required to view license terms or agreements before downloading it. The court stated that "reasonably conspicuous notice of the existence of contract terms and unambiguous manifestation of assent to these terms by consumers are essential if electronic bargaining is to have integrity and credibility." 306 F3d at 35. Of interest is that the court took judicial notice of California's consumer fraud statute, Bus & P C §17538, noting that (306 F3d at 34):

> [It] is one of the few state statutes to regulate on-line transactions in goods or services.… Although consumer fraud as such is not alleged in the present action, … we note that the statute is consistent with the principle of conspicuous notice of the existence of contract terms that is also found in California's common law of contracts.

The court concluded that, "where consumers are urged to download free software at the immediate click of a button, a reference to the existence of license terms on a submerged screen is not sufficient to place consumers on inquiry or constructive notice of those terms." 306 F3d at 38.

A related California case is *Pollstar v Gigmania Ltd.* (ED Cal 2000) 170 F Supp 2d 974. In *Pollstar*, the court, although denying the defendant's motion to dismiss, expressed concern about the enforceability of the browse-wrap license:

> Viewing the web site, the court agrees with the defendant that many visitors to the site may not be aware of the license agreement. Notice of the license agreement is provided by small gray text on a gray background. … No reported cases have ruled on the enforceability of a browse wrap license.… While the court agrees with [the defendant] that the user is not immediately confronted with the notice of the license agreement, this does not dispose of [the plaintiff's] breach of contract claim. The court hesitates to declare the invalidity and unenforceability of the browse wrap license agreement at this time.

PRACTICE TIP: To be reasonably assured that the terms of an agreement sent over the Web are enforceable, make sure that the viewer must assent to the agreement by clicking "I ACCEPT" to initiate the download.

For a well-reasoned article on click-wrap agreements, see Perry, *Drafting Enforceable Click-Wrap Agreements*, Intell

Prop Today (Oct. 1998). See also Internet Law and Practice in California, chap 7 (Cal CEB 2004).

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.42 D. Additional Strategies for Maintaining Trade Secrets in Mass-Marketed Software

§16.42 D. Additional Strategies for Maintaining Trade Secrets in Mass-Marketed Software

As dramatically illustrated by cases such as *Sega Enters. v Accolade, Inc.* (9th Cir 1992) 977 F2d 1510 (discussed in §§16.29, 16.48) and *Vault Corp. v Quaid Software Ltd.* (5th Cir 1988) 847 F2d 255 (discussed in §16.30), it can be dangerous to rely on copyright protection to protect the interfaces (Sega), security algorithms (Vault), or other functional features of computer programs from being reverse engineered and used to the detriment of the software vendor. Moreover, as illustrated by *Vault* and *Step-Saver Data Sys. v Wyse Technol.* (3d Cir 1991) 939 F2d 91, it is highly doubtful that prohibitions against copying and reverse engineering contained in shrink-wrap licenses are enforceable. However, in *ProCD, Inc. v Zeidenberg* (7th Cir 1996) 86 F3d 1447, discussed in §16.30, the Seventh Circuit held that shrink-wrap licenses are valid and enforceable contracts. The Eastern District of California has favorably cited the Seventh Circuit's approach to shrink-wrap licenses. See *Pollstar v Gigmania Ltd.* (ED Cal 2000) 170 F Supp 2d 974, 980 (browse-wrap license may be enforceable and valid); *Meridian Project Sys. v Hardin Constr. Co.* (ED Cal 2006) 426 F Supp 2d 1101, 1106 (end-user license agreements (treated as shrink-wrap licenses) are enforceable). For further discussion, see §16.30.

Thus, the software vendor is faced with a significant dilemma, particularly when the viability of the mass-marketed software (or software-based product) depends heavily on the continued secrecy of the underlying functional features (as in Vault's PROLOK program). In such situations, trade secret protection, along with patent protection in appropriate cases, may be the software vendor's only hope for protection against appropriation by competitors.

To maintain functional features of computer programs as trade secrets under California's Uniform Trade Secrets Act (UTSA) (CC §§3426-3426.11), the functional features must both (1) derive independent economic value from not being generally known to the public or to other persons who can obtain economic value from their disclosure or use and (2) be the subject of efforts that are reasonable in the circumstances to maintain their secrecy. CC §3426.1(d). See §§1.3-1.10 for discussion of what is a trade secret.

The UTSA does not explicitly require that a valid agreement exist between the software vendor and the consumer, nor does it require that the program or product be in a form that is difficult to reverse engineer. Thus, the availability of trade secret protection may simply turn on whether the software vendor has taken reasonable steps in the circumstances to maintain the secrecy of the functional features.

PRACTICE TIP: Software vendors should use confidentiality notices liberally (which may be in the form shown in §16.3) in connection with the sale and distribution of their respective software products to increase the likelihood that trade secrets will not be lost. For example, confidentiality notices should be included, when possible, on all diskettes, CD-ROMs, product packages, users' manuals, and advertisements for the product. Confidentiality notices should also be placed in all shrink-wrap and click-wrap licenses (preferably in large letters at the top of the agreement) used in connection with the product. Even though these licenses may not be enforceable, the inclusion of a confidentiality notice may nevertheless have some effect.

PRACTICE TIP: When possible, confidentiality notices should be embedded in the software product so that users who gain access to the software without going through normal distribution channels are put on notice of the obligation of confidentiality. For example, confidentiality notices should appear on initial screen displays generated during the execution of the program. It may also be possible to embed confidentiality notices in the product's object code so that a warning message is displayed if the object code is disassembled. This warning may, for example, state that disassembly of the program will expose the user (*i.e.*, the person conducting the disassembly) to confidential and proprietary trade secret information, and that disclosure or use of the information may be actionable. It is advisable that engineers and in-house counsel work closely together to find additional ways to embed confidentiality notices in the software.

Although these measures are not guaranteed to preserve the trade secrets in the mass-marketed software, they will at least provide the software vendor with a strong argument in court that it acted reasonably in the circumstances to maintain the confidentiality of its trade secrets.

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§16.42A E. Internet Publication of Trade Secrets

In *O'Grady v Superior Court* (2006) 139 CA4th 1423, 44 CR3d 72, Apple Computer, Inc. (Apple) sued several "Doe" defendants for misappropriation of trade secrets after their online publication of proprietary information about a new and yet unreleased Apple product. O'Grady and another individual were the publishers of online news magazines in which articles about the new product were posted. Denying the publishers' motion for a protective order, the trial court (see *Apple Computer, Inc. v Doe* (Cal Super, Mar 11, 2005, No. 1-04-CV-032178) 74 USPQ2d 1191) allowed Apple to subpoena the publishers' Internet hosting services for purposes of identifying the defendants who had disclosed Apple's trade secrets. The trial court ruled that, despite the California reporter's shield law (see Cal Const art I, §2(b) and Evid C §1070(a)), the defendants' identity was not protected from discovery because, in the trial court's view, they had stolen Apple's trade secrets and there was no exception in the Uniform Trade Secrets Act or the Penal Code to protect journalists.

The court of appeal overturned the trial court's ruling, holding that the federal Stored Communications Act (SCA) (18 USC §§2701-2712) prohibited disclosure of the information sought, and there was no exception in the SCA for civil discovery. The court found that Apple was seeking the contents of private messages stored on the hosts' servers, and disclosure would have violated the SCA. The court also found that the petitioners were protected by Cal Const art I, §2(b) and Evid C §1070(a), the California reporter's shield law, and by the privilege enjoyed by a free press to safeguard the identity of confidential sources. Applying the factors in *Mitchell v Superior Court* (1984) 37 C3d 268, 208 CR 152, the court held that the circumstances favoring disclosure (including Apple's argument that the matter involved theft of trade secrets) were outweighed by countervailing factors, particularly Apple's failure to exhaust alternative sources of the information.

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IV. PROTECTION UNDER FEDERAL COPYRIGHT LAW

§16.43 A. Computer Programs

In 1980, Congress amended the 1976 Copyright Act (17 USC §§101-1101) to specifically refer to a "computer program" as "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result." 17 USC §101.

For individuals, the duration of the copyright protection is the life of the author plus 50 years. 17 USC §302(a). For works made for hire, the duration is 95 years after the year of first publication or 120 years after the year of creation, whichever expires first. 17 USC §302(c).

NOTE: Copyrighted computer programs must contain trade secrets to enjoy the benefits of the trade secret laws. *Hogan Sys., Inc. v Cybersource Int'l, Inc.* (5th Cir 1998) 158 F3d 319 (dismissed action because information in copyrighted computer program not trade secret).

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.44 B. Preserving Copyright Protection

§16.44 B. Preserving Copyright Protection

Despite the availability of patent protection, software sold or extensively marketed to retail outlets must usually be protected under federal copyright law, if it is to be protected at all, because the requirements for sale and widespread marketing are incompatible with the need to maintain the software "secret" enough to enjoy protection under the trade secret laws. Copyright protection for unpublished software "subsists from its creation." 17 USC §302(a). An unpublished original work of software is thus covered by the Copyright Act whether or not it has a copyright notice. On publication (defined in 17 USC §101 to include an offer to distribute copies), however, the software may be marked with the statutory copyright notice, including the word "copyright," the abbreviation "Copr." or the symbol c in a circle, the year of first publication, and the name of the copyright owner. For several different samples of copyright notices, see forms 6.8-1 through 6.8-3, 16.3-1.

Although this copyright notice is no longer required under the Berne Convention Implementation Act of 1988 (Pub L 100-568, 102 Stat 2853), its use has certain advantages. See 2 Nimmer on Copyright §7.02[B] (1963).

The Copyright Office regulations give four examples of placement of this notice on machine-readable software (37 CFR §201.20(g)):

(1) at or near the title or near the end of printouts;

(2) displayed on a terminal at sign-on;

(3) continuously displayed on a terminal; and

(4) legibly on the "permanent" container for the software.

All of these should be used, if possible.

Registration of the software using Copyright Office Form TX within 3 months after the first publication of the work will protect the software owner's rights to statutory damages and attorney fees under 17 USC §§412(2), 504-505. At present, the Copyright Office will register object code under a "rule of doubt" if the author provides a letter certifying that the programs are works of authorship meeting the requirements of 17 USC §102(a). ("Rule of doubt" registration means that the submitted work has not been examined to see whether it contains copyrightable authorship.) Unlike regular copyright registrations, rule-of-doubt registrations do not enjoy a presumption of validity. Registration after the 3-month period does not affect the right to recover actual damages and profits or the right to seek an injunction under 17 USC §§502, 504.

To register a copyright in a computer program, a copy of the program must be deposited with the Copyright Office. The office retains the copy, which may later be relied on (*e.g.,* in an infringement action) as proof of what was copyrighted. Because the deposited copy is open to the public, a considerable risk arises that any trade secrets in the copy will be lost. However, as discussed in §16.46, the Copyright Office regulations provide several alternatives for complying with the deposit requirement (*e.g.,* by submitting only the object code) without disclosing trade secret information. *Compuware Corp. v Serena Software Intern., Inc.* (ED Mich 1999) 77 F Supp 2d 816 (trade secret not lost when owner filed unredacted copy of software with Copyright Office because there was no evidence that any third party ever reviewed filed copy). These deposit requirement alternatives generally reduce the risk of loss of trade secrets, but at the potential expense of making it more difficult to later show what was copyrighted. On the other hand, depositing a copy of the work without using any of these alternatives makes the copy available to the public and destroys any claim of confidentiality, which is essential to trade secret protection. *Weygand v CBS, Inc.* (CD Cal 1997) 43 USPQ2d 1120.

No registration or preregistration is required for enforcement of a copyright in works whose country of origin is not the United States. 17 USC §411(a). See 2 Nimmer §7.02[B] on the effect of implementation of the Berne Convention in the United States.

In *Omega S.A. v Costco Wholesale Corp.* (9th Cir 2008) 541 F3d 982, the Ninth Circuit upheld the right of Omega, the holder of a U.S. copyrighted design, to enjoin the sale of watches bearing its design. Omega had manufactured and sold the watches in Switzerland. Costco purchased the watches after they had been bought and imported into the U.S. by third parties. Section 109(a) of the Copyright Act (17 USC §109(a)), which codifies the "first sale doctrine," provides that once the owner consents to the sale of a copy "lawfully made under this title," it can no longer exercise its

distribution right with respect to those copies. Omega argued and the court agreed that to apply the Copyright Act to conduct occurring entirely outside the United States "would impermissibly apply the Copyright Act extraterritorially." 541 F3d at 988. The Supreme Court has granted certiorari. *Omega S.A. v Costco Wholesale Corp.* (2009) ___ US ___, 176 L Ed 2d 720, 130 S Ct 2089.

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§16.45 C. Rights Against Infringers Under Copyright Law

Copyright law normally provides excellent protection against blatant copying of the program, *e.g.,* by transferring a copyrighted program stored on a floppy disk to a blank floppy for resale. See 17 USC §§501-511. Note, however, that the United States Supreme Court, by order dated April 23, 2001, abrogated the 1909 Copyright Rules of Practice. Because of the elimination of these rules, it is no longer possible to obtain a writ of seizure without any preseizure hearing. Accordingly, the copyright owner's rights to preliminary relief of copyright impoundment are subject to the Federal Rules of Civil Procedure 65(f).

NOTE: Although the 1976 Copyright Act does not expressly provide for liability arising out of copyright infringement committed by another, one may be liable for contributory copyright infringement who, with knowledge of the infringing activity, induces, causes, or materially contributes to the infringing conduct of another. *MGM Studios, Inc. v Grokster, Ltd*. (2005) 545 US 913, 162 L Ed 2d 781, 125 S Ct 2764; *Ellison v Robertson* (9th Cir 2004) 357 F3d 1072, 1076; *Perfect 10, Inc. v Cybernet Ventures, Inc.* (CD Cal 2002) 213 F Supp 2d 1146, 1169. See §16.46A.

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§16.46 D. Copyright Registration for Trade Secret Software

The Copyright Office regulations provide several alternatives for complying with the deposit requirement (see §16.44) without submitting trade secret information. For example, the copyright owner can submit (1) the first and last 25 pages of source code with trade secret information blocked out, (2) the first and last 10 pages of source code with no blocked-out portions, or (3) the first and last 25 pages of object code, together with any 10 or more consecutive pages of source code. 37 CFR §202.20(c)(2)(vii)(A)(2). If the registration is made on the basis of an object code deposit, the Copyright Office will make its registration under a "rule of doubt," and inform the registrant that no decision has been made on the existence of copyrightable authorship. 37 CFR §202.20(c)(2)(vii)(B).

The Copyright Office's practice of accepting the first and last portions of a program for the deposit copy has been upheld in court. Because of the deference given to a government agency in interpreting and applying its own rules, the acceptance of the first and last portions of the entire program, rather than portions of each subprogram, does not destroy the presumption of validity of the copyright registration unless there is evidence of fraud or misrepresentation. *Fonar Corp. v Domenick* (2d Cir 1997) 105 F3d 99. Marking computer manuals with a copyright symbol probably does not vitiate trade secret protection. *Technicon Med. Info. Sys. Corp. v Green Bay Packaging, Inc.* (7th Cir 1982) 687 F2d 1032; *Balboa Ins. Co. v Trans Global Equities* (1990) 218 CA3d 1327, 267 CR 787. But see *Videotronics v Bend Elecs.* (D Nev 1983) 564 F Supp 1471. Depositing a copy with the Copyright Office may be inconsistent with a trade secret claim. *Warrington Assoc. v Real-Time Eng'g Sys.* (ND Ill 1981) 522 F Supp 367, 368.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.46A E. Contributory Infringement

§16.46A E. Contributory Infringement

To substantiate a claim of contributory infringement in the computer technology context, a plaintiff must show (1) that the defendant had knowledge of the infringing activity and (2) that the defendant induced, caused, or materially contributed to that activity. *Ellison v Robertson* (9th Cir 2004) 357 F3d 1072, 1076.

The breadth of protection available to copyright owners was the subject of the United States Supreme Court's unanimous decision in *MGM Studios, Inc. v Grokster, Ltd.* (2005) 545 US 913, 162 L Ed 2d 781, 125 S Ct 2764. The decision holds that distribution of file-sharing software, coupled with an intent to induce infringement of copyrighted songs, constitutes contributory copyright infringement. The defendants distributed free software that allowed computer users to share electronic files of music and movies through peer-to-peer networks. Their intention in doing so was not altruistic; rather, the defendants sold advertisements and streamed the advertising to users. The Court explained that one infringes contributorily by intentionally inducing or encouraging direct infringement, and infringes vicariously by profiting from direct infringement while declining to exercise a right to stop or limit the infringement. 162 L Ed 2d at 796.

The district court and Ninth Circuit Court of Appeals had found for the defendants based on the Supreme Court's ruling in *Sony Corp. v Universal City Studios, Inc.* (1984) 464 US 417, 78 L Ed 2d 574, 104 S Ct 774, that the Sony VCR was "capable of commercially significant noninfringing uses." In the lower courts' view, the defendants could not be liable because there was no showing that the file-sharing software afforded them knowledge of specific unlawful uses. Finding this view of *Sony* to be erroneous, the Supreme Court held that *Sony* did not displace other theories of secondary liability, and that nothing in *Sony* requires courts to ignore evidence of *intent* if that evidence exists. *MGM Studios, Inc.,* 545 US at 934, 162 L Ed 2d at 799.

NOTE: Although viewed as a victory for Hollywood, the long-term effects of *Grokster* are not clear because, under the court's rationale, the software at issue could have been lawfully distributed if the defendants had not clearly manifested an intent to induce widespread copyright infringement over the Internet. As reported in the New York Times, the *Grokster* decision has "established a new standard for software innovation: don't ask, don't sell, that is don't ask for or gather information on what users are doing with the software you write, and don't sell ads that profit from access to copyrighted material." Pareles, *Critic's Notebook; The Court Ruled, So Enter the Geeks,* New York Times, June 29, 2005.

In *Perfect 10, Inc. v Amazon.com, Inc*. (9th Cir 2007) 508 F3d 1146, a corporation operating a subscription website featuring photographs of natural models sought an injunction against Google to prevent direct and contributory copyright infringement. Specifically, the plaintiff sought to prevent Google's image search engines from displaying "thumbnail" copies of plaintiff's copyrighted photographs and also from linking to third party websites that hosted and served infringing full-size images. For purposes of direct infringement, the court held that defendant's use of frames and in-line links did not constitute a "display" of the full-size images stored on and served by infringing third party websites and did not constitute distribution of infringing copies. In addition, the court held that although Perfect 10 made a prima facie case that Google's thumbnail images infringe Perfect 10's display rights, the use of the images by Google falls within the fair use exception (17 USC §107). 508 F3d at 1165. The court relied on *Kelly v Arriba Soft Corp.* (9th Cir 2003) 336 F3d 811 for the proposition that a search engine's use of an image is transformable so long as the copy serves a different function than the original work. 508 F3d at 1165. The court held that the "significantly transformative nature of Google's search engine, particularly in light of its public benefit, outweighs Google's superseding and commercial uses of the thumbnails…" 508 F3d at 1166. The court explained that although Google is not liable for direct infringement, Google could be held liable for contributory infringement if it had actual knowledge that the infringing images were available using its search engine, could have taken simple measures to prevent further damages to the copyrighted works, and failed to do so. 508 F3d at 1171.

In *In re Napster, Inc. Litig. v Hummer Windblad Venture Partners* (ND Cal 2006) 80 USPQ2d 1726, the district court held that the plaintiffs were entitled to pursue recovery from the defendants under the *Grokster* theory of liability, discussed above, which does not require actual or even reasonable knowledge of specific infringing files, as well as

under the "reasonable knowledge" standard.

In *U.S. v American Soc'y of Composers, Authors & Publishers* (SD NY 2007) 485 F Supp 2d 438, relating to downloading of a musical file (as distinguished from "streaming" the music), the court held that the downloading of a digital musical file, in and of itself, does not constitute a public performance under 17 USC §106(4). Rather, the court found that downloading constituted a mechanical reproduction of the copyrighted work in the form of a "digital phonorecord delivery" and was therefore subject to a compulsory license under 17 USC §115.

In *UMG Recordings, Inc. v Veoh Networks, Inc.* (CD Cal 2009) 665 F Supp 2d 1099, the defendant operated an Internet service that enabled users to share videos for free. The district court granted the defendant's motion for summary judgment on the grounds that it was entitled to the safe harbor for Internet service providers under 17 USC §512(c).

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V. LIMITATIONS ON SCOPE OF COPYRIGHT PROTECTION

§16.47 A. Statutory Limitations on Copyright Protection

A software buyer may copy software only for archival purposes or adapt it only as needed to enable its use in conjunction with the buyer's hardware. These copies may be transferred by the buyer only as part of a transfer of all rights to the program. No adaptations of the original copyrighted program may be transferred without the copyright owner's authorization. 17 USC §117.

Under the idea/expression dichotomy, which is codified by 17 USC §102(b), copyright protection does not extend to any "idea, procedure, process, system, method of operation, concept, principle, or discovery." For example, although the particular expression (*i.e.*, the sequence of instructions and any comments) of an algorithm in a computer program may be protectable by copyright, the algorithm itself is not. (An algorithm is a step-by-step procedure for solving a problem or accomplishing some end.) Therefore, anyone who lawfully obtains a program's algorithms, *i.e.*, has not misappropriated a trade secret or violated a valid software license, is entitled to independently develop and market a competitive program that is not protected under the patent laws.

PRACTICE TIP: Copyright law, unlike a patent law, offers no protection against someone who devises a similar or even an identical program if the original was not copied or misappropriated.

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§16.48 B. Copying to Reverse Engineer

Reverse engineering of software generally involves converting object code (the machine-readable version of a program) into source code (the human-readable counterpart), using a disassembler or decompiler program and analyzing the source code to see how the program operates. Although this process normally involves intermediate copying of the copyrighted program, in appropriate circumstances copying constitutes a fair use of the copyright.

The leading case on this issue is *Sega Enters. v Accolade, Inc.* (9th Cir 1992) 977 F2d 1510. Sega manufactures video game consoles and game cartridges that plug into the consoles. The cartridges store game programs (in object code), which include special "interface" routines for communicating with the console. Although Sega licensed the interface to others to allow the licensees to develop game cartridges that work on the Sega console, Accolade found the terms of the license unacceptable, and chose to reverse engineer the Sega interface routines. This process involved purchasing a Sega game console and three game cartridges, wiring a decompiler into the console circuitry, and generating printouts of the resulting source code. Accolade used this information to develop and manufacture its own game cartridges that run on the Sega console.

Although there was no question that the reverse engineering process involved copying protected software, the court found the copying to be a fair use under 17 USC §107. In so holding, the court stated that "[if] there is good reason for studying or examining the unprotected aspects of a copyrighted computer program, disassembly for purposes of such study or examination constitutes fair use," noting that disassembly was Accolade's "only means of gaining access to unprotected aspects of the program." 977 F2d at 1520. See also *Atari Games Corp. v Nintendo of Am.* (Fed Cir 1992) 975 F2d 832; *Sony Computer Entertainment v Connectix Corp.* (9th Cir 2000) 203 F3d 596 (applied fair use defense and approved copying of copyrighted BIOS for use in reverse engineering process to create software emulation program).

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§16.49 C. Protection for GUIs

A graphical user interface, or a "GUI," refers to the display elements and associated commands of a computer program that, when combined with appropriate input devices such as a mouse and a keyboard, allow the user to control operation of the computer. The display elements may include menu bars, icons, buttons, status screens, and other textual and graphical elements.

In the early 1990s, Lotus Corporation sold the well-known Lotus 1-2-3 spreadsheet program, which includes a GUI that allows users to control the program by choosing various menu commands such as "COPY" and "PRINT." These commands are accessible through a two-line menu at the top of the screen. Borland International developed the Quattro spreadsheet program in order to compete with Lotus in the spreadsheet market. Quattro had its own menu but also had a Lotus 1-2-3 emulation mode that allowed the user to control the program using the Lotus 1-2-3 command hierarchy. In addition, the Quattro program allowed users to execute their existing Lotus 1-2-3 macros from within Quattro. Thus, users could switch from Lotus 1-2-3 to Quattro without having to learn a new menu structure and without having to rewrite their existing macros. In providing these features, Borland copied the menu command hierarchy but did not copy the actual Lotus 1-2-3 code.

In *Lotus Dev. Corp. v Borland Int'l* (1996) 516 US 233, 133 L Ed 2d 610, 116 S Ct 804, a one-page decision in an evenly divided court with one justice abstaining, the United States Supreme Court affirmed the court of appeals decision that the menu command hierarchy of Lotus 1-2-3 is an unprotectable "method of operation" under 17 USC §102(b) and that the menu hierarchy did not constitute a copyrightable "expression," even though the selection of the textual commands involved some expressive choices. In the court of appeals decision, Judge Boudin emphasized the functional aspects of the Lotus GUI, and indicated that providing copyright protection for Lotus's GUI would have patent-like consequences in that it would limit the ability of others to perform the task in the most efficient manner. *Lotus Dev. Corp. v Borland Int'l* (1st Cir 1995) 49 F3d 807, 819.

Another case that limits the availability of copyright protection for graphical user interfaces is *Apple Computer, Inc. v Microsoft Corp.* (9th Cir 1994) 35 F3d 1435. In this case, which involved computer icons and related features of the Apple Macintosh operating system, the court found that only "thin" copyright protection was appropriate and that infringement therefore required "virtual identity," not mere "substantial similarity." 35 F3d at 1442. The court based its decision in part on a finding that there were only a limited number of ways in which the basic ideas of the GUI could be expressed. In addition, the court found that several GUI features (such as the use of inverse video to indicate that an icon has been selected) had become industry standards and, as such, were unprotectable.

In a copyrighted program embodying a method of operation, the four-digit register codes for a call controller lacked sufficient originality for protection because they were arbitrarily assigned or sequential, and thus required de minimis creative effort. The values assigned to each code had sufficient originality, but were "unprotectable as scenes à faire because they were dictated by external functionality and compatibility requirements of the computer and telecommunications industries." *Mitel, Inc. v Iqtel Inc.* (10th Cir 1997) 124 F3d 1366, 1376.

PRACTICE TIP: In view of these decisions, companies seeking protection for new GUI-related features would be well advised to strongly consider patent protection. For examples of recently issued utility patents for GUI features, see U.S. Patent Nos. 5,491,784 (assigned to IBM) and 5,416,900 (assigned to Lotus Development Corporation).

More limited protection may also be available through design patents claiming a computer screen or a portion of a computer screen with an icon, although claims to an icon or a computer icon by itself will be rejected. See Manual of Patent Examining Procedure (MPEP), Guidelines for Examination of Design Patent Applications for Computer-Generated Icons, §1504.01(a) (8th ed 2001, rev 2008).

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§16.50 D. Limitations on Protection of Object Code

Copyright protection may be denied if there are only a limited number of ways to express subject matter, and therefore, a copyright for such a program would effectively monopolize the subject matter by monopolizing its expression. See *Morrissey v Procter & Gamble Co.* (1st Cir 1967) 379 F2d 675 (set of written rules for sales promotion contest not copyrightable, because individual could exhaust all possibilities of future use of rules). See also *Landsberg v Scrabble Crossword Game Players, Inc.* (9th Cir 1984) 736 F2d 485, in which the court held that whether two works were substantially similar depended on the type of work and the ideas expressed in them. The smaller the range of expression for the ideas in the work, the more similar the works must be to be found infringing. Following *Landsberg,* the court in *Moore Publ'g, Inc. v Big Sky Mktg.* (D Idaho 1991) 756 F Supp 1371, 1379, noted that, as potential varieties of expression increase, small resemblances are more likely due to copying than to chance.

Object code may be copyrighted. See *Apple Computer, Inc. v Franklin Computer Corp.* (3d Cir 1983) 714 F2d 1240; *GCA Corp. v Chance* (ND Cal 1982) 217 USPQ 718. The court in *Apple Computer* held that a computer program, whether in source code or object code, is a "literary work" under 17 USC §102(a) and is protected from unauthorized copying even if the object code is embodied in a read-only memory (ROM) chip and not in a traditional writing. The court held that the operating system program may be copyrighted, noting that the "mere fact that the operating system program may be etched on a ROM does not make the program either a machine, part of a machine, or its equivalent." In response to Franklin's argument that the operating system program was an uncopyrightable idea instead of the copyrightable expression of an idea, the court remanded the case to the district court with instructions to decide (if one of the parties presses the issue on remand) whether the expression and the idea had merged because there were few other ways of writing operating system programs for Apple Computer hardware. This decision implies that, if Franklin Computer could show that there were only a few ways to write these programs, they would not be copyrightable. There were no further reported developments in the case. For further discussion of *Apple Computer,* see 5 CEB Cal Bus L Rep 54 (Oct. 1983). But see *Data Cash Sys. v JS&A Group, Inc.* (ND Ill 1979) 480 F Supp 1063, aff'd (7th Cir 1980) 628 F2d 1038.

Protection for software can exist at various levels, from individual lines of code to data file organization or the arrangement of subroutines. If the organization of software merely follows the longhand steps taken in performing the task for which the software is written, however, the organizational aspect is neither original nor entitled to copyright protection. *MiTek Holdings, Inc. v Arce Eng'g Co.* (11th Cir 1996) 89 F3d 1548 (truss design program).

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§16.51 VI. OWNERSHIP OF COPYRIGHTED SOFTWARE

The copyright for software written by a computer programmer "within the scope of his or her employment" is owned by the employer under 17 USC §§101 and 201(b). Despite these statutes, it is prudent to require in the standard employment agreement that all rights to computer programs in any format, or to firmware or software developed by the employee, belong to the employer. At least one court has decided that the standard "invention" agreement did not include an assignment of rights in software, because the software was not patentable. See *Amoco Prods. Co. v Lindley* (Okla 1980) 609 P2d 733. Another court found that an employee who developed a computer program entirely on his own time with his own equipment owned the copyright even though he was hired to develop similar programs at work. *Avtec Sys. v Peiffer* (4th Cir 1995) 38 USPQ2d 1922 (unpublished). Even ownership of the software copyright does not always guarantee a successful outcome if an appropriate agreement with a customer is lacking. See *Asset Mktg. Sys., Inc. v Gagnon* (9th Cir 2008) 542 F3d 748, cert denied (2009) ___ US ___, 174 L Ed 2d 228, 129 S Ct 2442, discussed in §16.2. The *Gagnon* court found an "implied license" was granted to Asset in copyrighted software owned by Gagnon, an independent contractor, which included both the right to use and modify the copyrighted software. Without any discussion, the court thus seemingly included the right to make derivative works otherwise exclusively reserved to Gagnon under 17 USC §106. To add insult to injury, the court agreed that former employees of Gagnon could be hired by Asset to create the modified software.

PRACTICE TIP: To avoid the possibility of an employee or consultant owning copyrights that the company needs, employers should require any consultant who develops software to execute an assignment of his or her copyright interest in the work. The client employing the consultant should be advised that, for all programs that are not "works for hire" as defined in 17 USC §101, the consultant may terminate the assignment "at any time during a period of five years beginning at the end of thirty-five years from the date of execution of the grant" in spite of the agreement. 17 USC §203(a)(3), (5). See §§16.52-16.59 for a form of consultant's copyright assignment.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/ VII. CONSULTANT'S COPYRIGHT ASSIGNMENT/§16.52 A. Form: Introduction

VII. CONSULTANT'S COPYRIGHT ASSIGNMENT

§16.52 A. Form: Introduction

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ASSIGNMENT AGREEMENT

BY THIS AGREEMENT, as of _ _[*date*]_ _, _ _[*name of hiring company*]_ _ (referred to as "Company") agrees to hire _ _[*name of consultant*]_ _ (referred to as "Consultant") on the terms and conditions set forth below.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.53 B. Form: Agreement to Create Software

§16.53 B. Form: Agreement to Create Software

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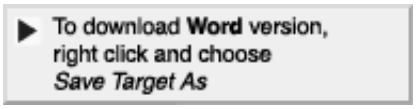

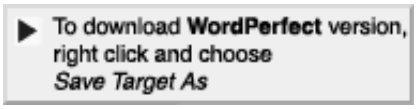

1. Consultant _ _[*name*]_ _ agrees to create for Company _ _[*describe programs*]_ _ (referred to as "Programs") as further described in Appendix A.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.54 C. Form: Consultant's Warranties

§16.54 C. Form: Consultant's Warranties

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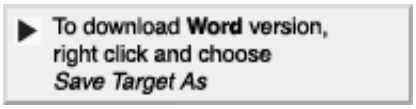

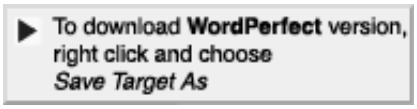

2. Consultant warrants that:

a. All Programs developed for Company shall be wholly original with Consultant, shall have not been published before, and shall not be copied in whole or in part from any other work;

b. Programs will not infringe on the copyright, or rights, of any person, firm, or corporation; and

c. Consultant has the unrestricted right, power, and authority to enter into this Agreement and knows of no third party claim to the Programs.

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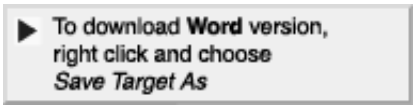
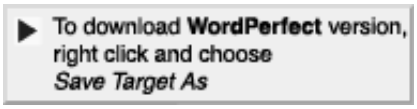
Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.55 D. Form: Confidentiality

§16.55 D. Form: Confidentiality

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§16.52-16.59.





3. Consultant shall receive and keep in trust and confidence (i) all information provided to Consultant either orally or in writing by Company, (ii) all Programs created by Consultant as a result of the performance of services for Company, and (iii) all Programs created by the Consultant that are based on the information that the Consultant receives from Company. Consultant shall not at any time, without first getting Company's written consent, (i) use this information for Consultant's own benefit or for the benefit of others, (ii) disclose this information, directly or indirectly, to others, or (iii) publish or otherwise disseminate this information.

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§16.56 E. Form: Consideration

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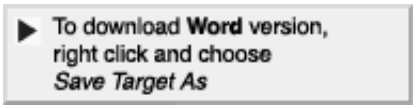

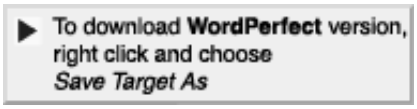

4. Company agrees to pay Consultant _ _[*dollar amount*]**_ _, and Consultant agrees to accept this amount as full consideration for Consultant's performance under this Assignment Agreement.**

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.57 F. Form: Ownership of Copyright

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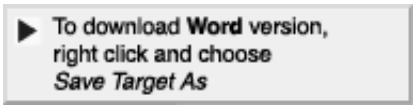

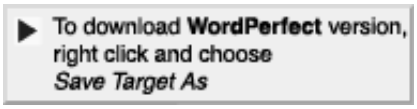

5. Consultant recognizes and agrees that all copyrights, copyright registrations, and copyrightable subject matter related to the programs or resulting from Consultant's services under this Agreement or based on Company's information, including the right to secure that copyright worldwide in the Company's name or otherwise, in any medium, shall be the Company's sole and exclusive property, and further agrees to hold those copyrights and all rights of any kind thereunder, IN TRUST for Company's use and benefit. Consultant and Company agree that all copyrightable subject matter that is specially ordered or commissioned for use as a contribution to a collective work, or is a supplementary work, a compilation, or an instructional text, as these terms are defined by 17 USC §101, shall be considered a "work made for hire" as this term is defined in 17 USC §101.

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§16.58 G. Form: Assignment of Copyright

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6. For valuable consideration, the receipt of which is hereby acknowledged, Consultant hereby irrevocably assigns and agrees to assign, sell, set over, and transfer to Company, its successors, and assigns, all the right, title, and interest of every kind, nature, or description in and to the above-identified programs. Consultant further irrevocably and exclusively assigns and agrees to assign as of the date of this Agreement all Consultant's rights in the copyright and all rights thereunder to this material to Company, its successors and assigns, including the right to secure copyright worldwide in the Company's name or otherwise in the Company's discretion in any medium.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.59 H. Form: Signatures

§16.59 H. Form: Signatures

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Consultant:

Date: _ _ _ _ _ _

__[*Signature*]__
Name: _ _[*Typed name*]_ _

Licensor:

Date: _ _ _ _ _ _

_ _[*Name of company*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This agreement may be used alone or incorporated into an employment agreement.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.59A VIII. PROTECTION UNDER DIGITAL MILLENNIUM COPYRIGHT ACT

§16.59A VIII. PROTECTION UNDER DIGITAL MILLENNIUM COPYRIGHT ACT

The Digital Millennium Copyright Act (DMCA) (Pub L 105-304, 112 Stat 2860) provides both civil and criminal penalties for circumventing a technological measure that effectively controls access to a copyrighted work, making it illegal to distribute hardware or software that defeats encryption protection. See 17 USC §1201. Preventing access, of course, is germane to almost any kind of reasonable efforts at protecting trade secrets.

The law also provides a safe harbor for limiting liability of copyright infringement by online service providers due to innocent transmission, caching, or storage of infringing material. See 17 USC §512. See *UMG Recordings, Inc. v Veoh Networks, Inc.* (CD Cal 2009) 665 F Supp 2d 1099.

PRACTICE TIP: Use encryption when disseminating any trade secret material over the Web or on CD-ROM, DVD, or other media, and include a prominent copyright label as described in §16.44.

In one of the first cases to challenge the validity of 17 USC §1201 of the Digital Millennium Copyright Act, *Universal City Studios, Inc. v Corley* (2d Cir 2001) 273 F3d 429, the defendants, who provided access to software for decrypting digitally encrypted digital versatile discs (DVDs) without a license, presented First Amendment and fair use defenses against the DMCA's applicability. The Second Circuit, affirming the district court, found these arguments unavailing. On the First Amendment challenge, the DMCA was held to be sufficiently related to an important government interest so as to meet the intermediate scrutiny test applied when a restriction on "expressive conduct" is content neutral. The court further rejected the defendant's argument that the DMCA unconstitutionally "*eliminates* fair use" of copyrighted materials. "The fact that the resulting copy will not be as perfect or as manipulatable as a digital copy obtained by having direct access to the DVD movie in its digital form, [sic] provides no basis for a claim of unconstitutional limitation of fair use." 273 F3d 459.

One of the more interesting questions presented by the defense in *Universal City Studios* was whether or not Congress had exceeded its constitutional authority to grant authors copyrights for a limited time by allowing copyright owners to effectively protect public domain works along with copyrighted materials perpetually. However, this issue was dismissed by the court as not ripe and not properly briefed for a decision on the merits. 273 F3d at 445.

A First Amendment challenge to the DMCA was also rejected by the federal district court in the Northern District of California. In *U.S. v Elcom, Ltd.* (ND Cal 2002) 203 F Supp 2d 1111, the district court refused to dismiss the indictment against a defendant for marketing a program that enables a purchaser of an electronic book to convert its format so that it is readable in any PDF viewer. As a result, "the restrictions imposed by the publisher are stripped away, leaving the eBook in a naked 'PDF' format that is readily copyable, printable and easily distributed electronically." Although the district court disagreed with the government's positions that (1) the DMCA did not implicate the First Amendment; (2) the sale of the program was not speech; and (3) the computer code was not speech, the court concluded that the DMCA did not target speech. "Thus, to the extent that the DMCA targets computer code, Congress sought to ban the code not because of what the code says but rather because of what the code does."

In *321 Studios v Metro Goldwyn Mayer Studios, Inc.* (ND Cal 2004) 307 F Supp 2d 1085, the plaintiff brought a declaratory judgment action claiming that it had the right to sell software for copying DVDs. The plaintiff questioned whether the encryption code used on DVDs (known as CCS) was effective, because the CSS access keys are widely available on the Internet. The district court rejected this argument, commenting that "this is equivalent to a claim that, since it is easy to find skeleton keys on the black market, a deadbolt is not an effective lock to a door." 307 F Supp 2d at 1094. See also *Realnetworks, Inc. v DVD Copy Control Ass'n* (ND Cal 2009) 641 F Supp 2d 913.

However, a similar argument was accepted by the Sixth District Court of Appeal in overturning a preliminary injunction in a trade secret action. In *DVD Copy Control Ass'n, Inc. v Bunner* (2004) 116 CA4th 241, 10 CR3d 185, the DVD Copy Control Association (DVD CCA) sued Bunner under California's trade secret act, seeking an injunction to prevent the use of the DeCSS decryption code. The unanimous panel of the court, reversing the preliminary injunction granted by the lower court, stated, "Further, there is a great deal of evidence to show that by the time DVD CCA sought the preliminary injunction prohibiting disclosure of the DeCSS program, DeCSS had been so widely distributed

that the CSS technology may have lost its trade secret status. There is no evidence at all to the contrary. Thus, DVD CCA has not shown a likelihood of success on the merits; nor has it demonstrated that it would suffer further harm if the preliminary injunction did not issue." 116 CA4th at 255.

For further discussion of the DMCA, see Internet Law and Practice in California §§1.24-1.43 (Cal CEB 2004).

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§16.59B IX. PROTECTION UNDER THE COMPUTER FRAUD AND ABUSE ACT

The Computer Fraud and Abuse Act (CFAA) (18 USC §1030) makes it a federal crime to knowingly access a protected computer without authorization and with intent to defraud. In *Shamrock Foods Co. v Gast* (D Ariz 2008) 535 F Supp 2d 962, the district court interpreted the language of the CFAA to mean that a "without authorization" violation only occurs when the initial access was not permitted, and an "exceeds authorized access" violation only occurs when the initial access to a protected computer is permitted but the access to certain information is not permitted. See also *International Airport Ctrs., LLC v Citrin* (7th Cir 2006) 440 F3d 418 (former employee violated CFAA by loading erasure program onto laptop to ensure that employer's deleted files could not be recovered); *U.S. v Nosal* (ND Cal, Apr. 13, 2009, No. CR 08-00237 MHP) 2009 US Dist Lexis 31423, *15 (in criminal case, discussion of effect of former employee's "nefarious intent" on whether computer access is "authorized" under CFAA).

The CFAA also grants a private right to maintain a civil action against persons so accessing a protected computer. In *Role Models Am., Inc. v Jones* (D Md 2004) 305 F Supp 2d 564, the district court judge denied relief to the plaintiff because the defendant did not "access" a computer but instead was a passive recipient of the alleged trade secret information by e-mail. However, there is nothing in this decision that interprets the statute to preclude using the statute as a basis for a trade secret civil action when the trade secret is misappropriated by "accessing" a protected computer without authorization.

For further discussion of the Computer Fraud and Abuse Act, see Internet Law and Practice in California §§18.3-18.7 (Cal CEB 2004).

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X. PATENT PROTECTION FOR COMPUTER TECHNOLOGY

§16.60 A. Advantages and Disadvantages of Patent Protection

Patent protection of computer software provides several significant advantages over copyright and trade secret protection. One advantage is that patent protection protects against the independent development of the invention. Patent protection also provides for treble damages in cases of willful infringement. However, these increased damages do not apply to the provisional rights to obtain reasonable royalties. 35 USC §284. See also 35 USC §154(d) (promulgating provisional rights to obtain reasonable royalties).

Patent protection also has the significant advantage over copyright protection of not being limited to a particular expression. See §16.47. Thus, for example, the first to invent a word processing program would, at least in theory, be entitled to a patent that covers all word processing programs; in contrast, copyright protection would protect only against copying the particular program (and possibly the specific screen displays of the program) written by the inventor. For examples of software patents with broadly drafted claims, see U.S. Patent Nos. 5,491,784, 4,626,836.

The Ninth Circuit decision in *Arizona Cartridge Remanufacturers Ass'n v Lexmark Int'l, Inc.* (9th Cir 2005) 421 F3d 981 suggests a very significant advantage to patenting certain types of technology. This court upheld enforceability of a "shrink wrap" single-use license placed on Lexmark's replacement cartridges for laser printer toners. The issue addressed was whether Lexmark had violated Bus & P C §17200, which prohibits "unfair competition." In granting Lexmark a summary judgment, the court held that it was within its rights as a patent holder to create a conditional sale with a "shrink wrap" type of license.

Patents also offer the potential for a substantial financial return, particularly when the claims are broad or difficult or impossible to design around. A prominent example is the recent litigation between NTP, Inc., the patent holder, and Research in Motion, Ltd., the manufacturer of the ubiquitous Blackberry wireless device linked to e-mails. The plaintiff, NTP, Inc., having been granted a permanent injunction (see *NTP, Inc. v Research In Motion, Ltd.* (Fed Cir 2005) 418 F3d 1282), threatened to close down the Blackberry system before agreeing to a settlement.

The fact that a single patent could actively disrupt an entire business has placed a very bright spotlight on the role of patents in the computer, business method, and Internet fields of commerce. Such publicity no doubt helped eBay recently to obtain a ruling from the U.S. Supreme Court vacating a permanent injunction based on a Federal Circuit holding that "courts will issue permanent injunctions against patent infringement absent exceptional circumstances." *eBay Inc. v MercExchange, LLC* (2006) 547 US 388, 164 L Ed 2d 641, 645, 126 S Ct 1837. In this unanimous decision by Justice Thomas, the Court ruled that

> [a]ccording to well-established principles of equity, a plaintiff seeking a permanent injunction must satisfy a four-factor test before a court may grant such relief. A plaintiff must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.... These familiar principles apply with equal force to disputes arising under the Patent Act. As this Court has long recognized, "a major departure from the long tradition of equity practice should not be lightly implied." [citations omitted] Nothing in the Patent Act indicates that Congress intended such a departure. To the contrary, the Patent Act expressly provides that injunctions "may" issue "in accordance with the principles of equity." 35 USC §283.

A finesse of the *eBay* holding has been initiated by the Federal Circuit in *i4i v Microsoft Corp.* (Fed Cir 2010) 598 F3d 831. Asserting that the permanent injunction was "narrow" and "applies only to users who purchase or license [the infringing software] after the date the injunction takes effect," the court upheld the injunction sought by i4i, whose patented software was rendered obsolete by Microsoft. 598 F3d at 861. The court also upheld a record high damage award of $200 million based on a hypothetical royalty of $98 for versions of Microsoft Word having XML editing capabilities and an additional $40 million in enhanced damages. 598 F3d at 853.

Certain disadvantages must also be considered in deciding whether to file for United States patent protection. One

disadvantage is the cost of preparing and pursuing the patent application. Another problem is the requirement of 35 USC §112 that the application set forth the "best mode" of practicing the invention. As a result of this requirement, the software owner may give up considerable trade secret information when the patent issues in the United States (or when the pending U.S. application or corresponding foreign application is published), whereas the United States copyright registration process specifically permits deletion of substantial portions of the source code. See California Business Litigation, chap 8 (Cal CEB 2002) on patents.

NOTE: The grant of certiorari in *Omega S.A. v Costco Wholesale Corp.* (9th Cir 2008) 541 F3d 982 (see §16.44) has resulted in some discussion as to whether a Supreme Court decision favoring international exhaustion of U.S. copyright rights may foreshadow a future decision supporting international exhaustion of U.S. patent rights. See, *e.g.,* Wegner, *International Patent Exhaustion: Whither the Supreme Court?,* available at http://www.grayonclaims.com/storage/InternationalExhaustionMar23.pdf. The recent decision, *FugiFilm Corp. v Benun* (Fed Cir 2010) 605 F3d 1366, denied exhaustion so that, assuming a petition for certiorari is filed, the Supreme Court could decide the issue under both copyright and patent law.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.61 B. Sufficiency of Disclosure

§16.61 B. Sufficiency of Disclosure

To be valid, a patent must disclose sufficient information to enable one who is skilled in the area to practice the invention. 35 USC §162. Few case decisions provide detailed guidance on what constitutes an adequate disclosure for the wide variety of software-related patents now being issued by the Patent Office. If the software constitutes part of a best mode of carrying out an invention, the requirement of describing such a best mode is generally satisfied by disclosing the functions of the software. Thus, flow charts or source code listings are not always required to adequately disclose the functions of software. *Fonar Corp. v General Elec. Co.* (1997) 107 F3d 1543. However, if the patent claims focus on the program architecture rather than having the software as only one component of the claim, then to guard against an insufficient disclosure the applicant should strongly consider including flow charts, flow diagrams, or both (*i.e.*, diagrams showing the flow of information between system components) to illustrate operation of the invention. Flow charts are usually most appropriate for applications that involve a single code module running on a single computer. The flow chart need not be arranged in exactly the same way as the source code, but it should describe the invention from a functional, use-oriented perspective. A recommended approach is to arrange the flow chart so that the specification describes the operation performed by the software program in controlling operation of the hardware (by referring to a hardware block diagram). The patent reader should be able to track through a sequence of computer steps by referring alternately to the flow chart and the hardware block diagram.

For inventions involving the interaction of many different hardware or software components, or both (as is common in applications that involve database queries, client-server type transactions, and communications over networks), flow diagrams should also (or alternatively) be included. (A flow diagram pictorially illustrates the flow of data, commands, and other information between the various hardware and/or software components of a computer system. This approach is in contrast to a flow chart, which illustrates the sequence of steps and decisions made during the execution of a program.) A common approach is to use an arrow that connects a source box to a destination box to illustrate a message being passed between the source and destination components. See, *e.g.,* U.S. Patent Nos. 4,405,829, 4,888,681. When a sequence of messages follows a particular order, the person preparing the patent application can label the arrows "A, B, C …" and a key can be provided on the drawing to identify the type or purpose of each message.

Patent protection can also offer much broader protection than a copyright because it may not be limited to the particular code that is copyright protected; it can protect the basic operational steps implemented by the software. For example, a patent was granted for communicating over a trusted pathway without regard to the program implementing that communication. There were only a limited number of ways of communicating, but that did not render the claimed communication pathway obvious. *In re Zurko* (Fed Cir 1997) 111 F3d 887, rev'd on other grounds (1999) 527 US 150, 144 L Ed 2d 143, 119 S Ct 1816.

When preparing the application, the applicant must decide whether to include a program listing. On one hand, the inclusion of a source code listing generally reduces the likelihood that the patent will later be found invalid for "best mode" reasons. See *White Consol. Indus. v Vega Servo Control, Inc.* (Fed Cir 1983) 713 F2d 788 (claim invalid for failure to disclose program listing because program was complex and would require 1.5 to 2 person years to generate). (A source code listing is a printout of the human-readable instructions of a computer program, typically in the programming language in which the program was written.) On the other hand, the inclusion of program listings presents at least two risks: (1) The listings may include trade secrets unrelated to the claimed invention, and (2) the listings may include errors or "bugs" not apparent at the time of filing, which could subject the patent to attack for failing to disclose a functionary embodiment of the invention. The practitioner should consider these competing concerns in light of the nature and complexity of the invention.

The need for disclosing source code is reduced by the decision that a description of the software function is likely to satisfy the best mode disclosure obligation, and that source code, and even flow charts, are not generally required. *Fonar Corp. v General Elec. Co., supra*. Unfortunately, the Federal Circuit has provided no guidance for identifying nongeneral cases in which source code, flow charts, or program architecture interfaces may be required. Thus, while

the need to disclose detailed code listings and descriptions of the language is greatly lessened, it is still appropriate in many cases. As the law in this area is still emerging, careful consideration must be given before withholding information from a patent application and keeping that information as a trade secret.

If a listing is submitted, it should include the usual copyright notice (see §16.44) so that the patent, when ultimately issued, will bear a copyright notice with the listing. When the code listing is voluminous, the practitioner should consider submitting the listing on a compact disk, as authorized by Manual of Patent Examining Procedure (MPEP) §608.05 (8th ed 2001, rev 2008).

Finally, patent applications that involve graphical user interface (GUI) features should include drawings (or possibly screen dumps) of the relevant screen displays. See, *e.g.*, U.S. Patent No. 5,491,784.

More limited protection may also be available through design patents claiming a computer screen or a portion of a computer screen with an icon, although claims to an icon or computer icon by itself will be rejected. Patent and Trademark Office, Guidelines for Examination of Design Patent Applications for Computer-Generated Icons (1996).

The disclosure requirement for patents requires disclosing both the best mode contemplated by the inventor and the closest prior art known to the inventor. Failure to disclose material prior art can make the patent unenforceable. *Cabinet Vision v Cabnetware* (SD Cal 1996) 40 USPQ2d 1168, aff'd in part and vacated on other grounds (Fed Cir 2000) 2000 US App Lexis 2030.

In *Ariad Pharm., Inc. v Eli Lilly & Co.* (Fed Cir 2010) 598 F3d 1336, the Federal Circuit affirmed the court's prior decisions that 35 USC §112 requires that the written description of the specification "demonstrate possession" as well as enablement of the invention. The majority opinion drew a strong dissent (598 F3d at 1366, dissenting opinion of Rader, J.):

> In sum, the statute supplies a test for description that has operated marvelously for decades, if not centuries. … Invention of new technologies strengthens and advances the "useful arts," but invention of new doctrines frustrates and confuses the law.

While this case pertained to a biotech invention (regulation of gene expression), it is likely to be asserted against pioneer "blocking" patents in any field.

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§16.62 C. Strategies for Mitigating Effect of 35 USC §112 Disclosure Requirements

The United States Patent and Trademark Office (PTO) publishes utility and patent applications filed on or after November 29, 2000. Patent applications are published 18 months from the earliest domestic or foreign filing date. 35 USC §122(b)(1)(A). Thus, trade secrets contained in a patent application are no longer kept secret during the entire application period. To ensure protection of trade secrets at the time of filing, however, an applicant can request nonpublication of the application. The applicant must certify that the invention disclosed has not and will not be the subject of an application filed in another country that requires 18-month publication. 35 USC §122(b)(2)(B)(i). If a nonpublication request is not submitted on filing, the applicant may desire to abandon the application under 37 CFR §1.138(c), and file a continuation with a nonpublication request. This must be done at least 4 weeks before the publication date. 37 CFR §1.138(c). If it becomes apparent during the application process that patent protection will be insufficient to adequately protect the trade secrets, the application can be abandoned before publication to preserve the trade secret status of the information.

PRACTICE TIP: An applicant seeking to abandon an application may seek a refund of the search and excess claims fees submitted with the application. The applicant must submit a declaration of express abandonment by way of petition before an examination has been made of the application. If a refund request is not filed with the declaration, or within 2 months of the declaration's filing date, the PTO may retain the fees. 37 CFR §1.138(d).

It may be possible to lessen the impact of the best mode requirement (see §16.60) by filing for patent protection early in the development cycle because 35 USC §112 requires disclosure of only the best mode known to the inventors at the time of the filing. (Of course, the disclosure must still satisfy the enabling requirement of §112.) Thus, isolating the inventor from later improvements made to the invention can remove the obligation to disclose the improvements in the patent application. *Glaxo Inc. v Novopharm Ltd.* (Fed Cir 1995) 52 F3d 1043. Modifications and additions (*e.g.*, improvements to disclosed algorithms) made after the filing date need not be included in the application and can therefore be maintained as trade secrets. This strategy may be particularly useful when a later filing date would require the disclosure of information that would create a security risk to the client's product or computer system, which is common in the field of computer networks and computer-controlled security systems.

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XI. PATENTABLE SUBJECT MATTER

§16.63 A. Interpretation of 35 USC §101

To be patentable, an invention must provide a "new and useful process, machine, manufacturer or composition of matter, or any new and useful improvement thereof." 35 USC §101. The patentability of software has been the subject of controversy since shortly after the widespread introduction of the digital computer, on the ground that software fails to satisfy the literal requirements of 35 USC §101. Despite §101's use of the expansive term "any" and the Supreme Court's acknowledgment (in *Diamond v Chakrabarty* (1980) 447 US 303, 309, 65 L Ed 2d 144, 100 S Ct 2204) that Congress intended §101 to extend to "anything under the sun that is made by man," the courts have interpreted §101 to exclude from protection laws of nature, physical phenomena, and abstract ideas. See, *e.g.*, *Diamond v Diehr* (1981) 450 US 175, 67 L Ed 2d 155, 101 S Ct 1048. The basic reason given by the Court for this exclusion is that laws of nature and natural phenomena are in essence manifestations of nature (*i.e.,* not "new"), free to all, and reserved exclusively to none. Software, however, is not considered a law of nature or natural phenomena.

In a long-awaited decision, the U.S. Supreme Court, by a 5-4 vote, ruled that business methods are not per se excluded from patentability by §101. *Bilski v Kappos* (2010) ___ US ___, 177 L Ed 2d 792, 130 S Ct 3218. Instead, the Court held, in an opinion written by Justice Kennedy, that "[r]ather than adopting categorical rules that might have wide-ranging and unforeseen impacts, the Court resolves this case narrowly on the basis of this Court's decisions in *Benson, Flook,* and *Diehr,* which show that petitioners' claims are attempts to patent abstract ideas." 177 L Ed 2d at 806. The Court further ruled that the Federal Circuit erred in holding that the machine-or-transformation test is the sole test for deciding whether an invention is a patent-eligible process (177 L Ed 2d at 803):

> As numerous *amicus* briefs argue, the machine-or-transformation test would create uncertainty as to the patentability of software, advanced diagnostic medicine techniques, and inventions based on linear programming, data compression, and the manipulation of digital signals.

Although Justice Kennedy went out of his way to state that the Court was not commenting on the patentability of a particular invention, "let alone holding that any of the above mentioned technologies from the Information Age should or should not receive patent protection" (177 L Ed 2d at 804), it is inevitable that his decision will serve to stimulate patent filing and patent litigation in computer technology.

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§16.64 B. Patent Office Position

Like the courts, the United States Patent and Trademark Office (PTO) has struggled with the issue of the patentability of software-related inventions. In doing so, the PTO has created and relied on some of its own exclusions to 35 USC §101. For example, until recently, the PTO recognized a "method of doing business" exception to §101. In addition, the PTO has relied on its "printed matter" doctrine (see Manual of Patent Examining Procedure (MPEP) §706.03(a) (8th ed 2001, rev 2008)) to reject claims directed merely to a novel computer program stored on a computer-readable medium. Consequently, the PTO's interpretation of §101 has generally been more restrictive than that of the courts.

However, after soliciting comments from the computer industry, the PTO published the Examination Guidelines for Computer-Related Inventions (1996) (Guidelines). These Guidelines represent a major shift in favor of patentability in the PTO's policy for handling software-related inventions and indicate the PTO's increased willingness to adhere to Federal Circuit precedent. For example, the Guidelines direct examiners to no longer reject claims as reciting "methods of doing business." The Guidelines also specify the types of information (*e.g.,* descriptive material, data structures, executable code) that constitute patentable subject matter when stored on a computer-readable medium, and in doing so, open the door to allowing claims to software stored on a disk. See Guidelines §IV.B.1.

In the context of inventive computer processes (*e.g.*, algorithms and executable code), the Guidelines shift the focus of the §101 inquiry to whether the software-related invention has or is limited to some "practical application." In this respect, the Guidelines significantly modify the current PTO position by indicating that a process claim that is limited by its terms to a practical application (*e.g.*, data caching) may be statutory even if the claim does not recite any presolution or postsolution activity. See Guidelines §IV.B.2(b), discussed in §16.66. The portions of the Guidelines that address the "practical application" inquiry are discussed in §§16.65-16.66.

The "Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility" (MPEP §210) were first published in November 2005 in the Official Gazette in response to the increase in business method patent applications. The Guidelines recite that to be patentable under 35 USC §101, the claimed subject matter must have utility that is specific, substantial, and credible, and that the invention must possess a "real world" value. One result of the Interim Guidelines has been to foster rejection of applications in fields other than business methods. For example, the Guidelines assert that electromagnetic signals are not eligible as a process, machine manufacture, or composition of matter, while case law recognizes that novel methods for analyzing signals may be patentable. See, *e.g., Arrhythmia Research Technol., Inc. v Corazonix Corp.* (Fed Cir 1992) 958 F2d 1053. Another area of controversy is that the Guidelines treat data transformation differently from physical transformation, again contrary to *Arrhythmia*. Section 2106 of the Guidelines had previously indicated a safe harbor for "Manipulation of Data Representing Physical Objects or Activities," which is not part of the Interim Guidelines.

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§16.65 C. Invention Must Have Some Practical Application

In connection with inventions that involve laws of nature, abstract ideas, or natural phenomena, the Examination Guidelines for Computer-Related Inventions (1996) published by the Patent and Trademarks Office (PTO) emphatically stresses the importance that the claimed invention have some practical application. For example, Guidelines §IV.A states:

> The subject matter courts have found to be outside the four statutory categories of invention [processes, machines, manufactures and compositions of matter] is limited to abstract ideas, laws of nature and natural phenomena. While this is easily stated, determining whether an applicant is seeking to patent an abstract idea, a law of nature or a natural phenomenon has proven to be challenging. These three exclusions recognize that subject matter that is not a practical application or use of an idea, a law of nature or a natural phenomenon is not patentable.
>
> Courts have expressed a concern over "preemption" of ideas, laws of nature or natural phenomena. The concern over preemption serves to bolster and justify the prohibition against the patenting of such subject matter. In fact, such concerns are only relevant to claiming a scientific truth or principle. Thus, a claim to an "abstract idea" is non-statutory because it does not represent a practical application of the idea, not because it would preempt the idea.

This problem typically arises when the applicant claims the invention as an algorithm or a law of nature per se, rather than claiming the practical application of the algorithm or law of nature. For example, suppose an applicant invents a mathematical algorithm for reversibly encrypting digital data. If the applicant simply describes and claims the algorithm as such, without referring to how the algorithm can be used in some practical manner, the PTO will likely reject the claims as being directed to unpatentable subject matter. If, however, the applicant describes and claims the use of the algorithm to securely send digital transactions over a public computer network, the PTO is more likely to view the application as patentable subject matter.

To evaluate whether the invention has some practical application, the Guidelines direct the PTO examiner to give deference to statements made by the applicant in the specification (Guidelines §II.A):

> The applicant is in the best position to explain why an invention is believed useful. Office personnel should therefore focus their efforts on pointing out statements made in the specification that identify all practical applications for the invention. Office personnel should rely on such statement throughout the examination when assessing the invention for compliance with all statutory criteria. An applicant may assert more than one practical application, but only one is necessary to satisfy the utility requirement.

PRACTICE TIP: The practitioner should emphasize the practical applications and advantages of the invention throughout the application, including both the summary of the invention and the detailed description portions of the application.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.65A D. Doctrine of Obviousness

§16.65A D. Doctrine of Obviousness

In April 2007, the United States Supreme Court issued what may prove to be a landmark decision on patentability, *KSR Int'l Co. v Teleflex, Inc.* (2007) 550 US 398, 167 L Ed 2d 705, 127 S Ct 1727, a case involving an automobile pedal sensor for computer-controlled throttles. The opinion establishes standards by which obviousness should be adjudicated, comparing relevant prior art to the patent claims at issue. In general, obviousness is based on whether a hypothetical person having ordinary skill in the art, with all prior art references, would regard the subject matter of the invention as obvious. *Boston Sci. Corp. v Johnson & Johnson* (ND Cal 2007) 534 F Supp 2d 1062, 1070 (quoting *Standard Oil Co. v American Cyanamid* (Fed Cir 1985) 774 F2d 448, 453).

A patent can be invalidated through the doctrines of anticipation or obviousness. See 35 USC §§102, 103. Section §103 defines unpatentable subject matter as anything that "as a whole" would have been "obvious at the time the invention was made to a person having ordinary skill in the art to which the subject matter pertains." 35 USC §103(a). In *KSR Int'l Co.,* the district court granted summary judgment of invalidity in favor of the alleged infringer; the Federal Circuit reversed, applying its "teaching, suggestion or motivation [TSM] test." The Supreme Court strongly rejected the "rigid approach" used by the Federal Circuit in applying the TSM test. Although the Court did not reject the TSM test entirely, the decision reflects a strong belief by the Court that the bar for patentability needs to be substantially higher. Many companies in the computer technology field would agree that the pendulum had swung too far in favor of the patentee; nonetheless, one would have hoped that the Supreme Court would not have relied on its often criticized "old elements" decision from 1950, which held that a "patent for a combination which only unites old elements with no change in their respective functions … obviously withdraws what is already known into the field of its monopoly and diminishes the resources available to skillful men." 167 L Ed 2d at 720, quoting *Great Atl. & Pac. Tea Co. v Supermarket Equip. Corp.* (1950) 340 US 147, 152, 95 L Ed 162, 167, 71 S Ct 127.

The Court set forth several initial factors for performing an objective analysis of obviousness (167 L Ed 2d at 715 (quoting *Graham v John Deere Co.* (1966) 383 US 1, 15 L Ed 2d 545, 86 S Ct 684)):

> Under §103, the scope and content of the prior art are to be determined; differences between the prior art and the claims at issue are to be ascertained; and the level of ordinary skill in the pertinent art resolved. Against this background the obviousness or nonobviousness of the subject matter is determined. Such secondary considerations as commercial success, long felt but unsolved needs, failure of others, etc., might be utilized to give light to the circumstances surrounding the origin of the subject matter sought to be patented.

Further, an obviousness analysis must consider the following factors to determine whether there was an apparent reason to combine the known elements in the fashion claimed by the patent at issue (167 L Ed 2d at 715):

- The interrelated teachings of multiple patents;
- The effect of demands known to the design community or present in the marketplace; and
- The background knowledge possessed by a person having ordinary skill in the art.

NOTE: The potential ramifications of the *KSR Int'l Co.* decision may be very significant to inventors and businesses that rely on innovation. See, *e.g., Shuffle Master, Inc. v MP Games LLC* (D Nev 2008) 553 F Supp 2d 1202, 1220; *Abbott Labs. v Sandoz, Inc.* (ND Ill 2007) 500 F Supp 2d 846, 850; Wegner, *Making Sense of KSR and Other Recent Patent Cases,* 106 Mich L Rev First Impressions 39 (2007); Kunin & Beverina, *KSR's Effect on Patent Law,* 106 Mich L Rev First Impressions 50 (2007); Greenhouse, *High Court Puts Limits on Patents,* New York Times, May 1, 2007.

A determination of obviousness under §103 is a question of law based on underlying findings of fact. *Boston Sci. Corp. v Johnson & Johnson* (ND Cal 2007) 534 F Supp 2d 1062, 1070; *Oakley, Inc. v Sunglass Hut Int'l* (Fed Cir 2003) 316 F3d 1331, 1339.

COMMENT: In *Roche Palo Alto LLC v Apotex, Inc.* (ND Cal 2007) 526 F Supp 2d 985, 996, the court, as a matter of first impression, assumed without deciding that the *KSR Int'l Co.* decision constituted a major change in the law of

obviousness sufficient to preclude the application of issue preclusion. The Supreme Court's actual holding was narrow, limited to the Federal Circuit's application of the TSM test, and did not purport to overrule or overturn any other decisions. Nonetheless, subsequent lower court decisions have regarded the decision as one that may affect existing Federal Circuit precedent regarding the application of the TSM test.

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Source: Business Law/Trade Secrets Practice in California/16 Protecting Computer Technology/§16.66 E. Claims Directed to Computer Processes

§16.66 E. Claims Directed to Computer Processes

According to the United States Patent and Trademark Office Examination Guidelines for Computer-Related Inventions (1996) (Guidelines), when a claim is directed to a computer-related "process" (*i.e.*, a method or series of steps) or to a general purpose computer for performing the process, the examiner should analyze the recited process for compliance with 35 USC §101. Guidelines §IV.B.2(b) summarizes the criteria for evaluating the process as follows:

> To be statutory, a claimed computer-related process must either: (1) result in a physical transformation outside the computer for which a practical application in the technological arts is either disclosed in the specification or would have been known to a skilled artisan, or (2) be limited by the language in the claim to a practical application within the technological arts.... The claimed practical application must be a further limitation upon the claimed subject matter if the process is confined to the internal operations of the computer. If a physical transformation occurs outside the computer, it is not necessary to claim the practical application. A disclosure that permits a skilled artisan to practice the claimed invention, *i.e.*, to put it to a practical use, is sufficient. On the other hand, it is necessary to claim the practical application if there is no physical transformation or if the process merely manipulates concepts or converts one set of numbers into another.

Thus, a claim to a process will meet the statutory requirements if it either (a) recites sufficient "transformation" activity outside the computer (which may be either presolution or postsolution activity) or (b) is limited by its terms to a practical application.

For examples of claims that satisfy requirement (a), see Guidelines §IV.B.2(b)(i)-(ii).

The Guidelines provide the following examples of claims that satisfy requirement (b) (Guidelines §IV.B.2(b)(ii)):

> A method of making a word processor by storing an executable word processing application program in a general purpose digital computer's memory, and executing the stored program to impart word processing functionality to the general purpose digital computer by changing the state of the computer's arithmetic logic unit when program instructions of the word processing program are executed.
>
> A digital filtering process for removing noise from a digital signal comprising the steps of calculating a mathematical algorithm to produce a correction signal and subtracting the correction signal from the digital signal to remove the noise.

As illustrated by these examples, the "practical application" can be phrased in broad terms (*e.g.*, "removing noise" instead of "removing noise from a cardiac signal") to avoid revealing more information than necessary.

Practitioners will often find that multiple, alternative bases are available for satisfying 35 USC §101. In such situations, the practitioner should present multiple claim sets, with each set relying on a different basis for satisfying §101. For example, suppose that a pacemaker-related invention uses a novel algorithm for processing physical activity data (measured by an activity sensor implanted in a patient) so as to dynamically adjust a pacing rate for applying electrical pulses to the heart. The practitioner could present at least three sets of method claims that encompass the underlying algorithm: for satisfying §101—one set that relies on the postsolution activity (*i.e.*, the application of stimulation therapy to the anatomy of the patient) as the basis, a second set that relies on the presolution activity (*i.e.*, the sensing of physical activity), and a third set that is explicitly limited to the art of cardiac pacing.

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17

Protecting Biotechnology

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I. INTRODUCTION
A. The Nature of Biotechnology §17.1
B. Practitioner's Role §17.2

II. PROTECTING PROPRIETARY RIGHTS IN BIOLOGICAL MATERIALS §17.3
A. Difficulty of Detecting Theft §17.4
B. Economic Espionage Act of 1996 §17.4A
C. Academic Practices and Problems With Proprietary Rights §17.5
1. *Institut Pasteur v U.S.* §17.6
2. *Genentech, Inc. v Eli Lilly & Co.* §17.7 [Deleted]
D. Ascertaining Proprietary Rights in Human-Derived Biomaterial §17.8
E. Government Regulations on Biotechnology Research §17.9
F. Employee Knowledge Versus Proprietary Information §17.10
G. Alleged Disclosure of Trade Secrets by Patent Attorneys §17.10A

III. PATENT AND TRADE SECRET PROTECTION
A. U.S. Patent Protection for Biotechnology Products §17.11
B. Microorganism Deposits Associated With Patent Filings §17.12
1. Disadvantages of Patents Flowing From Foreign Laws on Deposits §17.13
2. Rules Under Budapest Treaty §17.14
3. European Patent Practice §17.15
C. Choosing Patent or Trade Secret Protection §17.16
1. Advantages and Disadvantages of Patent Protection; Paris Convention §17.17
2. Advantages and Disadvantages of Trade Secret Protection §17.18

IV. DISSEMINATION AND RECEIPT OF BIOLOGICAL MATERIALS §17.19
A. Maintaining a Culture Collection §17.20
B. Requests From Outsiders for Company Materials §17.21
C. Accepting Biological Materials and Compounds From Outsiders §17.22

V. PROTECTING AGAINST THEFT OF BIOLOGICAL MATERIALS §17.23
A. Tagging Microorganisms to Protect Biotechnology Trade Secrets §17.24
B. Using Other Precautions Reasonable Under Circumstances §17.25
C. Using Safety Precautions to Enhance Security §17.26
D. Dealing With New and Departing Employees §17.27

VI. FORM DOCUMENTS
A. Form: Employee's Request for Approval to Release Biological Materials or Unpublished Information §17.28
B. Form: Letter for Release of Biological Materials as Unrestricted Gift §17.29
C. Form: Letter for Release of Biological Materials With Restrictions §17.30
D. Form: Agreement on Use of Biological Materials §17.31
E. Form: Employee's Request for Approval to Solicit Biological Materials or Unpublished Information §17.32
F. Form: Letter Requesting Biological Materials §17.33
G. Form: Receipt of Biological Material From Outsiders §17.34

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I. INTRODUCTION

§17.1 A. The Nature of Biotechnology

The term "biotechnology" as used here describes techniques that use living organisms, or materials derived from living organisms, to make or modify products, plants, or animals. Hence, biotechnology encompasses molecular biology and genetic engineering; transgenic organisms, engineered proteins and vaccines, and medical treatments. The technologies can be used in plant breeding and food fermentation, as well as pharmaceutical and environmental industries. A common thread that links these technologies together, and that is the source of most of the problems associated with the application of traditional trade secret principles to these technologies, is that their economic value arises from use of something that is alive at some point in the development or production chain. (For discussion of the basic scientific principles of modern biotechnology, see Alberts et al., Molecular Biology of the Cell (4th ed 2002))

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§17.2 B. Practitioner's Role

The recurring problems in biotechnology intellectual property are defining what proprietary rights exist, when they came into existence, and who owns them. The problem is particularly prevalent in biotechnology because the industry has close ties to academia, where (1) researchers change affiliations frequently; (2) research materials can come from different sources; (3) success is often measured by publications and requires dissemination of successful research; (4) informal collaborations often occur; and (5) funding for research can come from multiple sources with concurrent or conflicting obligations to proprietary rights. For example, *In re Univ. of Cal.* (Fed Cir 1992) 964 F2d 1128, 1131, illustrates how problems may arise from the movement of scientists from universities to private companies ("Issues arise from the movement of scientists from the university to Genentech, bringing with them Lilly-funded materials.").

Many biotechnology researchers are relative neophytes in trade secret and patent protection considerations, and are unaccustomed to the precautions necessary to limit and monitor access to culture collections and technical data. Although awareness of proprietary rights is increasing in academic institutions, many biotechnology researchers were educated and trained in environments where success is measured primarily by scientific publications and where information, cell lines, and probes are exchanged. Consequently, many biotechnology researchers are not as sensitive as they could be to the commercial interests at stake in industry. Hence, counseling a biotechnology company on intellectual property law requires a willingness to educate employees about these issues and a commitment by senior management to overhaul their intellectual property protection program.

Biotechnology legal counsel must also assist management in the difficult practical judgments on when to file patent applications and when to rely on trade secrets. Counsel must also protect the company from charges of misappropriation by advising it of the conditions under which biological materials can be sent to or accepted from outsiders.

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§17.3 II. PROTECTING PROPRIETARY RIGHTS IN BIOLOGICAL MATERIALS

Protection of proprietary biological materials, such as genetically engineered microorganisms or DNA, is complicated because a single specimen of the material is capable of reproducing itself in virtually unlimited quantities. Thus, misappropriation of minute amounts of proprietary biological materials can have substantial consequences.

It can also be difficult to ascertain who has what type of claim to proprietary rights in biotechnology. Different standards are used to establish ownership interests in patents and trade secrets, and the type of right owned determines the limits of contractually imposed obligations and commercial rights. Thus, the different types of potential claims should be considered when transferring or receiving biological materials.

Other problems arise from historical practices of open exchange of information and samples in the biological sciences. Researchers in academia and elsewhere often exchange proprietary novel biological materials with others working in the field. These exchanges, however, may not be in the nature of unrestricted gifts and may result in implied-in-fact proprietary contracts. Sorting out the potential rights may require an analysis of the long-standing course of dealing among the researchers. Claims of misappropriation of proprietary biological rights have arisen from dissemination among researchers of biological materials developed first in one laboratory and conveyed under ambiguous circumstances to other laboratories.

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§17.4 A. Difficulty of Detecting Theft

Small quantities of biological materials can be stolen, making their theft difficult to detect. Data from experiments is also easy to steal in the age of computers. Substantial economic loss can arise from the stolen material's ability to reproduce itself or from the researchers' ability to use stolen data to replicate a result. See *Upjohn Co. v Hygieia Biological Labs.* (ED Cal 1993) 151 FRD 355 (discovery issues dealing with difficulty in determining identity of tissue culture vaccine that was allegedly misappropriated); *American Cyanamid Co. v Fox* (NY Sup Ct 1964) 140 USPQ 199 (demonstrates need for employment agreements, as in other areas of technology, as well as excruciatingly detailed inventory control for proprietary biological materials).

Using biochemical and molecular biology techniques to prove genetic identity or derivation of cell lines might be one way to show misappropriation of a trade secret. In *Pioneer Hi-Bred Int'l v Holden Found. Seeds* (8th Cir 1994) 35 F3d 1226, Pioneer alleged that a competitor misappropriated the genetic make-up of its corn seed. Specifically, Pioneer alleged that one of Holden's seed lines was derived from one of its trade secret seed lines. Holden maintained that it developed the disputed seed line internally from its L120 seed line. Holden, however, had discarded the L120 line before Pioneer filed suit. Therefore, only the stocks of other lines that it had derived from the L120 line were available for genetic testing. 35 F3d at 1230.

To prove its case, Pioneer submitted data from electrophoresis, liquid chromatography, and growout testing. The district court also appointed an expert to assist the court in interpreting the scientific evidence. Based on the scientific evidence from the tests, the district court found that a secret "parent" line of corn seed had been misappropriated by Holden. In affirming the district court's findings, the Eighth Circuit Court of Appeals held that the test results were admissible evidence because the tests were (1) widely used in the industry, (2) conducted by qualified experts, and (3) relied on by both parties to prove their case. 35 F3d at 1230. The court cited the factors set forth in *Daubert v Merrell Dow Pharms., Inc.* (1993) 509 US 579, 125 L Ed 2d 469, 113 S Ct 2786.

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§17.4A 1. Economic Espionage Act of 1996

The Economic Espionage Act of 1996 (see 18 USC §§1831-1839 for the provisions protecting trade secrets) makes civil trade secret theft a crime and imposes significant prison sentences (ranging from 10 to 15 years) and stiff fines for convicted trade secret thieves. This law was enacted in part as a result of the difficulty in detecting theft of biological and high-tech trade secrets in the computer age.

One of the first criminal prosecutions under the Economic Espionage Act involved the anticancer drug Taxol. In July 1997, a federal grand jury indicted three Taiwanese defendants for their involvement in an alleged conspiracy to steal corporate trade secrets from a drug manufacturer. The indictment alleged that the defendants sought to obtain the processes, methods, and formulas for manufacturing Taxol, a drug regarded by the company as a highly valuable trade secret. During the discovery phase of the prosecution, defendants sought to discover information regarding the trade secrets they allegedly conspired to steal. The United States government moved for a protective order preventing the disclosure of the trade secrets to the defendants. The government argued that the defendants did not need the actual trade secrets because they had only been charged with attempt and conspiracy to steal trade secrets. The Third Circuit remanded the case to the district court for a determination of the discoverability of the trade secrets after balancing the government's need to preserve confidentiality of the trade secrets and the defendants' constitutional right to evidence material to their defense. *U.S. v Hsu* (3d Cir 1998) 155 F3d 189, 205.

In another Economic Espionage Act case, *U.S. v Martin* (1st Cir 2000) 228 F3d 1, a disgruntled employee of a veterinary products manufacturer relayed information on her employer's customer problems, confidential internal memoranda, product information, marketing materials, and research data to a potential competitor. A jury found defendant, the potential competitor, guilty of conspiracy to steal trade secrets (see 18 USC §1832(a)), and, on appeal, the First Circuit agreed. The First Circuit held that sufficient evidence existed for a jury to find an agreement existed, and to find that defendant had the necessary intent. The court also found that defendant's argument that he actually did not receive any trade secrets was irrelevant because he was found guilty of a conspiracy to steal trade secrets. 228 F3d at 13.

NOTE: The Economic Espionage Act (18 USC §1832(a)) should serve as a powerful deterrent to theft of biological trade secrets because of the broad definition given to trade secrets under the statute, and because actual theft of trade secrets does not need to be proven. Furthermore, the Federal Bureau of Investigation (FBI) will investigate allegations of misappropriated trade secrets under the Economic Espionage Act.

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§17.5 B. Academic Practices and Problems With Proprietary Rights

Much basic research in biotechnology has occurred in academic institutions. Accordingly, many biotechnology scientists are still in or have only recently left academic institutions.

Lately, some academic institutions, realizing the value of their research, have taken steps to protect and commercialize their proprietary rights. Nonetheless, exchanging novel biological materials with others in the field is widespread, although these exchanges have not traditionally been in the nature of unrestricted gifts, but have been subject to contracts implied in fact.

As a rule, researchers are expected to make any special materials they have developed freely available to colleagues. In return, by unspoken agreement, the colleagues will treat the material like property borrowed from a friend; in other words, as something not to be passed on to third parties or used for private gain without the owner's specific permission.

However, problems in assessing proprietary rights from unrestricted exchanges of information and materials with academic, government, and nonprofit institutions may arise.

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§17.6 1. *Institut Pasteur v U.S.*

Institut Pasteur v U.S. (1986) 10 Cl Ct 304, rev'd (Fed Cir 1987) 814 F2d 624, is an example of how litigation can arise from exchange of biological materials under express contracts restricting their use. The case also points out the broader problem of the possible existence of contracts implied in fact arising from tradition and a long-standing course of dealing in the biological sciences.

The Institut Pasteur of Paris, France, filed suit against the United States government for alleged misappropriation and misuse of certain biological materials provided to researchers at the National Cancer Institute for work on the problem of Acquired Immune Deficiency Syndrome (AIDS).

Both the Institut Pasteur and the National Cancer Institute are nonprofit organizations engaged in biological research. Both began working on attempts to prove that a virus caused AIDS and to isolate and identify that virus. As is common among noncommercial institutions, the interchange of information and materials between the two groups was considerable. Ultimately, the French did isolate a virus they believed to cause AIDS, which they described in several printed publications starting in May 1983.

A sample of the virus was then sent to the National Cancer Institute with a one-page letter of agreement stating simply that, without the prior consent of the Institut Pasteur (1) the virus would not be used for any industrial purposes and (2) the recipient would agree not to disseminate the virus to companies or other scientists.

Six months later, the National Cancer Institute published articles describing its isolation of the AIDS virus. Before publication, the United States had filed a patent application claiming methods of using the virus to screen blood products for exposure to the virus. When the National Cancer Institute patent issued a year later, it was immediately licensed to five U.S. companies. Royalty payments under those licenses were anticipated to reach $1 million in the first year. Pasteur filed suit for breach of express and implied contracts, claiming that the virus it supplied was used by the U.S. both for industrial purposes and as the basis for filing a patent application.

The United States and France settled the litigation, agreeing that (1) they would share patent rights for tests to screen blood for the presence of AIDS antibodies, (2) the patent would be jointly owned by the U.S. Health and Human Services Department and the Pasteur Institute, (3) each party would keep 20 percent of its royalties, and (4) the remaining 80 percent of the royalties would fund an international research and education foundation established to fund worldwide AIDS programs.

Institut Pasteur also examines the effect of a publication describing a novel biological material on the obligations of one who subsequently receives an actual sample of the product from its owner. The government asserted in its defense that public disclosure of the French virus in prior publications extinguished any proprietary right that Institut Pasteur may have enjoyed in the sample sent to the United States. This defense raises the issue of when actual access to a biological material is essential to place a biological invention in the public domain. It also raises the issue of the extent of liability of one who might, with some effort, have been able to reproduce biological materials disclosed in a publication but who chose instead to seek an actual sample of the material from the proprietor in exchange for a promise of confidentiality. Is the shortcut gained by not having to reproduce biological material from the literature sufficient consideration to support a contract not to use that material for commercial purposes?

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§17.7 2. *Genentech, Inc. v Eli Lilly & Co.* [Deleted]

This section has been deleted because the case discussion is obsolete.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.8 C. Ascertaining Proprietary Rights in Human-Derived Biomaterial

§17.8 C. Ascertaining Proprietary Rights in Human-Derived Biomaterial

Another threat to proprietary rights is posed when a commercially valuable product is derived from a human source. In *Moore v Regents of Univ. of Cal.* (1990) 51 C3d 120, 271 CR 146, a human donor of biological material that was commercially exploited by defendants (allegedly without the plaintiff's knowledge or consent) asserted a variety of proprietary rights and tort claims, such as conversion, unjust enrichment, and breach of fiduciary duty.

Plaintiff, who suffered from hairy-cell leukemia, had his spleen removed. Plaintiff alleged that one of the defendants, a physician, realizing that the plaintiff's cells were unique, took the plaintiff's spleen, which had been removed as part of his treatment. With the cells obtained and cultured from that spleen, and from numerous subsequent tissue extractions over the next seven years, the defendants developed commercial products with a potential market. The plaintiff further alleged that defendants informed him that these subsequent extractions were necessary for his well-being, but they did not inform him that the biological materials were being used for their research and commercial activity, rather than the plaintiff's medical treatment.

Seven years after his spleen was removed, the plaintiff was presented with a consent form to sign. He had still not been informed of the defendant's commercial activities, and signed. Five months later, he again consented to withdrawals of blood and bodily substances, but he expressly indicated on that form that he did not consent to the defendants' use of his cell-line nor of products that could be developed from that line. Without plaintiff's knowledge, two of the defendants then obtained a patent to the cell-line and products derived from it.

Subsequently, Moore brought an action against the Regents, alleging breach of fiduciary duty and lack of informed consent and conversion.

The California Supreme Court reviewed the following questions (among others): (1) whether human tissue is tangible personal property, and (2) whether a cause of action for conversion arises if human tissue, removed after consent to surgery, is later used to develop a product or procedure having potential commercial value without first obtaining the patient's express consent.

The court stated that Moore did not have a cause of action for conversion, holding that patients do not have ownership rights in excised cells under the alleged facts. 51 C3d at 137. However, the court held that failure to disclose to Moore the research and commercialization of the removed cells was a breach of fiduciary duty by Moore's physician, who had a duty to obtain Moore's informed consent before proceeding with the research.

Moore demonstrates the importance of monitoring biomaterials that one's company receives as well as biomaterials that are given to other entities for permitted purposes.

PRACTICE TIP: Before accepting biomaterials from an outside entity, the company should ascertain the history of that biomaterial and any restrictions on its use or commercialization.

In a related case that was depublished, and therefore not citable as precedent, a California Court of Appeal held that human sperm, deposited in a sperm bank by decedent and left to plaintiff under decedent's will, is a unique material not subject to the terms of property settlement under a disputed will. See *Hecht v Superior Court* (ordered not published on Jan. 15, 1997; former opinion at 50 CA4th 1289 (advance reports), 59 CR2d 222). The California Supreme Court denied review of the case, but ordered the opinion depublished. Ownership rights of bodily materials could still be an open question in California.

In *Hecht v Kaplan* (App Div 1996) 645 NYS2d 51 (a case not related to *Hecht v Superior Court*, discussed above), the court addressed the issue of a patient's right to recover damages for an unauthorized diagnostic blood test. Although this *Hecht* case did not involve the commercial exploitation of a patient's biological materials, the case is instructive about how courts may view patients' claims of proprietary rights in their own biological materials.

The plaintiff in *Hecht* sued her doctor for medical malpractice based on lack of informed consent. The plaintiff alleged that when the doctor withdrew blood with her consent to test for cytomegalovirus, the doctor also withdrew, without her consent, an extra vial of blood to test for human T-cell leukemia virus (HTLV). The court rejected the plaintiff's claim that the doctor's unauthorized testing constituted an affirmative violation of the patient's physical

integrity. The court further ruled that there was no unauthorized human research because the HTLV test was performed only on blood that had already been drawn from the patient during the course of standard medical care. The entire case was dismissed. The court factually distinguished *Moore* by pointing out that "many blood samples were drawn (from Moore) over a period of months and for a purpose unrelated to the patient's original problem and purely for defendants' research purposes." 221 AD2d at 104. In contrast, the court found that the possibly unauthorized blood sample was drawn only once from plaintiff Hecht "during the course of an unquestionably consented-to procedure and was used at least partially to benefit the plaintiffs." 221 AD2d at 104.

An interesting question is whether the outcome in *Hecht* would have been different had the doctor sold the blood sample, or the data derived from the blood sample, to a biotechnology or pharmaceutical concern for commercial research purposes. See *Greenberg v Miami Children's Hosp. Research Inst., Inc.* (SD Fla 2003) 264 F Supp 2d 1064 (no property interest in body tissue and genetic matter donated for research).

PRACTICE TIP: Biotechnology practitioners should advise their clients to establish procedures to ensure that biological materials used in their research have been obtained with the informed consent of the patients. Such procedures may guard against future claims of unauthorized use of the patients' biological materials.

The importance of specifying and allocating proprietary rights at the outset of a joint venture or collaboration is also illustrated by *Miles, Inc. v Scripps Clinic & Research Found.* (SD Cal 1993) 810 F Supp 1091. Miles and Scripps jointly owned Scripps-Miles, Inc., a corporation formed to commercialize immunochemical materials. Scripps-Miles was eventually dissolved. The patent rights to a cell line developed by two researchers employed by Scripps-Miles was assigned to Scripps. Miles sued for conversion of the right to commercialize the cell line, and accused the researchers of conspiring with Scripps to transfer that right to Scripps and its licensees.

The court granted defendants' motion to dismiss. Although the court held that a proprietary right existed in "a right to commercialize" cells, under *Moore v Regents of Univ. of Cal., supra,* there was no cause of action for conversion of a right to commercialize such property. The court indicated that a conversion action in this situation was not appropriate, because patent and contractual protections could adequately safeguard such rights.

However, in *U.S. v Arora* (D Md 1994) 860 F Supp 1091, the court distinguished *Moore v Regents of Univ. of Cal., supra,* and *Miles, Inc. v Scripps Clinic & Research Found., supra,* to find that cell lines are property capable of being converted, and that the tort of conversion applied to the intentional destruction of a cell line. 860 F Supp at 1099.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.9 D. Government Regulations on Biotechnology Research

§17.9 D. Government Regulations on Biotechnology Research

Government funding and regulation poses its own set of proprietary rights issues in biotechnology. Biotechnology research, particularly in academic institutions, is often funded, in whole or in part, by a government or other outside nonprofit source.

The availability of data generated under federal research grants impacts trade secret and patent rights generated from federally funded research. Under the Office of Management and Budget Circular A-110, which sets up uniform rules and procedures for administering federal research grants, federal agencies must ensure that all data generated under federal grants to hospitals and nonprofit institutions be made available to the public through procedures established under the Freedom of Information Act (FOIA). As a result, federally funded research scientists cannot prevent the disclosure of research data based on an assertion that the data may have commercial value. See chap 5 for a discussion of FOIA and, more generally, proprietary rights when dealing with the government.

NOTE: Federally funded researchers probably may prevent the disclosure of other commercially valuable information in the grant application and related documents. If research is funded by the National Institutes of Health (NIH), counsel should instruct the grant recipient to notify counsel of any FOIA requests before permitting the NIH to disclose such information (other than research data).

The apparent contradiction between the requirements for public disclosure of federally funded research and the pro-commercialization provisions of the Bayh-Dole Act (35 USC §§200-212) has prompted attempts to repeal the public disclosure requirement. See HR 88, 106th Cong, 1st Sess (1999).

PRACTICE TIP: Unless the law allowing public disclosure of federally funded research is changed, biotechnology practitioners must advise their clients who conduct federally funded research, or who have contractual relationships with federally funded research institutions, to reevaluate their existing procedures for obtaining patent protection or maintaining trade secret protection for federally funded research. In general, patent applications involving federally funded inventions will need to be filed much more expeditiously than before in light of the public's right to access the data underlying the patentable invention. For purposes of trade secret protection, it may be impossible to claim trade secret protection for prepublication research data because the new provision allows public access to such data, thereby destroying the requisite secrecy of the data.

The public availability of federally funded research data does not alter the grant fund recipient's obligations under the Bayh-Dole Act with respect to the commercialization of any federally funded inventions. See, *e.g.*, *Filmtec Corp. v Hydranautics* (Fed Cir 1992) 982 F2d 1546 (per statute, federal government owns patent rights for invention conceived during work under federal contract).

Because of the prevalence of federally funded research in this area, biotechnology practitioners should be very familiar with the Bayh-Dole Act, its implementing regulations (37 CFR §§401.1-401.17), and even guidelines promulgated by the various federal agencies governed by the act. These laws and guidelines directly impact the availability of trade secret and patent protection and the potential terms for license agreements involving government-funded research.

NOTE: Practitioners must keep monitoring the changing developments in this area. One way to stay informed regarding new developments is to routinely review the Federal Register for proposed regulations and guidelines.

Submissions of required information to federal agencies do not automatically preclude trade secret protection. For example, in *Amvac Chem. Corp. v Termilind, Ltd.* (D Or 1999) 1999 US Dist Lexis 20151, the court held that submission of information to the Environmental Protection Agency to register a pesticide did not necessarily preclude trade secret protection because the EPA does not automatically disseminate information such as analytical and process descriptions, even though the EPA regulations do not require the agency to maintain evidence in confidence.

The Food and Drug Administration may require the disclosure of trade secrets during its review of new drugs. Although the FDA has adopted regulations defining trade secrets (see 21 CFR §720.8(b)), it has no duty to notify a

manufacturer before disclosing confidential information. See *Pharmaceutical Mfrs. Ass'n v Weinberger* (DDC 1975) 401 F Supp 444 (no duty to notify manufacturer before disclosure under Freedom of Information Act). Claims that the FDA improperly disclosed trade secret information may be brought under the Federal Torts Claim Act (FTCA) (28 USC §§2671-2680). See *Jerome Stevens Pharm., Inc. v FDA* (DC Cir 2005) 402 F3d 1249 (claims that FDA improperly divulged confidential and trade secret information contained in new drug application (NDA) adequately alleged cause of action under FTCA).

Confidential disclosures to the FDA that concern the safety of drugs may be accessible by the public under the Freedom of Information Act. See *Pharmaceutical Mfrs. Ass'n v Weinberger, supra*. In *Public Citizen Health Research Group v Food & Drug Admin.* (D DC 2000) 2000 US Dist Lexis 4108, plaintiff made a Freedom of Information Act (FOIA) request for information from the Food and Drug Administration about the prescription drug Celebrex. The drug's manufacturer sought to protect disclosure of raw patient data, the names of its scientific investigators, and titles of its unpublished articles under Exemption 4 of the FOIA, which protects commercial or financial information that is privileged or confidential. 5 USC §552(b)(4).

The court rejected the manufacturer's argument that the raw patient data would help competitors conduct effective drug development, and that release of the data would discourage human participants from participating in future drug studies. These arguments were too speculative to fall under the FOIA exemption. However, the court also rejected the plaintiff's arguments that the manufacturer had waived the right to assert confidentiality for names of investigators and titles of unpublished articles because the manufacturer had approved release of the same information in other contexts. The court found that "the fact that information may be public will certainly affect the question of whether its disclosure under FOIA is likely to cause substantial competitive harm, but it is not dispositive." *Public Citizen Health Research Group v Food & Drug Admin, supra*.

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§17.10 E. Employee Knowledge Versus Proprietary Information

In *FMC Corp. v Peats* (Me 1987) 2 USPQ2d 1178, the court granted a broad preliminary injunction for misappropriation of trade secrets relating to the manufacture of agarose, barring FMC's former employee and a competitor from using FMC's trade secret. It also required that all tangible items containing trade secret information be returned to FMC, and barred defendants from performing any work in related enterprises.

However, noncompetition provisions in employee contracts may have limited value in preventing employees with unique backgrounds from working for competitors. In *Baxter Int'l v Morris* (8th Cir 1992) 976 F2d 1189, aff'd (8th Cir 1993) 11 F3d 90, the court upheld an injunction preventing a scientist employed by Microscan, a division of Baxter, from disclosing trade secrets to a competitor. The former Baxter employee accepted a position as a manager of bioscience projects with Microscan's only competitor. However, both the district court and the appellate court refused to enforce Baxter's noncompetition provision in its employment agreement, which prevented an employee from working for a competitor in any capacity for one year after terminating employment with Baxter. The court found the provision unduly broad and burdensome, given that there was no evidence that the former employee had actually disclosed any trade secrets.

In California, noncompetition agreements after termination of employment are generally unenforceable. See Bus & P C §§16600-16602.5. An antisolicitation agreement may be enforceable, however, if it is necessary to protect the employer's trade secrets. *John F. Matull & Assocs. v Cloutier* (1987) 194 CA3d 1049, 1054, 240 CR 211. See Advising California Employers and Employees, chap 11 (Cal CEB 2005). An injunction is not available on the grounds that a former employee's disclosure of a former employer's trade secrets to a new employer is unavoidable because California law does not recognize the doctrine of "inevitable disclosure." See *Danjaq, LLC v Sony Corp.* (CD Cal 1999) 50 USPQ2d 1638 (denying claims for misappropriation because plaintiffs could not rely on mere speculation about what employee might have disclosed); *Bayer Corp. v Roche Molecular Sys., Inc.* (ND Cal 1999) 72 F Supp 2d 1111, 1119 (denying preliminary injunction but ordering periodic discovery to monitor possible misuse). See also §12.13.

A theft of biological trade secrets case involving the University of South Florida (USF) provides an example of an extremely aggressive approach taken by a former employer against a former employee. The employee, a laboratory assistant at USF, was assigned to a corporate-sponsored research project involving water purification. When the employee left USF, he took the laboratory notebooks from the research project with him. USF demanded the return of the lab notebooks based on a claim that they contained trade secrets.

When the former employee refused, USF pressed criminal charges and later sued the former employee in a civil lawsuit. The former employee was convicted in a jury trial of second degree grand theft and a lesser included count of theft of trade secrets. He was also prohibited from using the stolen research for any purpose and was ordered to return the lab notebooks to USF. When the former employee later obtained United States patents based on the stolen trade secrets, he was ordered to assign the patents to USF and sentenced to prison for violating the terms of his parole. See *Taborsky v Florida* (Fl App 1995) 659 So2d 1112 (criminal action) and *Board of Regents v Taborsky* (Fl App 1994) 648 So2d 748 (civil action).

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.10A F. Alleged Disclosure of Trade Secrets by Patent Attorneys

§17.10A F. Alleged Disclosure of Trade Secrets by Patent Attorneys

Practitioners need to be very careful when representing clients in the same field of technology. A practitioner must maintain the duty of undivided loyalty and confidentiality to each client. For attorneys who are not sole practitioners, the knowledge that each attorney in a firm has regarding his or her client is imputed to the other attorneys in the firm under the ethical rules governing attorneys. Therefore, compliance with the ethical rules requires more than simply ensuring that each attorney in a law firm is not representing two clients with adverse interests in the same technology areas. A law firm must take steps to ensure that each of the firm's attorneys is generally aware of the subject matter of the various clients' patent portfolios so that potential conflicts of interest can be identified before they turn into actual conflicts of interest. While the circumstances surrounding each attorney-client relationship are extremely fact sensitive, there are precautions that biotechnology law firms can and should take to avert the so-called subject matter conflicts that are often unique to technology-driven industries. For instance, a law firm might establish procedures for circulating a general description of prospective client matters to each attorney in the firm. In this way, each attorney in the firm has a chance to review the descriptions and determine whether further analysis is warranted.

EXAMPLE: Attorney A represents a client with inventions in a narrow field of Alzheimer's research. Attorney B in the same firm is contemplating taking on a new client in the same narrow field of Alzheimer's research. If Attorney B is aware of the existing representation of Attorney A's client, Attorney B most likely would conclude that the firm could not represent both clients simultaneously in light of the substantial overlap in the technology underlying the inventions.

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III. PATENT AND TRADE SECRET PROTECTION

§17.11 A. U.S. Patent Protection for Biotechnology Products

Biotechnology materials, including DNA and genetically engineered organisms, are patentable. 35 USC §§101-103; *Diamond v Chakrabarty* (1980) 447 US 303, 65 L Ed 2d 144, 100 S Ct 2204 (genetically engineered bacteria are patentable). But see *Association for Molecular Pathology v USPTO* (SD NY 2010) 94 USPQ2d 1683 (mere extraction and purification of naturally occurring chemical element or compound not patentable; thus, patent claims for compositions of isolated DNA fragments invalid).

Sexually and asexually reproduced plants are also protectable under the utility patent laws to the extent that the other requirements of those laws are met. 35 USC §101. *J.E.M. Ag Supply, Inc. v Pioneer Hi-Bred Int'l, Inc.* (2001) 534 US 124, 151 L Ed 2d 508, 122 S Ct 593; *Ex parte Hibberd* (BPAI 1985) 227 USPQ 443.

In addition, asexually reproduced plants have been protectable under the Plant Patent Act (PPA) (35 USC §§161-164). Likewise, sexually reproduced plants are protectable to some extent under the Plant Variety Protection Act (PVPA) (7 USC §§2401-2582). The PPA and PVPA specifically exempt plant patents from the requirement that patent applications have a written description of the invention sufficient to enable persons skilled in the art to practice it. 35 USC §162; 7 USC §2442. The limited protection offered by the PPA and PVPA does not preempt the scope of protection offered under the utility patent laws. *J.E.M. Ag Supply, Inc.,* 534 US at 145, 151 L Ed 2d at 527.

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§17.12 B. Microorganism Deposits Associated With Patent Filings

A patent must contain a written description sufficient to enable anyone with requisite skills to make and use the invention. 35 USC §112. The written description requirement is met when a patent specification describes the claimed invention in sufficient detail that one skilled in the art can reasonably conclude that the inventor had possession of the claimed invention. See, *e.g., Moba, B.V. v Diamond Automation, Inc.* (Fed Cir 2003) 325 F3d 1306, 1319. Additionally, the specification must describe or enable the invention in such terms that one skilled in the art can make and use the claimed invention. See *Regents of Univ. of Cal. v Eli Lilly & Co.* (Fed Cir 1997) 119 F3d 1559, 1567 (adequate written description of genetic material requires definition through structure, formula, chemical name, or physical properties of claimed invention). In some cases, the enabling disclosure requirement of the patent laws may be met for biotechnology inventions by the applicant's depositing samples of microorganisms, cell lines, tissue cultures, viruses, plasmids, or other materials in a public repository before filing the application if the material is not known and readily available to the public. 37 CFR §1.802(b); *Enzo Biochem, Inc. v Gen-Probe, Inc.* (Fed Cir 2002) 323 F3d 956, 965 (reference in patent specification to deposit of genetic material may suffice to describe that material).

The deposit of a biological specimen in a public repository to meet the statutory requirements for patentability under §112 could create a potential dilemma for the applicant, who risks loss of control of unique biological materials by having to make a deposit before a patent can be obtained. The decision to make such a deposit is simplified by the ability in the United States to keep the deposit in confidence until the patent disclosing it actually issues. *In re Argoudelis* (CCPA 1970) 434 F2d 1390. A patent applicant can prevent public access to the deposited biological material until the United States Patent and Trademark Office (PTO) has indicated its willingness to issue a patent for that material.

Further, the microorganism probably need not be deposited in a *public* depository until after the application filing date; a private depository may be sufficient. In *In re Lundak* (Fed Cir 1985) 773 F2d 1216, the PTO took the position that the disclosure in the application was not enabling, because the essential biological materials had not been deposited in the public depository before the filing date. The court of appeals held that placing the biological material in a private depository was sufficient, assuming an otherwise adequate written description of the invention, if the applicant places the material in a public depository from which the public has access before the patent issues.

PRACTICE TIP: Biotechnology researchers can retain valuable biological materials that are the subject of pending patent applications in their own secure culture collections until a decision is made to accept issuance of a patent on the materials.

The Board of Patent Appeals and Interferences (BPAI) has held that the deposit procedure in *Argoudelis* is permissive, not mandatory, and that the manner in which the microorganisms may be obtained need only be adequately described. *Ex parte Goeddel* (BPAI 1985) 5 USPQ2d 1449. Deposit is required, however, if the microorganism does not commonly occur or if verbal disclosure of how to obtain it from a commonly occurring microorganism is not made. *Ex parte Hata* (BPAI 1987) 6 USPQ2d 1652.

PRACTICE TIP: In seeking patent protection for a biotechnology process, the patent applicant must verify whether the exclusive right conveyed by the patent term (20 years after the date of filing an application; 35 USC §154) is worth the commercial risks associated with placing essential biological materials in the hands of competitors. In making this decision, one should consider the likelihood of an independent discovery of the invention and the ease with which the product ultimately sold could, through reverse engineering, result in the development of equivalent biological materials.

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§17.13 1. Disadvantages of Patents Flowing From Foreign Laws on Deposits

As noted in §17.11, the United States has allowed utility patents to issue on the living fruits of biotechnology since at least 1980. The countries in Western Europe also allow this protection. European Patent Convention (2000) Rules 26-27 (relating to patents on products from microbiological processes), available at http://www.epo.org/patents/law/legal-texts/html/epc/2000/e/cl_ii.html. Similar protection is available in Japan and most other developed countries.

However, the flexibility of being able to maintain secret deposits in private depositories provided in United States practice by *In re Argoudelis* (CCPA 1970) 434 F2d 1390 and *In re Lundak* (Fed Cir 1985) 773 F2d 1216 is of questionable value in worldwide competition in the biotechnology industry because of the stricter deposit requirements in foreign countries.

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§17.14 2. Rules Under Budapest Treaty

Most countries that issue patents on the products of microbiological inventions require the deposit of biological materials essential to the practice of the patented invention to supplement a written disclosure. The Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purpose of Patent Procedure, Apr. 28, 1977, 32 UST 1241, TIAS No. 9768, permits a single deposit in an approved depository under specified conditions to suffice for all other national patent application filings. The deposit eliminates the need to deposit microorganism samples in a variety of other countries.

A requirement of the Budapest Treaty is that the organism be deposited in an accredited International Depository Authority. Budapest Treaty, arts 3, 7. The deposit must be made available to the public under the laws of each country in which patent protection is sought. Furthermore, depositories must be impartial and permit any depositor to make deposits. Budapest Treaty, art 6. Thus, it is doubtful that private culture collections (see *In re Lundak* (Fed Cir 1985) 773 F2d 1216) would be acceptable as depositories under the Budapest Treaty.

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§17.15 3. European Patent Practice

The United States practice of allowing the organism to be kept in confidence until the patent issues is not followed uniformly throughout the world. See *In re Argoudelis* (CCPA 1970) 434 F2d 1390, discussed in §17.12. European Patent Office Rule 28 provides that the deposited biological material may be made available in certain instances to others on the publication of a European patent application describing it. These applications are published about 18 months after their filing dates. For applications first filed in the United States, publication usually also occurs 18 months after the date of the original U.S. filing if a European application is filed concurrently. Accordingly, obtaining patent protection in Europe can be accomplished fairly easily if the European application is piggybacked on the U.S. filing, but this action must be weighed against the risk that the deposited biological material may be made available before the U.S. patent is granted.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.16 C. Choosing Patent or Trade Secret Protection

§17.16 C. Choosing Patent or Trade Secret Protection

Biotechnology concerns face a dilemma in choosing between trade secret protection and patent protection. See §§17.17-17.18 on the tradeoffs between these two forms of protection.

If unique biological materials are essential to commercialization of a particular technology and if applications to patent that technology would require depositing the biological materials, a researcher must decide among imperfect options:

- Keep the technology as a trade secret, thereby running not only the risk of independent discovery by others, theft of the secret, or inadvertent disclosure of the secret, but also the danger of being enjoined from using the technology based on patents applied for by subsequent inventors;
- File only in the United States, thereby preserving control of the material until the issuance of a United States patent can be assured but forgoing the ability to control competitors abroad; or
- File worldwide with the risk that the essential biological material will become available to others before patent rights are issued.

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§17.17 1. Advantages and Disadvantages of Patent Protection; Paris Convention

Patent applications for biotechnology products and processes have greatly increased in the last decade. However, the patent application process takes time for biotechnology inventions and entails substantial costs, particularly if international patent protection is sought. The scope of protection that can be obtained is difficult to predict at the time of filing. Patent enforcement can also be difficult, and in any litigation, costly. Furthermore, a patent might provide information that would permit a competitor to "invent around" the patent and avoid infringement because the patent laws require an applicant to submit a disclosure that enables both the use of the invention and the best mode of practicing it. 35 USC §112.

A disadvantage of protecting biotechnology proprietary rights with patents is the length of time between filing an application and issuance of a patent. The Patent and Trademark Office (PTO) has a huge backlog in its biotechnology area. It is common for 16 months to elapse between the initial filing and the first office action. Often, a biotechnology application takes 3 or more years to issue. Because foreign filing decisions under the International (Paris) Convention for the Protection of Industrial Property, Mar. 20, 1883, 25 Stat 1372, TS No. 379, 1 Bevans 80 (available at http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html), must be made within 1 year after the original U.S. filing, it is often necessary to decide whether to file a biotechnology patent application abroad without any input from the PTO on the likely patentability of the invention.

Another disadvantage is that unless an applicant requests otherwise, based on a certification that a patent application will not be foreign filed, U.S. patent applications will now be published by the PTO after 18 months. 35 USC §122(b). Therefore, unless certified, trade secret protection becomes lost, even if a patent never issues from the application. See Beckerman-Rodau, *The Choice Between Patent Protection and Trade Secret Protection: A Legal and Business Decision,* 84 J Pat & Trademark Off Soc'y 371, 381 (2002).

Member countries under the Paris Convention must treat nationals of member countries equally with their own nationals in protecting industrial property. The first filing of a patent application in a member country establishes a priority right as of its filing date that will be accorded to a corresponding patent application in any other member country if the latter is filed within 1 year after the first filing. Once the decision is made to file abroad and deposits of biological materials are referred to in foreign applications in order to comply with the foreign disclosure requirements, the deposits are likely to become available to the public long before a U.S. patent is issued on those materials or even any indication is given of the likelihood of the issuance of such a patent. Some flexibility is achieved by filing foreign patent applications under the Patent Cooperation Treaty, June 19, 1970, 28 UST 7645, TIAS No. 8733 (available at http://www.wipo.int/pct/en/texts/articles/atoc.htm), but it is still unlikely that any authoritative indication of the patentability of the basic invention would be received in the 20-month period set by the Patent Cooperation Treaty for the initiation of the national phase examination. See 35 USC §§351-376.

This dilemma has led to careful scrutiny to ascertain whether a deposit of biological materials is required. For example, in the manufacture of a protein by recombinant DNA techniques, a written description alone would be adequate to enable (a) preparation of probes for pieces of the DNA responsible for the manufacture of the product, (b) use of the probes to find the gene for that product, (c) excision of the operative gene from the host in which it is found, (d) incorporation of that excised gene into genetic material capable of replication and expression in a microbiological host, and (e) introduction of that recombinant DNA into a microbiological host. Whether such a disclosure would be enabling might depend only on public availability of the starting materials. In this situation, a patent application on the method of producing a known protein by recombinant DNA techniques might be acceptable in both the United States and foreign countries without a deposit of the organism that actually creates the protein.

However, legal risks are associated with these strategies. If the microorganism deposit is not timely filed, a finding by any national patent office or court that deposit of the microorganism was essential to an enabling disclosure would present a seemingly incurable defect in the patent application or patent. Attempts to withhold biological materials available as of the application filing date that constitute a preferred embodiment of the invention may result in patent invalidity through failure to disclose the best mode of practice. See 35 USC §112. Enforcement of a defective patent or

rights in the withheld trade secrets might also result in exposure to antitrust liability. See *Atari Games Corp. v Nintendo of Am.* (Fed Cir 1990) 897 F2d 1572, 1576 (patent owner can incur antitrust liability by enforcing patent that was obtained through fraud or that patent owner knew to be invalid).

PRACTICE TIP: The balance between the need to protect intellectual property on the one hand and scientists' need to publish on the other is often struck by regulating the timing of publications so that patent applications are filed first and the articles are published later.

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§17.18 2. Advantages and Disadvantages of Trade Secret Protection

Trade secret protection may be desirable to protect a method of manufacture or an organism that produces a particular protein, such as insulin, when only the protein is being sold commercially. Biotechnology innovations are sometimes less susceptible to reverse engineering than are other technologies. If a multitude of processes, expression vectors, and organisms can be used to obtain a particular end product, there is little chance of learning of the method, expression vector, or organism from the final product. Thus, trade secret protection may be suitable to protect the methods or tools used to produce the end product of bioengineering.

On the other hand, trade secret protection may be undesirable if the innovation sought to be protected is in an area of great activity, because someone else may obtain a patent on the same innovation held as a trade secret. The trade secret holder could then lose the right to make, use, or practice the trade secret if it is the same as or similar to the patented subject matter. But see *Rhone-Poulenc Agro SA v DeKalb Genetics Corp.* (Fed Cir 2001) 272 F3d 1335, vacated on other grounds (Fed Cir 2003) 284 F3d 1323 (wrongdoers who obtained patent on misappropriated trade secret could not argue that publication of patent terminated trade secret rights).

Moreover, proprietary information nondisclosure agreements may be of little benefit to the proprietary company. The damages a company may win in a trade secret action may not compensate for loss of a valuable trade secret. The loss may destroy a company's competitive edge in the industry—a crucial issue when most biotechnology companies are still in the research and development stages.

In addition, trade secret protection in the biotechnology industry is often viewed as deleterious to the free exchange of ideas between researchers, who put a premium on publishing, collaborative efforts, and presentations at scientific meetings. Because the biological sciences have a long history of open exchanges of information, and many scientists are offended by even legitimate attempts to curtail such exchanges, the likelihood of inadvertent disclosure is great.

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§17.19 IV. DISSEMINATION AND RECEIPT OF BIOLOGICAL MATERIALS

A biotechnology company should document the genealogy of all biological materials received or developed by the company and should document any restrictions placed on biological materials that it receives or disseminates. Unfortunately, the ability to secure perfect intellectual property law protection for one's proprietary materials is often inconsistent with the realities of commercial practice. Although a good intellectual property lawyer could write something close to an ironclad agreement covering every conceivable contingency that would allow a biotechnology company to accept biological material from a third party without risking charges of misappropriation, few people from whom the company would solicit those materials would sign it. Thus, a balance must be struck in generating form letters that will give maximum legal protection while allowing reasonably easy access to materials essential to the company's products.

A variety of form letters and negotiated agreements have been published to deal with these problems. Individual practitioners usually modify prior agreements or generate new ones with similar terms to deal with specific situations. The procedures described in §§17.20-17.22 have proved workable in most situations.

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§17.20 A. Maintaining a Culture Collection

Problems associated with maintaining a culture collection that acts as a depository for preserving strains of microorganisms developed or acquired by a company are unique to biological and pharmaceutical companies. Accurately characterizing and carefully preserving biological materials held in collections is essential. See Hunter, Belt & Halluin, *Guidelines for Establishing a Culture Collection Within a Biotechnology Company,* 1 Trends in Biotechnology 5 (Jan. 1986).

Culture collections regulate the flow of biological materials into and out of a company. Thus, materials that may be or are being held as trade secrets in collections must be carefully segregated and identified. By controlling access to the company's biological materials and the transfer of materials out of its culture collection, the company will be in a better position to prove misappropriation if litigation ensues. By controlling access to materials received from other companies and the transfer of materials into its collection the company will be better able to resist claims of misappropriation of another's trade secrets. Maintaining a central culture collection also helps ensure against destruction or contamination of valuable biological materials.

The company should centralize documentation of all incoming and outgoing biological materials, such as microorganism strains, cell lines, and expression vectors. Strains acquired from outside the company may have legal restrictions on their use and transfer. A scientist hired from academia may bring cultures from the university. Company use of these strains may be restricted without the consent of the institution from which they came. Unless a paper trail exists to establish the genealogy of materials used to develop commercial products, it may be difficult to prove that a commercial process or product was not derived from an acquired strain that was kept as a trade secret by another.

PRACTICE TIP: The company should maintain a separate restricted access collection available only to key company personnel and develop a sign-in, sign-out procedure. Cultures intended to be maintained as trade secrets should be kept in this collection to ensure the utmost secrecy by limiting their access to relatively few researchers.

For each culture in the collection, the culture collection staff should keep records of the growth and maintenance requirements, the origin of the strain, a record of experiments using the strain, and a record of any release of materials. In this manner, the company can monitor ownership of proprietary strains protectable as trade secrets.

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§17.21 B. Requests From Outsiders for Company Materials

Scientists and others employed by a biotechnology company may be contacted by outsiders requesting samples of biological materials or compounds it has developed. Because these materials may be among the company's most valuable assets, management should carefully review each request. A request for approval for release of materials to outsiders should be completed and submitted to management. The request serves to notify management of requests for materials and enables review of the requests in light of the names and affiliations of the outsiders making the requests. See §17.28 for a sample request.

PRACTICE TIP: Make sure your client understands the importance of having all employees understand the release procedures and *always* apply them.

After reviewing each request, if management decides to release the material it must then decide whether to restrict its use by the outsider. Biological materials are rarely furnished as unrestricted gifts, but if they are, they should be accompanied by a transmittal letter so stating.

Generally, if biological material is to be given to outsiders at all, it should be subject to certain restrictions that would apply to the use of the material, the use of any commercially exploitable invention derived from the material, and the publication of any paper relating to the material. For forms of letters explaining the restrictions placed on the biological material, to be signed by the outsider to signify acceptance of the restrictions, see §§17.30-17.31.

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§17.22 C. Accepting Biological Materials and Compounds From Outsiders

When a scientist finds that an outsider's biological material or compound is needed for research at a biotechnology company, management should review the request for authorization to obtain materials from outsiders. The scientist should complete a form that notifies management of the request so that appropriate evaluation of inventions and products that flow from the use of the materials can be made, both as to novelty and ownership. See §17.32.

When materials are requested from outsiders, the request should state that the company may use them for commercial use, and, therefore, can neither accept the materials in confidence nor incur an obligation to compensate the donor except to the extent they are covered by a valid United States patent. See §17.33.

One must assume that the persons from whom biological materials are requested are also receiving competent legal advice. Accordingly, the requesting party should anticipate responses to requests for biological materials that will seek to place restrictions on those materials. See, *e.g.,* §17.31. These requests must be reviewed and approved by management.

When the materials are received, management should be notified in a way that can be made a part of the company's permanent records. See §17.34.

The major legal issue associated with the use of agreements is assuring that they are executed by the appropriate parties. For example, a university researcher may believe that he has authority to disseminate biological material he developed. But the university's patent policy may require approval from other university employees for the release. The research involved in developing the biological material may have been funded by a patchwork of governmental and private grants that may impose additional or even conflicting requirements for approval. Insistence on execution of the agreement by all potentially interested parties is not only time consuming and expensive but might result in a refusal to provide the requested material. One must balance the pros and cons of receiving biological materials with less than ironclad assurances of having complete freedom to use them.

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§17.23 V. PROTECTING AGAINST THEFT OF BIOLOGICAL MATERIALS

Biotechnology companies must be counseled to retain control over physical samples of biological materials used in commercially important processes. See *American Cyanamid Co. v Fox* (1962) 234 NYS2d 364. See also §17.4. Physical security may be crucial in preventing theft of the materials. See chap 4 generally on protecting a company's trade secrets.

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§17.24 A. Tagging Microorganisms to Protect Biotechnology Trade Secrets

One way to identify a proprietary microorganism, and thereby to discourage its misappropriation, is to give the microorganism distinct characteristics by using genetic engineering techniques. In addition to the microorganism's commercially valuable characteristics, two or more genetic markers could be incorporated into the microorganism strain in a combination that normally would not appear in nature. A strain that possessed the characteristics incorporated into a proprietary microorganism would tend to prove that the strain was derived from that proprietary organism. The genetic markers could code for characteristics such as resistance to two different antibiotics or inhibition of growth at high temperatures in combination with antibiotic resistance.

Another method of preventing misappropriation of a commercially valuable microorganism or cell line is to use a strain or line that possesses characteristics that limit its ability to reproduce. If the microorganism were stolen, it would survive for only a few generations unless the specific conditions required for it to reproduce were known. For example, certain bacterial strains require specific amino acids in their growth medium to survive. Others are temperature sensitive and can grow only within specific temperature ranges. This technique is similar to safeguards against copying copyrighted works by the use of peculiar constructions or typographical errors.

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§17.25 B. Using Other Precautions Reasonable Under Circumstances

The Uniform Trade Secrets Act provides that a trade secret must be the "subject of efforts that are reasonable under the circumstances to maintain its secrecy." See CC §3426.1(d)(2). In *Pioneer Hi-Bred Int'l v Holden Found. Seeds* (8th Cir 1994) 35 F3d 1226, 1236, Pioneer protected the trade secret status of its corn seed lines by (1) restricting the use and dissemination of its seeds through the use of confidentiality agreements; (2) the absence of labels or other identification at field sites; (3) coding seed bags to avoid identification of the seed lines; and (4) commingling the seed lines with other corn to prevent others from easily identifying the seed line.

In contrast, in another, unpublished case, a trial court granted the defendant's motion for summary judgment on plaintiff's complaint for conversion, violation of Uniform Trade Secrets Act, and unfair competition when it found that the plaintiff failed to take reasonable efforts to protect the trade secret. See *Sun World Int'l, Inc. v Larson* (June 12, 2003, E032510, not certified for publication) 2003 Cal App Unpub Lexis 5712. Sun World grew "Sugraone" grapes, which could only be propagated through asexual reproduction from the cuttings of existing Sugraone vines. When Sun World pruned its vines, a shredding machine would cut the pruned pieces lying on the ground and eject the debris up to 100 feet. Consequently, some of the Sugraone vine debris landed on a paved road adjacent to the vineyard. Larson took the cuttings on the roadway and propagated the Sugraone grapes. The court of appeals affirmed the trial court's finding that Sun World abandoned the cuttings.

The question of what efforts are reasonable under the circumstances to prevent theft of biological materials from an industrial facility must be left ultimately to the economic judgment and ingenuity of individual companies. Counsel should educate management and employees on the risks of a breach of security. See chap 4. See also *Wyeth v Natural Biologics, Inc.* (D Minn, Oct. 2, 2003, No. 98-2469 (JNE/JGL)) 2003 US Dist Lexis 17713, aff'd (8th Cir 2005) 395 F3d 897 (Wyeth's efforts to maintain trade secrets determined to be reasonable for process of extracting estrogens when efforts included controlled gate access, closed-circuit cameras, guard force that regularly inspected premises, limited access to plant, briefing of new employees on importance of maintaining secrecy, information on process being provided only on need-to-know basis, and requiring employees, vendors, and contractors to sign confidentiality agreements).

An interesting question in biotechnology is deciding whether to allow valuable biological materials to be kept in public depositories. On one hand, they may be either stolen or obtained by proper means by the public. See §17.12. On the other hand, a deposit ensures a safe, independent source of the organism if on-site stocks are inadvertently destroyed or contaminated. In addition, access can be restricted, even in public depositories.

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§17.26 C. Using Safety Precautions to Enhance Security

To some extent, physical security has been facilitated by prevailing safety practices and guidelines promulgated by the National Institutes of Health for the conduct of certain kinds of biotechnology experiments. These guidelines evaluate the relative degree of safety hazard presented by a particular biotechnology experiment and assign physical containment requirements for conducting those experiments. The guidelines, titled Biosafety in Microbiological and Biomedical Laboratories (4th ed 1999), are published jointly by the United States Department of Health and Human Services, Centers for Disease Control and Prevention, and National Institutes of Health, and available at http://www.cdc.gov/od/ohs/biosfty/bmbl4/bmbl4toc.htm. The resulting sophisticated physical containment facilities in many biotechnology facilities make it difficult to purloin samples of biological materials.

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§17.27 D. Dealing With New and Departing Employees

New and departing employees pose another set of proprietary rights issues. New employees should be subject to an entrance interview to learn the extent of their previous employers' proprietary rights to their previous research and technology development. New employees should be advised against using their previous employers' trade secrets and biomaterials. An entrance interview also provides an opportunity for an employer to explain to a new employee his or her obligations of confidentiality and his or her proprietary rights. New employees should be required to sign an agreement that clearly sets forth the new employer's proprietary rights in technology that the employee develops. Any existing employees who have not signed a nondisclosure agreement should do so as soon as possible. For discussion of methods of dealing with employees, see §§2.3-2.9, 4.6, 4.12. For employee confidentiality agreements, see §§6.17-6.39.

Departing employees should participate in an exit interview in which an employer can review the departing employee's work and clarify the boundaries of the employer's proprietary rights. See §§4.13-4.15, 6.40-6.43.

Companies must also be reasonably vigilant in investigating whether their trade secrets have been misappropriated. In *Alamar Biosciences, Inc. v Difco Labs., Inc.* (ED Cal 1995) 40 USPQ2d 1437, MicroScan strongly suspected that a former employee had taken proprietary information relating to the use of resazurin in a colorimetric test when the employee left the company in 1987. Furthermore, the former employee exhibited colorimetric systems that appeared to use resazurin at scientific conventions and trade shows, and filed a PCT application for the use of resazurin in 1990. The district court held that under California law, MicroScan's failure to search patent data bases when it suspected that its former employee was using the proprietary information was unreasonable, and that its delay in asserting a claim for misappropriation of trade secrets was time barred. 40 USPQ2d at 1441.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/ VI. FORM DOCUMENTS/ §17.28 A. Form: Employee's Request for Approval to Release Biological Materials or Unpublished Information

VI. FORM DOCUMENTS

§17.28 A. Form: Employee's Request for Approval to Release Biological Materials or Unpublished Information

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REQUEST FOR APPROVAL TO RELEASE PLANTS, CELLS, BIOLOGICAL MATERIALS, OR UNPUBLISHED INFORMATION

This request should be filled out and sent to _ _[*name of manager who approves releases*]_ _**. After it is approved it will be returned to the employee, who should have the necessary correspondence prepared. The approved form should be stapled to a copy of the correspondence to become part of the permanent file.**

After approval for a release is received, subsequent releases to the same researcher do not require repeated approval. The employee must, however, send a copy of each cover letter to the Patent Committee. Each release that has NO restrictions must be preapproved by the Patent Committee.

Name and title of employee or researcher requesting release: _ _[*Name and title*]_ _

Description of material and/or information: _ _[*Describe material or information*]_ _

Type of release being requested: [ ] Gift [ ] Restricted

Publications or patent applications relating to the material requested: _ _[*Describe*]_ _

Briefly describe comparable material available from other sources: _ _[*Describe*]_ _

Intended use of material: _ _[*Describe*]_ _

Name and affiliation of outside person requesting material: _ _[*Describe*]_ _

(Attach a copy of the request letter.)

Does the Company have a preexisting agreement with recipient?

[ ] Yes [ ] No

If yes, is the agreement: [ ] Consulting

[ ] Confidential

[ ] Research Sponsorship

__[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Patent Committee approval is: [ ] Granted [ ] Denied

_ _[*Name of company*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: This form is for an employee's request that the employee's company release biological materials or unpublished information to an outside researcher. For a form that is used for an employee's request to ask for biological materials or unpublished materials from another researcher, see §17.32.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.29 B. Form: Letter for Release of Biological Materials as Unrestricted Gift

§17.29 B. Form: Letter for Release of Biological Materials as Unrestricted Gift

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Dear _ _[*name of researcher to whom material is released*]_ _:

In response to your recent request, _ _[*company name*]_ _ is please to provide you with _ _[*describe*]_ _.

We would appreciate it if you would keep us informed regarding the results you obtain with _ _[*describe*]_ _. Please refer any request you may receive for these materials to our company.

If you create an invention that you believe has commercial potential, our company would appreciate a chance to negotiate a license to use your invention to our mutual advantage.

We understand that you will use these materials in compliance with all laws and regulations _ _[*, including current NIH Guidelines for work with recombinant DNA,*]_ _ and that you and your institution will indemnify our company and hold us harmless from any claims or liabilities that arise as a result of your use of these materials.

We wish you success with these materials and look forward to hearing your results.

Sincerely,

_ _[*Name of company*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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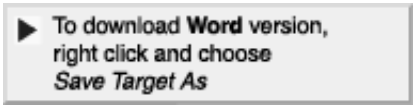
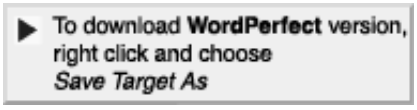
§17.30 C. Form: Letter for Release of Biological Materials With Restrictions





Dear _ _[*name*]_ _:

This letter is in response to your request for _ _[*describe*]_ _.

As you probably know, our company releases certain materials as gifts. The particular materials that you have requested, however, are especially valuable assets that our company normally would not release. Nevertheless, because of our company's interest in the work that you wish to undertake, the company is willing to release these cells to you if you will agree to abide by certain conditions.

These restrictions are contained in the attached agreement. If you agree to these conditions, please sign the agreement, have a representative of your _ _[*institution, e.g., university*]_ _ sign it also, and send one copy to me. The _ _[*describe materials*]_ _ will be sent to you soon afterwards.

If you have any questions, or if these conditions conflict with other obligations to which you are subject (such as a funding agreement with another corporation) please call me collect at _ _[*telephone number*]_ _.

Sincerely,

_ _[*Name of company*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.31 D. Form: Agreement on Use of Biological Materials

§17.31 D. Form: Agreement on Use of Biological Materials

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AGREEMENT ON USE OF BIOLOGICAL MATERIALS BETWEEN _ _[*NAME OF RESEARCHER*]_ _, _ _[*NAME OF RESEARCHER'S INSTITUTION*]_ _, **AND** _ _[*NAME OF COMPANY*]_ _ **FOR THE TRANSFER OF BIOLOGICAL MATERIALS**

I _ _[*name of researcher*]_ _ **of** _ _[*name of research facility*]_ _ **("Researcher") and** _ _[*name of researcher's institution*]_ _ **("Institute") hereby agree to the following conditions in consideration for receiving biological materials described in Paragraph 1 below from** _ _[*name of company*]_ _ **("Company").**

1. Company will supply Researcher with _ _[*describe biological material*]_ _ **("Material"). As used in this Agreement "Material" includes progeny, derivatives, and products derived from the plant strain, cells, or plasmids, as well as related unpublished information such as DNA or amino acid sequences or restriction maps.**

2. The Material will not be distributed or released to anyone other than coworkers working under Researcher's direct supervision and no one will be allowed to take or send this Material to any other location unless Company gives written permission in advance. On the Company's written request, which will not be exercised without justifiable cause, Researcher will destroy or return to Company all material received from Company.

3. This material will be used solely for academic or not-for-profit purposes.

4. Researcher will inform Company promptly of significant results that are related to the Material. Researcher will provide the Company with at least 30 days' notice before (a) submitting a manuscript for publication describing the results of Researcher's work, or (b) presenting information on the results of such work to people who are not obliged to keep the information confidential. The Company shall have the right to require information that characterizes the Material to be deleted from any proposed manuscript or presentation _ _[*; however, such right may not be exercised unreasonably*]_ _**.**

5. If research that involves the Material leads to the creation of a potentially commercial invention, Researcher and Institute will promptly notify Company. Company will have a first option to negotiate an exclusive license to manufacture, use, and sell the invention, under terms that are mutually agreeable. If such a license is not created, then Company may use the invention on a nonexclusive, royalty-free basis.

6. Researcher will use the Material in compliance with all laws and regulations, including current NIH Guidelines, for work with recombinant DNA. Institute and Researcher will indemnify Company and hold Company harmless from any claims or liabilities that arise as a result of Researcher's or Institute's use of these Materials.

Date: _ _ _ _ _ _ _ _[*Name of company*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Date: _ _ _ _ _ _ __[*Signature of researcher*]__
Name: _ _[*Typed name*]_ _
_ _[*Title and institution*]_ _

Date: _ _ _ _ _ _ _ _[*Name of institution*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _

Its: _ _[*Title*]_ _

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.32 E. Form: Employee's Request for Approval to Solicit Biological Materials or Unpublished Information

§17.32 E. Form: Employee's Request for Approval to Solicit Biological Materials or Unpublished Information

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§17.32-17.34.

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▶ To download **WordPerfect** version, right click and choose *Save Target As*

REQUEST FOR APPROVAL TO SOLICIT PLANTS, CELLS, BIOLOGICAL MATERIALS, OR UNPUBLISHED INFORMATION

This request should be filled out by employee and sent to _ _[*name of manager who approves requests*]_ _. After it is approved it will be returned to the employee, who should have form should be stapled to a copy of the correspondence to become part of the permanent file.

After approval for a release is received, subsequent requests to the same entity for the same materials do not require repeated approval. The employee must, however, send a copy of each cover letter to the Patent Committee. Each request subject to restrictions must be approved by the Patent Committee.

Description of material and/or information: _ _[*Describe material or information*]_ _.

Type of release being requested: [ ] Gift [ ] Restricted

Project for which material is requested: _ _[*Describe*]_ _

Briefly describe comparable material available from other sources: _ _[*Describe*]_ _

Name and affiliation of person to whom request will be addressed: _ _[*Describe*]_ _

(Attach a copy of the request letter.)

Does the Company have a preexisting agreement with the material supplier?

[ ] Yes [ ] No

If yes, is the agreement: **[ ] Consulting**

[ ] Confidential

[ ] Research Sponsorship

Patent Committee approval is: **[ ] Granted [ ] Denied**

__[*Signature of employee*]__
Name: _ _[*Typed name*]_ _

Comment: This form is for an employee's request for company approval to solicit biological materials or unpublished materials from another researcher. For a form that is used for an employee's request for company approval to release biological materials or unpublished information to another researcher, see §17.28.

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§17.33 F. Form: Letter Requesting Biological Materials

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§17.32-17.34.

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_ _[*Name and address of recipient*]_ _

Re: Request for _ _[*describe requested material*]_ _

Dear _ _[*name*]_ _**:**

As we discussed, our company, _ _[*name*]_ _**, would like to receive** _ _[*describe desired material*]_ _ **such as the** _ _[*name desired material*]_ _ **described in** _ _[*name of publication*]_ _**. Our company is interested in experiments involving** _ _[*generally describe area of interest*]_ _**.**

The company would be very grateful if you would supply these materials to us. If there is any cost for the shipment of the material, please let me know.

Please note that research at the company is directed to ultimate commercial applications of _ _[*describe applications, e.g., plant genetics and agricultural products*]_ _ **and it is possible that the requested materials may ultimately be used for commercial purposes. Because of this possibility, the company cannot accept materials from others in confidence or with any obligations to compensate the donor for their use, except to the extent that such use by the company may ultimately be found to infringe a valid United States patent. Please notify me immediately if this arrangement is unsatisfactory.**

We appreciate your assistance. If you have any questions, please call me collect at _ _[*phone number*]_ _**.**

Sincerely,

_ _[*Name of company*]_ _
By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

Comment: The description of the company's areas of interest in the first paragraph of the letter should be balanced to both justify the release of the desired material and avoid jeopardizing the company's trade secrets.

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Source: Business Law/Trade Secrets Practice in California/17 Protecting Biotechnology/§17.34 G. Form: Receipt of Biological Material From Outsiders

§17.34 G. Form: Receipt of Biological Material From Outsiders

The form text in this section is part of a larger form. For your convenience, downloading any one of the sections included in the form will download the entire form. The inclusive section numbers are §§17.32-17.34.

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COMPLETE THIS FORM AND FORWARD IT TO _ _[*NAME*]_ _ WHENEVER BIOLOGICAL MATERIAL IS RECEIVED

FROM ANYONE OUTSIDE THE COMPANY

The cell or plasmid designation is _ _[*name*]_ _.

Relevant features are _ _[*describe*]_ _.

The supplier is _ _[*name, address, and telephone number*]_ _.

List the contacts our company has made with others to obtain this material:

Date	Action Taken	Result	Material Received	Date Received

Status of restrictions:

[ ] Unrestricted Gift

[ ] Gift with a restriction on secondary distribution

[ ] Restricted (attach relevant correspondence or summarize restrictions)

Attach letters of request and transmittal if available. If not available, summarize any correspondence, phone conversations, etc., on an attached sheet.

__[*Signature*]__
Name: _ _[*Typed name*]_ _

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Source: Business Law/Trade Secrets Practice in California/Appendix A The Uniform Trade Secrets Act as Enacted in California (CC §§3426-3426.11)

Appendix A

The Uniform Trade Secrets Act as Enacted in California (CC §§3426-3426.11)

EDITOR'S NOTE: Code of Civil Procedure §2019.210 follows the Uniform Trade Secrets Act of this appendix.

3426. This title may be cited as the Uniform Trade Secrets Act.

3426.1. As used in this title, unless the context requires otherwise:

(a) "Improper means" includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means. Reverse engineering or independent derivation alone shall not be considered improper means.

(b) "Misappropriation" means:

(1) 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

(2) 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.

(c) "Person" means a natural person, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision or agency, or any other legal or commercial entity.

(d) "Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

(1) Derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and

(2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Legislative Committee Comment—Senate

1984 Addition

One of the broadly stated policies behind trade secret law is "the maintenance of standards of commercial ethics." *Kewanee Oil Co. v Bicron Corp.,* 416 U.S. 470 (1974). The Restatement of Torts, Section 757, Comment (f), notes: "A complete catalogue of improper means is not possible," but Section 1(1) includes a partial listing.

Proper means include:

1. Discovery by independent invention;

2. Discovery by "reverse engineering", that is, by starting with the known product and working backward to find the method by which it was developed. The acquisition of the known product must, of course, also be by a fair and honest means, such as purchase of the item on the open market for reverse engineering to be lawful;

3. Discovery under a license from the owner of the trade secret;

4. Observation of the item in public use or on public display;

5. Obtaining the trade secret from published literature.

Improper means could include otherwise lawful conduct which is improper under the circumstances; *e.g.,* an airplane overflight used as aerial reconnaissance to determine the competitor's plant layout during construction of the plant. *E.I. du Pont de Nemours & Co., Inc. v. Christopher,* 431 F.2d 1012 (CA5, 1970) cert. den., 400 U.S. 1024 (1970). Because the trade secret can be destroyed through public knowledge, the unauthorized disclosure of a trade secret is also a misappropriation.

The type of accident or mistake that can result in a misappropriation under Section 1(2)(ii)(C) involves conduct by a person seeking relief that does not constitute a failure of efforts that arc reasonable under the circumstances to maintain its secrecy under Section 1(4)(ii).

The definition of "trade secret" contains a reasonable departure from the Restatement of Torts (First) definition which required that a trade secret be "continuously used in one's business." The broader definition in the proposed Act extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use. The definition includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will *not* work could be a great value to a competitor.

Cf. Telex Corp. v IBM Corp., 510 F2d 894 (CA10, 1975) per curiam, cert. dismissed 423 US 802 (1975) (liability imposed for developmental cost savings with respect to product not marketed). Because a trade secret need not be exclusive to confer a competitive advantage, different independent developers can acquire rights in the same trade secret.

The words "method, technique" are intended to include the concept of "know-how."

The language "not being generally known to and not being readily ascertainable by proper means by other persons" does not require that information be generally known to the public for trade secret rights to be lost. If the principal persons who can obtain economic benefit from information are aware of it, there is no trade secret. A method of casting metal, for example, may be unknown to the general public but readily known within the foundry industry.

The phrase "and not being readily ascertainable by proper means by" was included in this section as originally proposed by the National Conference of Commissioners on Uniform State Laws. It was removed from the section in favor of the phrase "the public or to." This change was made because the original language was viewed as ambiguous in the definition of a trade secret. However, the assertion that a matter is readily ascertainable by proper means remains available as a defense to a claim of misappropriation.

Information is readily ascertainable if it is available in trade journals, reference books, or published materials. Often, the nature of a product lends itself to being readily copied as soon as it is available on the market. On the other hand, if reverse engineering is lengthy and expensive, a person who discovers the trade secret through reverse engineering can have a trade secret in the information obtained from reverse engineering.

Finally, reasonable efforts to maintain secrecy have been held to include advising employees of the existence of a trade secret, limiting access to a trade secret on "need to know basis", and controlling plant access. On the other hand, public disclosure of information through display, trade journal publications, advertising, or other carelessness can preclude protection.

The efforts required to maintain secrecy are those "reasonable under the circumstances." The courts do not require that extreme and unduly expensive procedures be taken to protect trade secrets against flagrant industrial espionage. See *E.I. du Pont de Nemours & Co., Inc. v. Christopher, supra*. It follows that reasonable use of a trade secret including controlled disclosure to employees and licensees is consistent with the requirement of relative secrecy.

3426.2. (a) Actual or threatened misappropriation may be enjoined. Upon application to the court, an injunction shall be terminated when the trade secret has ceased to exist, but the injunction may be continued for an additional period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.

(b) If the court determines that it would be unreasonable to prohibit future use, an injunction may condition future use upon payment of a reasonable royalty for no longer than the period of time the use could have been prohibited.

(c) In appropriate circumstances, affirmative acts to protect a trade secret may be compelled by court order.

3426.3. (a) A complainant may recover damages for the actual loss caused by misappropriation. A complainant also may recover for the unjust enrichment caused by misappropriation that is not taken into account in computing damages for actual loss.

(b) If neither damages nor unjust enrichment caused by misappropriation are provable, the court may order payment of a reasonable royalty for no longer than the period of time the use could have been prohibited.

(c) If willful and malicious misappropriation exists, the court may award exemplary damages in an amount not exceeding twice any award made under subdivision (a) or (b).

3426.4. If a claim of misappropriation is made in bad faith, a motion to terminate an injunction is made or resisted in bad faith, or willful and malicious misappropriation exists, the court may award reasonable attorney's fees and costs to the prevailing party. Recoverable costs hereunder shall include a reasonable sum to cover the services of expert witnesses, who are not regular employees of any party, actually incurred and reasonably necessary in either, or both, preparation for trial or arbitration, or during trial or arbitration, of the case by the prevailing party.

3426.5. In an action under this title, a court shall preserve the secrecy of an alleged trade secret by reasonable means, which may include granting protective orders in connection with discovery proceedings, holding in-camera hearings, sealing the records of the action, and ordering any person involved in the litigation not to disclose an alleged trade secret without prior court approval.

3426.6. An action for misappropriation must be brought within three years after the misappropriation is discovered or by the exercise of reasonable diligence should have been discovered. For the purposes of this section, a continuing misappropriation constitutes a single claim.

3426.7. (a) Except as otherwise expressly provided, this title does not supersede any statute relating to misappropriation of a trade secret, or any statute otherwise regulating trade secrets.

(b) This title does not affect (1) contractual remedies, whether or not based upon misappropriation of a trade secret, (2) other civil remedies that are not based upon misappropriation of a trade secret, or (3) criminal remedies, whether or not based upon misappropriation of a trade secret.

(c) This title does not affect the disclosure of a record by a state or local agency under the California Public Records Act (Chapter 3.5 (commencing with Section 6250) of Division 7 of Title 1 of the Government Code). Any determination as to whether the disclosure of a record under the California Public Records Act constitutes a misappropriation of a trade secret and the rights and remedies with respect thereto shall be made pursuant to the law in effect before the operative date of this title.

3426.8. This title shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this title among states enacting it.

3426.9. If any provision of this title or its application to any person or circumstances is held invalid, the invalidity does not affect other provisions or applications of the title which can be given effect without the invalid provision or application, and to this end the provisions of this title are severable.

3426.10. This title does not apply to misappropriation occurring prior to January l, 1985. If a continuing misappropriation otherwise covered by this title began before January l, 1985, this title does not apply to the part of the misappropriation occurring before that date. This title does apply to the part of the misappropriation occurring on or after that date unless the appropriation was not a misappropriation under the law in effect before the operative date of this title.

3426.11. Notwithstanding subdivision (b) of Section 47, in any legislative or judicial proceeding, or in any other official proceeding authorized by law, or in the initiation or course of any other proceeding authorized by law and reviewable pursuant to Chapter 2 (commencing with Section 1084) of Title 1 of Part 3 of the Code of Civil Procedure, the voluntary, intentional disclosure of trade secret information, unauthorized by its owner, to a competitor or potential competitor of the owner of the trade secret information or the agent or representative of such a competitor or potential competitor is not privileged and is not a privileged communication for purposes of Part 2 (commencing with Section 43) of Division 1.

This section does not in any manner limit, restrict, impair, or otherwise modify either the application of the other subdivisions of Section 47 to the conduct to which this section applies or the court's authority to control, order, or permit access to evidence in any case before it.

Nothing in this section shall be construed to limit, restrict, or otherwise impair, the capacity of persons employed by public entities to report improper government activity, as defined in Section 10542 of the Government Code, or the capacity of private persons to report improper activities of a private business.

EDITOR'S NOTE: Section 3426.11 still refers to Govt C §10542 even though in 1993 that Government Code section was repealed and replaced by Govt C §8547.2.

Code of Civil Procedure §2019.210 specifies certain procedures in actions under the Uniform Trade Secrets Act. That section

reads:

In any action alleging the misappropriation of a trade secret under the Uniform Trade Secrets Act (Title 5 (commencing with Section 3426) of Part 1 of Division 4 of the Civil Code), before commencing discovery relating to the trade secret, the party alleging the misappropriation shall identify the trade secret with reasonable particularity subject to any orders that may be appropriate under Section 3426.5 of the Civil Code.

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Source: Business Law/Trade Secrets Practice in California/Appendix B The Uniform Trade Secrets Act

Appendix B

The Uniform Trade Secrets Act

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Editor's Note: The Uniform Act as reprinted here includes the amendments made by the National Conference of Commissioners in August 1985.

Prefatory Note

A valid patent provides a legal monopoly for seventeen years in exchange for public disclosure of an invention. If, however, the courts ultimately decide that the Patent Office improperly issued a patent, an invention will have been disclosed to competitors with no corresponding benefit. In view of the substantial number of patents that are invalidated by the courts, many businesses now elect to protect commercially valuable information through reliance upon the state law of trade secret protection. *Kewanee Oil Co. v. Bicron Corp.,* 416 U.S. 470 (1974), which establishes that neither the Patent Clause of the United States Constitution nor the federal patent laws pre-empt state trade secret protection for patentable or unpatentable information, may well have increased the extent of this reliance.

The recent decision in *Aronson v. Quick Point Pencil Co.* (1979) [440 US 257, 59 L Ed 2d 296,] 99 S Ct 1096, 201 USPQ 1 reaffirmed *Kewanee* and held that federal patent law is not a barrier to a contract in which someone agrees to pay a continuing royalty in exchange for the disclosure of trade secrets concerning a product.

Notwithstanding the commercial importance of state trade secret law to interstate business, this law has not developed satisfactorily. In the first place, its development is uneven. Although there typically are a substantial number of reported decisions in states that are commercial centers, this is not the case in less populous and more agricultural jurisdictions. Secondly, even in states in which there has been significant litigation, there is undue uncertainty concerning the parameters of trade secret protection, and the appropriate remedies for misappropriation of a trade secret. One commentator observed:

Under technological and economic pressures, industry continues to rely on trade secret protection despite the doubtful and confused status of both common law and statutory remedies. Clear, uniform trade secret protection is urgently needed….

Comment, "Theft of Trade Secrets: The Need for a Statutory Solution," 120 U.Pa.L.Rev. 378, 380-81 (1971).

In spite of this need, the most widely accepted rules of trade secret law, §757 of the Restatement of Torts, were among the sections omitted from the Restatement of Torts, 2d (1978).

The Uniform Act codifies the basic principles of common law trade secret protection, preserving its essential distinctions from patent law. Under both the Act and common law principles, for example, more than one person can be entitled to trade secret protection with respect to the same information, and analysis involving the reverse engineering of a lawfully obtained product in order to discover a trade secret is permissible. *Compare* Uniform Act, Section 1(2) (misappropriation means acquisition of a trade secret by means that should be known to be improper and unauthorized disclosure or use of information that one should know is the trade secret of another) with *Miller v. Owens-Illinois, Inc.,* 187 USPQ 47, 48 (D.Md. 1975) (alternative holding) (prior, independent discovery a complete defense to liability for misappropriation) and *Wesley-Jessen, Inc. v. Reynolds,* 182 USPQ 135, 144-45 (N.D. Ill. 1974) (alternative holding) (unrestricted sale and lease of camera that could be reversed engineered in several days to reveal alleged trade secrets preclude relief for misappropriation).

For liability to exist under this Act, a Section 1(4) trade secret must exist and either a person acquisition of the trade secret, disclosure of the trade secret to others, or use of the trade secret must be improper under Section 1(2). The mere copying of an unpatented item is not actionable.

Like traditional trade secret law, the Uniform Act contains general concepts. The contribution of the Uniform Act is substitution of unitary definitions of trade secret and trade secret misappropriation, and a single statute of limitations for the various property, quasi-contractual, and violation of fiduciary relationship theories of noncontractual liability utilized at common law. The Uniform Act also codifies the results of the better reasoned cases concerning the remedies for trade secret misappropriation.

Uniform Trade Secrets Act

1. Definitions.

2. Injunctive Relief.

3. Damages.

4. Attorney's Fees.

5. Preservation of Secrecy.

6. Statute of Limitations.

7. Effect on Other Law.

8. Uniformity of Application and Construction.

9. Short Title.

10. Severability.

11. Time of Taking Effect.

12. Repeal.

§1. Definitions

As used in this [Act], unless the context requires otherwise:

(1) "Improper means" includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means;

(2) "Misappropriation" means:

(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 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.

(3) "Person" means a natural person, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision or agency, or any other legal or commercial entity.

(4) "Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

(i) derives independent economic value, actual or potential, from not 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.

Comment

One of the broadly stated policies behind trade secret law is "the maintenance of standards of commercial ethics." *Kewanee Oil Co. v*

Bicron Corp. (1974) 416 US 470. The Restatement of Torts, Section 757, Comment (f), notes: "A complete catalogue of improper means is not possible," but Section 1(1) includes a partial listing.

Proper means include:

1. Discovery by independent invention;

2. Discovery by "reverse engineering", that is, by starting with the known product and working backward to find the method by which it was developed. The acquisition of the known product must, of course, also be by a fair and honest means, such as purchase of the item on the open market for reverse engineering to be lawful;

3. Discovery under a license from the owner of the trade secret;

4. Observation of the item in public use or on public display;

5. Obtaining the trade secret from published literature.

Improper means could include otherwise lawful conduct which is improper under the circumstances; *e.g.,* an airplane overflight used as aerial reconnaissance to determine the competitor's plant layout during construction of the plant. *E.I. du Pont de Nemours & Co., Inc. v Christopher* (CA5, 1970) 431 F2d 1012 cert denied, 400 US 1024 (1970). Because the trade secret can be destroyed through public knowledge, the unauthorized disclosure of a trade secret is also a misappropriation.

The type of accident or mistake that can result in a misappropriation under Section 1(2)(ii)(C) involves conduct by a person seeking relief that does not constitute a failure of efforts that are reasonable under the circumstances to maintain its secrecy under Section 1(4)(ii).

The definition of "trade secret" contains a reasonable departure from the Restatement of Torts (First) definition which required that a trade secret be "continuously used in one's business." The broader definition in the proposed Act extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use. The definition includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will *not* work could be a great value to a competitor.

Cf. Telex Corp. v IBM Corp. (CA10, 1975) 510 F2d 894 per curiam, cert dismissed 423 US 802 (1975) (liability imposed for developmental cost savings with respect to product not marketed). Because a trade secret need not be exclusive to confer a competitive advantage, different independent developers can acquire rights in the same trade secret.

The words "method, technique" are intended to include the concept of "know-how."

The language "not being generally known to and not being readily ascertainable by proper means by other persons" does not require that information be generally known to the public for trade secret rights to be lost. If the principal persons who can obtain economic benefit from information are aware of it, there is no trade secret. A method of casting metal, for example, may be unknown to the general public but readily known within the foundry industry.

Information is readily ascertainable if it is available in trade journals, reference books, or published materials. Often, the nature of a product lends itself to being readily copied as soon as it is available on the market. On the other hand, if reverse engineering is lengthy and expensive, a person who discovers the trade secret through reverse engineering can have a trade secret in the information obtained from reverse engineering.

Finally, reasonable efforts to maintain secrecy have been held to include advising employees of the existence of a trade secret, limiting access to a trade secret on "need to know basis", and controlling plant access. On the other hand, public disclosure of information through display, trade journal publications, advertising, or other carelessness can preclude protection.

The efforts required to maintain secrecy are those "reasonable under the circumstances." The courts do not require that extreme and unduly expensive procedures be taken to protect trade secrets against flagrant industrial espionage. See *E.I. du Pont de Nemours & Co., Inc. v Christopher, supra*. It follows that reasonable use of a trade secret including controlled disclosure to employees and licensees is consistent with the requirement of relative secrecy.

§2. Injunctive Relief

(a) Actual or threatened misappropriation may be enjoined. Upon application to the court, an injunction shall be terminated when the trade secret has ceased to exist, but the injunction may be continued for an additional reasonable period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.

(b) In exceptional circumstances, an injunction may condition future use upon payment of a reasonable royalty for no longer than the period of time for which the use could have been prohibited. Exceptional circumstances include, but are not limited to, a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation that renders a prohibitive injunction inequitable.

(c) In appropriate circumstances, affirmative acts to protect a trade secret may be compelled by court order.

Comment

Injunctions restraining future use and disclosure of misappropriated trade secrets frequently are sought. Although punitive perpetual injunctions have been granted, *e.g., Elcor Chemical Corp. v. Agri-Sul, Inc.*, 494 S.W.2d 204 (Tex. Civ. App. 1973), Section 2(a) of this Act adopts the position of the trend of authority limiting the duration of injunctive relief to the extent of the temporal advantage over good faith competitors gained by a misappropriator. See, *e.g., K-2 Ski Co. v. Head Ski Co., Inc.,* 506 F.2d 471 (CA9, 1974) (maximum appropriate duration of both temporary and permanent injunctive relief is period of time it would have taken defendant to discover trade secrets lawfully through either independent development or reverse engineering of plaintiff's products).

The general principle of Section 2(a) and (b) is that an injunction should last for as long as is necessary, but no longer than is necessary, to eliminate the commercial advantage or "lead time" with respect to good faith competitors that a person has obtained through misappropriation. Subject to any additional period of restraint necessary to negate lead time, an injunction accordingly should terminate when a former trade secret becomes either generally known to good faith competitors or generally knowable to them because of the lawful availability of products that can be reverse engineered to reveal a trade secret.

For example, assume that A has a valuable trade secret of which B and C, the other industry members, are originally unaware. If B subsequently misappropriates the trade secret and is enjoined from use, but C later lawfully reverse engineers the trade secret, the injunction restraining B is subject to termination as soon as B's lead time has been dissipated. All of the persons who could derive economic value from use of the information are now aware of it, and there is no longer a trade secret under Section 1(4). It would be anti-competitive to continue to restrain B after any lead time that B had derived from misappropriation had been removed.

If a misappropriator either has not taken advantage of lead time or good faith competitors already have caught up with a misappropriator at the time that a case is decided, future disclosure and use of a former trade secret by a misappropriator will not damage a trade secret owner and no injunctive restraint of future disclosure and use is appropriate. See, *e.g., Northern Petrochemical Co. v. Tomlinson,* 484 F.2d 1057 (CA7, 1973) (affirming trial court's denial of preliminary injunction in part because an explosion at its plant prevented an alleged misappropriator from taking advantage of lead time); *Kubik, Inc. v. Hull,* 185 USPQ 391 (Mich. App. 1974) (discoverability of trade secret by lawful reverse engineering made by injunctive relief punitive rather than compensatory).

Section 2(b) deals with the special situation in which future use by a misappropriator will damage a trade secret owner but an injunction against future use nevertheless is inappropriate due to exceptional circumstances. Exceptional circumstances include the existence of an overriding public interest which requires the denial of a prohibitory injunction against future damaging use and a person's reasonable reliance upon acquisition of a misappropriated trade secret in good faith and without reason to know of its prior misappropriation that would be prejudiced by a prohibitory injunction against future damaging use. *Republic Aviation Corp. v. Schenk,* 152 USPQ 830 (N.Y.Sup.Ct. 1967) illustrates the public interest justification for withholding prohibitory injunctive relief. The court considered that enjoining a misappropriator from supplying the U.S. with an aircraft weapons control system would have endangered military personnel in Viet Nam. The prejudice to a good faith third party justification for withholding prohibitory injunctive relief can arise upon a trade secret owner's notification to a good faith third party that the third party has knowledge of a trade secret as a result of misappropriation by another. This notice suffices to make the third party a misappropriator thereafter under Section 1(2)(ii)(B)(I). In weighing an aggrieved person's interests and the interests of a third party who has relied in good faith upon his or her ability to utilize information, a court may conclude that restraining future use of the information by the third party is unwarranted. With respect to innocent acquirers of misappropriated trade secrets, Section 2(b) is consistent with the principle of 4 Restatement [of] Torts (First) §758(b) (1939), but rejects the Restatement's literal conferral of absolute immunity upon all third parties who have paid value in good faith for a trade secret misappropriated by another. The position taken by the Uniform Act is supported by *Forest Laboratories, Inc. v. Pillsbury Co.,* 452 F.2d 621 (CA7, 1971) in which a defendant's purchase of assets of a corporation to which a trade secret had been disclosed in confidence was not considered to confer immunity upon the defendant.

When Section 2(b) applies, a court has discretion to substitute an injunction conditioning future use upon payment of a reasonable royalty for an injunction prohibiting future use. Like all injunctive relief for misappropriation, a royalty order injunction is appropriate only if a misappropriator has obtained a competitive advantage through misappropriation and only for the duration of that competitive advantage. In some situations, typically those involving good faith acquirers of trade secrets misappropriated by others, a court may conclude that the same considerations that render a prohibitory injunction against future

use inappropriate also render a royalty order injunction inappropriate. See, generally, *Prince Manufacturing, Inc. v. Automatic Partner, Inc.,* 198 USPQ 618 (N.J.Super.Ct. 1976) (purchaser of misappropriator's assets from receiver after trade secret disclosed to public through sale of product not subject to liability for misappropriation).

A royalty order injunction under Section 2(b) should be distinguished from a reasonable royalty alternative measure of damages under Section 3(a). See the Comment to Section 3 for discussion of the differences in the remedies.

Section 2(c) authorizes mandatory injunctions requiring that a misappropriator return the fruits of misappropriation to an aggrieved person, *e.g.,* the return of stolen blueprints or the surrender of surreptitious photographs or recordings.

Where more than one person is entitled to trade secret protection with respect to the same information, only that one from whom misappropriation occurred is entitled to a remedy.

§3. Damages

(a) Except to the extent that a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation renders a monetary recovery inequitable, a complainant is entitled to recover damages for misappropriation. Damages can include both the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss. In lieu of damages measured by any other methods, the damages caused by misappropriation may be measured by imposition of liability for a reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret.

(b) If willful and malicious misappropriation exists, the court may award exemplary damages in an amount not exceeding twice any award made under subsection (a).

Comment

Like injunctive relief, a monetary recovery for trade secret misappropriation is appropriate only for the period in which information is entitled to protection as a trade secret, plus the additional period, if any, in which a misappropriator retains an advantage over good faith competitors because of misappropriation. Actual damage to a complainant and unjust benefit to a misappropriator are caused by misappropriation during this time alone. See *Conmar Products Corp. v. Universal Slide Fastener Co.*, 172 F.2d 150 (CA2, 1949) (no remedy for period subsequent to disclosure of trade secret by issued patent); *Carboline Co. v. Jarboe*, 454 S.W.2d 540 (Mo. 1970) (recoverable monetary relief limited to period that it would have taken misappropriator to discover trade secret without misappropriation). A claim for actual damages and net profits can be combined with a claim for injunctive relief, but, if both claims are granted, the injunctive relief ordinarily will preclude a monetary award for a period in which the injunction is effective.

As long as there is no double counting, Section 3(a) adopts the principle of the recent cases allowing recovery of both a complainant's actual losses and a misappropriator's unjust benefit that are caused by misappropriation. *E.g., Tri-Tron International v. Velto,* 525 F.2d 432 (CA9, 1975) (complainant's loss and misappropriator's benefit can be combined). Because certain cases may have sanctioned double counting in a combined award of losses and unjust benefit, *e.g., Telex Corp. v. IBM Corp.,* 510 F.2d 894 (CA10, 1975) (per curiam), cert. dismissed, 423 U.S. 802 (1975) (IBM recovered rentals lost due to displacement by misappropriator's products without deduction for expenses saved by displacement; as a result of rough approximations adopted by the trial judge, IBM also may have recovered developmental costs saved by misappropriator through misappropriation with respect to the same customers), the Act adopts an express prohibition upon the counting of the same item as both a loss to a complainant and an unjust benefit to a misappropriator.

As an alternative to all other methods of measuring damages caused by a misappropriator's past conduct, a complainant can request that damages be based upon a demonstrably reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret. In order to justify this alternative measure of damages, there must be competent evidence of the amount of a reasonable royalty.

The reasonable royalty alternative measure of damages for a misappropriator's past conduct under Section 3(a) is readily distinguishable from a Section 2(b) royalty order injunction, which conditions a misappropriator's future ability to use a trade secret upon payment of a reasonable royalty. A Section 2(b) royalty order injunction is appropriate only in exceptional circumstances; whereas a reasonable royalty measure of damages is a general option. Because Section 3(a) damages are awarded for a misappropriator's past conduct and a Section 2(b) royalty order injunction regulates a misappropriator's future conduct, both remedies cannot be awarded for the same conduct. If a royalty order injunction is appropriate because of a person's material and prejudicial change of position prior to having reason to know that a trade secret has been acquired from a misappropriator, damages, moreover, should not be awarded for past conduct that occurred prior to notice that a misappropriated trade secret has been acquired.

Monetary relief can be appropriate whether or not injunctive relief is granted under Section 2. If a person charged with misappropriation has materially and prejudicially changed position in reliance upon knowledge of a trade secret acquired in good faith and without reason to know of its misappropriation by another, however, the same considerations that can justify denial of all injunctive relief also can justify denial of all monetary relief. See *Conmar Products Corp. v. Universal Slide Fastener Co.,* 172 F.2d 150 (CA2, 1949) (no relief against new employer of employee subject to contractual obligation not to disclose former employer's trade secrets where new employer innocently had committed $40,000 to develop the trade secrets prior to notice of misappropriation).

If willful and malicious misappropriation is found to exist, Section 3(b) authorizes the court to award a complainant exemplary damages in addition to the actual recovery under Section 3(a) an amount not exceeding twice that recovery. This provision follows federal patent law in leaving discretionary trebling to the judge even though there may be a jury, *compare* 35 USC §284 (1976).

Whenever more than one person is entitled to trade secret protection with respect to the same information, only that one from whom misappropriation occurred is entitled to a remedy.

§4. Attorney's Fees

If (i) a claim of misappropriation is made in bad faith, (ii) a motion to terminate an injunction is made or resisted in bad faith, or (iii) willful and malicious misappropriation exists, the court may award reasonable attorney's fees to the prevailing party.

Comment

Section 4 allows a court to award reasonable attorney fees to a prevailing party in specified circumstances as a deterrent to specious claims of misappropriation, to specious efforts by a misappropriator to terminate injunctive relief, and to willful and malicious misappropriation. In the latter situation, the court should take into consideration the extent to which a complainant will recover exemplary damages in determining whether additional attorney's fees should be awarded. Again, patent law is followed in allowing the judge to determine whether attorney's fees should be awarded even if there is a jury, *compare* 35 USC Section 285 (1976).

§5. Preservation of Secrecy

In an action under this [Act], a court shall preserve the secrecy of an alleged trade secret by reasonable means, which may include granting protective orders in connection with discovery proceedings, holding in-camera hearings, sealing the records of the action, and ordering any person involved in the litigation not to disclose an alleged trade secret without prior court approval.

Comment

If reasonable assurances of maintenance of secrecy could not be given, meritorious trade secret litigation would be chilled. In fashioning safeguards of confidentiality, a court must ensure that a respondent is provided sufficient information to present a defense and a trier of fact sufficient information to resolve the merits. In addition to the illustrative techniques specified in the statute, courts have protected secrecy in these cases by restricting disclosures to a party's counsel and his or her assistants and by appointing a disinterested expert as a special master to hear secret information and report conclusions to the court.

§6. Statute of Limitations

An action for misappropriation must be brought within 3 years after the misappropriation is discovered or by the exercise of reasonable diligence should have been discovered. For the purposes of this section, a continuing misappropriation constitutes a single claim.

Comment

There presently is a conflict of authority as to whether trade secret misappropriation is a continuing wrong. Compare *Monolith Portland Midwest Co. v. Kaiser Aluminum & Chemical Corp.,* 407 F.2d 288 (CA9, 1969) (not a continuing wrong under California law —limitation period upon all recovery begins upon initial misappropriation) with *Underwater Storage, Inc. v. U. S. Rubber Co.,* 371 F.2d 950 (CADC, 1966), cert. den., 386 US 911 (1967) (continuing wrong under general principles—limitation period with respect to a specific act of misappropriation begins at the time that the act of misappropriation occurs).

This Act rejects a continuing wrong approach to the statute of limitations but delays the commencement of the limitation period until an aggrieved person discovers or reasonably should have discovered the existence of misappropriation. If objectively reasonable notice of misappropriation exists, three years is sufficient time to vindicate one's legal rights.

§7. Effect on Other Law

(a) Except as provided in subsection (b) this [Act] displaces conflicting tort, restitutionary, and other law of this State providing civil liberties for misappropriation of a trade secret.

(b) This [Act] does not affect:

(1) contractual remedies, whether or not based upon misappropriation of a trade secret;

(2) other civil remedies that are not based upon misappropriation of a trade secret; or

(3) criminal remedies, whether or not based upon misappropriation of a trade secret.

Comment

This Act does not deal with criminal remedies for trade secret misappropriation and is not a comprehensive statement of civil remedies. It applies to a duty to protect competitively significant secret information that is imposed by law. It does not apply to a duty voluntarily assumed through an express or an implied-in-fact contract. The enforceability of covenants not to disclose trade secrets and covenants not to compete that are intended to protect trade secrets, for example, is governed by other law. The Act also does not apply to a duty imposed by law that is not dependent upon the existence of competitively significant secret information, like an agent's duty of loyalty to his or her principal.

§8. Uniformity of Application and Construction

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among states enacting it.

§9. Short Title

This [Act] may be cited as the Uniform Trade Secrets Act.

§10. Severability

If any provision of this [Act] or its application to any person or circumstances is held invalid, the invalidity does not affect other provisions or applications of the [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

§11. Time of Taking Effect

This [Act] takes effect on _____, and does not apply to misappropriation occurring prior to the effective date. With respect to a continuing misappropriation that began prior to the effective date, the [Act] also does not apply to the continuing misappropriation that occurs after the effective date.

Comment

The Act applies exclusively to misappropriation that begins after its effective date. Neither misappropriation that began and ended before the effective date nor misappropriation that began before the effective date and continued thereafter is subject to the Act.

§12. Repeal

The following Acts and parts of Acts are repealed:

(1)

(2)

(3)

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Appendix C

Comparison of Trade Secrets, Patents, Copyrights, and Trademarks

Lowell Anderson

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Patents, copyrights, and trade secrets can coexist because they protect different aspects of intellectual property. In some instances, however, one form of protection may preempt or limit other forms.

	Trade Secret	Utility Patent	Copyright	Trademark
Interest protected	Business information	Functional embodiment of idea—inventions	The expression as embodied in art, writing, etc.; ideas not protected	Consumer recognition of brands for goods; avoid likelihood of confusion
Governing statutes	State law: CC §§3426-3426.11; Govt C §6254.7(d); Pen C §499c	Federal law: 35 USC §§1-376	Federal law: 17 USC §§101-1332	Federal law: 15 USC §§1051-1141n State law: Bus & P C §§14200-14342
Criteria for obtaining	Not generally known, economically valuable, and reasonable steps to maintain secrecy	New, useful, nonobvious	Originality required; exists from time work is created	First to use in commerce to distinguish or identify goods; federal registration can limit common law rights
Time to take steps for protection	Before disclosure to public or those who can use secret	No later than one year after printed publication, sale, offer to sell, or public use	Any time but must register before lawsuit; registration date affects remedies and defenses	Whenever good faith intent to use in commerce exists or after actual use in commerce
Registration office	No registration procedure	United States Patent and Trademark Office	United States Copyright Office	United States Patent and Trademark Office; state regulation and common law protection also available
Normal duration of protection	As long as remains secret; contractual extensions for	20 years after the earliest priority date for applications filed	Life of author plus 70 years for post-1/1/78 works; for	10-year period, renewable as long as properly used

	specific parties possible	on or after June 8, 1995	works made for hire, 95 years after publication or 120 years after creation, whichever is first.	
Prohibited acts	Disclosure, acquisition, or use (misappropriation)	Make, use, sell, or offer to sell device or process defined in patent claims	Copying and substantial similarity	Likelihood of confusion
Scope of injunctive protection	Right to stop use by misappropriators for time needed to reverse engineer secret information and to eliminate head-start advantage	Right to exclude even as to independent creators	Copying of particular expression proscribed; independent creation avoids infringement	As long as used; scope coextensive with consumer recognition of mark and goods for unregistered marks
Damages	Compensatory damages; treble damages and attorney fees in certain cases	Compensatory damages not less than reasonable royalty; treble damages and attorney fees in certain cases	Either compensatory or statutory damages are available. Statutory damages by the jury and increased statutory damages and attorney fees by the court are available only if registration precedes infringement.	Compensatory damages; treble damages and attorney fees in certain cases

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Source: Business Law/Trade Secrets Practice in California/Appendix D Civil Trade Secrets Statutes in Other Jurisdictions

Appendix D

Civil Trade Secrets Statutes in Other Jurisdictions

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The following states have statutes that are modeled after the Uniform Act:

State	Effective Date	Statutory Citation
Alabama	8-12-87	Ala Code §§8-27-1—8-27-6
Alaska	9-2-1988	Alaska Stat §§45.50.910-45.50.945
Arizona	4-11-1990	Ariz Rev Stat §§44-401—44-407
Arkansas	3-12-1981	Ark Code Ann §§4-75-601—4-75-607
California	1-1-1985	CC §§3426-3426.11
Colorado	7-1-1986	Colo Rev Stat Ann §§7-74-101—7-74-110
Connecticut	6-23-1983	Conn Gen Stat Ann §§35-50—35-58
Delaware	4-15-1982	Del Code Ann, Tit 6, §§2001-2009
District of Columbia	3-16-1989	DC Code Ann §§36-401—36-410
Florida	10-1-1988	Fla Stat Ann §§688.001-688.009
Georgia	7-1-1990	Ga Code Ann §§10-1-760—10-1-767
Hawaii	7-1-1989	Hawaii Rev Stat §§482B-1—482B-9
Idaho		Idaho Code §§48-801—48-807
Illinois	1-1-1988	765 Ill Comp Stat §§1065/1-1065/9
Indiana	2-25-1982	Ind Code §§24-2-3-1—24-2-3-8
Iowa	4-27-1990	Iowa Code Ann §§550.1-550.8
Kansas	7-1-1981	Kan Stat Ann §§60-3320—60-3330
Kentucky	4-6-1990	Ky Rev Stat Ann §§365.880-365.900
Louisiana	7-19-1981	La Rev Stat Ann §§51:1431-51:1439
Maine	5-22-1987	Me Rev Stat Ann, Tit 10, §§1541-1548
Maryland	7-1-1989	Md Code Ann [Commercial Law] §§11-1201—11-1209
Michigan	12-30-1998	1999 M.C.L.A. §§445.1901-445.1910
Minnesota	7-1-1990	Minn Stat Ann §§325C.01-325C.08
Mississippi	7-1-1990	Miss Code Ann §§75-26-1—75-26-19
Missouri	10-6-1995	Mo Rev Stat §§417.450-417.467
Montana		Mont Code Ann §§30-14-401—30-14-409
Nebraska	7-9-1988	Neb Rev Stat §§87-501—87-507

Nevada	3-5-1987	Nev Rev Stat §§600A.010-600A.100
New Hampshire	1-1-1990	NH Rev Stat Ann §§350-B:1—350-B:9
New Mexico	4-3-1989	NM Stat Ann §§57-3A-1 to 57-3A-7
North Dakota	7-1-1983	ND Cent Code §§47-25.1-01—47-25.1-08
Ohio	7-22-1994	Ohio Rev Code Ann §§1333.61-1333.69
Oklahoma	1-1-1986	Okla Stat Ann, Tit 78, §§85-94
Oregon	1-1-1988	Or Rev Stat §§646.461-646.475
Pennsylvania	1-1-2004	12 Pa C S §§5301-5308
Rhode Island	7-1-1986	RI Gen Laws §§6-41-1—6-41-11
South Carolina	6-15-1992	SC Code Ann §§39-8-10—39-8-130
South Dakota	7-1-1988	SD Codified Laws §§37-29-1—37-29-11
Tennessee	7-1-2000	Tenn Code Ann §§47-25-1701—47-25-1709
Utah	5-1-1989	Utah Code Ann §§13-24-1—13-24-9
Vermont	7-1-1996	Vt Stat Ann, Tit 9, §§4601-4609; Tit 12 §523
Virginia	7-1-1986	Va Code Ann §§59.1-336 to 59.1-343
Washington	1-1-1982	Wash Rev Code Ann §§19.108.010-19.108.940
West Virginia	7-1-1986	W Va Code §§47-22-1 to 47-22-10
Wisconsin	4-24-1986	Wis Stat §134.90
Wyoming	7-1-2006	Wyo §§40-24-101 to 40-24-110

The following states have statutes that are not modeled after the Uniform Act:

State	Statutory Citation
Massachusetts	Mass Gen Laws, ch 93, §§42-42A
North Carolina	NC Gen Stat §§66-152 to 66-157

The following states have no codified civil trade secrets statutes: New Jersey, New York, and Texas.

As of 2010, however, legislation to adopt the Uniform Trade Secrets Act is pending in Massachusetts (HB 329), New Jersey (AB 921), and New York (AB6185/SB4162). North Carolina and Texas have no pending legislation.

See http://www.nccusl.org/nccusl/LegByAct.pdf.

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Source: Business Law/Trade Secrets Practice in California/Table of Statutes, Regulations, and Rules

Table of Statutes, Regulations, and Rules

CALIFORNIA

Constitution

Art I, §1: §§5.22, 5.26

Art I, §2(b): §§2.18, 4.2, 11.30D, 16.42A

Art I §2(b): §§11.30D, 16.42A

Art I, §19: §5.26

Statutes

BUSINESS AND PROFESSIONS CODE

6077-6078: §13.1

7067.5: §5.21

7503-7503.14: §5.21

7506.5: §5.21

14200-14272: §9.13

14200-14342: App C

14220(c): §9.13

14220(f): §9.13

16600: §§1.2, 1.5, 2.31, 2.32-2.32D, 4.4, 4.6, 4.11, 4.15, 6.16, 6.21, 6.57, 10.4, 10.6, 10.16, 10.38, 11.6B, 11.17A, 11.41, 11.47, 12.1, 12.13, 12.23

16600-16602.5: §§4.6, 17.10

16601: §§2.32, 11.41, 12.8

16601-16602: §§2.32, 11.41

16601-16602.5: §10.46

16602: §§2.32, 11.41

16602.5: §11.41

16606: §§2.2, 2.13, 2.17, 2.24

16607(a): §§1.5, 2.13, 2.17, 2.24

16750.1: §11.36

17081: §11.49

17200: §§4.6, 6.21, 6.23, 11.49, 11.53, 16.60

17200-17210: §§8.41, 11.17A

17203: §§11.35, 11.49

17205: §11.49

17208: §§11.49, 11.53

17500: §11.53

17538: §16.41

CIVIL CODE

Div 4, Pt 1, Title 5: App A

19: §11.13A

47: §§11.30-11.30A, 11.30C, 11.33A

47(b): §§11.3, 11.30-11.30A, 13.1, 13.12

47(c): §§4.14, 11.30

47(d): §11.30

654-655: §2.12

655: §2.1

980-985: §§2.1, 2.12

983: §3.14

1572: §11.44

1573: §§11.44-11.45

1573(1): §11.44

1573(2): §11.44

1614: §§2.27, 6.16

1615: §2.27

1620: §11.38

1621: §11.38

1624: §7.2

1668: §13.11

1670.5: §2.30

1673 (former): §§1.2, 2.32

1717: §11.38

1717(a): §11.38

1750-1756: §6.31

1750-1784: §8.41

1792-1793.02: §§16.26, 16.31

1798-1798.78: §§5.2, 5.24

1798.1: §5.24

1798.3(a): §5.24

1798.21: §5.24

1798.24: §5.24

1798.24(g): §5.24

1798.29: §16.2

1798.29(e)(1)-(5): §16.2

2860: §14.18

3294: §11.40

3369: §11.49

3391: §11.38

3422: §§12.4, 12.7

3423(e): §11.38

3424: §12.10

3426: App A

3426-3426.11: §§1.2, 3.5, 4.1, 4.26, 5.22, 5.26, 6.3, 6.24, 7.1, 9.5, 10.23, 11.1, 11.17A, 11.22, 12.1, 13.1, 15.2, 15.33, 16.29, 16.42, Apps C-D

3426.1: §§1.2, 1.9

Comment: §§1.2, 1.4, 1.6, 1.9-1.11, 2.14, 10.36, 10.48, 12.8

3426.1(a): §§1.11, 1.13, 10.47, 12.9

3426.1(b): §§1.11, 10.24, 10.47-10.48

3426.1(b)(1): §§10.15, 11.44

3426.1(b)(1)-(2): §10.24

3426.1(b)(1)-(2)(A): §1.12

3426.1(b)(2)(B)-(C): §10.12

3426.1(b)(2)(B)(i): §10.31

3426.1(b)(2)(B)(i)-(ii): §11.44

3426.1(b)(2)(B)(iii): §10.37

3426.1(d): §§1.3, 2.1, 2.14, 4.4, 4A.1, 6.3, 8.4, 10.24, 10.26, 10.31, 12.8, 16.42

3426.1(d)(1): §§1.7, 2.25, 4.2, 9.2

3426.1(d)(2): §§2.25, 2.35, 4.2, 4.8, 10.5, 17.25

3426.2: §§1.11, 1.15, 12.1, 12.4, 12.7-12.8, 12.10, 12.13

3426.2(a): §§1.11, 12.1A, 12.3, 12.9-12.10, 12.13

3426.2(b): §§12.3, 12.12

3426.2(c): §§1.11, 12.11, 12.13

3426.3: §§12.1, 12.20, 12.22

3426.3(a): §§1.15, 12.20

3426.3(b): §§1.15, 12.21

3426.3(c): §§1.15-1.16, 11.40, 11.44, 12.1, 12.22

3426.4: §§1.15, 6.30, 8.42, 10.22, 11.2, 11.6A, 11.19, 11.24, 12.1, 12.17, 12.23-12.24

3426.5: §13.13, App A

3426.6: §§2.1, 11.13, 11.13B, 11.45

3426.7: §§1.16, 11.35, 11.37-11.38, 11.49-11.50, 12.1, 12.25

3426.7(b): §§12.10, 13.1

3426.8: §11.13

3426.11: §11.30A

CODE OF CIVIL PROCEDURE

Div 1, Pt 2: App A

Pt 3, Title 1, Chap 2: App A

43: App A

128(a)(8)(A)-(B): §11.34

128(a)(8)(B): §11.34

128.5: §§1.15, 11.2

128.7: §§11.2, 12.23

337: §11.38

338(c): §§11.43, 11.51

338(d): §§11.44-11.45

339: §§11.37-11.38, 11.43, 11.45, 11.47-11.48, 11.50

343: §11.53

351: §11.13C

395: §11.6A

410.10: §12.5

425.16: §11.17A

425.16(b)(1): §11.17A

425.16(e)(2): §11.30C

430.10: §11.17

437c(a): §11.18

437c(p)(2): §11.18

446(a): §11.2

511.010-516.050: §§11.20A, 11.51

512.020(b)(1): §11.51

512.060: §11.51

526: §12.4

526(a)(2): §§12.6-12.7

527: §12.6

527(a): §§11.2, 12.6

527(c): §12.6

527(d)(1): §12.6

527(d)(4): §12.6

529(a): §12.16

631(d): §8.33

632: §12.14

638: §12.14

904.1(a)(6): §12.18

907: §12.23

995.710-996.560: §12.16

995.930(b): §12.16

995.960(c): §12.16

996.010: §12.16

996.440: §12.16

1032: §§12.23-12.24

1060: §11.4

1084: App A

1084-1097: §11.30A

1280-1294.2: §8.33

1281: §3.27

1281-1281.9: §8.33

1281.8: §11.6A

1281.85: §8.33

1281.85(b): §8.33

1281.85(c): §8.33

1284.2: §12.24

1285: §8.33

2019(d): §§11.21A, 11.22

2019(d) (former): §§11.21A, 11.33B

2019.210: §§1.16, 7.8, 11.20-11.21A, 11.22-11.24, 12.8, 12.23, App A

2025.420: §11.33C

2025.420(b)(13): §11.33C

3426.1: App A

3426.2: App A

3426.3: App A

3426.4: App A

3426.5: App A

3426.6: App A

3426.7: §§11.23, 11.43, App A

3426.8: App A

3426.9: App A

3426.10: App A

3426.11: App A

COMMERCIAL CODE

Div 9: §§9.4, 9.8, 9.11, 9.13

1201(43)(a)-(b): §9.9

1201(43)(d): §9.9

2204(1): §16.30

2204(2): §16.30

2316: §§16.26, 16.31

2719: §16.31

9101-9709: §9.4

9102(42): §§9.5, 9.8

UCC Comment 5d: §9.5

9102(44): §9.8

9102(75): §9.8

9102(a)(44): §9.11

UCC Comment 4.a: §9.11

9103: §9.11

9108: §9.15

9108(a): §9.7

9108(b): §§9.7-9.8

9109(c): §9.11

9109(c)(1): §9.5

9203: §9.11

9203(b): §9.10

9203(b)(3): §9.6

9307(e): §9.12

9308: §9.5

9310(a): §9.12

9312: §9.11

9322: §9.11

9322(a)(1): §9.11

9324: §9.11

9408: §9.10

9501(a)(2): §9.12

9502(a): §9.12

9503: §9.12

9504(1): §9.15

9504(2): §9.15

9515(a): §9.12

9515(d): §9.12

9516: §9.12

9601(a)(1): §9.17

9610: §9.17

9610(a): §9.17

9620: §9.17

9623: §9.17

9625: §9.17

CORPORATIONS CODE

300-318: §11.45

EVIDENCE CODE

352: §11.33B

500: §11.33

777(c): §11.20

940: §11.31

1060: §§2.18, 2.25, 5.22, 5.24, 11.26, 11.30A, 13.13

1061: §2.25

1061(b): §2.18

1061(b)(4): §13.13

1062: §13.13

1070(a): §§2.18, 4.2, 11.30D, 16.42A

FAMILY CODE

910: §11.3

FOOD AND AGRICULTURAL CODE

29041: §5.21

38946: §5.21

GOVERNMENT CODE

Title 1, Div 7, Chap 3.5: App A

810-996.6: §5.26

814: §5.26

1098(a): §5.26

1098(b): §5.26

6250: §5.21, App A

6250-6270: §§4.27, 6.9, 11.32

6250-6276.48: §§5.1-5.2, 5.20-5.21, 5.25-5.26

6252(b): §5.21

6252(c): §5.21

6252(e): §5.21

6252(e)-(g): §5.21

6252(g): §5.21

6253(a): §5.21

6253(b): §5.21

6254: §§4.27, 5.21

6254-6254.29: §5.21

6254(aa): §5.21

6254(e): §5.21

6254(i): §5.21

6254(k): §§5.21-5.22

6254(n): §5.21

6254.2: §5.21

6254.6: §5.21

6254.7: §2.25

6254.7(d): §§2.16, 5.22, App C

6254.7(f): §5.21

6255(a): §§5.21, 5.23

6258: §5.21

8547.2: App A

10542: App A

11350: §5.26

HEALTH AND SAFETY CODE

44346(b): §2.20

INSURANCE CODE

533: §§13.11, 14.19

1861.07: §4.27

LABOR CODE

219: §10.3

232: §10.16

232.5: §10.16

923: §10.16

1050: §4.15

1054: §4.15

1197: §10.3

2860: §§2.1, 2.3-2.4, 2.12, 2.19, 2.23, 2.31, 10.17

2863: §10.38

2870: §§2.1, 2.4, 2.12, 2.19, 2.23, 4.6, 6.23, 6.28, 6.36, 6.38, 6.41, 10.3, 10.17, 11.39

2870-2872: §2.23

2870(a): §2.23

2871: §§2.19, 2.23, 11.39

2872: §§2.12, 2.19, 2.23, 4.6, 6.23, 6.38

3351-3351.5: §2.23

3351.5(c): §2.34

3353: §2.23

3357: §2.23

6322: §2.20

PENAL CODE

496(a): §13.4

496(c): §13.4

499c: §§2.15, 6.24, 9.5, 12.1, 13.3-13.4, 13.9A, 16.27, App C

499c(a)(9): §§2.15, 2.25, 13.3

499c(b): §13.3

499c(c): §13.3

502: §13.5

502(c): §13.5

502(d): §13.5

502(e): §13.5

502(g): §13.5

502.01: §13.5

519: §13.1

801: §§13.3-13.4

801-802: §13.5

802: §§13.3-13.4

REVENUE AND TAXATION CODE

11342: §2.20

VEHICLE CODE

11713: §14.12

ACTS BY POPULAR NAME

California Information Practices Act (CIPA): §§5.2, 5.24, 5.27

California Public Records Act (CPRA): §§4.27, 5.1-5.2, 5.20-5.23A, 5.24-5.27, 6.9, 11.32, App A

Consumer Legal Remedies Act (CLRA): §§6.31, 8.41

Government Claims Act: §5.26

Model State Trademark Law: §9.13

Proposition 64: §11.49

Unfair Competition Law (UCL): §§2.1, 8.41, 11.17A, 11.35

Uniform Trade Secrets Act (UTSA): §§1.2-1.7, 1.8A, 1.11-1.14, 1.16, 2.1, 2.3, 2.14, 3.5, 4.1-4.2, 4.26, 5.22, 5.26, 6.3, 6.24, 6.37, 7.1, 7.8, 8.4, 9.5, 10.23-10.24, 10.48, 11.1, 11.6, 11.13, 11.15-11.16, 11.17A, 11.22-11.24, 11.30D, 11.33, 11.35, 11.38, 11.41, 11.43-11.45, 11.49-11.50, 12.1, 12.2, 12.7-12.13, 12.20-12.25, 13.1, 13.3-13.4, 13.13, 15.2, 15.33, 16.27, 16.29, 16.42-16.42A, 17.25, Apps A-B

Regulations

CALIFORNIA CODE OF REGULATIONS

Title 2

22600.1: §9.13

Rules

CALIFORNIA RULES OF COURT

2.550-2.551: §11.33C

2.580: §11.33C

2.585: §11.33C

8.46: §11.33C

CALIFORNIA RULES OF PROFESSIONAL CONDUCT

1-100: §13.1

2-100: §11.27

3-110: §§10.33, 15.1, 15.42

3-110(C): §14.20

5-100: §13.1

5-120: §11.30

Jury Instructions

CALIFORNIA JURY INSTRUCTIONS, CIVIL (CACI) APPROVED

303: §11.38

305: §§11.38, 11.50

UNITED STATES

Constitution

Art III: §11.11

Amend I: §§1.8, 2.18A, 4.2, 11.20B, 11.30C, 11.33C, 11.48, 12.5, 12.8, 16.59A

Amend V: §§5.26, 9.5, 11.31, 13.11

Amend VI: §§13.9A, 13.10

Amend VII: §12.22

Amend XIV: §12.22

Statutes

UNITED STATES CODE

Title 5

551(2): §5.14

552: §§2.21, 4.27, 4A.14, 5.1-5.2, 5.12-5.14, 5.19, 5.21, 5.26, 6.9, 11.32

552(a)(3)(A): §5.12

552(b)(3): §§5.12-5.13

552(b)(4): §§4.27, 5.12, 5.14, 6.11, 17.9

552a: §§5.2, 5.19

552a(b): §5.19

552a(b)(2): §5.19

702: §§5.17-5.18

706: §§5.18, 5.26

706(2)(A): §5.17

3701-3707: §4.27

Title 7

2401-2582: §17.11

2442: §17.11

Title 9

2: §8.33

Title 10

2320(b)(1): §5.7

Title 11

330: §12.23

365: §9.10

365(c)(1): §9.10

365(c)(i): §9.10

365(n): §8.31

547: §9.9

Title 15

1: §11.36

14: §7.30

15(b): §11.36

1051-1141n: App C

1060: §7.1

1114: §14.9

1117: §11.53

1125: §14.9

1125(a): §§11.10, 11.53

1126: §§11.53, 12.11

1126(h)-(i): §§11.53, 12.11

1127: §14.9

1311-1314: §2.21

1905: §2.21

2051-2085: §5.13

2055(b)(1): §5.13

7262: §10.6

Title 16

470aa-470mm: §5.13

Title 17

101: §§2.34, 5.3, 10.17, 16.43-16.44, 16.51, 16.57

101-810: §2.34

101-1101: §§5.28, 16.43

101-1332: App C

101(2): §2.34

102: §§7.8, 10.17, 10.23, 10.27

102(a): §§16.44, 16.50

102(b): §§2.24, 2.34, 16.47, 16.49

106: §§10.23, 11.52, 16.51

106(4): §16.46A

107: §§16.46A, 16.48

109(a): §16.44

115: §16.46A

117: §16.47

201(a): §2.34

201(b): §§2.34, 5.3, 16.51

203(a)(3): §16.51

203(a)(5): §16.51

204: §7.1

204(a): §2.34

301: §§2.24, 11.37, 11.52, 16.27, 16.30

301-305: §10.24

301(a): §§11.10, 16.27

301(b)(3): §2.34

302(a): §§16.43-16.44

302(c): §16.43

408(a): §10.27

411: §10.27

411(a): §16.44

412(2): §16.44

501-511: §16.45

502: §16.44

504: §16.44

504-505: §16.44

505: §11.10

507(b): §11.52

512: §16.59A

512(c): §16.46A

1201: §16.59A

Title 18

1029(a): §13.9

1029(c): §13.9

1029(e)(1): §13.9

1030: §§11.11, 12.1, 16.59B

1341: §§11.55, 13.6

1343: §13.6

1349: §13.6

1831: §4.28

1831-1839: §§2.21A, 9.5, 13.9A, 13.11, 13.13, 17.4A

1832: §13.9A

1832(a): §17.4A

1832(b): §13.9A

1839: §2.21A

1839(3): §2.21A

1839(4): §2.21A

1905: §§4.27, 5.2, 5.13-5.14, 5.18, 5.26

1961: §13.7

1961-1968: §§11.55, 13.7

1962(c)-(d): §13.7

1963: §13.7

1963(a): §13.7

1964: §13.7

2311-2322: §13.8

2314: §13.8

2314-2315: §13.8

2315: §13.8

2510-2522: §11.26

2701-2712: §§2.18, 4.2, 11.26, 11.30D, 16.42A

3282: §§13.6-13.9

3293: §13.6

Title 28

1292(a)(1): §12.19

1292(c): §§11.7, 12.5

1292(c)(1): §12.19

1295: §12.5

1332: §§11.8, 12.5

1338: §12.5

1338(a): §§11.8, 11.11

1338(b): §11.12

1367: §§11.11, 12.5

1367(a): §11.8

1367(c): §11.11

1404: §11.9

1404(a): §11.16

1441: §11.8

1441(a): §11.9

1658: §11.53

2201: §11.4

2671-2680: §17.9

Title 29

151-169: §10.16

Title 35

1-376: §§5.28, 11.54, App C

101: §§1.16, 2.35, 16.63-16.64, 16.66, 17.11

101-103: §§3.8, 17.11

102: §§10.30, 16.65A

102(b): §§3.3, 3.25, 11.54

102(g): §11.54

103: §§2.35, 16.65A

103(a): §16.65A

112: §§2.35, 3.8, 10.32, 11.54, 16.60-16.62, 17.12, 17.17

122: §§5.13, 10.28, 11.54

122(b): §17.17

122(b)(1): §2.35

122(b)(1)(A): §§7.6, 16.62

122(b)(2): §10.33

122(b)(2)(B)(i): §§2.35, 7.6, 16.62

154: §17.12

154-155: §10.32

154-156: §10.24

154(d): §§3.4, 16.60

155A: §10.32

156: §10.32

161-164: §17.11

162: §§16.61, 17.11

173: §§10.24, 10.32

200-212: §17.9

261: §§2.35, 7.1, 7.27, 8.4

271: §§7.24, 10.23, 11.54

271(a): §7.3

273: §11.54

283: §16.60

284: §§12.22, 16.60, App B

285: App B

286: §11.54

287: §10.28

351-376: §17.17

Title 50

App §§2401-2420: §16.19A

INTERNAL REVENUE CODE

1(h): §15.32

41: §§15.13-15.14

41(c)(4): §15.14

41(h)(1)(B): §15.14

56: §§15.6, 15.26

56(b)(2)(A)(ii): §15.26

56(b)(2)(D): §15.26

56(c): §15.26

59(e): §15.26

162: §§15.5, 15.10, 15.13-15.14, 15.19, 15.27

165: §§15.44, 15.46

165(a): §15.44

167: §§15.4, 15.12-15.14, 15.18, 15.27-15.28, 15.30, 15.32, 15.34, 15.44, 15.46

167(a): §15.5

167(a)(1): §15.27

167(f): §15.5

167(f)(1): §15.5

168: §§15.27, 15.44

174: §§15.5, 15.13-15.14, 15.17, 15.19, 15.22, 15.24

174(a): §§15.5, 15.14-15.15, 15.17, 15.22, 15.26-15.27

174(b): §§15.14, 15.16-15.18, 15.26-15.27

174(c): §15.22

174(e): §15.25

197: §§15.4-15.10, 15.12-15.13, 15.18, 15.31-15.32, 15.34, 15.40-15.41

197(a): §15.6

197(c)(2): §§15.5, 15.13

197(d)(1)(c)(ii): §15.5

197(d)(1)(c)(iii): §15.5

197(e)(3)(A): §15.5

197(e)(4): §15.5

197(e)(4)(D): §§15.5, 15.10

197(f)(1): §§15.9, 15.41

197(f)(2): §15.9

197(f)(3): §15.40

197(f)(7): §§15.32, 15.34

197(f)(9): §15.8

311(b): §15.47

332: §15.9

338: §15.6

338(b)(5): §15.6

341: §15.50

351: §§15.2, 15.9, 15.37-15.38, 15.47

361: §15.9

453: §15.40

453(g)(1)(A): §15.40

453(i): §15.40

461: §15.13

482: §15.42

483: §15.40

542(a): §15.42

691: §15.48

691(c): §15.48

707(b)(1): §15.40

707(b)(2): §§15.32, 15.40

721: §§15.2, 15.9, 15.47

731: §15.9

751(c): §15.50

751(d): §15.50

1031: §15.9

1033: §15.9

1060: §15.6

1221: §§15.2, 15.32, 15.34

1221(a)(1): §15.34

1221(a)(2): §15.34

1221(a)(3): §15.34

1222(1)-(4): §15.39

1222(3): §§15.32, 15.39

1223: §§15.32, 15.39

1223(1)-(2): §15.39

1231: §§15.2, 15.32, 15.34, 15.39

1231(a)(3): §15.39

1231(b)(1)(C): §15.34

1235: §§15.2, 15.5, 15.32

1239: §§15.32, 15.40

1239(b): §15.40

1245: §§15.32, 15.40

1249: §§15.32, 15.40

1274: §15.40

1274(d): §15.40

1366: §15.47

1504(a)(4): §15.6

ACTS BY POPULAR NAME

Administrative Procedure Act (APA): §5.17-5.18, 5.26-5.27

American Jobs Creation Act (AJCA): §15.5

Antitrust Civil Process Act: §2.21

Archeological Resources Protection Act: §5.13

Bayh-Dole Act: §17.9

Clayton Act: §11.55

§3: §7.30

Computer Fraud and Abuse Act (CFAA): §§11.11, 12.1, 16.59B

Consumer Product Safety Act: §5.13

Copyright Act: §§2.34, 9.11, 11.52, 12.7, 16.27, 16.30, 16.44

§109(a): §16.44

§117: §16.30

Copyright Act of 1976: §§11.10, 11.37, 11.44, 11.46, 11.52, 16.27, 16.43, 16.45

§301: §11.45

Copyright Act of 1909: §4.20

Copyright Revision Act of 1976: §2.34

Digital Millennium Copyright Act (DMCA): §16.59A

Economic Espionage Act of 1996 (EEA): §§2.21A, 4A.2, 4.28, 13.9A-13.9B, 13.11, 13.13, 17.4A

Electronic Communications Privacy Act: §11.26

Export Administration Act of 1979 (EAA): §16.19A

Federal Arbitration Act (FAA): §16.41

Federal Torts Claim Act (FTCA): §17.9

Federal Trade Secrets Act (FTSA): §§5.2, 5.13, 5.17-5.18, 5.26-5.27

Freedom of Information Act (FOIA): §§2.21, 4.27, 4A.14, 5.1-5.2, 5.12-5.19, 5.21, 5.26-5.27, 6.9, 6.11, 11.32, 12.8, 17.9

Exemption 3: §§5.12-5.13

1976 amendment: §5.13

Exemption 4: §§5.12, 5.14, 17.9

Intellectual Property Bankruptcy Protection Act: §16.26

Jobs and Growth Tax Relief Reconciliation Act of 2003: §15.32

Lanham Act: §§11.10, 11.53, 12.11, 14.9

§43(a): §§11.10, 11.53

National Labor Relations Act of 1935 (NLRA): §10.16

National Stolen Property Act: §13.8

Patent Act: §§2.35, 7.30, 9.11, 12.7, 16.60

Patent Cooperation Treaty: §17.17

Plant Patent Act (PPA): §17.11

Plant Variety Protection Act (PVPA): §17.11

Privacy Act of 1974: §§5.2, 5.19, 5.27

Racketeer Influenced and Corrupt Organizations Act (RICO): §§11.6, 11.12, 11.55, 13.7

Revenue Reconciliation Act of 1993 (RRA 1993): §15.4

Sarbanes-Oxley Act of 2002: §§4A.1A, 13.9B

§404: §10.6

Securities Exchange Act: §11.53

Sherman Act: §§7.30, 11.36

Stored Communications Act (SCA): §§2.18, 4.2, 11.30D, 16.42A

Tax Reform Act of 1986: §15.47

Trade Secrets Act: §§4.14, 5.14

White-Collar Crime Penalty Enhancement Act of 2002: §13.6

SESSION LAWS

Pub L 108-357, §847, 118 Stat 1418: §15.5

Pub L 108-27, 117 Stat 752: §15.32

Pub L 107-204, 116 Stats 806: §13.6

Pub L 107-204, 116 Stat 745: §§10.6, 13.9B

Pub L 105-304, 112 Stat 2860: §16.59A

Pub L 103-66, 107 Stat 416: §15.4

Pub L 100-568, 102 Stat 2853: §16.44

Pub L 99-514, 100 Stat 2085: §15.47

PROPOSED LEGISLATION

HR 88, 106th Cong, 1st Sess (1999): §17.9

Regulations

CODE OF FEDERAL REGULATIONS

Title 9

390.9: §5.12

Title 17: §15.34

240.15d-15(f)(3): §10.6

Title 21

20.61(a): §5.14

720.8(b): §17.9

Title 26

] §1.197-2(b)(4): §15.5

Title 37

1.13: §10.28

1.19: §10.28

1.138(c): §16.62

1.138(d): §16.62

1.802(b): §17.12

201.1(d): §10.27

201.20(g): §16.44

202.20(c)(2)(vii): §2.34

202.20(c)(2)(vii)(A)(2): §§2.34, 16.46

202.20(c)(2)(vii)(B): §16.46

401.1-401.17: §17.9

Title 48: §§2.11, 5.2

Pts 1-53: §6.9

15.506(e): §5.14

27.400-27.409: §2.11

27.404-1: §2.11

27.404-2: §2.11

52.227-14: §§5.28, 6.10

52.227-14(a): §5.4

52.227-14(a) (FAR): §5.3

52.227-14(b)(1): §5.4

52.227-14(b)(1)(ii): §5.8

52.227-14(b)(2)(ii): §5.4

52.227-14(c): §5.4

52.227-14(g): §5.4

52.227-14(g)(1)(ii): §5.8

52.227-14(g)(4)(i)(b): §5.4

52.227-14(g)(4)(i)(b)(5): §5.4

52.227-14(i): §5.4

52.227-19 (FAR): §6.10

52.227-20: §5.10

52.227-20(d)(1): §5.10

227.7103-5: §5.5

227.7103-5(a): §5.6

227.7103-5(b)(4): §5.9

227.7103-5(b)(4)(i): §5.9

227.7103-5(d): §5.10

227.7103-5(d)(1): §5.10

227.7103-5(d)(2): §5.10

227.7104: §5.10

227.7104(b): §5.10

227.7202-1(a): §5.7

227.7202-3: §6.10

227.7202-3(a): §5.7

227.7202-3(b): §5.7

227.7202-4: §5.7

227.7203-5(a): §5.6

227.7203-5(d): §5.10

227.7204: §5.10

252.227-7013—252.227-7015 (DFAR): §6.10

252.227-7013(a)(7): §5.8

252.227-7013(a)(13): §5.8

252.227-7013(a)(14) (DFAR): §5.3

252.227-7013(e)(1): §5.11

252.227-7013(e)(2): §5.11

252.227-7014(a)(14)(i): §5.8

252.227-7014(a)(15): §5.6

252.227-7015(b)(1): §5.7

252.227-7015(b)(2): §5.7

252.227-7015(c): §5.7

252.227-7018(b)(4): §5.10

FEDERAL REGISTER

69 Fed Reg 22 (Jan. 2, 2004): §15.14

52 Fed Reg 23782 (June 23, 1987): §5.16

52 Fed Reg 23781 (June 23, 1987): §§5.12, 5.15

FEDERAL ACQUISITION REGULATIONS (FAR)

Subpt 27.4: §2.11

52.227-14: §6.10

52.227-14(g): §6.10

52.227-19: §6.10

DEPARTMENT OF DEFENSE SUPPLEMENTS TO FAR (DFAR)

252.227-7013: §6.10

252.227-7014: §6.10

252.227-7015(b): §6.10

252.227-7202-3(a): §6.10

EXPORT ADMINISTRATION REGULATIONS

Supp No. 2-15 CFR Pt 748, para (o)(3)(i): §8.24

TREASURY REGULATIONS

1.41-4(a)(2)(i)-(iii): §15.14

1.41-4(c)(6): §15.14

1.41-4(e) (proposed): §15.14

1.162-11(a): §15.11

1.165-2(a): §15.44

1.165-2(b)-(c): §15.44

1.167(a)-3(a): §§15.4, 15.27-15.28

1.167(a)-8: §15.44

1.167(a)-8(a)(1): §15.44

1.167(a)-8(a)(3)(i): §15.46

1.167(a)-8(a)(4): §15.44

1.167(a)-8(b): §15.46

1.167(b)-1(a): §§15.12, 15.30

1.174-1: §15.17

1.174-2(a)(1): §15.20

1.174-2(a)(2): §15.20

1.174-2(a)(3): §15.21

1.174-2(a)(3)(vii): §15.23

1.174-2(a)(5): §15.23

1.174-2(a)(6): §15.25

1.174-2(a)(8): §§15.22, 15.24

1.174-2(b): §15.22

1.174-2(b)(3): §§15.22, 15.24

1.174-2(b)(4): §15.22

1.174-2(b)(8): §15.24

1.174-3(a): §15.15

1.174-3(b)(1): §15.15

1.174-3(b)(1)-(2): §15.15

1.174-3(b)(3): §15.15

1.174-4(a)(1): §15.17

1.174-4(a)(2): §15.18

1.174-4(a)(3): §§15.16, 15.18

1.174-4(a)(4): §15.18

1.174-4(a)(5): §§15.16-15.17

1.174-4(b)(1): §15.16

1.174-4(b)(2): §§15.16-15.17

1.197-2(b)(11): §15.5

1.197-2(c)(4)(i): §15.5

1.197-2(c)(13): §15.5

1.197-2(e): §15.5

1.197-2(f)(2): §15.6

1.197-2(f)(3)(ii): §15.5

1.197-2(f)(3)(ii)(B): §15.5

1.197-2(f)(3)(iii): §15.5

1.197-2(h)(1)(ii): §15.8

1.197-2(iii): §15.5

1.338-6(b): §15.6

1.338-6(b)(2)(ii): §15.6

1.338-6(b)(2)(vi): §15.6

1.338-6(vii): §15.6

1.461-1(a)(1): §§15.11, 15.13

1.861-18: §15.35

1.1031-(a)(2)(c)(3): §15.9

1.1031(a)-2(b)(2): §15.9

1.1031(a)-2(b)(3): §15.9

1.1031(a)-2(c)(1): §15.9

1.1031(a)-2(c)(1)-(2): §15.9

1.1060-1(c): §15.6

1.1235-1(c)(2): §15.33

1.1235-2(a): §15.32

1.1235-2(b)(1)(i): §15.38

1.1235-2(b)(2): §15.38

20.2031-1(b): §15.51

TEMPORARY TREASURY REGULATIONS

1.197-1T: §§15.7-15.8

Court Rules

FEDERAL RULES OF APPELLATE PROCEDURE

2: §12.19

FEDERAL RULES OF CIVIL PROCEDURE

8(a)(2): §11.17

9(b): §11.40

11: §§11.2, 11.19

11(a): §11.2

12(b)(6): §§11.2, 11.17

26: §§11.22, 11.26

26(a): §11.25

26(a)-(c): §11.26

26(c): §11.26

26(f): §11.25

34: §11.26

52: §12.14

52(a): §§12.14, 12.19

53: §11.33A

56: §11.17

56(f): §11.18

60(b): §11.34

65: §§11.33C, 12.5, 12.14

65(a)-(b): §12.6

65(b)(2): §12.6

65(b)(4): §12.6

65(c): §12.17

65(d): §§12.8, 12.14

65(d)(1): §11.34

65(f): §16.45

65.1: §12.17

FEDERAL RULES OF EVIDENCE

501: §11.26

615: §11.20

703: §11.33A

706(a): §11.33A

FEDERAL DISTRICT COURT RULES

Central District of California Local Rules

52-2: §12.14

65-3—65-10: §12.17

Eastern District of California Local Rules

52-290: §12.14

65.1-151: §12.17

Northern District of California Local Rules

7-2: §12.14

65-1: §12.14

65.1-1: §12.17

Southern District of California Local Rules

65.1.2: §12.17

Rulings

REVENUE RULINGS

74-456: §15.29

71-564: §§15.2, 15.35, 15.38, 15.47

64-56: §§15.2, 15.35, 15.37-15.38, 15.47

60-227: §15.48

57-544: §15.48

55-17: §15.2

54-581: §15.46

REVENUE PROCEDURES

2004-11: §15.5

2000-50 (former): §15.5

2000-50: §15.5

69-19: §15.2

INTERNAL REVENUE SERVICE LETTER RULINGS

200602034: §15.9

UNIFORM CODES AND ACTS

UNIFORM COMMERICAL CODE (UCC): §§11.47, 16.30

Art 9: §9.4

UNIFORM TRADE SECRETS ACT: §1.2, 1.8-1.8A, 2.21A, 10.37, 11.13, 11.33A, 12.7, 12.13, 12.20, 12.22, 16.29, App B, App D

§1: §§1.2, 5.14

§1(1): App A, App B

§1(2): App B

§1(2): App B

§1(2)(ii)(B)(I): App B

§1(2)(ii)(C): Apps A-B

§1(4): App B

§1(4)(i): §1.8A

§1(4)(ii): Apps A-B

§2: App B

§2(a): App B

§2(a), Comments: §12.9

§2(b): App B

§2(c): App B

§3, Comment: §12.22, App B

§3(a): App B

§3(b): App B

§4: App B

§5, Comments: §11.33A

§6, Comment: §§11.13, 11.13B

§7, Comments: §1.16

OUT-OF-STATE STATUTES AND ACTS

ALABAMA

Ala Code §§8-27—1-8-27-6: App D

ALASKA

Alaska Stat §§45.50.910-45.50.945: App D

ARIZONA

Ariz Rev Stat §§44-401—44-407: App D

ARKANSAS

Ark Code Ann §§4-75-601—4-75-607: App D

COLORADO

Colo Rev Stat Ann §§7-74-101—7-74-110: App D

Uniform Act: §§12.19, 12.21

CONNECTICUT

Conn Gen Stat Ann §§35-50—35-58: App D

Uniform Act: §§12.13, 12.20

DELAWARE

Del Code Ann, Tit 6, §§2001-2009: App D

Del Code Ann, Tit 19, §805: §2.12

Uniform Act: §12.20

DISTRICT OF COLUMBIA

DC Code Ann §§36-401—36-410: App D

FLORIDA

Fla Stat Ann §§688.001-688.009: App D

GEORGIA

Ga Code Ann §§10-1-760—10-1-767: App D

HAWAII

Hawaii Rev Stat §§482B-1—482B-9: App D

IDAHO

Idaho Code §§48-801—48-807: App D

ILLINOIS

765 ILCS §1060/2: §2.12

765 ILCS §§1065/1-1065/9: App D

Uniform Act: §§4.7, 11.38, 12.2, 12.9

INDIANA

Ind Code §§24-2-3-1—24-2-3-8: App D

IOWA

Iowa Code Ann §§550.1-550.8: App D

Uniform Act: §§1.4, 11.18, 11.33A, 11.41, 11.45, 11.54, 12.21

KANSAS

Kan Stat Ann §§44-130: §2.12

Kan Stat Ann §§60-3320—60-3330: App D

Uniform Act: §§11.6, 11.13, 11.38, 12.21

KENTUCKY

Ky Rev Stat Ann §§365.880-365.900: App D

LOUISIANA

La Rev Stat Ann §§51:1431-51:1439: App D

La Rev Stat Ann §§51:1961-51:1966: §16.30

Louisiana Software License Enforcement Act (LSLEA): §16.30

Uniform Act: §11.6

MAINE

Me Rev Stat Ann, Tit 10, §§1541-1548: App D

MARYLAND

Md Code Ann [Commercial Law] §§11-1201—11-1209: App D

Uniform Act: §12.22

MASSACHUSETTS

Mass Gen Laws, ch 93, §§42-42A: App D

Massachusetts Disclosure Act: §9.5

HB 329: App D

MICHIGAN

1999 M.C.L.A. §§445.1901-445.1910: App D

MINNESOTA

Minn Stat Ann §181.78: §2.12

Minn Stat Ann §§325C.01-325C.08: App D

Uniform Act: §§11.13, 11.18, 12.5, 12.10, 12.20, 16.2, 16.28

MISSISSIPPI

Miss Code Ann §§75-26-1—75-26-19: App D

MISSOURI

Mo Rev Stat §§417.450-417.467: App D

MONTANA

Mont Code Ann §§30-14-401—30-14-409: App D

Uniform Act: §§11.40, 12.22

NEBRASKA

Neb Rev Stat §§87-501—87-507: App D

NEVADA

Nev Rev Stat 600A.010-600A.100: App D

Nev Rev Stat 600A.032: §4A.17

NEW HAMPSHIRE

NH Rev Stat Ann §§350-B:1—350-B:9: App D

NEW JERSEY

AB 921: App D

NEW MEXICO

NM Stat Ann §§57-3A-1—57-3A-7: App D

NEW YORK

AB6185/SB4162: App D

NORTH CAROLINA

NC Gen Stat §66-57.2: §2.12

NC Gen Stat §§66-152—66-157: App D

Uniform Act: §4.11

NORTH DAKOTA

ND Cent Code §34-02-11: §2.12

ND Cent Code §§47-25.1-01—47-25.1-08: App D

OHIO

Ohio Rev Code Ann §§1333.61-1333.69: App D

OKLAHOMA

Okla Stat Ann, Tit 78, §§85-94: App D

OREGON

Or Rev Stat §§646.461-646.475: App D

Uniform Act: §§11.45, 12.8-12.10

PENNSYLVANIA

12 Pa C S §§5301-5308: App D

RHODE ISLAND

RI Gen Laws §§6-41-1—6-41-11: App D

Uniform Act: §§11.54, 12.20-12.21

SOUTH CAROLINA

SC Code Ann §§39-8-10—39-8-130: App D

SOUTH DAKOTA

SD Codified Laws §§37-29-1—37-29-11: App D

Uniform Act: §§11.9, 11.18, 11.33C

TENNESSEE

Tenn Code Ann §§47-25-1701—47-25-1709: App D

UTAH

Utah Code Ann §§13-24-1—13-24-9: App D

Utah Code Ann §34-39-3: §2.12

Uniform Act: §§4.11, 4.15

VERMONT

Vt Stat Ann, Tit 9, §§4601-4609: App D

Vt Stat Ann, Tit 12 §523: App D

VIRGINIA

Va Code Ann §§59.1-336—59.1-343: App D

Virginia Computer Crimes Act: §11.10

Uniform Act: §§11.38, 12.1, 12.3, 12.7, 12.21, 12.23

WASHINGTON

Wash Rev Code §49.44.140: §2.12

Wash Rev Code Ann §§19.108.010-19.108.940: App D

Uniform Act: §§4.14, 11.13, 11.44, 12.10

WEST VIRGINIA

W Va Code §§47-22-1—47-22-10: App D

WISCONSIN

Wis Stat §134.90: App D

Uniform Act: §§11.13, 12.9, 12.20

WYOMING

Wyo §§40-24-101—40-24-110: App D

INTERNATIONAL TREATIES AND TERMS OF TRADE

Berne Convention: §§4.20, 6.8, 16.44

Art 3(1)(a): §4.20

Art 15: §4.20

Berne Convention Implementation Act of 1988: §16.44

Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purpose of Patent Procedure, Apr. 28, 1977, 32 UST 1241, TIAS No. 9768: §17.14

Art 3: §17.14

Art 6: §17.14

Art 7: §17.14

European Patent Convention (2000) Rules 26-27: §17.13

European Patent Office Rule

28: §17.15

International (Paris) Convention forthe Protection of Industrial Property, Mar. 20, 1883, 25Stat 1372, TS No. 379, 1Bevans 80: §§11.53, 12.11, 17.17

Patent Cooperation Treaty, June 19, 1970, 28 UST 7645, TIAS No. 8733: §§8.9, 17.17

Treaty of Rome: §7.24

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Source: Business Law/Trade Secrets Practice in California/Table of Cases

Table of Cases

02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc. (ND Cal 2006) 420 F Supp 2d 1070: §§4.9, 4.19

02 Micro Int'l, Ltd. v Monolithic Power Sys., Inc. (ND Cal 2005) 399 F Supp 2d 1064: §§1.12, 12.4, 12.20-12.22

3M v Pribyl (7th Cir 2001) 259 F3d 587: §§12.8-12.9

321 Studios v Metro Goldwyn Mayer Studios, Inc. (ND Cal 2004) 307 F Supp 2d 1085: §16.59A

777388 Ontario Ltd. v Lencore Acoustics Corp. (ED NY 2000) 105 F Supp 2d 56: §11.2

A

A Major Difference, Inc. v Wellspring Prods., LLC (D Colo 2006) 243 FRD 415: §11.20

A.H. Emery Co. v Marcan Prods. Corp. (SD NY 1967) 268 F Supp 289, aff'd (2d Cir 1968) 389 F2d 11: §§4.9, 4.19

A.J. Indus. v U.S. (9th Cir 1974) 503 F2d 660: §15.46

A.O. Smith Corp. v Petroleum Iron Works Co. (6th Cir 1934) 73 F2d 531: §1.7

ABBA Rubber Co. v Seaquist (1991) 235 CA3d 1, 286 CR 518: §§1.4, 1.8A, 10.34, 12.4, 12.16

ACLU v Deukmejian (1982) 32 C3d 440, 186 CR 235: §5.21

ALRB v Richard A. Glass Co. (1985) 175 CA3d 703, 221 CR 63: §12.18

AMP, Inc. v Fleischhacker (7th Cir 1987) 823 F2d 1199: §§1.9, 11.22, 12.8

ARCO v USA Petroleum (1990) 495 US 328, 109 L Ed 2d 333, 110 S Ct 1884: §7.27

AT&T Corp. v Microsoft Corp. (ND Cal 2003) 2003 US Dist Lexis 8710: §4.2

Abbott Labs. v Ortho Diagnostic Sys. (Fed Cir 1995) 47 F3d 1128: §7.1

Abbott Labs. v Sandoz, Inc. (ND Ill 2007) 500 F Supp 2d 846: §16.65A

Abdallah v United States Sav. Bank (1996) 43 CA4th 1101, 51 CR2d 286: §11.2

Abdul-Jabbar v General Motors Corp. (9th Cir 1996) 85 F3d 407: §11.53

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F

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J

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V

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Source: Business Law/Trade Secrets Practice in California/Table of References

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Source: Business Law/Trade Secrets Practice in California/Table of Forms

Table of Forms

Bilateral confidential disclosure agreement, 6.48

Biotechnology

Budapest treaty deposits—American type culture collection, 17.35

Employee's request for approval to release biological materials or unpublished information, 17.28

Employee's request for approval to solicit biological materials or unpublished information, 17.32

Letter for release of biological materials as unrestricted gift, 17.29

Letter for release of biological materials with restrictions, 17.30

Letter requesting biological materials, 17.33

Receipt of biological material from outsiders, 17.34

Restrictions on use of biological materials, 17.31

Buy-sell agreement clause, 6.56

Client interview sheet: information on change of employment, 10.10

Confidential disclosure provisions for cover sheet on proprietary information, 6.52

Confidential disclosure provisions for inclusion in purchase agreements and purchase orders, 6.51

Confidentiality and nondisclosure letter agreement, 7.36

Confidential notice and copyright notice for software, 16.3

Consultant's copyright assignment

Agreement to create software, 16.53

Assignment of copyright, 16.58

Confidentiality, 16.55

Consideration, 16.56

Consultant's warranties, 16.54

Introduction, 16.52

Ownership of copyright, 16.57

Signatures, 16.59

Copyright notices

Avoiding use of copyright symbol for unpublished works, 6.8-2

Short-form standard copyright legend, 6.8-1

Unpublished works, 6.8-3

Employee confidentiality and invention assignment agreement

Amendment, 6.27

Assignment of inventions, 6.23-1

Attorney fees, 6.30

Attorney-in-fact, company's appointment as, 6.23-3

Binding effect, 6.33

Company's written notification of Lab C §2870, exhibit B, 6.38

Definitions, 6.18

Effective date of agreement, 6.19

Employee's certification on termination, exhibit C, 6.39

Employee's continued assistance in obtaining patent or copyright, 6.23-2

Exhibit A, employee's statement, 6.37

Exhibits, 6.28

Governing law, 6.31

Heading and introductory provisions, 6.17

Integration, 6.34

Noncompetition after termination of employment, 6.21-3

Noncompetition during employment, 6.21-2

Nonsolicitation of specific client, 6.21-4

Notice and record addresses, long-form, 6.26-1

Notice and record addresses, short-form, 6.26-2

No waiver, 6.29

Prior approval of company for publications or presentations, 6.20-2

Prior knowledge and relationships, 6.22

Protection of company's confidential information, 6.20-1

Severability, 6.32

Signature block, 6.36

Specific performance of agreement, 6.25

Termination of employment, 6.24

Warning of effect of agreement, 6.35

Federal acquisition regulations

Commercial items provided to federal government, legend for, 6.10-1

Commercial software product CDs, legend for, 6.10-2

Freedom of Information Act, legend claiming exemption from, 6.11

Noncommercial items provided to government, legend for, 6.10-3

Interviews with prospective employees

Long-form confidentiality agreement for interviews with prospective employees, 6.14

Short-form confidentiality agreement for interviews with prospective employees, 6.13

Letter to former employee, 6.42

Letter to new employer, 6.43

Licensing agreement

Amendments, 8.35

Arbitration, 8.33

Attorney fees, 8.42

Binding effect, 8.44

Construction, 8.36

Default

Allowing additional time to cure, 8.31-6

Events of default, heading and introduction, 8.31-1

Failure to perform other covenants, 8.31-4

Grace period, 8.31-3, 8.31-5

Insolvency provision, 8.31-7

Payment defaults, 8.31-2

Definitions, 8.4-1

Disclosure giving licensee right to terminate royalty obligations, 8.26-2

Disclosure of nonproprietary information, 8.26-1

Disclosure of technical information, 8.24

Down payment, 8.14-1

Duration of agreement, 8.30

Exhibits, 8.38

Future improvements, 8.22

Governing law and choice of forum, 8.41

Grant-back, 8.23

Headings, 8.40

Improvements defined, 8.4-2

Integration, 8.37

Licensed manufacturing territory defined, 8.4-3

Licensed patents defined, 8.4-4

Licensed processes and licensed products defined, 8.4-5

Licensed property defined, 8.4-6

Licensed sales territory defined, 8.4-7

Licensed territory defined, 8.4-8

Licensed trademarks defined, 8.4-9

Licensee and licensor defined, 8.4-10

Licensee indemnifying licensor, 8.29-2

License grant

Basic grant clause, 8.6

Grant clause for licensing trade secrets disclosed in patent applications, 8.9

Grant clause, improvements owned by licensor, 8.13-1

Grant clause including licensee's modifications to licensed subject matter, improvement owned by party developing them, 8.13-2

Grant clauses for trade secret and patent hybrid licenses, 8.8

Grant clauses for trade secret and trademark hybrid licenses, 8.10

Grant clause with no right of sublicense, 8.11

Grant clause with right of sublicense, 8.12

Restrictive grant clause, 8.7

Licensor indemnifying licensee, 8.29-1

Notice, record address, 8.34

No waiver, 8.39

Payment terms, 8.18

Primary licensed territory defined, 8.4-11

Recitals, 8.3

Records, 8.28

Remedies

Heading and introduction, 8.32-1

Liquidated damages, 8.32-5

Postdefault interest, 8.32-2

Right to terminate agreement, 8.32-3

Specific performance, 8.32-4

Reports, 8.27

Royalties

Allocation of royalties if hybrid trade secret and patent license, 8.17

Basic royalty provision, 8.15-1

Defined, 8.4-12

Down payment credited against royalties, 8.14-2

Licensee's improvements or modifications assigned or licensed to licensor, 8.15-4

Maximum royalty payment, 8.15-3

Minimum royalty payment, 8.15-2

Royalties to increase on issuance of patent, 8.15-5

Royalty provision providing economic incentive to practice trade secrets in designated territory, 8.16-1

Value of licensed property decreasing on issuance of patent, 8.15-6

Secrecy, 8.25-1

Secrecy, exclusive license, 8.25-2

Severability, 8.43

Signature block, 8.45

Technical information defined, 8.4-13

Title and introduction, 8.2

Trademarks, use of, 8.19

Trade secrets defined, 8.4-14

Waiver, 8.39

Warranties, 8.20

Warranties, limitation of, 8.21

Log book agreement provisions, 6.46

New employee's acknowledgment of confidentiality agreement, 6.15

No-hire provision, 6.58

On-site employee confidentiality agreement, 6.54

Paid up license, 8.18

Proprietary rights legends

Documents retained electronically, restrictions on dissemination, 6.5-3

Highly confidential or restricted information (short-form legend), 6.4-3

Legend for electronic mail and facsimile transmission (long-form), 6.6-1

Limited right to copy electronic mail and facsimile transmission, 6.6-2

Limiting information to internal use (short-form legend), 6.4-1

Limiting information to need to know (short-form legend), 6.4-2

Long-form restricted rights legend, 6.5-1

No right to copy electronic mail and facsimile transmission, 6.6-3

Restriction on dissemination, 6.5-2

Security agreement grant clause describing trade secrets collateral, 9.8

Security interest, perfection of

Additional language for description of trade secret collateral, 9.15

Financing statement (UCC-1), 9.14

Financing statement addendum (UCC-1Ad)-California, 9.14A

Shrink-wrap license

Acceptance of license, 16.40

Confidentiality, 16.33

Governing law, 16.39

Introduction, 16.32

License grant, 16.34

Limitation of remedies, 16.37

Limited warranty, 16.36

Sublicensing, assignment, and transfer, 16.38

Term, 16.35

Software license agreement

Assignment and sublicensing, 16.15

Attorney fees and costs, 16.22

Binding effect, 16.19

Concluding clause and signatures, 16.26

Confidential information, 16.8

Copies, 16.9

Definitions, 16.5

Disclaimer of warranty, 16.14

Entire agreement, 16.25

Export controls, 16.19A

Governing law, 16.18

Government ownership, 16.19B

Headings, 16.24

Independent contractor status, 16.17

Introduction, 16.4

License fee, 16.11

Nonexclusive license, 16.7

Notices, 16.20

Remedies, 16.16

Security, 16.10

Severability, 16.23

Termination, 16.12

Term of license, 16.6

Title to licensed program, 16.13

Waiver of breach, 16.21

Submission of ideas

Confidential disclosure waiver agreement, 3.12

Confidential disclosure waiver agreement, transmittal letter to submitter enclosing waiver agreement, 3.13

No acceptance without agreement, policy statement, 3.9

No acceptance without agreement, transmittal letter to submitter enclosing company policy, 3.10

No delivery without agreement for submission of ideas, 3.22

No disclosure without first securing statutory rights, agreement for submission of ideas, 3.20

No distribution pending notice of policy, statement of policy, 3.15

No receipt whatsoever, transmittal letter describing policy, 3.7

Unilateral confidential disclosure agreement, 6.49

Visitor's agreement (long-form), 6.45

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Source: Business Law/Trade Secrets Practice in California/Index

Index

A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

The symbol "" after a section number indicates that a form appears in the section.

Abandonment of Trade Secret

Tax consequences of abandoning trade secret, 15.44-15.45

Academic Institutions, Biotechnology Research at. See Biotechnology

Addresses

Arrestee's addresses released for commercial purposes only as unconstitutional limit on commercial speech, 2.16

Licensing agreement, address provision in, 8.34

Secretary of State's office, 9.13

Adhesion Contracts

Enforceability of, 2.30

Shrink-wrap license for software characterized as, 16.30

Administrative Review

Government agency's decision to disclose data, privateparty's request for reviewof, 5.26

Advertising Injury. See Insurance Coverage for Trade Secret Misappropriation

Agency

Personal jurisdiction over misappropriator of trade secrets based on agency relationship, 11.6

Alternative Minimum Tax (AMT)

Research and experimental expenditures, capitalizationand amortization of, 15.26

Ambiguities

Employee agreement, admissibility of evidence to show ambiguity of, 6.34

Resolving ambiguities in insurance policy against insurer, 14.3

Amendments and Modifications

Complaint's failure to trigger advertising injury coverage, insured's negotiations with plaintiff to amend complaint, 14.18

Confidentiality and invention assignment agreement, amendment of, 6.27

Injunction bond, modification of, 12.17

Licensing agreement, modifications to. See **Licensing Agreements**

Litigation privilege, amendment affecting communication by previous employer to prospective employer about rehiring current or former employee, 11.30

Misappropriation of trade secrets, amendment of claim, 11.29

Amortization of Trade Secret Purchase. See Taxes

Antitrust

Generally, 11.36

Bad faith lawsuit against competitor, antitrust consequences of, 11.2, 11.36

Discovery order in antitrust suit, appealability of, 11.26

Enforcement of defective patent, antitrust liability for, 17.17

Licensing agreement for trade secret, Justice Department's antitrust guidelines. See **Licensing Agreements**

Appeals

Discovery, appealability of order denying, 11.26

Injunctive relief for trade secret misappropriation, appeal of. See **Injunction Against TradeSecret Misappropriation**

Sealing appellate record to prevent disclosure of trade secret, 11.33C

Arbitration

Adhesion contract, unenforceability of, 2.30

Employment agreement, arbitration clause in, 6.32, 11.6A

Internet, enforceability of arbitration provision in contract delivered over, 16.41

Licensing agreement, provision providing for arbitration of, 8.33

Assignments

Computer software, assignment of. See **Computers and Computer Software**

Consideration for contract assigning rights in invention

Generally, 2.27

Insufficient consideration, examples of, 2.29

Sufficient consideration, examples of, 2.28

Contractual provisions affecting ownership

Generally, 2.26

Adhesion contract and other contractual defenses, 2.30-2.31

Consideration (see Consideration for contract assigning rights in invention, above)

Time limits on assignment of ownership rights, 2.31

Inventions

Breach of contract action involving assignment of invention, 11.39

Consideration for assignment of invention (see Consideration for contract assigning rights in invention, above)

Employee confidentiality and invention assignment agreement. See **Employee Confidentiality Agreements**

Enforceability of assignment of employee inventions in employment agreement, statutory limitations on, 2.19

Non-exclusive patent or copyright license, consent of licensor required for assignment of, 9.10

Licensing agreements. See **Licensing Agreements**

Transfer of trade secret by sale characterized as assignment, 15.36

Attachment of Security Interests. See Security Interests in Trade Secrets

Attorney-Client Privilege

Crime or fraud in misappropriation of trade secret, waiver of attorney-client privilege in cases of, 11.44

Disclosure of trade secret to attorney by employee protected by, 10.15

Former corporate employee, nonapplicability of privilege to communications with, 11.27

Waiver of, 11.30B

Attorney General

Communications to Attorney General regarding misappropriation of trade secrets, absolute privilege for, 13.12

Attorneys

Avoiding misappropriation claims, legal advice regarding. See **Avoiding Misappropriation Claims**

Background information collected by attorney

Generally, 6.1

Client interview checklist for protection of trade secret, 6.2

Biotechnology. See **Biotechnology**

Client, privileged communications with. See **Attorney-Client Privilege**

Conflict of interest

Representing clients in same field of technology, 17.10

Technology, avoidance of conflict of interest in representing clients in same field of, 17.10A

Criminal charges for misappropriator of trade secrets, attorney's advice for, 13.14

Disciplinary action against attorney threatening criminal action in trade secrets civil action, 13.1

In-house counsel

Evaluation of unsolicited material by, 3.17

Protective order, in-house counsel prohibited from access to opposing party's trade secret materials under, 11.20

Insurer, attorney's responsibility for tendering defense of lawsuit to, 14.20

Licensing agreement, preliminary information required for drafting of, 8.1

Submitter of unsolicited idea, legal advice for, 3.4

Threatening letter from former employer's attorney, responding to, 10.14

Work-product privilege. See **Work-Product Privilege**

Attorneys' Fees

Bad faith. See **Bad Faith**

Computers and software

Copyright registration as requirement for protection of right to attorney fees, 16.44

Licensing agreement, recoveryof fees in litigation involving, 16.22

Unauthorized access to computer systems and data, action for damages and fees for, 13.5

Confidentiality and invention assignment agreement, attorney fees provision, 6.30

Conspiracy, insufficiency of contingent fee to make attorney member of, 11.42

Employment contract, effect of one-sided fee agreement in, 11.38

Licensing agreements. See **Licensing Agreements**

Misappropriation of trade secret, award of attorney fees in action for, 1.15, 11.2, 12.23

Racketeer Influenced and Corrupt Organizations Act (RICO), action for damages and fees under, 11.55, 13.7

Receiving stolen trade secret, action for damages and fees for, 13.4

Audits. See Trade Secret Audits

Avoiding Misappropriation Claims

Generally, 10.1

Adoption of corporate trade secrets policy

Established company, adoption of trade secrets policy by, 10.6

New company, adoption of trade secrets policy by, 10.2

Attorneys

Mobile employee (see Mobile employee, legal advice for, below)

New or prospective employees (see New or prospective employee, advising employer of, below)

Nondisclosure agreements (NDAs), counsel's assistance in settling disputes over, 10.20

Public domain, attorney ensuring that information former employer claims as trade secret not in, 10.22

Availability of information for public use

Generally, 10.23-10.24

Copyright information, method of searching for and evaluating, 10.27

Patent information, method of searching for and evaluating, 10.28

Preutilization checklist for determining if information available for use, 10.25

Trade secret information, method of searching for and evaluating, 10.26

Checklists and questionnaires

Change of employment, client interview sheet on, 10.10

Preutilization checklist for determining if information available for use, 10.25

"Clean room" for independently replicating technology once licensed from former partner, 10.20

Clean room procedure, use of, 10.35

Confidentiality obligation, information obtained under

Generally, 10.37

Buyer of business, nonsolicitation of seller's customers, 10.46

Consultants and independent contractors, employer's use of, 10.4, 10.42

Employer and employee relationship, confidentiality required by, 10.3, 10.38

Licensee-licensor relationship, confidentiality required by, 10.39

Officer's or director's relationship with corporation, duty of confidentiality resulting from, 10.40

Partnership or joint venture relationship, duty of confidentiality arising from, 10.41

Prospective purchaser or licensee, confidentiality obligations arising from relationship with, 10.45

Specifications or technical manuals disclosed to potential contractor, confidentiality of information in, 10.44

Suppliers and vendors, nondisclosure duty of, 10.44

Unsolicited disclosures, receipt of, 10.43

Contracts

Nondisclosure agreements (NDAs), counsel's assistance in settling disputes over, 10.20

Nonpublic information of former employer, new employees signing contract not to use, 10.2

Nonpublic property of former employer, new employee signing contract not to bring into company facilities, 10.12

Hiring, reducing trade secrets risk in

Mobile employee (see Mobile employee, legal advice for, below)

New or prospective employees (see New or prospective employee, advising employer of, below)

Independent research and investigation, information obtained by

Mobile employee's right to use knowledge and skill acquired through independent research, 10.30

Results of independent research, use of, 10.35

Reverse engineering, using results of, 1.13, 10.36

Information acquired by employee

Ascertaining character of, 10.18

Sources of information (see Sources of information, below)

Intelligence-gathering techniques, rules governing, 10.21

Investigating new employee's knowledge and experience

Client interview sheet on change of employment, 10.10

Collecting information about new employee, 10.9

Reverse engineering, using results of, 10.36

Technical matters, advising prospective employee not to disclose, 10.9

Mobile employee, legal advice for

Generally, 10.15

Announcing change of employment to customers of former employer, 10.19

Duty of loyalty owed to former employer, 10.38

Education and independent research, mobile employee's right to use knowledge and skill acquired through, 10.30

Information acquired by employee, ascertaining character of, 10.18

Information owned by former employer, identification of, 10.17

Relevant agreements, review of, 10.16

New or prospective employee, advising employer of

Counseling employer of prospective new employee, 10.7

Impropriety, avoiding appearance of, 10.11

Informing former employer of nature of employee's work, 10.13

Informing new employee not to disclose former employer's trade secrets, 10.12

Investigating new employee's knowledge (see Investigating new employee's knowledge and experience, above)

Nonpublic property of former employer, new employee signing contract not to bring into company facilities, 10.12

Post hiring conduct, advising new employee about, 10.13

Prehiring advice for new employer, 10.8

Threatening letter from former employer's attorney, responding to, 10.14

Time, resource, telephone, or e-mail services of former employer, instructing new employee not to use for purposes relating to new job, 10.11

Public domain, determining if information in

Generally, 10.29

Attorney ensuring that information former employer claims as trade secret not in public domain, 10.22

Expired U.S. patent, information obtained from, 10.32

Foreign patents, information published in application for, 10.33

General and basic knowledge, patent protection prohibited, 10.30

Published literature and internet websites, lack of trade secret protection for information found in, 10.31

Research (see Independent research and investigation, information obtained by, above)

Sources of information

Accident or mistake, prohibition against using information obtained by, 10.48

Confidentiality obligation (see Confidentiality obligation, information obtained under, above)

Independent research and investigation (see Independent research and investigation, information obtained by, above)

Public domain (see Public domain, determining if information in, above)

Specialized knowledge, protection as trade secret, 10.34

Theft, misappropriation by, 10.47

Bad Faith

See also **Good Faith**

Antitrust consequences of unfounded trade secret litigation against competitor, 11.2, 11.36

Attorney fees

Injunction, fee award for bad faith motion to terminate injunction or for bad faith opposition to motion to terminate, 12.23

Misappropriation of trade secrets, fee award in action for bad faith, 1.15, 6.30, 11.2, 12.23

Denial of existence of contract, unavailability of punitive damages for, 11.40

Distinguishing between frivolous and bad faith trade secret claims, 12.23

Failure to identify trade secret as bad faith, 11.24

Insurance coverage, bad faith denial of. See **Insurance Coverage for Trade Secret Misappropriation**

Bankruptcy and Insolvency

Security interest in trade secret based on preexisting claim, voiding security as preferential transfer, 9.9

Trade secret misappropriation, effect of bankruptcy on damages award, 11.3

Bias and Prejudice

In limine motion for restriction of evidence to eliminate undue prejudice, 11.33B

Biotechnology

Generally, 17.1

Academic practices, problems regarding

Generally, 17.5

Institut Pasteur v U.S., exchange of biological materials under express contract restricting use, 17.6

Attorneys

Conflict of interest in representing clients in same field of technology, avoidance of, 17.10A

Filing patent applications versus reliance on trade secrets, attorney advising biotechnology companies on, 17.2

Bayh-Dole Act's impact on trade secret or patent protection for federally funded research, 17.9

Blood test, patient's lack of rights to recover damages for unauthorized, 17.8

Defined, 17.1

Dissemination and receipt of biological materials

Generally, 17.19

Accepting biological materials and compounds from outsiders, 17.22

Culture collection, maintenance of, 17.20

Employee's request for approval to release biological materials or unpublished information, 17.28

Employee's request for approval to solicit biological materials or unpublished information, 17.32

Letter for release of biological materials as unrestricted gift, 17.29

Letter for release of biological materials with restrictions, 17.30

Letter requesting biological materials, 17.33

Receipt of biological material from outsiders, 17.34

Request for company materials by outsiders, 17.21

Restrictions on use of biological materials, 17.31

Economic Espionage Act. See **Economic Espionage Act (EEA)**

Microorganism deposits associated with patent filings

Generally, 17.12

Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the Purpose of Patent Procedure, 17.14

European patent practice, disclosure of deposited biological material under, 17.15

Foreign laws regarding deposits, disadvantages of, 17.13

Movement of scientists from universities to private companies, problems involving, 17.2

Patents and trade secret protection

Generally, 17.11

Choosing patent or trade secret protection, 17.16-17.18

Filing patent applications versus reliance on trade secrets, attorney advising biotechnology companies on, 17.2

Microorganisms (see Microorganism deposits associated with patent filings, above)

Proprietary rights in protecting biological materials

Generally, 17.3

Academic practices (see Academic practices, problems regarding, above)

Ascertaining proprietary rights in biotechnology, 17.8

Employee knowledge versus proprietary information, 17.10

Government funding and regulations, proprietary rights issues involved with, 17.9

Submission of required information to federal agencies, trade secret protection not precluded by, 17.9

Theft of biological materials, difficulties in detecting, 17.4

Release of biological materials (see Dissemination and receipt of biological materials, above)

Theft of biological materials, protecting against

Generally, 17.23

Criminal prosecution of former employee for stealing laboratory notebooks, 17.10

Detecting theft of biological materials, difficulties in, 17.4

New and departing employees, issues involving, 17.27

Reasonable efforts to protect biological materials from theft, 17.25

Safety precautions to enhance security, 17.26

Tagging microorganisms to protect biotechnology against trade secrets, 17.24

Third parties, dissemination of biotechnology materials to (see Dissemination and receipt of biological materials, above)

Bond for Injunction. See Injunction Against Trade Secret Misappropriation

Breach of Contract

See also **Contracts**

Generally, 11.38

Assignment of invention, action arising from, 11.39

Breach of confidentiality and breach of contract, party's inability to recover for both, 11.37

Computer software license agreement, breach of. See **Computers and Computer Software**

Jurisdiction over breach of contract claims, state law governing, 11.7

Licensing agreement. See **Licensing Agreement**

Noncompetition agreement, breach of, 11.41

Promise by employee not to disclose trade secrets as basis for breach of contract and indemnity claim, 10.13

Protective order, violators subject to separate liability for breach of contract for disclosing information subject to, 11.20D

Punitive damages for breach of contract, 11.40

Statute of limitations for breach of contract, 11.38

Budapest Treaty

Deposit of microorganisms under, 17.14

Burden of Proof

See also **Proof**

Ascertainable useful life of trade secret, burden on taxpayer to prove, 15.28

California Public Records Act, burden on public agency to show exemption from disclosure under, 5.21

Corporate opportunity doctrine, plaintiff's burden of proof under, 2.10

Development or release of invention similar to unsolicited idea, burden on company to show independent development, 3.5

Discovery of trade secret, burden of proof regarding, 11.26

Information not readily known, burden on plaintiff to show, 1.8A

Information readily ascertainable, burden on defendant to show, 1.2, 1.8A

Litigation of trade secret misappropriation. See **Litigation of Trade Secret Misappropriation**

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Punitive damages request, burden of proof on defendant regarding financial considerations, 12.22

Valuation of trade secret, taxpayer's burden to prove, 15.51

Buy-Sell Agreement

Generally, 6.55

Form of buy-sell agreement clause, 6.56

Intellectual property rights defined in non-disclosure agreement, effect of buy-sell agreement on, 4.7

California Commercial Code

General intangibles defined under, 9.5

Security interests in trade secrets governed by, 9.4

California Information Practices Act (CIPA), 5.24

California Public Records Act (CPRA)

Burden of proof on public agency to show exemption from disclosure under Act, 5.21

Definition of public records, 5.21

Disclosure of information submitted to state agencies under, 4.27

Discovery of information under, 11.32

State contractors. See **State Contractors, Proprietary Rights of**

California Uniform Trade Secrets Act (UTSA). See Uniform Trade Secrets Act, California (UTSA)

Capital Gains and Losses on Sale or License of Trade Secret

Generally, 15.32

Capital assets, definition of, 15.34

Damages for injuries to capital asset, qualification for capital gains treatment, 15.52

Disposition of IRC §197 intangibles, restrictions on recognition of losses on, 15.41

Exchange of trade secrets (see Sale or exchange of trade secret, transfer of all substantial rights, below)

Licensing trade secret (see Sale or exchange of trade secret, transfer of all substantial rights, below)

Long-term capital gains

Holding period required for long-term capital gain treatment, 15.39

Restrictions on availability of long-term capital gain treatment of sale of trade secret, 15.40

Sale or exchange of trade secret, transfer of all substantial rights

Generally, 15.35

Exclusive trade secret license as sale of trade secret, 15.37

Limited exclusive licenses, effect of transferor's retention of rights to trade secret, 15.38

Transfers in form of sale of trade secret, 15.36

Cease and Desist Letter, 10.15, 11.3

Certificates and Certification

Confidentiality and invention assignment agreement, provision for employee's certificate on termination, 4.14, 6.39

Charts, Checklists, Questionnaires, and Tables

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Client interview checklist, 6.2

Comparison of Trade Secrets, Patents, Copyrights, and Trademarks, App C

Exit interview checklist, 6.41

General steps for protecting trade secrets in dealing with government, 5.28

Secured transactions, checklist for setting up, 9.21

Trade secret audit, 4A.21-4A.22

Choice of Law

Generally, 11.6B

Computer software. See **Computers and Computer Software**

Consumers Legal Remedies Act (CLRA) effect on enforcementof form selection clause, 8.41

Foreign law governing trade secret agreement, parties' selection of, 6.31

Injunction against trade secret misappropriation, effectof choice of forum on, 12.13

Insurer's duty to defend, effect of forum on, 14.19

Licensing agreement, governing law provision, 8.41

Noncompetition agreement, California courts ignoring choice of law provisions in, 11.41

Parties' agreement, effect of forum on application of choice of law specified in, 12.7

Cities and Counties

Fixtures filing, statement filed with County Recorder, 9.12

Collateral, Trade Secrets as. See Security Interests in Trade Secrets

Commercial Code. See California Commercial Code

Common Law

Definition of trade secret under, 5.14

Lost profits, third party's liability for disclosure of trade secrets resulting in, 12.20

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Ownership of trade secrets under common law. See **Ownership of Trade Secrets**

Public access to court documents in civil trial, common law right of, 11.33C

Unfair competition, common law action for, 11.49, 14.11

Uniform Trade Secrets Act, effect on common law protection of trade secrets, 1.13, 1.16, 11.23

Compensation

Licensing agreement, compensation for. See **Licensing Agreements**

Submission of ideas, waiver of compensation for. See **Submission of Ideas**

Trade secret protection for salary information, lack of, 4.2

Competition. See Covenant Against Competition; Unfair Competition

Compilation of Information

Nonsecret information, trade secret protection for compilation of, 7.8

Computers and Computer Software

See also **Internet**

Generally, 16.1-16.2

Amortization of computer software, restrictions on, 15.5-15.6

Assignment and sublicensing

Consultant's assignment ofcopyright (see Consultant's assignment of copyright, agreement for, below)

Hypertext Markup Language (HTML) used to construct Web site, 7.12

Licensing agreement for software, 16.15

Shrink-wrap license, sublicensing and assignment of, 16.38

Attorney fees. See **Attorneys' Fees**

Breach of license agreement

Remedies for, 16.16

Waiver of breach, requirements for, 16.21

Capital assets, exclusion of software from definition of, 15.34

Choice of law

License for software, governing law provision, 16.18

Shrink-wrap license for software program, governing law provision, 16.39

Computer Fraud and Abuse Act, criminal action for accessing protected computer without authorization and with intent to defraud, 16.59B

Confidentiality

Generally, 16.2

Consultant's agreement regarding confidentiality, 16.55

License agreement provision regarding confidentiality of information, 16.8

Mass-marketed software, use of confidentiality notices, 16.42

Notice of confidentiality and copyright notice for software, 16.3

Shrink-wrap license, confidentiality provision in, 16.33

Consultant's assignment of copyright, agreement for

Assignment of copyright, 16.58

Confidentiality, provision for, 16.55

Consideration for creation and assignment of software program, 16.56

Introduction, 16.52

Ownership of copyright by consultant's employer, 16.57

Signatures, 16.59

Software, agreement to create, 16.53

Warranties by consultant, 16.54

Copyrights

Generally, 16.2, 16.43

Confidential notice and copyright notice for software, 4.20, 16.3

Consultant's assignment of copy- right (see Consultant's assignment of copyright, agreement for, above)

Contributory infringement, 16.46A

Deposit of computer program with Copyright Office, alternatives for reducing risk of loss of trade secret, 16.44, 16.46

Digital Millennium Copyright Act, penalties for distributing hardware or software designed to defeat encryption protection, 16.59A

Federal preemption of state trade secret laws under federal Copyright Act, 16.27

Graphical user interfaces (GUIs), limited copyright protection for, 16.49

Hypertext Markup Language (HTML) used to construct Web site as copyrightable, 7.8

Infringement of software, remedies under Act, 16.45

Monopolization of subject matter, denial of copyright protection if copyright resulting in, 16.50

Object code, limits on copyright protection for, 16.50

Ownership of copyrighted software (see Ownership of copyrighted software, below)

Preemption of state trade secret laws under federal Copyright Act, 16.27

Registration of copyright, 16.44, 16.46

Reverse engineering of software, copying of copyrighted program as fair use, 16.48

Source code listing, copyright notice for, 16.61

Statutory limits on copyright protection, 16.47

Unpublished software, protection for, 16.44, 16.46

Dissemination of computer codes, effect of First Amendment on restrictions, 4.2

Encryption technology. See **Encryption Technology**

Escrow, placement of source codes in, 16.26

Expedited discovery to prevent destruction of electronically stored evidence, 12.1-12.2

Federal Acquisition Regulations (FAR), effect of. See **Federal Acquisition Regulations (FAR)**

Federal Copyright Act (see Copyrights, above)

General intangibles and vessel, software included within definition of, 9.8

Goods, computer program included within definition of, 9.8

Hacking

Customer list stored on computer, owner's duty to notify customers of security breach when personal information acquired by unauthorized person, 16.2

Parents' liability for children's hacking, 11.43

Licensing agreement for software

Assignment and sublicensing, 16.15

Attorney fees and costs, 16.22

Binding effect of agreement on successors and assigns, 16.19

Breach of license agreement (see Breach of license agreement, above)

Browse-wrap license, enforceability of, 16.41

Concluding clause and signatures, 16.26

Confidentiality of information, provision regarding, 16.8

Copying of software, 16.9

Definitions, 16.5

Entire agreement, license agreement as, 16.25

Export controls, 16.19A

Fee for license, 16.11

Governing law for agreement, 16.18

Government ownership, 16.19B

Headings, 16.24

Hypertext Markup Language (HTML) used to construct Web site, 7.9

Independent contractor status of licensee, 16.17

Introduction, 16.4

Mass-marketed software (see Mass-marketed software, below)

Nonexclusive license, 16.7

Notices required or permitted under agreement, 16.20

Security protection for licensed software, 4.25, 16.10

Severability of provisions, 16.23

Shrink-wrap license (see Shrink-wrap license agreement, below)

Termination of license agreement, 16.12

Term of license, 16.6

Title to licensed program, 16.13

Warranty, disclaimer of, 16.14

Mass-marketed software

Generally, 16.29

Click-wrap licenses, 16.41

Confidentiality notices, use of, 16.42

Shrink-wrap licenses (see Shrink-wrap license agreement, below)

Strategies for maintaining trade secrets in mass-marketed software, 16.42

Misappropriation of software, proof of, 16.28

Notice license (see Shrink-wrap license agreement, below)

Notices

Confidentiality notice (see Confidentiality, above)

Licensing agreement, notices required and permitted under, 16.20

Security interest in copyright, effect of failing to file notice of, 9.11

Original computer software, ownership of, 10.17

Ownership of copyrighted software

Generally, 16.51

Consultant's assignment of copyright (see Consultant's assignment of copyright, agreement for, above)

Licensed program, title to, 16.13

Patent protection for computer technology

Advantages and disadvantages of patent protection, 16.60

Application for patent, sufficiency of disclosure in, 16.61

Claims directed to computer-related process, criteria for evaluating process for compliance with 35 USC §101, 16.66

Graphical user interfaces (GUIs), 16.49, 16.61

Interpretation of 35 USC §101, patentability of software, 16.63

Mitigating effect of disclosure requirements, strategies for, 16.62

Obviousness or anticipation, invalidating patent under doctrines of, 16.65A

Patent Office's position on patentability of software-related inventions, 16.64

Practical application requirement, 16.65

Penalty for unauthorized access to computer systems and data under Pen C §502, 13.5

Proprietary rights legends. See **Proprietary Rights Legends**

Protective order, 11.28

Re-export of technology and software, export regulations requiring letter from ultimate recipient concerning restrictions on, 8.24

Security measures for protecting, 4.25, 4A.7

Shrink-wrap license agreement

Generally, 16.30-16.31

Acceptance of license, 16.40

Confidentiality of information in program, unauthorized disclosure prohibited, 16.33

Governing law, 16.39

Introduction, 16.32

License grant, 16.34

Limited warranty, 16.36

Patenting technology, advantages of, 16.60

Remedies for defective disks, limits on, 16.37

Sublicensing, assignment, and transfer of license, 16.38

Termination of agreement, 16.35

Signatures

Consultant's assignment of software copyright, signature provision, 16.59

Licensing agreement for software, signature clause, 16.26

Source code

Licensing agreement, deposit of source code with third party, 4.25

Patent invalidity, effect of source code on, 16.61

Sublicensing software (see Assignment and sublicensing, above)

Tax credit for internal use software, 15.14

Trespass to chattel for intangibles used without authorization, 11.43

Uniform Commercial Code, software not constituting "goods" under, 9.11

Warranties

Consultant's warranties in assignment of copyright agreement, 16.54

Disclaimer of warranty in software license agreement, 16.14

Shrink-wrap license agreement, limited warranty in, 16.36

Web site construction, copyrightable nature of Hypertext Markup Language (HTML) used for, 7.8-7.9, 7.12

Wrongful use of computer programs, extension of trade secret protection to, 16.27

Concurrent Interests in Trade Secret. See Ownership of Trade Secrets

Confidentiality

See also **Disclosure**; **Disclosure; Nondisclosure Agreements**

Accident or mistake, prohibition against using information obtained by, 10.48

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Breach of implied-in-fact confidentiality agreement, claim for, 11.38

Buy-sell agreements, 6.55, 6.56

Casual visitors (see Visitors, below)

Computer software programs. See **Computers and Computer Software**

Consideration for confidentiality agreement

Continued employment as consideration for confidentiality and invention assignment agreement, 4.4, 6.16, 11.39

Forum selection clause, enforcement if confidentiality agreement supported by consideration, 6.31

Constructive fraud arising out of confidential relationship, 11.44

Copyright notices. See **Copyrights**

Duty of confidentiality

Breach of duty of confidentiality, elements of, 11.37

Consultants and independent contractors, duty of confidentiality arising from employer's relationship with, 10.4, 10.42

Information disclosed in confidence, protection of, 10.32

Officer's and director's relationship with corporation, duty of confidentiality arising from, 10.40

Shop right doctrine, exception involving employee's breach of confidential duty, 2.8

Employee confidentiality agreement. See **Employee Confidentiality Agreement**

Government entities, confidentiality of trade secrets in dealings with. See **Federal Contractors, Proprietary Rights of**

Licensing agreements. See **Licensing Agreements**

Manuals, confidential information in. See **Manuals**

No-hire agreement with client, 4.7, 6.57, 6.58

On-site employees from another company

Generally, 6.53

On-site employee confidentiality agreement, 6.54

Oral contract for confidentiality, enforceability of, 4.5

Patent applications. See **Patents**

Proprietary rights legends. See **Proprietary Rights Legends**

Prospective licensee, confidentiality and disclosure agreement with, 7.34, 7.36

Protective orders. See **Protective Orders**

Recipient and submitter of idea, implied confidential relationship between, 3.4

RICO claim based on confidential information disclosed to or withheld from government agency prohibited, 11.55

Security measures to protect trade secrets. See **Security Measures To Protect Trade Secrets**

Specifications or technical manuals disclosed to potential contractor, confidentiality of information in, 10.44

Submission of ideas. See **Submission of Ideas**

Unauthorized possession of confidential information, court order for or injunction for return of, 11.28, 11.51

Unsealing of sealed confidential records, 11.33C

Visitors. See **Visitors**

Waiver

Confidentiality and invention assignment agreement, no waiver provision in, 6.29

Order sealing record, effect of failing to request, 11.33C

Conflict of Interest. See Attorneys

Consent

Assignment of non-exclusive patent or copyright license, consent of licensor required for, 9.10

Shop right to use invention or development, employee's consent creating, 2.7

Consideration

Assignment of rights in invention, consideration for. See **Assignments**

Computer software, consideration for creation and assignment of, 16.56

Confidentiality agreement, consideration for. See **Confidentiality**

Security interest in trade secret, consideration for security agreement, 9.9

Written agreement, presumption of consideration from, 2.27

Conspiracy

Civil conspiracy, 11.42

Misappropriation of trade secrets, criminal penalty for conspiracy, 13.3

Parties in economic relationship, inability to conspire to interfere with relationship, 11.47

Constitutional Law

Commercial speech, arrestee's addresses released for commercial purposes only as unconstitutional limit on, 2.16

Computer codes, effect of First Amendment on restrictions on dissemination of, 4.2

Digital Millennium Act, constitutionality of, 16.59A

Fifth Amendment privilege against self-incrimination, applicability in trade secrets misappropriation case, 11.31

First Amendment

Civil litigation documents filed in court, right to access to, 11.33C

Government documents, right of access to, 2.18A

Punitive damages for misappropriation of trade secrets, limits on, 12.22

Takings. See **Takings**

Construction and Interpretation

See also **Definitions**

Assignor estoppel doctrine, 11.39

California Public Records Act, construction of exemptions from, 5.21

Commercial records, 5.14

Computer Fraud and Abuse Act, construction of, 16.59B

Computer software

IRC §197 intangibles, 15.5

35 USC §101 interpretation of statute and patentability of software, 16.63

Insurance policies. See **Insurance Coverage for Trade Secret Misappropriation**

Licensing agreement, construction of, 8.36

Misappropriation of advertising ideas, misappropriation of trade secrets within, 14.9

Shield law contained in Evid C §1070, 2.18, 11.30D, 16.42A

Third party complaint of patent violation, advertising injury provision inapplicable to, 14.9

Consultants

See also **Experts**

Assignment of computer program copyright by consultant. See **Computers and Computer Software**

Duty of confidentiality arising from relationship between consultant and employer, 10.4, 10.42

Contempt

Discovery order, review of through finding of contempt for failure to comply with order for disclosure of trade secret, 11.26

Enjoined activities, action for contempt requiring notice of, 12.8

Protective order, penalties for civil contempt for violation of, 11.20D

Contractors

Government contractors

Federal contractors. See **Federal Contractors, Proprietary Rights of**

State contractors. See **State Contractors, Proprietary Rights of**

Independent contractors. See **Independent Contractors**

Specifications or technical manuals disclosed to potential contractor, confidentiality of information in, 10.44

Contracts

See also **Breach of Contract**

Adhesion contracts. See **Adhesion Contracts**

Assignments. See **Assignments**

Avoiding misappropriation of trade secrets, requiring new employee to sign contract prohibiting certain acts. See **Avoiding Misappropriation Claims**

Bad faith denial of existence of contract, unavailability of punitive damages for, 11.40

Breach of confidence claim, 11.37

Computer software. See **Computers and Computer Software**

Confidentiality agreements. See **Confidentiality; Employee Confidentiality Agreements**

Consideration. See **Consideration**

Copyright laws, no preemption of contract rights under state laws, 16.30

Employee confidentiality agreements. See **Employee Confidentiality Agreements**

Implied-in-fact contract, statute of limitations for, 11.38

Licensing agreements. See **Licensing Agreements**

Misappropriation of trade secrets, contractual remedies for, 12.25

Nondisclosure agreements. See **Nondisclosure Agreements**

Oral contracts. See **Oral Contracts**

Ownership of trade secrets, contractual provisions affecting. See **Ownership of Trade Secrets**

Security measures to protect trade secrets. See **SecurityMeasures To Protect Trade Secrets**

Specific performance. See **Specific Performance**

Uniform Trade Secrets Act (California), no preemption of contractual remedies not based on misappropriation of trade secret, 1.16, 11.38

Conversion

Generally, 11.43

Destroyed property, limited remedy for, 11.43

Intangibles, applicability of conversion to, 11.43

Patient's action for conversion of excised body cells, lack of ownership rights, 17.8

Trespass to chattel for intangibles used without authorization, 11.43

Copyrights

Generally, 2.34, 11.52

Assignment of exclusive copyright license, consent required for, 9.10

Breach of confidence claim, connection with copyright remedies, 11.37

Capital assets, copyrights excluded from definition of, 15.34

Comparison of trade secrets, patents, copyrights, and trademarks, App C

Computer software programs. See **Computers and Computer Software**

Copyright notices

Generally, 4.20, 6.7

Absence of copyright notice, effect of, 10.27

Short-form standard copyright legend, 6.8-1

Unpublished works, avoiding use of copyright symbol for, 6.8-2

Unpublished works, legend for, 6.8-3

Damages

Generally, 11.52

Computer software, copyright registration as requirement for protection of right to statutory damages, 16.44, 16.46

Distinction between ideas and expressions, 2.34

Distinguishing between trade secret and copyright protection, 11.21

Duration of copyright, 16.43

Infringement action, copyright registration as prerequisite for, 10.27

Internet, effect of postings on copyrights, 10.31

Investigating copyright status of work, 10.27

Notices (see Copyright notices, above)

Original works of authorship, copyright law protecting, 10.23

Perfection of interest in copyrightable material, 9.20

Preemption of state actions under federal Copyright Act

Generally, 11.10, 11.52, 16.27

Breach of confidence, no preemption under federal Copyright Act for claim of, 11.37

Breach of fiduciary duty, impact of federal Copyright Act on remedies for, 11.45

California Commercial Code, preemption of, 9.11

Common law misappropriation of trade secret, preemption by copyright statutes, 11.46

Contract rights under state laws, no preemption under copyright laws, 16.30

Fraud claims, no preemption under Act, 11.44

Protection of copyright, no federal preemption of state trade secrets laws, 2.34

Unregistered copyrights, 9.11

Public domain information, noncopyrightability of, 10.24

Security in copyright interest, perfection of, 9.11

Unfair competition claim joined with copyright claim, original jurisdiction of federal court over, 11.12

Work for hire, 2.34

Corporations

See also **Shares and Shareholders**

Conspiracy, inability of corporation to conspire with own officers and directors, 11.42

Covenant not to compete. See **Covenant Against Competition**

Fiduciary duty

Corporate opportunity doctrine, duty of corporate officer to assign invention made by officer to corporation, 2.10

Relationship between officers and directors with corporation, duty of confidentiality arising from, 10.40

Termination of officers' and directors' fiduciary duty, 11.45

Former corporate employee, applicability of attorney work-product privilege to communications with, 11.27

Misappropriation of trade secret

Action against shareholder or director for misappropriation, director's lack of authority to bring, 11.3

Personal liability of directors and officers for, 10.10

Taxes

Evasion of taxes by licensing or assigning trade secrets to related foreign corporation, 15.42

Liquidation of corporation, tax consequences of, 15.50

Transferring trade secret to corporation, tax consequences of, 15.47

Costs

See also **Expenses and Expenditures; Fees**

Computer software license, recovery of costs in litigation involving, 16.22

Racketeer Influenced and Corrupt Organizations Act (RICO), action for damages and costs under, 13.7

Receiving stolen trade secret, action for damages and costs, 13.4

Uniform Trade Secrets Act, awarding costs under, 12.24

Covenant Against Competition

Breach of noncompetition agreement, 11.41

Choice of law provision in noncompetition agreement, California courts ignoring, 11.41

Declaratory relief action challenging enforcement of restrictive covenant, 11.41

Employee confidentiality agreement, noncompetition provision in, 6.21

Enforceability of noncompetition agreements, 2.32-2.32D, 4.6-4.7, 11.41, 17.10

Exceptions to statutory prohibition against noncompetition agreements, 2.32, 2.32B

Injunction's geographic scope, contract limiting, 12.8

Knowledge or skills acquired by employee while working for employer, restrictive covenant in employment contract, 4.14

No-hire clause in employer-employer agreement, unenforceability of, 11.41

Sham agreement, nonenforceability of, 11.41

Solicitation of seller's customers, implied duty to refrain from, 10.46

Termination without cause, effect on enforcement of restrictive employment covenant, 6.24

Wrongful termination of employee for refusing to sign unenforceable noncompetition agreement, 11.38, 11.41

Coworkers

Fiduciaries soliciting coworkers before starting new company, avoidance of, 10.2

Termination of employment, enforceability of agreement not to solicit nonsecret customers or coworkers after, 2.32A

Criminal Liability for Trade Secret Misappropriation

See also **Theft**

Generally, 13.1

Advantages of criminal action, 13.10

Computer Fraud and Abuse Act, criminal action for accessing protected computer without authorization and with intent to defraud, 16.59B

Disadvantages of criminal action, 13.11

Economic Espionage Act (EEA). See **Economic Espionage Act (EEA)**

E-mail, criminal liability for using. See **Electronic Mail and Fax Transmissions**

Felony or misdemeanor for misappropriation of trade secret, value of trade secret determining, 13.3

Initiating criminal action

Alleged misappropriator, attorney's advice for, 13.14

Contacting proper authorities, 13.13

Evidence memorandum, submission to proper authorities, 13.12

Remedies for trade secret misappropriation, 12.25

Statutes protecting trade secrets

Generally, 13.2

Definition of trade secret under Pen C §499c, 2.15

Fraud and related activity in connection with access device (18 USC §1029), 13.9

Mail fraud and wire fraud (18 USC §§1341, 1343), 13.6

National Stolen Property Act (18 USC §§2311-2322), 13.8

Racketeer Influenced and Corrupt Organizations Act (RICO, 18 USC §1962), 13.7

35 USC §1905, penalties for divulging trade secrets under, 2.21

Unauthorized access to computer systems and data (Pen C §502), 13.5

Unauthorized disclosure of trade secret, federal criminal penalties for, 4.27

Cross-Examination

Expert appointed by court, cross-examination of, 11.33A

Customers

California Uniform Trade Secrets Act, customer lists protected as trade secrets, 1.4-1.5

Change of employment, announcing to customers, 2.32A

Computerized customer list, owner's duty to notify customers of security breach when personal information acquired by unauthorized person, 16.2

Depreciation of customer lists prohibited, 15.29

Identity of customers

Agreement barring solicitation of customers, unenforceability if customers identity not trade secret, 11.41

Lack of protection for, 1.5

Informing customers of employee's change of employment, 10.8

Injunctive relief to protect customer list, 12.2

List of customers containing public information, trade secret protection for, 4.2

Solicitation of customers

Agreement barring solicitation of customers, unenforceability if customers identity not trade secret, 11.41

Announcing change of employment to customers of former employer, 10.19

Definition of solicitation, 10.19

Distinguishing solicitation from notification of customers, 10.8, 11.41

Misappropriation of trade secret, soliciting former employer's customers as, 1.12

Purchase of business, implied duty not to directly solicit seller's customers, 10.46

Termination of employment, enforceability of agreement not to solicit nonsecret customers or coworkers after, 2.32A

Damages

See also **Punitive Damages**

Breach of confidence, award of damages in action for, 11.37

Capital gains treatment of damages recovered for injuries to capital asset, 15.52

Computer systems and data, damages for unauthorized access to, 13.5

Copyright violations. See **Copyrights**

Expert's fraudulent documents, action for damages based on, 11.33A

Injunctions

Bond to ensure payment of damages, 12.16

Permanent injunction, inadequacy of monetary compensation for misappropriation of trade secret, 12.7

Interference with prospective business advantage, damages for, 11.47

Lanham Act, recovery of damages under, 11.53

Licensing agreement, recovery of damages under, 8.32

Misappropriation of trade secrets

Generally, 1.15, 11.3

Actual loss or unjust enrichment as basis for damages award, 12.20

Measure of actual damages, 12.20

Punitive damages, 1.15, 11.40, 12.22

Royalty, damages based on, 1.15, 11.54, 12.21

Racketeer Influenced and Corrupt Organizations Act (RICO), action for treble damages under, 11.55, 13.7

Receiving stolen trade secret, action for treble damages, 13.4

Trade libel, damages for, 11.48

Unfair competition, damages as restitution for, 11.49

Unjust enrichment, recovery of damages for, 12.20

Death

Estate tax on unpaid royalties for sale or license of trade secret, 15.48

Debtors. See Security Interests in Trade Secrets

Declaratory Relief

Insured's declaratory relief action regarding insurer's duty to defend, 14.16

Restrictive covenant, declaratory relief action challenging enforceability of, 11.41

Deductions. See Taxes

Defenses

Adhesion contract and other contractual defenses, 2.30-2.31

Litigation of trade secret misappropriation. See **Litigation of Trade Secret Misappropriation**

Definitions

See also **Construction and Interpretation**

Abnormal retirement (of trade secret), 15.46

Abuse of discretion, 12.18

Advertisement, 14.6

Advertising, 14.12

Advertising injury, 14.12

Advertising injury of comprehensive general liability insurance policy, 14.2, 14.5-14.6, 14.9

Ascertainable useful life (of trade secret), 15.28

Assignment (of trade secret), 7.1

Attachment, 9.6

Biotechnology, 17.1

Capital assets, 15.34

Clean room procedure, 10.35

Click-wrap licenses, 16.41

Computer program, 16.43

Computer-related process, 16.66

Computer software, 15.5

Confidential information, 5.14, 5.26, 10.3

Confidentiality and invention assignment agreement, definition of terms, 6.18

Constructive fraud, 11.44

Conversion, 11.43

Copyrights, 15.34

Customer-based intangibles, 15.29

Employee, 2.34

Express contract, 11.38

Fair market value, 15.51

Fiduciary duty, 11.45

Flow chart, 16.61

Flow diagram, 16.61

General intangibles, 9.5, 9.8

Goods, 9.8

Government purpose rights, 5.9

Graphical user interface, 16.49

GUIs, 16.49

Head start injunction, 12.1A

Hired to invent, 2.4

Holdover clause, 2.31

Hybrid license agreements, 7.3

Implied-in-fact agreement, 11.38

Improper means of acquiring knowledge of trade secret, 1.11

Improper means of acquiring trade secret, 10.47

Inevitable disclosure, 1.11, 4.15, 12.13

Information, 1.3

Infringement, 14.11

Invention, 6.18

Invention assignment agreements, 2.26

Judicial proceedings, 11.38

Knock-out provision (trade secret royalty), 7.23

Know-how trade secrets, 2.5

License (for trade secret), 7.1

Limited rights data, 5.4, 5.8

Litigation insurance, 14.3

Look-see fee, 7.35

Misappropriation of trade secret, 1.11, 10.31, 10.37, 11.44, 14.9

Negative information, 1.6

Notice license, 16.30

Object code, 16.50

Person, 5.14, 5.26

Personal and advertising injury, 14.6

Personal information, 5.24, 16.2

Publication, 16.44

Public records, 5.21

Ready ascertainability (of information), 1.8A

Release, 4.2

Research and experimental expenses, 15.20-15.24

Restricted rights software, 5.4, 5.8

Reverse engineering, 10.36

Reverse FOIA action, 5.17

Reverse palming off, 11.53

Rule of doubt registration (copyrights), 16.44

Sale (of trade secret), 7.1

Shrink-wrap license, 16.30

Solicitation of former employer's customers, 10.19

Source code listing, 16.61

Supplemental jurisdiction, 11.11

Technical data, 5.3

Title, 14.10

Trade libel, 11.48

Trademark, 14.9

Trademark infringement, 14.9

Trade secret (common law), 5.14

Trade secret, 1.3, 4.2, 4A.1, 10.24, 10.26

Trade secret audit, 4A.2

Trade secret, statutory definitions of. See **Ownership of Trade Secrets**

Unfair, 11.49

Unfair competition, 11.49, 14.11

Unfair conduct (in direct competition), 11.49

Unjust enrichment, 11.50

Unpatentable subject matter, 16.65A

Vacatur, 11.34

Writing, 5.21

Demurrers, 11.17

Department of Defense FAR Supplement (DFARS). See Federal Acquisition Regulations (FAR)

Depreciation. See Taxes

Derivations

Injunction against derivations based on trade secret information, 12.8

Directors of Corporation. See Corporations

Disclosure

See also **Confidentiality**

Attorney-client privilege, employee's disclosure of trade secret to attorney protected by, 10.15

Avoiding misappropriation claim, advising prospective employee against making specific disclosures. See **Avoiding Misappropriation Claims**

Biotechnology, disclosure of. See **Biotechnology**

California Public Records Act. See **California Public Records Act (CPRA)**

Computer technology, disclosures relating to. See **Computers and Computer Software**

Confidentiality agreement insufficient to satisfy requirements for nondisclosure, 5.14

Contempt. See **Contempt**

Federal contractors. See **Federal Contractors, Proprietary Rights of**

Federal Trade Secrets Act. See **Federal Trade Secrets Act**

Freedom of Information Act. See **Freedom of Information Act (FOIA)**

Government agency's decision to disclose data, private party's request for review of, 5.26

Inadvertent disclosure of privileged information, treatment of, 11.20A

Inevitable disclosure. See **Inevitable Disclosure of Trade Secret**

Injunctions. See **Injunction Against Trade Secret Misappropriation**

Intentional or inadvertent disclosure of trade secret, liability under California Uniform Trade Secrets Act (UTSA) for, 1.12

Invention, employer requiring disclosure of, 2.19

Licensing agreement. See **Licensing Agreements**

Litigation of trade secret misappropriation. See **Litigation of Trade Secret Misappropriation**

Nonlitigants, effect of disclosure by, 11.30-11.30A

Ownership of trade secrets. See **Ownership of Trade Secrets**

Patent application, disclosure of information in. See **Patents**

Preliminary disclosures of confidential information

Generally, 6.47

Bilateral confidential disclosure agreement, 6.48

Unilateral confidential disclosure agreement, 6.49

Protective orders. See **Protective Orders**

Public access to court documents, disclosure of trade secrets resulting from, 11.33C

Public Records Act. See **California Public Records Act (CPRA)**

Reasonable efforts to prevent inadvertent and intentional disclosure of trade secrets, 1.10

Sealing discovery materials not used at trial nor submitted as basis for adjudication, 11.33C

Security measures to prevent disclosure of trade secrets. See **Security Measures To Protect Trade Secrets**

Special master or court-appointed expert, disclosure of trade secret to, 11.33A

Stipulation to sealing record to prevent disclosure of trade secret, 11.33C

Submission of ideas. See **Submission of Ideas**

Suppliers (see Vendors and suppliers, disclosures to, below)

Unauthorized disclosure as cause of damage, 12.20

Unsolicited disclosures, receipt of, 10.43

Vendors and suppliers, disclosures to

Generally, 4.7, 6.50, 10.44

Confidential disclosure provisions for cover sheet on proprietary information, 6.52

Confidential disclosure provisions for inclusion in purchase agreements and purchase orders, 6.51

Discovery

Attorney-client privilege. See **Attorney-Client Privilege**

Business records and documents, nonapplicability of Fifth Amendment protection to, 11.31

Estoppel, contesting existence of trade secret prevented by, 11.29

Expedited discovery to prevent destruction of electronically stored evidence, 12.1-12.2

Fifth Amendment privilege against self-incrimination, 11.31

Freedom of Information Act, discovery of information under, 11.32

Identification of trade secret before discovery, 11.21

Informal pretrial discovery, 11.30A

Limited discovery plan, court's imposition of, 11.25

Misappropriation of trade secrets, discovery in action for, 11.2

Potential witnesses, discovery of attorney's comments to, 11.27

Protective orders. See **Protective Orders**

Public Records Act, discovery of information under, 11.32

Self-incriminating information, discovery prohibited, 11.31

Stipulated order delegating to attorneys responsibility for designating secrets, 11.20

Summary judgment motion, obtaining discovery before hearing on, 11.18

Testifying expert and counsel, discovery of communications between, 11.33A

Testimony privilege, exclusion of trade secret information from, 11.30-11.30A

Third party's trade secret, discovery of, 11.26

Discretion of Court

Abuse of discretion defined, 12.18

Attorney fees, discretion of court to award, 12.23

Court-appointed expert, discretion of federal court to allow testimony only from, 11.33A

Injunction against trade secret misappropriation. See **Injunction Against Trade Secret Misappropriation**

Punitive damages for misappropriation of trade secrets, discretion of court regarding, 12.22

Transfer of misappropriation action, federal court's discretion regarding, 11.16

Dismissal of Actions

Incorporating settlement agreement into dismissal order, 11.34

Pleading facts establishing misappropriation of trade secret, dismissal for failure regarding, 11.17

Revelation of trade secret in complaint, denial of motion to dismiss for failure concerning, 11.2

Validity of disputed patent, effect of dismissal with prejudice on challenge to, 7.4A

Doctors. See Physicians and Surgeons

Duty To Defend. See Insurance Coverage for Trade Secret Misappropriation

Economic Espionage Act (EEA)

Generally, 13.9A, 17.4A

Avoiding exposure to EEA liability, 13.9B

Trade secret defined under, 2.21A

Electronic Mail and Fax Transmissions

Former employer's e-mail, employer instructing new employee not to use for purposes relating to new job, 10.11

Permanent injunction against sending e-mails to former employer's employees, 11.43

Proprietary legend for, 6.6

Security measures for electronic transmission of trade secrets, 4A.18

Transmitting trade secret information across state lines via e-mail, criminal liability for, 13.8

Trespass to chattels, use of company's e-mail not constituting, 11.43

Wire fraud, use of e-mail to entice employees to reveal trade secrets as, 13.9

E-Mail. See Electronic Mail and Fax Transmissions

Employee Confidentiality Agreements

See also **Nondisclosure Agreements**

Generally, 4.6-4.7, 4A.13, 6.12

Assignment of invention (see Confidentiality and invention assignment agreement, below)

Confidentiality and invention assignment agreement

Generally, 6.16, 10.16

Amendment of agreement, 6.27

Assignment of invention, 4.6, 6.23-1, 11.39

Attorney fees, 6.30

Attorney-in-fact, appointment of company as, 6.23-3

Binding effect of agreement on successors and assigns, 6.33

Continued assistance of employee in applying for patent or copyright for invention, 6.23-2

Continued employment as consideration for, 4.4, 6.16, 11.39

Definitions, 6.18

Effective date of agreement, 6.19

Employee's certificate on termination, 6.39

Exhibits, 6.28

Fixed term of confidentiality expiring, effect of, 11.39

Governing law, 6.31

Heading and introductory provision, 6.17

Integration of agreement, 6.34

Lab C §2870, company's written notification of, 6.38

Noncompetition after termination of employment, 6.21-2

Noncompetition during employment, 6.21-1

Notice and record addresses of parties, 6.26

No waiver provision, 6.29

Ownership of trade secrets. See **Ownership of Trade Secrets**

Prior approval of company for publication or presentation, 6.20-2

Prior knowledge and inventions, employee's statement of, 6.37

Prior knowledge of confidential information and disclosure of relationships preventing enforcement of agreement, 6.22

Prospective employees (see Interviews with prospective employees, below)

Protection of company's confidential information, 6.20-1

Severability of agreement, 6.32

Signature block, 6.36

Specific performance of confidentiality agreement, 6.25

Termination of employment, 6.24

Warning of effect of agreement, 6.35

Duty of confidentiality, employer and employee relationship requiring, 10.3, 10.38

Interviewing former employees, effect of confidentiality agreement on, 11.27

Interviews with prospective employees

Generally, 4.11

Long-form confidentiality agreement for interviews with prospective employees, 6.14

Short-form confidentiality agreement for interviews with prospective employees, 6.13

Invention assignment agreement (see Confidentiality and invention assignment agreement, above)

Investigation into employer's wrongdoing, confidentiality agreement not preventing participation by former employees, 6.20

Knowledge or skills acquired by employee while working for employer, restrictive covenant in employment contract, 4.14

New employee's acknowledgment of confidentiality agreement, 6.15

Trade secret audit reviewing current confidentiality agreements, 4A.9

Employee Manuals

Confidential material, instructions in employee manual on, 4.12

Employers and Employees

Arbitration clause in employment agreement, 6.32, 11.6A

Attorney-client privilege, employee's disclosure of trade secret to attorney protected by, 10.15

At-will employment doctrine, erosion of, 6.16

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Biotechnology. See **Biotechnology**

Confidentiality agreement. See **Employee Confidentiality Agreement**

Covenant against competition. See **Covenant Against Competition**

Criminal liability. See **Criminal Liability for Trade Secret Misappropriation**

Customers. See **Customers**

Fiduciary duty of employees. See **Fiduciary Duty**

Former employees

Avoiding misrepresentation claim. See **Avoiding Misappropriation Claims**

Confidentiality agreements. See **Employee Confidentiality Agreements**

Criminal prosecution of former employee for stealing laboratory notebooks, 17.10

E-mails, permanent injunction against sending to employees of former employer, 11.43

Ex parte communications withformer employee of opposing party, 11.27

Letter to former employee regarding company's proprietary interests, 6.42

Litigation privilege, amendment affecting communication by previous employer to prospec-tive employer about rehiring current or former employee, 11.30

Injunction against misappropriation. See **Injunction Against Trade Secret Misappropriation**

Interviews

Avoiding misappropriation claims, client interview sheet on change of employment, 10.10

Confidentiality agreements for interviews with prospective employees. See **Employee Confidentiality Agreements**

Entrance interview to determine previous employer's proprietary rights to employee's researchand technology development, 17.27

Exit interviews. See **Termination of Employment**

Scheduling interviews during prospective employee's time off, 10.11

Inventions. See **Inventions**

Key employee's departure from company, effect on value oftrade secret as collateral, 9.19

Labor market, right of employee to move freely in, 10.8

Misappropriation of trade secrets, counseling prospective new employer to avoid. See **Avoiding Misappropriation Claims**

No-hire agreement

Employer-employer noncompetition agreement, unenforceability of no-hire clause in, 11.41

Owner of trade secret entering into with client, 4.7, 6.57, 6.58

Notice to new employer regarding employee's possession of company's trade secrets, 4.15

On-site employees from another company. See **Confidentiality**

Ownership of property acquired by employee through employment, 10.17

Ownership of trade secret. See **Ownership of Trade Secret**

Penalties for preventing employeefrom obtaining new employment by misrepresentation, 4.15

Preparing to compete doctrine, employee's right to prepare for starting own business or join competing business, 2.10

Proprietary rights legends. See **Proprietary Rights Legends**

Public policy favoring employee's right to move freely in workplace, 1.2, 2.32, 10.8, 10.38, 11.41, 12.13

Restricting employee mobility, using trade secret laws for prohibited, 1.9

Security measures to protect trade secrets. See **Security Measures To Protect Trade Secrets**

Termination of employment. See **Termination of Employment**

Unenforceable terms in employment agreement, employer's avoidance of, 11.38

Wrongful termination of employee for refusing to sign unenforceable noncompetition agreement, 11.38

Encryption Technology

Digital Millennium Copyright Act, penalties for distributing hardware or software designed to defeat encryption protection, 16.59A

Engineers

Public domain, lack of trade secret protection for general engineering principles in, 1.9

Environmental Impact Statement (EIS)

No requirement of disclosing trade secret in, 2.16

Escrow

Computer source codes, placement in escrow, 16.26

Estate Tax, Federal

Sale or license of trade secret, estate tax on unpaid royalties for, 15.48

Estoppel

Contesting existence of trade secret prevented by, 11.29

Ownership of trade secret arising by estoppel, 2.11

Shop right to use invention or development arising by estoppel, 2.7

Ethics

Arbitrators, ethical standards for, 8.33

Evidence

Definition of trade secrets under Evid C §§1060-1061, 2.18

Discovery. See **Discovery**

Expedited discovery to prevent destruction of electronically stored evidence, 12.1-12.2

In limine motions to restrict evidence in trade secret misappropriation action, 11.33B

Post-trial motion to place evidence under seal, 11.33C

Public policy against agreements to suppress evidence, 11.20A

Scientific test results, standards for admissibility of, 17.4

Submission of evidence memorandum in criminal action to proper authorities, 13.12

Execution of Documents. See Signatures

Exhibits

Confidentiality and invention assignment agreement, exhibits for, 6.28

Licensing agreement, exhibits attached to, 8.38

Exit Interviews. See Termination of Employment

Ex Parte

Civil writ of possession for stolen property, ex parte application for, 11.51

Former employee of opposing party, ex parte communications with, 11.27

Temporary restraining order, ex parte proceeding in federal court for, 12.6

Expenses and Expenditures

See also **Costs; Fees**

Look-see fee, recovery of expenses in preparing prelicensing materials for prospective licensee through use of, 7.35

Value of trade secret, effect of development costs on, 7.15

Experiments, Deduction of Costs of. See Taxes

Experts

See also **Consultants**

Generally, 11.33A

Court-appointed expert, disclosure of trade secrets to, 11.33A

Limits on expert's testimony, 11.33A

Misappropriation trade secrets, effectof officer's reliance on expert's advice, 11.3

Preparation of witness, 11.33A

Protective order, disclosing tradesecret information to expertunder, 11.20

Unsolicited ideas, evaluation by outside experts, 3.16

Exports. See International Trade

Extension of Time

Injunction against trade secret misappropriation, extension of time for, 12.10

FAR. See Federal Acquisition Regulations (FAR)

Fax Transmissions. See Electronic Mail and Fax Transmissions

Federal Acquisition Regulations (FAR)

Generally, 5.3

Department of Defense FAR Supplement (DFARS)

Generally, 5.3

Commercial technical data, 5.7

Government funds, technology developed with, 5.6

Mixed funding, 5.9

Non-commercial data, 5.8

Notice to government regarding limited rights, 5.11

Source of funding as basis for government's rights under DFARS, 5.5

Determining scope of government's license under FAR, 5.4

Government purpose rights, 5.9

Limited rights data, 5.4, 5.8

Miscellaneous types of government rights, 5.10

Proprietary rights legends. See **Proprietary Rights Legends**

Requirements for limiting government rights, 5.11

Restricted rights software, 5.4, 5.8

Small Business Innovation and Research (SBIR) data rights, 5.10

Specifically negotiated license rights, 5.10

Federal Contractors, Proprietary Rights of

See also **State Contractors, Proprietary Rights of**

Generally, 5.1, 5.27

Checklist, steps protecting trade secrets in dealing with government, 5.28

Confidentiality (see Statutes and regulations imposing duty of confidentiality on government entities, below)

Freedom of Information Act (FOIA)

Generally, 5.12

Exemption 3 of FOIA, agency disclosing information prohibited, 5.13

Exemption 4 of FOIA, nonapplicability of statute to trade secrets, 5.14

Objecting to disclosure of records under FOIA request, 5.16

Reverse FOIA-Administrative Procedures Act, 5.17

Liability of government agencies or employees for improper disclosure of trade secret information, 5.26

Statutes and regulations imposing duty of confidentiality on government entities

Generally, 5.2, 5.27

Executive Order No. 12600, 5.15-5.16

Federal Acquisition Regulations (FAR). See **Federal Acquisition Regulations (FAR)**

Federal Trade Secrets Act, 5.18

Freedom of Information Act (see Freedom of Information Act (FOIA), above)

Privacy Act of 1974, 5.19

Voluntary disclosure versus mandatory disclosure of information, treatment of, 5.14

Federal Preemption

See also **Preemption**

Copyright law, preemption of state action under. See **Copyrights**

Fraud and unjust enrichment, patent law preempting state law claims for, 11.50

Patents. See **Patents**

Security interest in intellectual property, federal regulations preempting California Commercial Code, 9.5

State law claims, preemption of, 11.50

Uniform Trade Secrets Act, preemption upstate standard for awarding punitive damages, 12.22

Federal Trade Secrets Act

Generally, 5.18

Improper disclosure of trade secrets under, 5.26

Knowledge or skills acquired by employee while working for employer, inapplicability of Act to, 4.14

Fees

See also **Costs; Expenses and Expenditures**

Attorney fees. See **Attorneys' Fees**

Computer software, fee for license agreement, 16.11

Financing statement, listing names on, 9.12

Licensing agreements. See **Licensing Agreements**

Patent issue fees, 11.54

Fiduciary Duty

Breach of fiduciary duty, claim based on, 11.45

Competitors, employee's duty not to assist, 11.45

Constructive fraud arising out of fiduciary relationship, 11.44

Corporations. See **Corporations**

Information, no breach of fiduciary duty based on refusal to share, 11.45

Mail fraud as breach of, 13.6

Research and commercialization of patient's body cells, doctor's breach of fiduciary duty in failing to disclose, 17.8

Resignation of employee, fiduciary duty ending at, 2.10

Statute of limitations for breach of fiduciary duty, 11.45

Financing Plans. See Marketing and Financing Plans

Financing Statement

Listing names on, 9.12

Methods for filing, 9.13

First Amendment. See Constitutional Law

Fixtures

County Recorder, filing fixtures filing with, 9.12

Foreign Countries. See International Trade

Forfeiture

Racketeer Influenced and Corrupt Organizations Act (RICO), forfeiture provisions of, 13.7

Unauthorized access to computer systems and data, forfeiture of hardware or software used for, 13.5

Former Employees. See Employers and Employees

Forum. See Choice of Law

Fraud and Misrepresentation

Attorney-client privilege in cases of crime or fraud, 11.44

Computer Fraud and Abuse Act, criminal action for accessing protected computer without authorization and with intent to defraud, 16.59B

Criminal liability for trade secret misappropriation. See **Criminal Liability for Trade Secret Misappropriation**

Expert's fraudulent documents, action for damages based on, 11.33A

Fiduciary relationship, constructive fraud arising out of, 11.44

Limitation of actions. See **Statutes of Limitations**

Mail and wire fraud. See **Mail and Wire Fraud**

Patent law preempting state law claims for fraud and unjust enrichment, 11.50

Preventing employee from obtaining new employment by misrepresentation, penalties for, 4.15

Punitive damages, availability of, 11.40

Removal of action to state courts on grounds of fraudulent joinder of defendants, 11.9

Statute of limitations

Generally, 11.44

Access device to obtain trade secret, statute of limitations for fraudulent use of, 13.9

Concealment of misappropriation, tolling of statute of limitations for, 11.13C

Wrongful acquisition of trade secret through fraud or constructive fraud, 11.44

Freedom of Information Act (FOIA)

Discovery of information under, 11.32

Exemption of trade secrets from disclosure under, 4.27, 5.12-5.14

Federal research grants to hospitals and nonprofit institutions, disclosure of data under FOIA, 17.9

Government contractors, proprietary rights of. See **Federal Contractors, Proprietary Rights of**

Legend claiming exemption from Act, 6.11

Purpose of, 4.27

35 USC §1905 as coextensive statute, 2.21

Frivolous and Nonmeritorious Claims

Distinguishing between frivolous and bad faith trade secret claims, 12.23

Future Misappropriation of Trade Secret. See Inevitable Disclosure of TradeSecret

General Knowledge and Skills

Generally, 10.30

Injunction barring use of general knowledge or principles prohibited, 12.8

Matters of general or public knowledge, trade secret protection prohibited for, 1.9

Patent protection prohibited, 10.30

Uniform process for combining known characteristics and components, trade secret protection for, 2.1

Unsealed court records, information not considered generally known as result of being in, 4.2

Genetic Engineering. See Biotechnology

Geographical Restrictions

Injunction's geographic scope, contract limiting, 12.8

Licensing agreements. See **Licensing Agreements**

Gifts

Biological materials, letter for releaseof as unrestricted gift, 17.29

Contract of sale or license of trade secret, gift to third party as anticipatory assignment of income, 15.49

Good Faith

See also **Bad Faith**

Inevitable disclosure injunction against hiring new employee, hiring company's good faith as factor in, 10.7

Valuation of trade secret as collateral dependent on good faith of debtor/trade secret owner, 9.3

Goodwill

Amortization of goodwill acquired after August 10, 1993, restrictions on, 15.8

Covenant not to compete, exception to unenforceability for sale of business goodwill, 2.30, 4.6

Depreciation of goodwill prohibited, 15.29

Governing Law. See Choice of Law

Government Agencies. See Local Government

Government Contractors

Federal contractors. See **Federal Contractors, Proprietary Rights of**

State contractors. See **State Contractors, Proprietary Rights of**

Hacking. See Computers and Computer Software

Handbooks. See Employee Manuals

Hearings

Preseizure hearing as requirement for writ of seizure, 16.45

Holdover Clause

Enforceability of, 2.31

Hospitals

Federal research grants for hospitals, disclosure of data under FOIA, 17.9

Ideas. See Submission of Ideas

Identity of Customers. See Customers

Implied-in-Fact Contract, 11.38

Improvement of Licensing Agreement. See Licensing Agreements

Income in Respect of Decedent (IRD)

Royalty payments owed on sale or license of trade secret, treatment of, 15.48

Income Tax. See Taxes

Indemnity

Advertising injury provisions of comprehensive general liability policy, duty to indemnify under, 14.2

Licensing agreement provision for indemnification of third party, 8.29

Promise by employee not to disclose trade secrets as basis for breach of contract and indemnity claim, 10.13

Independent Contractors

Agent of misappropriator of trade secret, independent contractor as, 11.6

Computer software licensee, independent contractor status of, 16.17

Copyright protection of work for hire, 2.34

Duty of confidentiality arising from relationship between consultant and employer, 10.4, 10.42

Ownership of trade secret developed by, 2.11, 2.23

Work-for-hire doctrine, 10.17

Independent Development

See also **Research; Reverse Engineering**

Misappropriation of trade secret, independent development as affirmative defense to claim of, 1.13

Records showing independent development of ideas, importance of keeping, 10.2

Industrial Espionage

Security measures to prevent, 4.28

Inevitable Disclosure of Trade Secret

Generally, 12.13

Definition of inevitable disclosure, 1.11

Injunction against employee's employment with new employer on grounds of, 4.11, 4.15, 10.7, 12.13, 17.10

Public policy favoring employee mobility, imposing after-the-fact implied covenant not to compete by using inevitable disclosure doctrine prohibited, 11.41, 12.13

Rejection of inevitable disclosure doctrine in California, 4.11

Inferences. See Presumptions and Inferences

Information Practices Act. See California Information Practices Act (CIPA)

In-House Counsel. See Attorneys

Injunction Against Trade Secret Misappropriation

Generally, 1.15

Appellate review

California state court, 12.18

Federal court, 12.19

Preliminary injunction against trade secret misappropriation, requirement that judgment contain sufficient findings of fact and conclusions of law for appellate review, 12.14

Attorney fees for bad faith motion to terminate injunction or for bad faith opposition to motion to terminate injunction, 12.23

Balancing harm or hardships under Uniform Trade Secrets Act, 12.3, 12.5

Bond for interlocutory injunctions

Generally, 12.15

California state courts, bond requirements in, 12.16

Federal courts, bond requirements in, 12.17

Choice of forum, effect of, 12.13

Common law misappropriation oftrade secret, injunctive relief for, 11.46

Damages. See **Damages**

Discretion of court

Duration of injunction, court's discretion in setting, 12.10

Scope of injunctive relief, court's discretion in setting, 12.7

Duration of permanent injunction

Generally, 12.9

Variable termination date, 12.10

Economic Espionage Act, obtaining injunctive relief under, 13.9A

Freedom of Information Act, action to enjoin disclosure under Act brought by party submitting information to government, 5.12

Head start injunction, 12.1A

Identification of trade secret, 11.21, 11.24

Illustration of injunction remedies, 12.2

Inevitable disclosure of trade secrets, injunction against employee's employment with new employer on grounds of, 4.11, 4.15, 10.7, 12.13, 17.10

Interlocutory injunctions (see Bond for interlocutory injunctions, above)

Irreparable injury, defendant's actions resulting in, 12.7

Limits on, 12.13

Lost profits based on future sales, effect of injunction barring future use of trade secrets on recovery of, 12.21

Permanent injunction

Generally, 12.7

Affirmative acts to protect trade secrets, court order for, 12.11

Appellate review (see Appellate review, above)

Duration of permanent injunction (see Duration of permanent injunction, above)

Royalty in lieu of injunction, court's imposition of, 12.12

Specificity and scope of injunction, 12.8

Preliminary injunctions

Generally, 12.3

Bond requirements (see Bond for interlocutory injunctions, above)

California courts, standards for preliminary injunctions in, 12.4

Decryption program enablingusers to copy movies stored on DVDs, denial of preliminary injunction against web publisher for posting, 16.59A

Existence of trade secret as prerequisite for, 1.8

Federal courts, standards for preliminary injunctions in, 12.5

Order granting or denying preliminary injunction or TRO, statement of facts, 12.14

Possession of trade secret by former employer as insufficient basis for injunction, 12.13

Pretrial motion for preliminary injunction, 11.15

Seal, placing injunction containing trade secret under, 11.33C

Sister-state's reasonable connection with dispute, reversal of injunction based on, 11.4

Speculative injunctions prohibited, 12.13

Temporary restraining orders (TRO)

Generally, 12.6

Appellate review of, 12.19

Bond requirements (see Bond for interlocutory injunctions, above)

Federal court's finding of facts in granting TRO, 12.14

Immediate and irreparable harm required for issuance of TRO, 12.6

Pretrial motion for TRO, 11.15

Termination of injunction, 12.8

Threatened misappropriation, injunction against

Generally, 12.13

Prior restraint in violation of First Amendment, objection to injunction based on, 12.8

Variations of threatened misappropriation, 12.13

Time limits for permanent injunction (see Duration of permanent injunction, above)

Types of injunctions, 12.1A

Unfair competition, injunctive relief from, 11.49

Injunctions (Generally)

Breach of confidence, injunctive relief for, 11.37

Confidential information improperly obtained, injunction for return of, 11.51

Disclosure of trade secrets required from former employer, short duration injunctions to prevent, 4.11

E-mails, permanent injunction against sending to employees of former employer, 11.43

Interference with prospective economic advantage, permanent injunction to prevent, 11.47

Inventions developed by employee, enforceability of employer's rights by injunctive relief, 11.39

Stipulations

Bond for injunction, parties' stipulation to waiver of, 12.16

Witness's testimony, court orderfor despite stipulation preven-ting witness from testifying, 11.20A

Trade libel, injunctive relief against, 11.48

In Limine Motions, 11.33B

Insolvency. See Bankruptcy and Insolvency

Insurance Coverage for Trade Secret Misappropriation

Generally, 14.1, 14.3

Advertising injury provisions of comprehensive general liability policies

Generally, 14.4

Application of advertising injury provisions to trade secret litigation, 14.7-14.13

Causal connection between advertising activities and trade dress infringement, 14.10, 14.13

Causal nexus between advertising injury and advertising activity, requirement of, 14.13

Complaint's failure to trigger advertising injury coverage, actions by insured, 14.18

Covered offenses, requirement that misconduct fall within, 14.8

Definition of advertising injury, 14.2, 14.5-14.6

Definition of personal and advertising injury, 14.6

Determining if insured engaged in advertising activity, 14.12

Duty to defend and duty to indemnify under, 14.2

Infringement of title, 14.10

Limited solicitation as advertising injury, 14.12

Nonfunctional trade dress infringement as advertising injury, 14.9-14.10

Third party complaint of patent violation, advertising injury provision inapplicable to, 14.9

Unfair competition, common law tort of, 14.11

Widespread promotional activities of insured, advertising injury clause's applicability limited to, 14.9, 14.12

Attorney's responsibility for tendering defense of lawsuit to insurer, 14.20

Bad faith denial of insurance coverage

Generally, 14.17

Procedural issues before denying duty to defend, 14.18

Comprehensive general liability policies (see Advertising injury provisions of comprehensive general liability policies, above)

Coverage strategy for trade secret cases

Insured's strategies (see Insured's coverage strategies, below)

Plaintiff's strategies, 14.14

Criminal prosecution for misappropriation of trade secrets, effect on defendant's insurance coverage, 13.11

Duty to defend

Generally, 14.3

Advertising injury provisions of general liability policies, duty to defend under, 14.2

Bad faith denial of insurance coverage (see Bad faith denialof insurance coverage, above)

Choice of law, effect of forum on insurer's duty to defend, 14.19

Importance of insurance coverage, 14.1

Insured's coverage strategies

Bad faith denial of insurance coverage (see Bad faith denialof insurance coverage, above)

Declaratory relief action by insured, 14.16

Review of insurance policy, 14.15

Interpretation of policy

Ambiguities in insurance policies, resolution against insurer, 14.3

Question of law, interpretation of insurance contract as, 14.16

Litigation over misappropriation oftrade secrets, insurance coverage triggered by, 11.5

Intellectual Property

Biotechnology. See **Biotechnology**

Copyrights. See **Copyrights**

Literary projects, nondeductibility of research for, 15.23

Patents. See **Patents**

Trademarks. See **Trademarks**

Intentional Interference With Prospective Economic Advantage, 11.47

Interlocutory Injunctions. See Injunction Against Trade Secret Misappropriation

International Trade

Economic Espionage Act, punishment of trade secret misappropriation under, 13.9A

Foreign laws and regulations regarding trade secrets

Biotechnology, disadvantages of foreign laws regarding deposit of microorganisms with patent filings, 17.13

Choice of law provision in trade secret agreement selecting law of foreign country as governing law, 6.31

Foreign patent application, availability of information for use in U.S., 10.33

Re-export of technology and software, export regulations requiring letter from ultimate recipient concerning restrictions on, 8.24

Internet

See also **Computers and Computer Software**

Arbitration provision in contract delivered over Internet, enforceability of, 16.41

Copyright, trademark, or patent, effect of Internet posting on, 1.8, 10.31

Decryption program enabling users to copy movies stored on DVDs, preliminary injunction against web publisher for posting, 16.59A

Distribution of information over Internet, effect on trade secret protection, 10.31, 11.20C, 11.30D, 16.42A

Personal jurisdiction based on Internet use, 11.6C

Submission of ideas over, 3.5

Interpretation of Cases and Statutes. See Construction and Interpretation

Interviews

Client interview checklist, 6.2

Employment interviews. See **Employers and Employees**

Inventions

Assignment of invention. See **Assignments**

Confidentiality and invention assignment agreement. See **Employee Confidentiality Agreements**

Definition of invention, 6.18

Disclosure of invention, employer requiring, 2.19

Notice. See **Notice and Notification**

Ownership of trade secret, determining if employee hired to invent, 2.4

Inventory

Capital assets, inventory excluded from definition of, 15.34

Investigation

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Copyright status of work, investigation of, 10.27

Employee confidentiality agreementnot preventing participation by former employees in investigation into employer's wrongdoing, 6.20

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Joinder

Trade secret misappropriation, 11.3

Joint Venture

Biological materials, allocation of proprietary rights in joint venture involving, 17.8

Duty of confidentiality arising from relationship between joint venturers, 10.41

Reacquiring ownership of trade secret after termination of joint venture, 15.47

Judges

Discretion of court. See **Discretion of Court**

Issues decided in trial by, 11.33

Judgments

Declaratory judgment, accused misappropriator's motion for, 11.4

Summary judgment. See **Summary Judgment**

Tax treatment of, 15.52

Vacating judgment disclosing trade secret, use of settlement agreement for, 11.34

Jurisdiction in Misappropriation Actions. See Litigation of Trade Secret Misappropriation

Key Employees

Value of trade secret as collateral, effect of key employees' departure from company on, 9.19

Know-How Trade Secrets

Ownership of know-how trade secrets, determination of, 2.5

Labeling Documents. See Proprietary Rights Legends

Lanham Act

Generally, 11.53

Claim under Lanham Act, avoidance of stating, 11.10

False or misleading descriptions of product as advertising injury under, 14.9

Learned Intermediary

Licensing agreements, use of learned intermediary to evaluate, 7.35A

Legends. See Proprietary Rights Legends

Libel. See Trade Libel

Licensing Agreements

Antitrust considerations in licensing grant-back clause, 8.23

Antitrust guidelines issued by Department of Justice

Generally, 7.25

Exclusivity in licensing intellectual property, antitrust considerations in, 7.26

Future licenses subject to consent of present licenses, effect of granting, 7.31

Grant-back provisions, licensee required to grant licensor right to exploit improvements in trade secret made by licensee, 7.29

Hybrid licenses, 7.24

Price controls and use restrictions, 7.28

Territorial restrictions in trade secret licenses, lack of statutory support for, 7.27

Tying provisions, illegality of, 7.30

Assignment

Contract of sale or license of trade secret, gift to third party as anticipatory assignment of income, 15.49

Corporation assigning trade secret to foreign affiliate corporation in attempt to evade U.S. taxes, 15.42

Distinguishing assignment from licensing agreement, 7.1

Royalty payments, assignment or licensing licensee's improvements or modifications to licensor, 8.15-4

Attorney fees

Form provision regarding fees, 8.42

Litigation involving license, recovery of fees in, 16.22

Avoiding misappropriation claims based on information obtained from or disclosed to licensee. See **Avoiding Misappropriation Claims**

Breach of agreement

Computer software license, breach of. See **Computers and Computer Software**

Confidentiality provisions of licensing agreement, effect of failure to abide by, 10.39

Maintaining secrecy, failure regarding, 8.25

Term of licensing agreement, breach of agreement as grounds for, 7.4A

Waiver of breach, restrictions on, 8.39

Capital gains. See **Capital Gains and Losses on Sale or License of Trade Secret**

Compensation for agreement

Down payment, 8.14-1

Royalty payments (see Royalties, below)

Terms for payment, 8.18

Computer software. See **Computers and Computer Software**

Conversion of trade secret license into patent license, 7.6

Default

Additional time to cure default, 8.31-6

Failure to perform other covenants, 8.31-4

Grace period, 8.31-3, 8.31-5

Heading and introduction, 8.31-1

Insolvency provisions, 8.31-7

Payment defaults, 8.31-2

Remedies (see Remedies, below)

Disclosure before licensing

Confidentiality and disclosure agreement, 7.34, 7.36

Demonstration of trade secret's benefits, 7.33

Initial logistic problems in licensing trade secret, 7.32

Look-see fee, recovery of expenses in preparing prelicensing materials for prospective licensee through use of, 7.35

Nonconfidential information, disclosure to prospective licensee of, 7.33

Disclosure of information

Nonproprietary information, disclosure of, 8.26-1

Technical information, 8.24

Termination of royalty obligationsby licensee after disclosure of trade secret, 8.26-2

Domestic versus foreign patent rights

Issuance of patent, effect on trade secret license, 7.6

Value of patent, variation among countries, 7.5

Drafting suggestions, 7.11

Employee's use of employer's time and resources in making development, employer's nonexclusive and nontransferable implied license to use development, 2.6

Exclusivity of license

Generally, 7.11

Antitrust considerations, 7.26

Computer software license, nonexclusive provision, 16.7

Hybrid licenses, exclusivity versus nonexclusivity of, 7.24

Royalty rate, effect of exclusive license in determining, 7.21

Sale of trade secret, exclusive trade secret license as, 15.37

Secrecy provision in licensing agreement, 8.25-2

Standing of licensee to sue, 7.11

Tax treatment of exclusive and nonexclusive types of licenses, 15.10

Fees

Attorney fees (see Attorney fees, above)

Computer software, fee for licensing, 16.11

Look-see fee determined by trade secret's value, 7.35

Foreign patent rights (see Domestic versus foreign patent rights, above)

Form for licensing agreement

Amendments, 8.35

Arbitration, provision providing for, 8.33

Attorney fees, 8.42

Binding effect of agreement, 8.44

Choice of law, 8.41

Compensation (see Compensation for agreement, above)

Construction of agreement, 8.36

Default (see Default, above)

Definitions, 8.4

Disclosure of information (see Disclosure of information, above)

Duration of agreement (see Time, below)

Exclusive license, secrecy provisions for, 8.25-2

Exhibits, 8.38

Governing law, 8.41

Grant-back provision, 8.23-1

Grant clause (see Grant clause identifying rights conferred in licensed trade secret, below)

Headings, 8.40

Improvements (see Improvements or modifications, below)

Integration of agreement, 8.37

Licensed patents defined, 8.4-4

Licensed processes and licensed products defined, 8.4-5

Licensed property defined, 8.4-6

Licensed trademarks defined, 8.4-9

Licensee and licensor defined, 8.4-10

Notice, provision requiring, 8.34

Paid up license, 8.17A

Primary licensed territory defined, 8.4-11

Recitals, 8.3

Record address of parties, 8.34

Records, 8.28

Remedies (see Remedies, below)

Reports, 8.27

Royalties (see Royalties, below)

Secrecy, 8.25-1

Severability of provisions, 8.43

Signature block, 8.45

Sublicenses (see Sublicenses, below)

Technical information (see Technical information, below)

Territorial restrictions (see Territorial restrictions on license, below)

Third parties (see Third parties, below)

Title and introduction, 8.2

Trademarks, use of, 8.19

Trade secrets defined, 8.4-14

Waiver of breach of agreement, restrictions on, 8.39

Warranties (see Warranties, below)

Geographical restrictions on license (see Territorial restrictions on license, below)

Grant clause identifying rights conferred in licensed trade secret

Generally, 7.7, 8.5

Basic grant clause, 8.6

Exclusivity of license, 7.11

Geographic territory in which licensed product may be exploited, restrictions on, 7.10

Licensed intellectual property, identification of, 7.8

Licensed product, limiting use of trade secret identifying, 7.9

Licensee's modifications to licensed subject matter, improvement owned by licensor, 8.13-1

Licensee's modifications to licensed subject matter, improvement owned by party developing modifications, 8.13-2

Patent applications, grant clause for licensing trade secrets disclosed in, 8.9

Restrictive grant clause, 8.7

Sublicenses (see Sublicenses, below)

Trade secret and patent hybrid licenses, grant clauses for, 8.8

Trade secret and trademark hybrid licenses, grant clauses for, 8.10

Hybrid license, grant clause for trade secret in combination with trademark, 8.10

Hybrid licenses, trade secret license in combination with patent rights

Generally, 7.3, 7.24

Domestic versus foreign patent rights (see Domestic versus foreign patent rights, above)

Grant clauses for trade secret and patent hybrid licenses, 8.8

Invalid patent, standing of licensee to challenge, 7.4

Lear doctrine, applicability to hybrid licenses, 7.4-7.4A

Royalties, allocation of, 8.17

Improvements or modifications

Definition of improvements, 8.4-2

Future improvements, 8.22

Grant clause (see Grant clause identifying rights conferred in licensed trade secret, above)

Royalty payments, assignment or licensing of licensee's improvements or modifications to licensor, 8.15-4

Indemnification of third parties (see Third parties, below)

Learned intermediary used to evaluate licensing agreements, 7.35A

Modifications

Grant clause (see Grant clause identifying rights conferred in licensed trade secret, above)

Improvements (see Improvements or modifications, above)

Oral agreement for licensing of trade secret, 7.2

Paid up license, 8.17A

Patents

Application for patent, grant clause for licensing trade secrets disclosed in, 8.9

Exclusive licensing agreement, effect of, 7.11

Hybrid license (see Hybrid licenses, trade secret license in combination with patent rights, above)

Royalties (see Royalties, below)

Standing of licensee to challenge invalid patent, 7.4

Preliminary information required by attorney before drafting licensing agreement, 8.1

Relationship with prospective licensee, confidentiality obligations arising from, 10.45

Remedies

Damages, recovery of, 8.32

Heading and introduction, 8.32-1

Liquidated damages, 8.32-5

Postdefault interest, 8.32-2

Right to terminate agreement, 8.32-3

Specific performance, 8.32-4

Royalties

Generally, 7.19

Allocation of royalties in hybrid trade secret and patent license, 8.17

Basic royalty provision, 8.15-1

Basis for calculation of royalties, designation in licensing agreement of, 7.22

Definition of royalties, 8.4-12

Disclosure of trade secret, licensee's termination of royalty obligations after, 8.26-2

Down payment for licensing agreement, crediting against royalties, 8.14-2

Economic incentive to practice trade secrets in designated territory, royalty provision providing, 8.16

Establishing royalty rates, 7.21

Estate tax on unpaid royalties, 15.48

Exception to *Lear* doctrine, 7.4A

Expiration of patent, per se illegality of contract requiring payment of royalties after, 7.4

Formula or set amount, royalty established by, 7.16

Hybrid licenses, 7.24

Improvements or modifications by licensee assigned or licensed to licensor, 8.15-4

Income in respect of decedent, treatment of royalties owed on sale or license of trade secret, 15.48

Issuance of patent, increase of royalties on, 8.15-5

Issuance of patent, value of licensed property decreasing on, 8.15-6

Limiting licensed technology to use with identified products as aid in monitoring compliance with royalty provisions of license, 7.9

Look-see fee credited towards royalties, 7.35

Loss of trade secret, continued royalty payments despite, 7.20

Maximum royalty payment, 7.23, 8.15-3

Minimum royalty payment, 7.23, 8.15-2

Structured royalty rate as part of, 7.3

Validity of patent, right to collect royalties up to time of challenging, 7.4

Software licensing agreement. See **Computers and Computer Software**

Standing

Exclusive licensee's standing to sue, 7.11

Invalid patent, standing of licensee to challenge, 7.4

Sublicenses

Generally, 7.12

Grant-back license involving right to sublicense, 8.23-2

Grant clause with no right of sublicense, 8.11

Grant clause with right of sublicense, 8.12

Taxes. See **Taxes**

Technical information

Defined, 8.4-13

Disclosure of, 8.24

Territorial restrictions on license

Generally, 7.10

Antitrust considerations, 7.27

Exclusivity provisions of license limited to restrictions regarding territory, 7.11

Hybrid licenses, description of licensed territory in agreement for, 7.24

Licensed manufacturing territory, definition of, 8.4-3

Licensed sales territory, definition of, 8.4-7

Licensed territory, definition of, 8.4-8

Primary licensed territory, definition of, 8.4-11

Royalty provision providing eco-nomic incentive to practice trade secrets in designated territory, 8.16

Third parties

Licensee indemnifying licensor, 8.29-2

Licensor indemnifying licensee, 8.29-1

Time

Computer software license, duration of, 16.6

General provision for duration of agreement, 8.30

Trademarks. See **Trademarks**

Types of licenses

Exclusive licenses (see Exclusivity of license, above)

Express versus implied license, 7.2

Hybrid licenses (see Hybrid licenses, trade secret license in combination with patent rights, above)

Unfair competition, licensing restrictions as, 7.11

Valuation of trade secrets

Generally, 7.13

Cost of developing trade secret, 7.15

Desirability of trade secret, value determined by, 7.17

Litigation involving infringement or theft of trade secret, effect on trade secret's value of delay in licensing, 7.18

Look-see fee determined by trade secret's value, 7.35

Owner's use of trade secret, valuation of trade secret influenced by, 7.14

Projected net profit, allocating percentage of, 7.16

Relative value of patent rights and trade secret rights in licensing trade secrets in combination with patent rights, 7.3

Royalty rate (see Royalties, above)

Warranties

General provision for, 8.20

Limits on warranties, 8.21

Limitation of Actions. See Statutes of Limitations

Litigation of Non-UTSA Claims

Generally, 11.35

Antitrust violation, bad faith action for trade secret misappropriation as, 11.2, 11.36

Civil conspiracy, 11.42

Common law misappropriation of trade secrets, 11.46

Confidentiality, elements of breach of duty of, 11.37

Contract, breach of. See **Breach of Contract**

Conversion of property. See **Conversion**

Copyright Act. See **Copyrights**

Fiduciary duty, action based on breach of, 11.45

Fraud or constructive fraud, wrongful acquisition of trade secret through, 11.44

Interference with prospective business advantage, 11.47

Lanham Act. See **Lanham Act**

Noncompetition agreement, breach of, 11.41

Patents. See **Patents**

Possession, civil writ for stolen property, 11.51

Trade libel, 11.48

Unfair competition. See **Unfair Competition**

Unjust enrichment, 11.50

Litigation of Trade Secret Misappropriation

Attorney fees, award of, 1.15, 11.2, 12.23

Burden of proof

Affirmative defenses, 1.8A

Secrecy, plaintiff's burden in misappropriation action to show reasonable efforts to maintain, 4.8, 16.29

Business entities (see Persons or business entities, filing lawsuits against, below)

Choice of law. See **Choice of Law**

Common law right of public access to court documents in civil trial, 11.33C

Continuous misappropriation as single claim, 11.13B

Costs of litigation. See **Costs**

Damages. See **Damages**

Defenses

Independent development and reverse engineering as defenses to charges of misappropriation, 1.13

Ready ascertainability of information as defense to claim of trade secret misappropriation, 1.8A, 1.14

Reverse engineering as defense to claim of misappropriation, 1.13, 10.36

Disclosure of trade secrets

Nonlitigant, lack of privilege for disclosure by, 11.30-11.30A

Special master, disclosure by, 11.33A

Discovery. See **Discovery**

Dismissal of action. See **Dismissal of Actions**

Expert appointed by court, 11.32

Forum selection clause

Generally, 11.38

Limits on scope of, 11.6A

Identifying trade secrets

Generally, 11.21

Failure to identify trade secret, effect of, 11.24

Federal court, identifying trade secret in, 11.22

Reasonable particularity, identifying trade secret in protective order with, 11.21A

Strategies for identifying trade secrets, 11.23

In limine motions to restrict evidence to eliminate undue prejudice, 11.33B

Investigation of case prior to filing complaint, 11.2

Issues at trial, 11.33

Jurisdiction and venue

Generally, 11.6

Agency relationship, personal jurisdiction over misappropriator of trade secrets based on, 11.6

Choice of law specified in parties' agreement, effect of forum on application of, 12.7

Claims arising under federal law, test for determining, 11.10

Diversity jurisdiction, requirements for, 11.9

Enforcement of order after conclusion of litigation, retaining jurisdiction for purposes of, 11.34

Federal versus state court, applicable law, 11.7

Forum selection clause (see Forum selection clause, above)

Fraudulent joinder of defendants, removal of action to state court, 11.9

Injunctions, court's personal jurisdiction over misappropriators for purposes of, 12.8

Internet use, exercise of personal jurisdiction based on, 11.6C

Lanham Act, concurrent federal and state jurisdiction under, 11.53

Racketeer Influenced and Corrupt Organizations Act (RICO) claims, state courts' concurrent jurisdiction over, 11.55

Removal of action to federal court, 11.8

Stipulation to venue, effect of public policy on, 11.6A

Supplemental jurisdiction of federal courts over related state claims, 11.11

Unfair competition related to patent, trademark, or copyright claims, 11.12

Motions (see Pretrial motions, below)

Personal jurisdiction (see Jurisdiction and venue, above)

Persons or business entities, filing lawsuits against

Generally, 11.3

Declaratory judgment, accused misappropriator's motion for, 11.4

Insurance coverage, lawsuit triggering, 11.5

Posttrial motion to place evidence under seal, 11.33C

Pretrial motions

Demurrers, 11.17

Dismissal of action for failure to state claim, 11.17

Preliminary injunction and temporary restraining order, 11.15

Summary judgment, 11.18

Transfer of federal action to other district or division, 11.16

Public access to court documents, 11.33C

Reasonable diligence in discovery of misappropriation, determination of, 11.13A

Self-incrimination, fifth amendment privilege against, 11.31

Specious claims, 12.23

Statute of limitations under Uniform Trade Secrets Act (UTSA). See **Misappropriation of Trade Secrets**

Submission of ideas, litigation over. See **Submission of Ideas**

Tax consequences of trade secret litigation, 15.52

Value of trade secret, effect of litigating infringement or theft of trade secret on, 7.18

Venue (see Jurisdiction and venue, above)

Local Government

Liability of government agencies or employees for improper disclosure of trade secret information, 5.26

Proprietary information, protection for in dealings with local government, 5.25

Lost Profits

Common law remedy for third party's disclosure of trade secrets resulting in loss profits, 12.20

Future sales, effect of injunction barring future use of trade secrets on recovery of lost profits based on, 12.21

Income tax on recovery of lost profits, 15.52

Measure of damages under UTSA, inclusion of lost profits in, 12.20

Mail and Wire Fraud

E-mail used to entice employees into revealing trade secrets as wire fraud, 13.9

Penalty for mail and wire fraud, 18 USC §§1341, 1343, 13.6

Racketeering activity, mail or wire fraud constituting pattern of, 11.55

Malicious Prosecution

Insurer's liability for bringing declaratory relief action against insured, 14.16

Malpractice. See Medical Malpractice

Manuals

Employee manual, instructions on confidential material in, 4.12

Specifications or technical manuals, confidentiality of information disclosed to potential contractor, 10.44

Manufacturing Methods

Protection of manufacturing methods as negative information, 1.4

Marketing and Financing Plans

Protection of marketing and financing plans as trade secrets, 1.4

Mass-Marketed Software. See Computers and Computer Software

Medical Malpractice

Unauthorized diagnostic bloodtest, plaintiff's action basedon, 17.8

Microorganisms. See Biotechnology

Misappropriation of Trade Secrets

Generally, 11.3

Accident or mistake, effect of acquiring trade secret by, 10.48

Amendment of claim, 11.29

Attorney General, absolute privilege for communications to, 13.12

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Biotechnology. See **Biotechnology**

Burden of proof

Misappropriator's burden of proof to show trade secret no longer secret, 12.10

Reasonable efforts to maintain secrecy, burden on plaintiff in action for misappropriation of trade secret to show, 4.8, 16.29

Summary judgment motion, accused party's burden of showing action lacks merit, 11.18

Uniform Trade Secrets Act (UTSA), burden of proof under, 11.33

Common law claims

Attorney fees in action for misappropriation of trade secrets under common law, 12.23

Requirements for, 11.46, 12.20

Uniform Trade Secrets Act superseding common law misappropriation claims, 3.5

Confidentiality provisions of licensing agreement, effect of failure to abide by, 10.39

Constructive knowledge of misappropriation, 1.11

Continuous misappropriation of trade secrets as single claim, 2.1, 11.13B

Conversion as form of misappropriation, 11.43

Copyright Act, preemption of misappropriation claim by. See **Copyrights**

Criminal liability for misappropriation. See **Criminal Liability for Trade Secret Misappropriation**

Damages. See **Damages**

Defense to claim of misappropriation. See **Litigation of Trade Secret Misappropriation**

Defined, 1.11, 10.31, 10.37, 11.44, 14.9

Director's or officer's liability for, 10.40

Economic Espionage Act (EEA). See **Economic Espionage Act(EEA)**

Employers and employees. See **Employers and Employees**

Hiring competitor's employee not constituting, 10.8

Improper means, acquiring trade secret by, 10.47

Independent contractor as agent of misappropriator of trade secret, 11.6

Individual defendants, disadvantage of naming in complaint, 11.3

Inevitable disclosure. See **Inevitable Disclosure of Trade Secret**

Injunction against trade secret misappropriation. See **Injunction Against Trade Secret Misappropriation**

Insurance coverage. See **Insurance Coverage for Trade Secret Misappropriation**

Investigation of misappropriation

Failure to investigate, effect of, 11.13A, 17.27

Filing complaint for misappropriation of trade secrets, importance of investigation before, 11.2

Prefiling investigation, 11.19

Litigation. See **Litigation of Trade Secret Misappropriation**

Proof

Burden of proof (see Burden of proof, above)

Circumstantial evidence proving misappropriation of trade secrets, 1.12

Computer software program, proof of misappropriation of, 16.28

Reverse engineering or independent development defense to charges of misappropriation of trade secret, proof of, 1.13

Publication of misappropriated information under name of non-author, true author's claim under Lanham Act, 11.53

Punitive damages, 1.15, 12.22

Reasonable diligence in discovery of misappropriation, determination of, 11.13A

Remedies for misappropriation. See **Remedies for Trade Secret Misappropriation**

Security measures to prevent misappropriation of trade secrets. See **Security Measures To Protect Trade Secrets**

Solicitation of former employer's customers as misappropriation of trade secret, 1.12

Standing to bring misappropriation of trade secret action, effect of lack of ownership on, 11.28

Statute of limitations for misappropriation claim under UTSA

Generally, 2.1, 11.13

Constructive knowledge of misappropriation commencing limitations period, 11.13A

Failure to investigate misappropriation constituting actual or constructive knowledge, 11.13A

Third party misappropriator, commencing of statute of limitations for action against, 11.13B

Tolling of statute for concealment of misappropriation, 11.13C

Style of doing business, misappropriation of, 14.2

Uniform Trade Secrets Act, California (UTSA)

Application of Act to misappropriations of trade secrets occurring after January 1, 1985, 1.2

Burden of proof under, 11.33

Common types of misappropriation, 1.12

Contractual or civil remedies not based on misappropriation of trade secret, no preemption under Act of, 1.16

Definition of misappropriation under Act, 1.11

Independent development and reverse engineering as defensesto charges of misappropriation, 1.13

Injunctive relief under Act for misappropriation of trade secret, 12.7

Preemption of common law misappropriation by UTSA, 11.23

Preemption of state law claims based on same facts as trade secret misappropriation, 11.49

Remedies for actual or threatened misappropriation of trade secret, 1.16

Statute of limitations for misappropriation claim (see Statute of limitations for misappropriation claim under UTSA, above)

Unknown or future acts of trade secrets misappropriation, 11.34

Unsolicited ideas, misappropriation charge based on receipt of. See **Submission of Ideas**

Waiver of attorney-client privilege in cases of crime or fraud in misappropriation of trade secret, 11.44

Misrepresentation. See Fraud and Misrepresentation

Mistake

Confidential information obtained by accident or mistake, prohibition against using, 10.48

Privileged information, inadvertent disclosure of, 11.20A

Mobile Employees. See Avoiding Misappropriation Claims

Model Uniform Trade Secrets Act. See Uniform Trade Secrets Act (Proposed)

Modifications. See Amendments and Modifications

Monopolies

Denial of copyright protection if copyright resulting in monopoly, 16.50

National Stolen Property Act

Misappropriation of trade secrets, criminal prosecution of, 13.8

Negative Information

Protection of negative information as trade secret, 1.4, 1.6, 12.8

Negligence

Interference with prospective business advantage, liability for wrongful negligent act, 11.47

Negotiations

California forum, parties negotiating away right to, 6.31

Complaint's failure to trigger advertising injury coverage, insured's negotiations with plaintiff to amend complaint, 14.18

Confidentiality and disclosure agreement during negotiation of licensing agreement, 7.34, 7.36

No-Hire Agreement. See Employers and Employees

Noncompetition Agreement. See Covenant Against Competition

Nondisclosure Agreements (NDAs)

See also **Confidentiality; Employee Confidentiality Agreements**

Advising client on, 3.4

Buy-sell agreement, effect on intellectual property rights defined in non-disclosure agreement, 4.7

Disputes over, 10.20

Effect of, 2.33A

Identification badge and visitor's confidentiality and nondisclosure agreement, 6.44

Outsiders, nondisclosure agreements with, 4.7

Submission of ideas, non-disclosure agreement providing for specific period of confidentiality, 3.27

Third parties, nondisclosure agreements with, 4.7

Nonmeritorious Claims. See Frivolous and Nonmeritorious Claims

Nonprofits Organizations

Federal research grants for nonprofit institutions, disclosure of data under FOIA, 17.9

Notice and Notification

Computerized customer list, owner's duty to notify customers of security breach when personal information acquired by unauthorized person, 16.2

Computer software license. See **Computers and Computer Software**

Contempt action requiring notice of enjoined activities, 12.8

Copyright notices. See **Copyrights**

Customers, notification distinguished from solicitation of, 11.41

Delivery of material with notice of confidentiality and other proprietary legends, 3.24

Employee's possession of company's trade secrets, notice to new employer regarding, 4.15

Financing statement, notice to third parties of security interest in collateral, 9.12

Inventions

Confidentiality and invention assignment agreement. See **Employee Confidentiality Agreements**

Employment agreement provision requiring employee to assign invention to employer, notifying employee of inapplicability of provision to invention qualifying under Lab C §2870, 2.19

Licensing agreement, notice provision in, 8.34

Noncompetition agreements. See **Covenant Against Competition**

Patent notice, absence of, 10.28

Work-product privileged documents, notifying opposing counsel of inadvertent disclosure of, 11.20A

Officers of Corporation. See Corporations

On-Site Employees From Another Company. See Confidentiality

Oral Contracts

Confidentiality, enforceability of oral contract for, 4.5

Licensing of trade secret, oral agreement for, 7.2

Other States

Civil trade secrets statutes in, App D

Ownership of Trade Secrets

Generally, 2.1

Assignment of trade secret. See **Assignments**

Common law rules affecting ownership

Generally, 2.2

Corporate opportunity doctrine, fiduciary duty of corporate officer to assign invention made by officer to corporation, 2.10

Employer versus employee (see Employer versus employee under common law, below)

Estoppel, ownership of trade secret arising by, 2.11

Independent contractor, ownership of trade secret developed by, 2.11

Computer program, ownership of. See **Computers and Computer Software**

Concurrent interests (shop right doctrine)

Breach of confidential duty, exception to shop right doctrine involving, 2.8

Estoppel, shop right arising by, 2.7

Time and resources belonging to employer, employee's use of, 2.6

Transferability of shop rights, limits on, 2.9

Definitions (see Statutes affecting ownership, below)

Disclosure of trade secret

Environmental impact statement, trade secret not subject to public disclosure in, 2.16

Limits on owner's privilege to refuse, 11.26

Nondisclosure agreement, effect of, 2.33A

Parties to dispute regarding ownership of trade secret preventing disclosure to third parties, 2.13

Employer versus employee under common law

Generally, 2.3

Change in job duties to "inventing status", effect of, 2.4

Concurrent interests (see Concurrent interests (shop right doctrine), above)

Employee hired to invent, determination if, 2.4

Know-how trade secrets, determining ownership of, 2.5

Preliminary considerations in determining ownership, 2.5

Independent contractor, ownership of trade secret developed by, 2.11, 2.23

Other intellectual property, effect on ownership

Generally, 2.33

Confidentiality agreements, 2.33A

Copyright protection, no federal preemption of state trade secrets laws, 2.34

Patent protection, effect on state trade secrets laws, 2.35

Preparing to compete doctrine, employee's right to prepare for starting own business or join competing business, 2.10

Presumption of ownership

Control over intangibles, ownership dependent on, 2.24

Employment, ownership dependent on, 2.23

Person taking steps to protect trade secrets, presumption of ownership for, 2.25

Shop right doctrine (see Concurrent interests (shop right doctrine), above)

Standing to bring misappropriation of trade secret action, effect of lack of ownership on, 11.28

Statutes affecting ownership

Generally, 2.12

Bus & P C §§16606, 16607(a), definition of trade secrets under, 2.17

Economic Espionage Act, definition of trade secrets under, 2.21A

18 USC §1905, definition of trade secrets under, 2.21

Evid C §§1060-1061, definition of trade secrets under, 2.18

First Amendment right of accessto government documents, 2.18A

Govt C §6254.7(d), definition of trade secrets under, 2.16

Lab C §§2860, 2870(a), definition of trade secrets under, 2.19

Multiple statutes affecting ownership, application of, 2.22-2.25

Pen C §499c, definition of trade secrets under, 2.15

Presumption of ownership (see Presumption of ownership, above)

Restatement of Law (Third) on Unfair Competition, definition of trade secret under, 2.21B

Rev & T C §11342, definition of trade secrets under, 2.20

Statutory definitions of trade secrets, 2.13-2.21

Uniform Trade Secrets Act, definition of trade secrets under, 1.3, 2.14

Partnerships

"Clean room" for independently replicating technology once licensed from former partner, 10.20

Covenants against competition. See **Covenant Against Competition**

Duty of confidentiality arising from relationship between partners, 10.41

Fiduciary duty of partners to co-partners, 11.45

Sale or liquidation of partnerships, effect on trade secret owned by partnership, 15.50

Patents

Generally, 2.35, 11.54

Absence of patent notice, effect of, 10.28

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Biotechnology. See **Biotechnology**

Comparison of trade secrets, patents, copyrights, and trademarks, App C

Computer technology, patent protection for. See **Computers and Computer Software**

Confidentiality

Application for patent, confidentiality trade secret matter in, 7.6

Microorganism deposit for patent filing, confidentiality until patent issued, 17.12

Defective patent, antitrust liability for enforcement of, 17.17

Definition of licensed patents, 8.4-4

Disclosure of information in patent application, effect of

Generally, 1.8, 2.35, 10.32, 11.54, 16.61

Foreign patent applications, availability of information for use in U.S., 10.33

Distinguishing between trade secret and patent protection, 10.34, 11.21

Employer's ownership of patentable invention created by employee, 10.17

Expired patents, 10.32

Federal law, patent's involvement in dispute not raising question of, 11.10

Federal preemption

Common law misappropriation of trade secret, preemption by patent statutes, 11.46

State protection of trade secrets not preempted by patent law, 2.35, 10.34

Unpatented product, federal preemption of state law prohibiting copying of, 10.29

U.S. patent laws, no preemption of trade secret protection by, 11.54

General knowledge and skills, prohibition against patent protection for, 10.30

Improvements to patented invention, trade secret protection for, 8.22

Internet posting of information, effect on patent, 10.31

Jurisdiction over patent claims, federal law governing, 11.7

License of trade secrets in combination with patent rights. See **Licensing Agreements**

Nonpublication at application to protect trade secrets, request for, 16.62, 17.17

Permission of patent holder to make, use, sell, or offer to sell patented invention, requirement of, 10.23

Publication of patent application

Generally, 7.6, 11.54, 16.62

Early publication of patent application if submitter chooses to make non-confidential disclosure, 3.4

Time limit for publishing patent application after priority filing date, 2.35

Public domain information, nonpatentability of, 10.24

Self-developed patents, nonapplicability of amortization rules to, 15.18

Submission of ideas after filing for patent. See **Submission of Ideas**

Unauthorized disclosure, patent rights lost because of, 11.54

Unfair competition claim joined with patent claim, original jurisdiction of federal court over, 11.12

Validity of patent, agreement not to challenge, 7.4A

PCs. See Computers and Computer Software

Penal Statutes Protecting Trade Secrets. See Criminal Liability for Trade Secret Misappropriation

Penalties

Bad faith action against competitor, sanctions for, 11.2

Contempt. See **Contempt**

Digital Millennium Copyright Act, penalties for distributing hardware of software designed to defeat encryption technology, 16.59A

Dismissal of action as sanction. See **Dismissal of Actions**

Economic Espionage Act, penalties for violation of, 13.9A, 17.4A

Forfeiture. See **Forfeiture**

Misappropriation of trade secrets, criminal liability for. See **Criminal Liability for Trade Secret Misappropriation**

Preventing employee from obtaining new employment by misrepresentation, penalties for, 4.15

Protective orders for secrecy of trade secret, penalties for violation of, 11.20D

Perfection of Security Interest. See Security Interests in Trade Secrets

Physicians and Surgeons

Research and commercialization of patient's body cells, doctor's breach of fiduciary duty in failing to disclose, 17.8

Plants and Seeds

Patent protection for sexually and asexually reproduced plants, 17.11

Registration of seeds for protection under Plant Variety Protection Act (PVPA), 17.11

Secrecy of corn seed lines, reasonable efforts to maintain, 17.25

Possession, Writ of

Recovery of stolen property by use of civil writ of possession, 11.51

Preemption

See also **Federal Preemption**

Misappropriation of trade secrets, preemption of California civil remedies, 11.35

Uniform Trade Secrets Act. See **Uniform Trade Secrets Act, California (UTSA)**

Prejudice. See Bias and Prejudice

Preliminary Injunctions. See Injunction Against Trade Secret Misappropriation

Presumptions and Inferences

Access to court documents, presumption of, 11.33C

Copyright registration, presumption of validity for, 16.44, 16.46

Legislature's enactment of legislation with knowledge of existing statutes, presumption affecting, 1.2

License agreement for trade secret, presumption of nonexclusivity, 7.11

Ownership of trade secret by employer, statutory presumption of. See **Ownership of Trade Secrets**

Reasonable efforts to maintain secrecy of trade secret, presumption of lack of protection absent showing of, 4.8

Written agreement, presumption of consideration from, 2.27

Price Controls

Resale price maintenance as per se violation of trade secret license, 7.28

Privacy Act of 1974, 5.19

Privilege

Anti-SLAPP claims, 11.30C

Attorney-client privilege. See **Attorney-Client Privilege**

Communications to Attorney General regarding misappropriation of trade secrets, absolute privilege for, 13.12

Disclosure of trade secret, limits on owner's privilege to refuse, 11.26

Expert's fraudulent documents, nonapplicability of litigation privilege to, 11.33A

Joint defense or common interest doctrine not recognized privilege in California, 11.20A

Litigation privilege, restrictions on, 11.30-11.30A

Self-incrimination, fifth amendment privilege against, 11.31

Testimony privilege, exclusion of trade secret information from, 11.30-11.30A

Work-product privilege. See **Work-Product Privilege**

Procedural Audits for Protecting Trade Secrets. See Trade Secret Audits

Proof

See also **Burden of Proof**

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Proprietary Rights Legends

Generally, 4.19, 6.3

Computers and software

Electronically retained documents, 6.5-3

Federal acquisition regulations (see Federal acquisition regulations, below)

Copyright notices. See **Copyrights**

Electronic mail and facsimile transmissions, long-form legend for, 6.6-1

Federal acquisition regulations

Generally, 6.9

Commercial items provided to government, legend for, 6.10-1

Commercial software productCDs, legend for, 6.10-2

Freedom of Information Act, legend claiming exemption from, 6.11

Noncommercial items provided to government, legend for, 6.10-3

Government contractors submitting proprietary information to federal government, marking information with appropriate legend, 5.18

Highly confidential or restricted information (short-form legend), 6.4-3

Limited right to copy electronic mailor facsimile transmissions, 6.6-2

Limiting information to internal use (short-form legend), 6.4-1

Limiting information to need to know (short-form legend), 6.4-2

Long-form restricted rights legend (general use), 6.5-1

No right to copy electronic mail or facsimile transmissions, 6.6-3

Restrictions on dissemination of document, 6.5-2

Software (see Computers and software, above)

Submission of unsolicited material

Effect of marking material with confidentiality notices andother proprietary legends, 3.24

Implied confidential relationship between submitter of idea and recipient based on proprietary legend, 3.4

Protection Plans for Trade Secrets.See Security Measures To Protect Trade Secrets

Protective Orders

Generally, 11.20

Economic Espionage Act, 13.9A

Effect of, 11.20A

Establishing good cause for protective order, court prohibited from delegating responsibility to counsel, 11.33C

Federal court, order compelling disclosure requiring proof information relevant and necessary to lawsuit, 11.20B

Identifying trade secret with reasonable particularity in, 11.21A

Independent source, effect of obtaining information from, 11.20D

In-house counsel prohibited from access to opposing party's trade secrets materials under protective order, 11.20

Third party's access to information subject to protective order, 11.20A

Trial, protection of trade secret at, 11.33C

Publication

Internet publication of trade secrets, 10.31, 11.20C, 11.30D, 16.42A

Misappropriated information published under non-author's name, true author's claim under Lanham Act, 11.53

Obscure publication of information, effect on trade secret status of information, 1.8A

Patent application. See **Patents**

Public Domain

Avoiding misappropriation claims, determining if information in public domain. See **Avoiding Misappropriation Claims**

Engineering principles in public domain, lack of trade secret protection for, 1.9

Internet, effect on public domain, 10.31

Public Knowledge. See General Knowledge and Skills

Public Policy

Choice of law provision, unenforceability if in violation of California public policy, 6.31, 8.41

Employee's right to move freely in labor market, 1.2, 2.32, 10.8, 10.38, 11.41, 12.13

Foreign country's public policy, California court's application of, 6.31

Suppression of evidence, public policy against agreements for, 11.20A

Venue, unenforceability of stipulation in violation of public policy, 11.6A

Public Records Act. See California Public Records Act (CPRA)

Punitive Damages

See also **Damages**

Breach of confidentiality, award of punitive damages for, 11.37

Breach of contract, punitive damages for, 11.40

Constructive fraud claim, punitive damages for, 11.44

Misappropriation of trade secrets, 1.15, 11.40, 12.22

Trade libel, damages for, 11.48

Unfair competition, punitive damages under common law for, 11.49

Uniform Trade Secrets Act. See **Uniform Trade Secrets Act, California (UTSA)**

Questionnaires. See Charts, Checklists, Questionnaires, and Tables

Questions of Law and Fact

Confidential relationship between submitter of idea and recipient as question of fact, 3.4

Existence of trade secret, 11.18

General knowledge and skill versus trade secrets, factual analysis of, 1.9

Insurance contract, interpretation of contract as question of law, 14.16

Punitive damages as factual question for federal jury, 12.22

Reasonable efforts to maintain secrecy as question of fact, 4.8

Racketeer Influenced and Corrupt Organizations Act (RICO)

Generally, 11.55

Criminal penalty for stealing trade secrets under, 13.7

Ready Ascertainability of Information. See Uniform Trade Secrets Act, California (UTSA)

Real Property

Capital assets, real property used in trade or business excluded from definition of, 15.34

Expenditures to acquire land, nondeductibility of, 15.22

Receiving Stolen Property

Pen C §496, penalties for receiving stolen property, 13.4

Recordation of Instruments

Model State Trademark Law, recordation of instruments under, 9.13

Records and Reports

California Public Records Act. See **California Public Records Act (CPRA)**

Commercial records, construction of term, 5.14

Discovery. See **Discovery**

Freedom of Information Act. See **Freedom of Information Act (FOIA)**

Government regulation requiring business to maintain records as insufficient grounds for seizing records in warrantless search, 11.32

Independent development of ideas, importance of keeping records showing, 10.2

Licensing agreement provisions for records and reports, 8.27-8.28

Municipal court records, transfer to superior court, 2.18

Public access to court documents in civil trial, common law right of, 11.33C

Sealing records, 11.33C

Unlabeled documents' eligibility for treatment as trade secret under California Uniform Trade Secrets Act (UTSA), 6.3

Unsealed court records, information not considered generally known as result of being in, 4.2

Release in Trade Secrets Dispute, 4.2

Religious Beliefs

Economic value, religious scripture lacking in, 1.6

Remedies for Trade Secret Misappropriation

Generally, 1.16

Attorney fees, award of, 12.23

Contractual and criminal remedies for trade secret misappropriation, 12.25

Costs awarded to prevailing party, 12.24

Damages. See **Damages**

Injunctions. See **Injunction Against Trade Secret Misappropriation**

Royalties for misappropriation of trade secrets. See **Royalties**

Summary of available remedies, 12.1

Removal

Generally, 11.8

Fraudulently joined defendant, removal to state court if diversity based on, 11.9

Reports. See Records and Reports

Research

See also **Independent Development**

Avoiding misappropriation claims. See **Avoiding Misappropriation Claims**

Biotechnology research. See **Biotechnology**

Deductions for. See **Taxes**

Entrance interview to determine previous employer's proprietary rights to employee's research and technology development, 17.27

Patient's body cells, doctor's breach of fiduciary duty in failing to disclose research and commercialization of, 17.8

Restitution

Unfair business practice, restitution as remedy in action for, 11.49

Reverse Engineering

See also **Independent Development**

Computer program, copying of copyrighted program as fair use in reverse engineering process, 16.48

Defined, 10.36

License agreement for trade secret, cost of reverse engineering as factor in valuing trade secret, 7.15

Misappropriation of trade secret, reverse engineering as defense to claim of, 1.13, 10.36

Royalties, effect of reverse engineering of trade secret on obligation to pay, 7.20

RICO. See Racketeer Influenced and Corrupt Organizations Act (RICO)

Royalties

Injunction against misappropriation of trade secret, court's imposition of royalty in lieu of, 12.12

License agreements, royalties for. See **Licensing Agreements**

Reasonable royalty awarded by court in lieu of damages for trade secret misappropriation, 1.15, 11.54, 12.21

Reverse engineering of trade secret, effect on obligation to pay royalties, 7.20

Rules of Court

Public access to court documents, local rules of court affecting right of, 11.33C

Safety Standards

Biological materials, safety precautions to enhance security for, 17.26

Salaries. See Compensation

Sale of Property

Assignment, transfer of trade secret by sale characterized as, 15.36

Capital gain from sale of trade secret. See **Capital Gains and Losses on Sale or License of Trade Secret**

Contract of sale or license of trade secret, gift to third party as anticipatory assignment of income, 15.49

Estate tax on unpaid royalties for sale or license of trade secret, 15.48

Installment sale of trade secrets subject to imputed interest rules, 15.40

Secured creditor's sale or disposition of trade secret held as collateral, 9.17

Tax consequences of sale. See **Taxes**

Unintended release of information on product sales, prevention of, 4.26

Sanctions. See Penalties

Search and Seizure

Government regulation requiring business to maintain records as insufficient grounds for seizing records in warrantless search, 11.32

Secretary of State

Address for, 9.13

Filing financing statements against debtors or collateral in California with Secretary of State. See **Security Interests in Trade Secrets**

Securities. See Shares and Shareholders

Security Bond for Injunction. See Injunction Against Trade Secret Misappropriation

Security Interests in Trade Secrets

Generally, 9.1, 9.22

Advantages of using trade secrets as collateral, 9.2

Attachment of security interest

Generally, 9.6

Clause describing trade secrets collateral, 9.8

Debtor's rights in collateral, 9.10

Reference to trade secret in written security agreement, 9.7

Value for collateral, 9.9

California Commercial Code, security interests governed by, 9.4

Checklist for setting up simple secured transactions, 9.21

Description of collateral in security agreement, 9.7

Disadvantages of using trade secrets as collateral, 9.3

General intangibles, trade secrets included in definition of, 9.5

Model State Trademark law, recording security interests under, 9.13

Perfection of security interest

Generally, 9.11

Additional language for description of trade secret collateral, 9.15

Filing financing statement, perfection of security interest by, 9.12

Financing statement (UCC-1), 9.14

Financing statement addendum (UCC-1Ad)-California, 9.14A

Priority of security interest, verification of, 9.16

Rights of secured creditor, 9.17

Sale or disposition of collateral by secured creditor, requirements regarding, 9.17

Special consideration in use of trade secrets as collateral

Generally, 9.18

Maintaining value of trade secret, 9.19

Obtaining value from trade secret in event of debtor's default, 9.20

Types of collateral, differentiating among, 9.8

Security Measures To Protect Trade Secrets

Generally, 4.1, 4A.1, 4A.10

Benign neglect, loss of trade secrets through, 4A.20

Computer software, security measures to protect licensed, 4.25, 16.10

Contractual confidential obligation, creation of

Generally, 4.4

Employees, contracts with. See **Employee Confidentiality Agreements**

Oral contracts, enforceability of, 4.5

Outsiders, nondisclosure agreements with, 4.7

Covenant against competition. See **Covenant Against Competition**

Dealings with government or third parties, protecting proprietary information in, 4A.14

Departure of employee

Documenting obligations of departing employee, 4.14

Exit interview, 4.13

Notice to new employer regarding employee's possession of company's trade secrets, 4.15

Documents, procedures for protecting

Generally, 4A.17

Access to trade secret documents, limits on, 4.21

Copying of trade secret documents, restrictions on, 4.22

Copyright notices, 4.20

Disposal of waste or trash, 4.23

Marking documents as confidential, 4A.17

Proprietary legends, 4.19

Electronic security for protection of trade secrets, 4A.18

Elements of effective trade secret protection plans, 4A.12

Employees' access to trade secrets, restrictions on, 4.17

Employees, procedures in dealing with

Generally, 4A.13

Departing employees, procedures for handling, 4A.13

Departure of employee (see Departure of employee, above)

Instructions for employees in handling of confidential materials, 4.12

Interviewing job applicants, agreement to protect confidential information, 4.11

Screening new employees, 4A.13

Training programs for employees on what constitutes trade secret, 4A.13

Formal policies and procedures to protect trade secrets, benefits of, 4A.11

Government, protecting proprietary information in dealings with, 4A.14

Government regulatory agencies, disclosure of trade secret information to, 4.27

Industrial espionage, security measures to prevent, 4.28

Licensing agreement provision for maintaining secrecy of trade secret, 8.25-1

Maintaining secrecy

Generally, 3.4, 4.2

Contractual confidential obligations (see Contractual confidential obligation, creation of, above)

Obligations of confidentiality (see Obligations of confidentiality, below)

Reasonable efforts to maintain secrecy (see Reasonable efforts to maintain secrecy, below)

Obligations of confidentiality

Contractual confidential obligation (see Contractual confidential obligation, creation of, above)

Implied confidential obligation, 4.3

Physical security measures

Generally, 4.16-4.17, 4A.16

Employee's access to trade secrets, restrictions on, 4.17

Facilities protection, 4A.16

Visitor's access to trade secrets, restrictions on, 4.18, 4A.15

Reasonable efforts to maintain secrecy

Generally, 4.8-4.10

Adequate measures to protect trade secrets, examples of, 4.9

Computers and computer networks, security for, 4.25

Dissemination of information to public, procedures for, 4.24

Documents (see Documents, procedures for protecting, above)

Employees (see Employees, procedures in dealing with, above)

Inadequate measures to protect trade secrets, examples of, 4.10

New companies, 10.5

Physical security measures (see Physical security measures, above)

Product sales, preventing unintended release of information in, 4.26

Termination of employment (see Departure of employee, above)

Unsolicited submissions of inventions and ideas, importance of established policies and procedures for handling, 4A.19

Seeds. See Plants and Seeds

Seizure. See Search and Seizure

Self-Incrimination, Privilege Against, 11.22

Setting Aside. See Vacating and Setting Aside

Settlement

Incorporating settlement agreement into dismissal order, 11.34

Patent's validity, agreement not to challenge, 7.4A

Tax treatment of, 15.52

Shares and Shareholders

See also **Corporations**

Derivative action by shareholders against corporate officers for misappropriation of trade secrets, 11.3

Shop Right Doctrine. See Ownership of Trade Secrets

Shrink-Wrap License Agreement. See Computers and Computer Software

Signatures

Computer software. See **Computers and Computer Software**

Confidentiality and invention assignment agreement, signature block for, 6.36

Licensing agreement, signature block, 8.45

SLAPP Suits

CCP §426.16, anti-SLAPP motions under, 11.17A

Defamation claim, effect of anti-SLAPP statute on, 11.30C

Smoking. See Tobacco

Software. See Computers and Computer Software

Solicitation

Advertising injury, limited solicitation as, 14.12

Customers, solicitation of. See **Customers**

Fiduciaries soliciting coworkers before starting new company, avoidance of, 10.2

Source Code. See Computers and Computer Software

Special Master

Disclosure of trade secrets to, 11.33A

Specific Performance

Confidentiality and invention assignment agreement, specific performance of, 6.25

Licensing agreement provision for specific performance, 8.32-4

Sperm

Property settlement under disputed will, sperm left to plaintiff by decedent not subject to, 17.8

Standing

Generally, 2.1

Licensee's standing to sue. See **Licensing Agreements**

Misappropriation of trade secret action, effect of lack of ownership on standing to bring, 11.28

State Contractors, Proprietary Rights of

See also **Federal Contractors, Proprietary Rights of**

California Public Records Act

Generally, 5.21

Public interest exemption, 5.23

Recent developments under CPRA, 5.23A

Trade secret exemption, 5.22

Liability of government agencies or employees for improper disclo-sure of trade secret information, 5.26

Statutes and regulations protecting proprietary information

Generally, 5.20

California Information Practices Act, 5.24

California Public Records Act (see California Public Records Act, above)

Statute of Frauds

Oral licensing agreement for trade secret, applicability of statute of frauds to, 7.2

Statutes of Limitations

See also **Time**

Antitrust claims, 11.36

Breach of confidence, 11.37

Breach of contract, 11.38

Conspiracy, 11.42

Conversion of assets, 11.43

Copyright claim, 11.52

Declaratory judgment action, effect on running of statute of limitations, 11.4

Federal laws, general statutes of limitations for, 11.53

Fiduciary duty, breach of, 11.45

Fraud. See **Fraud and Misrepresentation**

Implied-in-fact contract, 11.38

Interference with prospective economic advantage, 11.47

Lanham Act, no statute of limitations under, 11.53

Letter implying trade secret misappropriation, statute of limitations triggered by, 4.15, 11.2

Mail and wire fraud, 13.6

National Stolen Property Act, misappropriation of trade secrets under, 13.8

Patent infringement, 11.54

Racketeer Influenced and Corrupt Organizations Act, 11.55, 13.7

Receiving stolen property, 13.4

Theft of trade secret. See **Theft**

Tolling of statute of limitations for fraudulent concealment of misappropriation, 11.13C

Trade libel, 11.48

Unauthorized access to computer systems and data, 13.5

Unfair competition, 11.49

Uniform Trade Secrets Act (UTSA), misappropriation claim under. See **Misappropriation of Trade Secrets**

Unjust enrichment, 11.50

Stipulations

Designation of secrets, stipulated order delegating to attorneys responsibility for, 11.20

Injunctions. See **Injunctions (Generally)**

Sealing record to prevent disclosure of trade secret, stipulation to, 11.33C

Venue, unenforceability of stipulation in violation of public policy, 11.6A

Stolen Property. See Theft

Sublicenses

Licensing agreements. See **Licensing Agreements**

Software. See **Computers and Computer Software**

Submission of Ideas

Generally, 3.1-3.2

Confidential disclosure waiver agreement

Generally, 3.11

Follow-up by recipient after submitter's return or refusal to sign waiver agreement, 3.26

Form, 3.12

Transmittal letter to submitter enclosing waiver agreement, 3.13

Evaluation of unsolicited material (see Unsolicited ideas, recipient's receipt of, below)

Initial contact by submitter

Generally, 3.3

Disclosure of idea, 3.4

Nondisclosure agreement, advising client on, 3.4

Internet, submission of ideas over, 3.5

Litigation strategies

Recipient's strategies, 3.27

Submitter's strategies, 3.28

No acceptance of unsolicited ideas without agreement

Generally, 3.8

Confidential disclosure waiver agreement (see Confidential disclosure waiver agreement, above)

Policy on handling unsolicited disclosures of ideas, 3.9

Transmittal letter to submitter enclosing company policy, 3.10

No delivery without confidentiality agreement

Generally, 3.21

Agreement for submission of ideas, 3.22

Non-disclosure agreement providing for specific period of confidentiality, 3.27

No receipt of unsolicited ideas

Generally, 3.6

Transmittal letter describing policy, 3.7

Patent rights, no disclosure by submitter before securing

Generally, 3.19

Agreement for submission of ideas after filing for patent, 3.20

Protection of submitter's ideas, confidentiality agreement for, 3.19

Submitter's response to company policy

Generally, 3.18

In-person delivery based on implied understanding, 3.25

No delivery without confidentiality agreement (see No delivery without confidentiality agreement, above)

Notice of confidentiality and other proprietary legends, delivery of material with, 3.24

Patent rights (see Patent rights, no disclosure by submitter before securing, above)

Shrink-wrap confidentiality agreement, delivery of material with, 3.23

Unsolicited ideas, recipient's receipt of

Generally, 3.5, 10.43

Delay in distribution of unsolicited material pending notice to submitter of company's policy on unsolicited ideas, 3.14, 3.15

Established policies and procedures for handling submissions of unsolicited inventions and ideas, importance of, 4A.19

In-house committee, evaluation of unsolicited material by, 3.17

Litigation strategies for recipient, 3.27

No acceptance without agreement (see No acceptance of unsolicited ideas without agreement, above)

No receipt policy (see No receipt of unsolicited ideas, above)

Outside experts, evaluation of unsolicited material by, 3.16

Proprietary rights legends. See **Proprietary Rights Legends**

Waiver of confidentiality (see Confidential disclosure waiver agreement, above)

Summary Judgment

Conversion of motion for dismissal for failure to plead sufficient facts establishing misappropriation into motion for summary judgment, 11.17

Pretrial motion for summary judgment in misappropriation case, 11.18

Suppliers

California Uniform Trade Secrets Act (UTSA), supplier lists protected as trade secrets under, 1.4

Disclosures to suppliers. See **Disclosure**

Surgeons. See Physicians and Surgeons

Tables. See Charts, Checklists, Questionnaires, and Tables

Takings

Characterization of trade secrets as property under takings clause of U.S. Constitution, 15.2

Government agency's disclosure of trade secrets without owner's permission, takings claim for, 5.26

Taxes

Generally, 15.1

Abandonment of trade secret, tax consequences of, 15.44-15.45

Acquisition of trade secrets

Generally, 15.3

Amortization (see Amortization of trade secrets purchase, below)

Licensed trade secrets (see Licensee's tax treatment of licensed trade secrets, below)

Amortization of costs of self-developed trade secrets

Ascertainable useful life of trade secret, determination of, 15.28

Capitalization of costs, 15.27

Goodwill and related mass assets, prohibition against depreciation of, 15.29

Straight-line method of depreciation used for trade secrets, 15.30

Amortization of trade secret purchase

Generally, 15.4

Effective date of amortization regulations, 15.7

Intangible property, definition under IRC §197, 15.5-15.6

IRC §174, amortization period under, 15.18

Related party and churning transactions, exceptions to application of IRC §197 to, 15.8

Research and experimental expenditures (see Research and experimental expenditures, deductions for, below)

Self-developed trade secret, prohibition against amortization of, 15.13

Subsequent transfers of IRC §197 property, restrictions on deducting loss based on, 15.9

Time period for amortization, 15.6

Burden of proof on taxpayer to prove ascertainable useful life of trade secret, 15.28

Capital gains. See **Capital Gains and Losses on Sale or License of Trade Secret**

Corporations. See **Corporations**

Death, transfer of trade secret after, 15.48

Definition of trade secrets under Rev & T C §11342, 2.20

Depreciation deduction for trade secret

Generally, 15.4

Amortization (see Amortization of costs of self-developed trade secrets, above)

Customer-based intangibles, depreciation of, 15.29

Method of depreciation under IRC §167, 15.15

Estate tax on unpaid royalties for sale or license of trade secret, 15.48

Experiments (see Research and experimental expenditures, deductions for, below)

Exploitation of trade secrets

Generally, 15.31

Capital gains on sale or license of trade secret. See **Capital Gains and Losses on Sale or License of Trade Secret**

Internal use of trade secret by taxpayer, no tax consequences as result of, 15.43

License payments received by licensor, taxation of, 15.42

Gift of contract of sale or license of trade secret as anticipatory assignment of income, 15.49

Goodwill. See **Goodwill**

Governing law, 15.2, 15.33

Income in respect of decedent, treatment of royalties owed on sale or license of trade secret, 15.48

IRC §174 (see Research and experimental expenditures, deductions for, below)

Licensee's tax treatment of licensed trade secrets

Depreciation under IRC §167, method of, 15.15

Exclusive and nonexclusive types of licenses, treatment of, 15.10

Timing of deduction, 15.11

Liquidation or sale of business, transfer of trade secret on, 15.50

Research and experimental expenditures, deductions for

Alternative minimum tax, capitalization and amortization of research and experimental expenses in computation of, 15.26

Amortization period under IRC §174, 15.18

Contracted services, deductibility of, 15.24

Definition of research and experimental expenses, 15.20-15.24

Electing §174(a) treatment, 15.15

Electing §174(b) treatment, 15.16

Interplay between IRC §§174(a) and 174(b) elections, 15.17

Land and depreciable assets, nondeductibility of, 15.22

Literary and historical projects, nondeductibility of research for, 15.23

Management and operating expenses excluded from current research and experimental expenses, 15.21

Reasonableness of expenses, requirement regarding, 15.25

Tax credit for incremental research expenses, 15.14

Trade or business, requirement that expenses incurred in connection with, 15.19

Self-developed patents, nonapplicability of amortization rules to, 15.18

Self-developed trade secrets, owner's tax treatment of

Generally, 15.5, 15.13

Amortization of development costs (see Amortization of costs of self-developed trade secrets, above)

Development costs, deduction, capitalization, or credit for, 15.14

Research and experimental expenditures (see Research and experimental expenditures, deductions for, above)

Settlement or judgment involving trade secret, tax consequences of, 15.52

Valuation. See **Valuation**

Worthlessness of trade secret, deductibility of loss resulting from, 15.44, 15.46

Technical Manuals

Potential contractor, confidentiality of information in specifications or technical manuals disclosed to, 10.44

Telephones

Cell phones, security measures to prevent data storage or capture of images by, 4A.18

Instructing new employee not to use former employer's telephone for purposes relating to new job, 10.11

Temporary Restraining Orders. See Injunction Against Trade Secret Misappropriation

Termination of Employment

Documents employee must return to company on, 6.24

Employee's certificate on termination, 6.39

Employment agreement, termination provision in, 6.24

Enforceability of agreement not to solicit nonsecret customers or coworkers after, 2.32A

Enforcement of noncompetition agreements after, 4.6-4.7, 6.24, 17.10

Exit interviews

Checklist for exit interview, 6.41

Protection of trade secret, exit interview as means of, 4.13

Termination certificate upon termination of employee, 4.14, 6.39

Trained personnel, exit interview conducted by, 4.13, 6.40

Letter to former employee regarding company's proprietary interests, 6.42

Letter to new employer on possible conflict, 6.43

Procedures for termination of employee, 6.40

Security measures during departure of employee. See **Security Measures To Protect Trade Secrets**

Territorial Restrictions on License. See Licensing Agreements

Terrorism

California Public Records Act (CPRA), exemptions for documents assessing vulnerability to terrorist attacks, 4.27, 5.21

Theft

See also **Criminal Liability for Trade Secret Misappropriation**

Generally, 4A.1A, 10.47

Attempted theft of trade secrets, effect of content of stolen materials on charging defendant with, 13.9A

Biological materials, protecting against theft of. See **Biotechnology**

Civil writ of possession for stolen property, recovery of stolen property by use of, 11.51

Computer software, unauthorized use of, 16.27

Criminal statutes prohibiting knowing theft of trade secrets, purpose of, 4.28

Economic Espionage Act, penalties for theft of trade secret under, 17.4A

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Pen C §499c, penalty for theft of trade secret, 13.3

Receiving stolen property, penalties for, 13.4

Statute of limitations for theft

Generally, 11.51, 13.3

National Stolen Property Act, statute of limitations for misappropriation of trade secrets under, 13.8

Value of trade secret, effect of litigating theft of trade secret on, 7.18

Third Parties

Advertising injury provision inapplicable to third party complaint of patent violation, 14.9

Attachment, effect on third parties, 9.6

Biotechnology materials, dissemination to third parties. See **Biotechnology**

Confidentiality. See **Confidentiality**

Depreciable property constructed by taxpayer for third party, limits on deductibility of costs as research and experimental expenses, 15.22

Discovery of third party's trade secret, 11.26

Financing statement, notice to third parties of security interest in collateral, 9.12

Licensing agreements. See **Licensing Agreements**

Lost profits, third party's liability for disclosure of trade secrets resulting in, 12.20

Nondisclosure agreements with third parties, 4.7

Parties to dispute regarding ownership of trade secret preventing disclosure to third parties, 2.13

Protective order, third party gaining access to information subject to, 11.20A

Security measures to protect trade secrets from third parties. See **Security Measures To Protect Trade Secrets**

Visitors. See **Visitors**

Threatened Misappropriation. See Injunction Against Trade Secret Misappropriation

Time

See also **Statutes of Limitations**

Amortization of trade secret purchase, time period for, 15.6

Assignment of ownership rights in trade secrets, reasonable time limits on, 2.31

Biotechnology patent, average time for issuance of, 17.17

Copyright, duration of, 16.43

Extension of time for injunction against trade secret misappropriation, 12.10

Holdover clause, expiration of, 2.31

Injunction against trade secret misappropriation, time limits on. See **Injunction Against Trade Secret Misappropriation**

Licensee of trade secret, timing of deduction, 15.11

Licensing agreements. See **Licensing Agreements**

Long-term capital gains treatment, holding period required for, 15.39

Patent applications, time for publishing, 7.6, 16.62

Patent applications, time for publishing after priority filing date, 2.35

Removal of action to federal court, time limit for, 11.8

Temporary restraining order, time limit for expiration of, 12.6

Title. See Ownership of Trade Secrets

Tobacco

Unconstitutionality of Massachusetts Disclosure Act requiring tobacco companies to disclose list of ingredients to state, 5.26

Trade Libel

Generally, 11.48

Nonprivileged statements regarding litigation subjecting declarant to claims of trade libel, 11.30C

Trademarks

Comparison of trade secrets, patents, copyrights, and trademarks, App C

Definition of licensed trademark, 8.4-9

Distinguishing between trade secret and trademark protection, 11.21

Internet posting of information, effect on trademark, 10.31

Licensing agreement

Grant clauses for trade secret and trademark hybrid licenses, 8.10

Use of trademarks, provision for, 8.19

Perfection of security interest, 9.11

Transfer of assignor's business, invalidity of assignment of trademark not accompanied by, 9.11

Unfair competition claim

Original jurisdiction of federal court over unfair competition claim joined with trademark infringement claim, 11.12

Passing off and trademark infringement, 14.11

Trade Secret Audits

Generally, 4A.1-4A.2

Checklist for trade secret audit, 4A.21-4A.22

Goals of, 4A.2

Physical and electronic security measures, review of, 4A.7

Policies and procedures for protection of trade secrets, review of, 4A.6

Protective agreements, review of, 4A.9

Scope of audit, 4A.4

Team for conducting audit

Generally, 4A.3

Identification of company's intellectual property assets by audit team, 4A.5

Protection plans, audit team developing and implementing. See **Security Measures to Protect Trade Secrets**

Screening of new employees by, 4A.13

Technological advances, trade secret audit taking into account, 4A.8

Trade Secrets Act. See Federal Trade Secrets Act

UCC. See Uniform Commercial Code (UCC)

Unconscionability

Adhesion contract, enforceability of, 2.30

Unfair Competition

Generally, 11.49

Breach of confidence claim combined with unfair competition claim, award of damages and injunctive relief for, 11.37

Common law tort of, 11.49, 14.11

Definition of unfair competition, 11.49

Disgorgement of profits not authorized remedy in action for unfair business practices, 11.49

Forum selection clause, unenforceability of, 8.41

Lanham Act. See **Lanham Act**

Licensing restrictions as, 7.11

Patent or copyright claim, unfair competition related to, 11.12

Restatement of Law (Third) on Unfair Competition, definition of trade secret under, 2.21B

Trademarks. See **Trademarks**

Use of trade secret as unfair competition, 2.32C

Uniform Commercial Code (UCC)

Software not constituting "goods" under, 9.11

Uniform Trade Secrets Act (Proposed)

See also **Uniform Trade Secrets Act, California (UTSA)**

Reasonable efforts to maintain secrecy, Act's requirements of, 16.29

Text of Act, App B

Uniform Trade Secrets Act, California (UTSA)

See also **Uniform Trade Secrets Act (Proposed)**

Generally, 1.2

Accident or mistake, prohibition against using information obtained by, 10.48

Actions prohibited under, 10.23

Combination trade secret, requirements for, 1.9A

Common law protection, effect of UTSA on, 1.13, 1.16, 11.23

Computer programs, requirementsfor trade secret protection for, 16.42

Criminal remedies for misappropriation of trade secrets, effect of Act on, 13.1

Damages for misappropriation of trade secrets. See **Damages**

Definition of trade secrets under, 1.3, 2.14

Existence of trade secret, objective analysis for determining, 1.4

Information constituting trade secret

Generally, 1.4

Customer lists, 1.4-1.5

Economic value of information as prerequisite for trade secret protection, 4.2

Independent economic value, requirement that information have, 1.7

Negative information as protectable trade secret, 1.4, 1.6, 12.8

Injunction against trade secret misappropriation. See **Injunction Against Trade Secret Misappropriation**

Intentional or inadvertent disclosureof trade secret, liability for, 1.12

Liability of government agencies or employees for improper disclosure of trade secrets, 5.26

Litigation under Act. See **Litigation of Trade Secret Misappropriation**

Misappropriation of trade secrets. See **Misappropriation of Trade Secrets**

Not generally known requirement

General knowledge and skill versus trade secrets, 1.9

Secrecy and ready ascertainability of information, 1.8-1.8A

Preemption

Breach of confidence, no preemption under UTSA for claim of, 11.37

Civil remedies, no preemption by UTSA of, 1.16

Common law trade secret misappropriation, preemption of, 11.23

Contractual remedies, no preemption by UTSA of, 1.16, 11.38

State law claims based on same facts as trade secret misappropriation, preemption of, 11.49

Pre-UTSA case law, persuasiveness of, 1.2

Punitive damages

Limits on award under UTSA, 1.16

Preemption of state standard for awarding, 12.22

Ready ascertainability of information

Burden on defendant to show, 1.2, 1.8A

Disproving information qualifying as trade secret on grounds information readily ascertainable, 1.8A

Misappropriation of trade secret, ready ascertainability of information as defense to claim of, 1.8A, 1.14

Reasonable efforts to maintain secrecy, Act's requirements of, 1.10, 16.29

Remedies for trade secret misappropriation. See **Remedies for Trade Secret Misappropriation**

Restatement of Torts or Restatement of Unfair Competition as precursors to UTSA, 1.2

Secrecy requirement under Act, 4.2

Text of Act, App A

Unlabeled documents' eligibility for treatment as trade secret under UTSA, 6.3

Universities, Biotechnology Research at. See Biotechnology

Unjust Enrichment, 11.50, 12.20

Unsolicited Ideas. See Submission of Ideas

UTSA. See Uniform Trade Secrets Act, California (UTSA)

Vacating and Setting Aside

Disclosure of trade secret in judgment, settlement agreement vacating judgment, 11.34

Valuation

Generally, 15.51

Felony or misdemeanor for misappropriation of trade secret, value of trade secret determining, 13.3

Good faith of debtor/trade secret owner, valuation of trade secret as collateral dependent on, 9.3

Information known only to developer, value of, 1.1

License agreement, valuation of trade secret. See **Licensing Agreements**

Maintaining value of trade secret, 9.19

Patent, variation in value among foreign countries, 7.5

Vendors, Disclosures to. See Disclosure

Venue. See Litigation of Trade Secret Misappropriation

Verification

Advantages of verified complaint, 11.2

Visitors

Access to trade secrets, restrictions on, 4.18, 4A.15

Identification badge and visitor's confidentiality and nondisclosure agreement, 4A.15, 6.44

Log book agreement provisions, 6.46

Long-form visitor's agreement, 6.45

Waiver

Attorney-client privilege, waiver of, 11.30B

Breach of licensing agreement, restrictions on waiver of, 8.39, 11.44

Computer software license, waiver of breach of, 16.21

Confidentiality. See **Confidentiality**

Copyright claim, waiver of to pursue trade secret claim, 11.52

Crime or fraud in misappropriation of trade secret, waiver of attorney-client privilege in cases of, 11.44

Injunction bond, parties' stipulation to waiver of, 12.16

Submission of unsolicited ideas, waiver of confidentiality. See **Submission of Ideas**

Work-product privilege, waiver of, 11.30B

Warnings

Confidentiality and invention assignment agreement, warning of effect of agreement, 6.35

Warranties

Computer software, warranties for. See **Computers and Computer Software**

Licensing agreement, warranties in. See **Licensing Agreement**

Wire Fraud. See Mail and Wire Fraud

Witnesses

Discovery of attorney's comments to potential witnesses, 11.27

Experts. See **Experts**

Litigation privilege limited to parties and witnesses, 11.30-11.30A

Stipulated injunction preventing witness from testifying, court order for witness's testimony despite, 11.20A

Words and Phrases. See Construction and Interpretation; Definitions

Work-For-Hire Doctrine, 2.34, 10.17

Work-Product Privilege

Former corporate employee, applicability of privilege to communications with, 11.27

Notifying opposing counsel of inadvertent disclosure of work-product privileged documents, 11.20A

Waiver of, 11.30B

Writs

Possession, recovery of stolen property by use of civil writ, 11.51

Seizure, requirements for writ of, 16.45

Wrongful Termination

Unenforceable noncompetition agreement, wrongful termination of employee for refusing to sign, 2.32A, 11.38, 11.41

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