TRADE SECRETS DAMAGES: UNDERSTANDING THE LAW IS A FRAMEWORK FOR SUCCESS

I. INTRODUCTION

The flexible and creative approach to damages in trade secrets cases means that parties to such claims may find themselves on one or the other end of confusing and unexpected damage demands. This article identifies issues and explains the damages at stake in trade secrets cases. Armed with this knowledge will enable litigants to minimize or maximize damages depending on which side they are on.

II. OVERVIEW OF THE UNIFORM TRADE SECRETS ACT

The Uniform Trade Secrets Act (“UTSA”) provides a legal framework intended to improve trade secrets protection for industry. 1 Published by the Uniform Law Commission in 1979 and amended in 1985, the UTSA has subsequently been adopted by 47 states and is pending adoption in Massachusetts. 2 The UTSA defines “trade secrets” as:

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. 3

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2 Id.
3 UTSA § 1.4.
To further its goal of increased protection for trade secrets, the UTSA defines “improper means” of trade secrets—including “theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means”—and sets forth remedies for wrongs committed. These remedies include injunctive relief, attorney’s fees, and damages.

III. TRADE SECRETS REMEDIES

A. Injunctive Relief

Section 2(a) of the UTSA provides for injunctive relief from actual or threatened trade secrets misappropriation; however, the length of the injunction may not exceed the time the trade secret exists plus time for the “headstart” (the competitive advantage gained through misappropriation) to expire. In addition to these rights, Section 2(b) allows for the payment of reasonable royalties instead of an injunction under certain exceptional circumstances. This has been referred to as a royalty order injunction. The commentary to Section 2 defines exceptional circumstances for a royalty order injunction as the existence of a public interest that would be compromised by injunctive relief and a third party’s “reasonable reliance upon acquisition of a misappropriated trade secret in good faith and without reason to know if its prior misappropriation would be prejudiced by a prohibitory injunction against future damaging use.”

The public interest exception was at issue in Republic Aviation Corp. v. Schenk, where the court considered against enjoining a misappropriator because an injunction would have prohibited the misappropriator from supplying the U.S. with an aircraft weapons control system during

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4 UTSA § 1.1.
5 UTSA § 2(a).
6 UTSA § 2(b).
7 UTSA § 2 cmt.
wartime. The second exception is where the court favors the interests of a third party who has relied in good faith upon his or her ability to use the misappropriated information (the “innocent acquirer”) over the interests of a trade secret owner.

**B. Attorney’s Fees**

UTSA Section 4 addresses attorney’s fees and stipulates that a court may award attorney’s fees to a plaintiff where the misappropriation has been made in bad faith or willfully and maliciously. The UTSA does not define “bad faith” or “willfully and maliciously;” however, states tend to look inwardly at their own statutory and common law definitions of the terms in order to determine the appropriate standards.

**C. Damages**

Damages, the final remedy offered by the UTSA and the focus of this paper, are addressed in Section 3 of the UTSA.

**IV. TRADE SECRETS DAMAGES**

**A. “The Reasonable Certainty” Standard Must Be Met**

A plaintiff bears the burden of proof in establishing damages. It must prove the existence of a legally protectable trade secret, a nexus between the misappropriation and the asserted harm or unjust gain, and the damages caused by a defendant’s misappropriation. As with damages in many types of litigation, damages in trade secrets cases must be proven with “reasonable certainty.” For example, it is well-settled that lost profits, the most common type of damages

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8 Id.
9 Id.
10 UTSA § 4.
12 UTSA § 3.
in trade secrets cases, must be proven with reasonable certainty. However, what “reasonably certain” means in United States courts is significantly less certain. In 1977, Justice Lent of the Oregon Supreme Court wrote:

I must confess . . . that I have no more idea what reasonable certainty means than I have as to the meaning of certainty. I would assume that it is some lesser quantum of proof than . . . beyond a reasonable doubt, or to a moral certainty.15

While some of the confusion has been cleared since then, inconsistent and vague interpretations in opinions have left the term still subject to ambiguity.

For example, in 1991, the Supreme Court of Nebraska stated, “while it is true that [lost profits] damages need not be proved with mathematical certainty, neither can they be established by evidence which is speculative and conjectural.”16 In contrast, another court surmised that a plaintiff has the burden to present evidence with a tendency to show the probable amount of damages to allow the trier of fact “to make the most intelligible and accurate estimate which the nature of the case will permit.”17 Additionally the Pennsylvania Superior Court attacked the topic with the following discussion:

[D]amages need not be proved with mathematical certainty, but only with reasonable certainty, and evidence of damages may consist of probabilities and inferences . . . . Although the law does not command mathematical precision from evidence in finding damages, sufficient facts must be introduced so that the court can arrive at an intelligent estimate without conjecture.18

In an effort to reconcile these and other interpretations, Robert Lloyd published a comprehensive review of courts’ descriptions of reasonable certainty and analysis of their

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similarities. This paper, *The Reasonable Certainty Requirement in Lost Profits Litigation: What it Really Means*, puts forth six factors that Lloyd posits courts use to determine whether a plaintiff has proven its lost profits with reasonable certainty. These factors include:

1. the court’s confidence that the estimate is accurate;
2. whether the court is certain that the injured party suffered at least some damage;
3. the degree of blameworthiness or moral fault of the part of the defendant;
4. the extent to which the plaintiff produced the best available evidence of lost profits;
5. the amount at stake; and
6. whether there is an alternative method of compensating the injured party.

Although no court has yet instituted Lloyd’s six factors as its test for reasonable certainty, the factors have been referenced in several articles discussing the definition of reasonable certainty.

Justice Posner more recently addressed the definition of reasonable certainty in a 2012 opinion in *Apple, Inc. v. Motorola, Inc.* There, he specified two factors to assess whether an expert’s testimony is sufficient to establish lost profits with reasonable certainty:

1. whether the expert has employed the same “level of intellectual rigor” in the courtroom that an expert in the relevant field would; and

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19 Supra note 14, at 11.
20 Id. at 18-19.
21 Id. at 18-19.
2. whether the expert has “sufficiently” described how his opinion was derived from the evidence he reviewed.24

Expanding upon the first factor, Posner commented that an expert’s failure to use “the same approach that would have been required by the applicable professional standards to use to deal with an identical issue outside the litigation context” renders the expert’s opinion inadmissible, “with possible exceptions.”25 He took a similar hard line approach with the second factor, stating: “Any step that renders the analysis unreliable . . . renders the expert’s testimony inadmissible. This is true whether the step completely changes a reliable methodology or merely misapplies that methodology.”26

Putting these factors to work to evaluate the merits of Apple and Motorola’s experts, Posner concluded that Apple’s damage expert provided an inadmissible damages estimation for Apple patent ‘002.27 Apple patent ‘002 prevents a digital device’s notification window from being partially obstructed, and Apple contended that Motorola infringed upon the patent by implementing such a feature in its digital devices.28 While Motorola’s expert estimated that such infringement would have caused $100,000 in damages, Apple’s expert proffered that such damages totaled $14 million.29 Apple’s expert’s estimate was based upon a Motorola consumer survey where respondents were asked to select their top five reasons for purchasing a phone worth $270 that also had the non-partial-obstruction feature.30 Because 15% of the respondents selected “appealing features and functions,” Apple’s expert multiplied $270 by 15% and determined that the non-partial-obstruction feature—one of a multitude of features—was worth

24 *Id.*
25 *Id.*
26 *Id.* quoting *In re Paoli R.R. Yard PCB Litigation*, 35 F.3d 717, 745 (3rd Cir. 1994).
27 *Id.* at *4.
28 *Id.* at *2.
29 *Apple, Inc.*, 2012 WL 1959560 at *2-4.
30 *Id.* at *4.
approximately $40 per phone.31 Additionally, since four percent of the respondents noted that they “reviewed notifications” every day, Apple’s expert multiplied the $40 by .02—arbitrarily discounting the amount by half because “reviewed notifications” might not refer to the notification bar—and, multiplying that amount by the number of phones sold, arriving at his $14 million figure.32

Describing Apple’s expert’s calculations as based upon “unverified, indeed arbitrary, assumption[s],” Posner commented that the expert had estimated only the value of the notification window, not the value of avoiding partial obstruction of the window.33 In fact, Posner surmised that had Motorola hired Apple’s expert to determine the value of implementing non-partial obstruction, Motorola would have called him a “[d]ummy” had he offered the same analysis.34 Consequently, Posner held that Apple’s expert’s use of an unreliable methodology that no expert would have used outside the context of litigation rendered his damages estimation inadmissible.35

While opinions and articles such as these have not eliminated the confusion surrounding reasonable certainty, they have shed light on this inherently unclear concept.

B. Theories of Trade Secrets Damages

The UTSA lists three separate categories of trade secrets damages: actual loss (including lost profits where applicable); unjust enrichment; and reasonable royalties.36 Recognizing that the assignment of damages is an inherently complicated task and “that every case requires a

31 Id.
32 Id.
33 Id.
34 Id. at *5.
36 See UTSA § 3(a).
flexible and imaginative approach to the problem of damages,”\textsuperscript{37} the UTSA provides that—“as long as there is no double counting”—a plaintiff may recover under multiple theories of damages in order to be fully compensated for the loss caused by misappropriation.\textsuperscript{38}

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.\textsuperscript{39}

The availability and calculation of damages under each of these three theories of recovery are as follows.

1. **Actual Loss**

Actual loss damages allow a plaintiff to recoup the losses that were incurred as a direct result of the misappropriation. Actual loss damages are usually calculated by determining a plaintiff’s profit loss because such calculations are conceptually just and generally encapsulate all actual losses.\textsuperscript{40} However, while the conceptual basis for lost profits damages is straightforward, the legal and economic realities of modern-day business models mean that calculation of lost profits is often complex and fact-specific. Consequently, courts have developed a multitude of methods to calculate lost profits.

In one popular method, lost profits are calculated from a plaintiff’s lost “net profits” or “incremental profits.”\textsuperscript{41} If some of the lost profits resulted from lost revenues, the costs associated with those revenues are deducted.\textsuperscript{42} The court utilized this calculation method in

\begin{itemize}
  \item \textsuperscript{37} Univ. Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518, 538 (5th Cir. 1974).
  \item \textsuperscript{38} UTSA § 3(a) and cmt to § 3.
  \item \textsuperscript{39} UTSA § 3(a).
  \item \textsuperscript{41} Id.
  \item \textsuperscript{42} Id.
\end{itemize}
State Indus., Inc. v. Mor-Flo Indus., Inc., where the patent owner requested lost profits as a result of the defendant’s infringement of a patent covering a method of insulating a water heater tank using polyurethane foam.  

Although the court stated that there was “some testimony that fixed costs might have varied slightly,” it held that the district court did not abuse its discretion by disregarding such variations in calculating its lost profits award because “[n]o greater precision is required.” Therefore, the court’s lost profit calculation reflected only the percentage of sales revenue the patent owner had lost because of the infringement that would have been the patent owner’s profit.

Under another common method of calculation, the court awards plaintiffs the defendants’ sales revenues multiplied by the plaintiffs’ profit margin. In David Fox & Sons, Inc. v. King Poultry Co., the court held that this method was appropriate to determine the plaintiffs’ lost profits. There, plaintiffs, who sold poultry, alleged that defendants—former employees of plaintiffs—had used plaintiffs’ customer lists and other confidential information in their new, competing business venture. Defendants challenged the first element of the lost profits calculation—the defendants’ sales—on the grounds that plaintiffs would not have been able to secure all the sales that the defendants had. The court accepted the defendants’ proof establishing that they had made sales to two customers who would not have made such purchases from plaintiffs even without the defendants’ market presence. Accordingly, the court held that defendants’ should not have been liable for those sales and determined that plaintiffs’ lost profits

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43 883 F.2d 1573, 1575 (Fed. Cir. 1989).
44 Id. at 1579-80.
45 Id. at 1579-80.
48 Id.
49 Id.
50 Id.
toted the defendant’s other sales multiplied by the plaintiffs’ profit margin.\textsuperscript{51} Multiple trade secrets or violations, or the apportionment of damages among defendants further complicate the analysis.

While actual loss is usually synonymous with lost profits, courts have allowed a plaintiff to use other methods to calculate actual losses in order to best approximate the value of the loss of the trade secret to a plaintiff under the circumstances. For example, in \textit{Precision Plating \& Metal Finishing, Inc. v. Martin-Merietta Corp.}, the court allowed the plaintiff to calculate actual loss based upon the investment value of the trade secret.\textsuperscript{52} There, the plaintiff owned a secret process used to fill pits and pores in metal castings to be used in housing missile guidance systems.\textsuperscript{53} Since an established market for the process did not yet exist, the trial court reasoned that the value of the trade secret could be best approximated by looking at what an investor would have paid to own the process, taking into account the information available at the time of the misappropriation.\textsuperscript{54} Additionally, in \textit{Basic Chems., Inc. v. Benson}, the court held that the calculation of actual losses could include reference to the value of the plaintiff’s business.\textsuperscript{55} There, the defendant (the former president of the plaintiff’s business) resigned and created a new, competing business.\textsuperscript{56} He then used trade secrets from plaintiff’s business to market his new business’s products in a manner that led customers to believe that the products were being offered by the plaintiff’s business.\textsuperscript{57} The trial court looked at the plaintiff’s business records—

\textsuperscript{51}\textit{Id.}  
\textsuperscript{52} 435 F.2d 1262, 1263-64 (5th Cir. 1970).  
\textsuperscript{53}\textit{Id.} at 1263.  
\textsuperscript{54}\textit{Id.} at 1264.  
\textsuperscript{55} 251 N.W.2d 220, 233 (Iowa 1977).  
\textsuperscript{56}\textit{Id.} at 223.  
\textsuperscript{57}\textit{Id.} at 229.
including sales volume and net profits—directly before the misappropriation to determine the value of the business and ultimately the amount of actual loss.\(^{58}\)

2. **Unjust Enrichment**

Instead of or even in addition to actual damages, courts may also award unjust enrichment. Unjust enrichment can include the defendant’s increased revenues, decreased production costs, avoided development costs, or advantages caused by his or her headstart in the market.\(^{59}\) Federal law provides that a plaintiff seeking unjust enrichment damages in a trademark or copyright infringement case is only responsible for identifying the revenues.\(^{60}\) Once the plaintiff has identified the revenues, the defendant must identify deductions for costs unrelated to the infringement.\(^{61}\) While the UTSA does not explicitly separate burdens of proof for trade secrets damages, some courts have explicitly adopted the approach taken in trademark and copyright infringement cases. For example, in *USM Corp. v. Marson Fastener Corp.*, the Massachusetts’ appellate court held that after the plaintiff proves that the defendant profited from sales of products produced through improper use of a trade secret “the burden shifts to the defendant to demonstrate those costs properly to be offset against its profit and the portion of its profit attributable to factors other than the trade secret.”\(^{62}\) As the defendant in *David Fox & Sons, Inc.* did, a defendant should attempt to establish that a plaintiff would not have been able to make the same sales that the defendant did because some of the sales were based upon a previous relationship, unique skills, proximity to the customer, etc.\(^{63}\)

\(^{58}\) *Id.* at 233.


\(^{63}\) See *David Fox & Sons, Inc.*, 23 N.Y.2d at 914.
Courts are similarly split on when the accounting period for profits starts and its duration. In *Vulcan Detinning Co. v. Am. Can Co.*, the court held that the defendant did not have notice that it was infringing upon the plaintiff’s secret detinning process until the plaintiff filed suit.\(^{64}\) Therefore, the court stated that the accounting period began on the date of filing. In contrast, in *Colgate-Palmolive Co. v. Carter Prods., Inc.*, the court held that the accounting period commenced on the date that the defendant began to market its misappropriated product.\(^{65}\) The duration of the accounting period similarly varies and is generally limited by two factors: the applicability of the headstart rule; and whether the trade secret can still be protected. Under the headstart rule, “if the only effect of a trade secret misappropriation is to make it possible for the defendant to develop and market a product sooner than it would have otherwise done, the defendant is deemed to have been unjustly enriched only to that extent, and the period of accounting may be limited accordingly.”\(^{66}\) For example, a defendant who is able to quickly develop a product by using a misappropriated trade secret may argue that he or she would have been able to reverse engineer the product from the product itself without use of the trade secret. Clearly, however, the misappropriation gave the defendant a “headstart” as reverse engineering would have taken more time. The headstart rule does not allow the accounting period to carry on past the time at which the defendant would have been able to produce the product by reverse engineering. In *Timely Prods. Corp. v. Arron* and *McNamara v. Powell*, the courts held that the issuance of a patent that embodies the technology of the trade secret eliminates the owner’s right to protect the trade secret.\(^{67}\) The courts reasoned that such public disclosure cut off the owners’

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\(^{65}\) 230 F.2d 855, 865 (4th Cir. 1956).
\(^{67}\) 523 F.2d 288, 304 (1975); 256 A.D. 554, 559 (N.Y. 1939).
rights to limit others’ use or disclosure. Therefore, the accounting periods expired on the dates of the issuances of the patents.

3. Reasonable Royalty

When Section 3(a) of the UTSA was originally drafted in 1979, it did not provide for reasonable royalty as a measure of trade secret damages. Although reasonably royalty was added in 1985, this delay caused inconsistent interpretations of the UTSA between early and late adopters. For example, it was not until its late-2010 opinion in *Ajaxo, Inc. v. E*Trade Fin. Corp.* that California—an early adopter of the UTSA—expressly allowed for reasonable royalty recovery for trade secret misappropriation.

Although reasonable royalty is now a widely accepted measure of trade secret damages, it is used infrequently relative to actual loss and unjust enrichment. Where there is little or no evidence of actual loss or unjust enrichment, courts turn to reasonable royalty—the royalty that the plaintiff and defendant would have agreed upon for use of the trade secret—as the measure of damages. Courts usually first look to whether there is any documentation that shows the value the parties themselves placed on the misappropriated information. Where any such document, such as a royalty agreement or offer and counter offer in anticipation thereof, exists, courts have tended to look toward them in order to calculate a plaintiff’s reasonable royalty. In *Univ. Computing Co. v. Lykes-Youngstown Corp.*, the appellate court affirmed the trial court’s decision to go so far as to charge the jury to estimate the probable outcome of a negotiation between the

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68 *Timely Prods. Corp.*, 523 F.2d at 304; *McNamara*, 256 A.D. at 559.
69 *Timely Prods. Corp.*, 523 F.2d at 304; *McNamara*, 256 A.D. at 559.
71 Rosenhouse, *supra* note 66, at 12.
72 *Id.*
73 *Id.*
parties at the time the misappropriation began.\textsuperscript{74} There, the plaintiff brought an action alleging misappropriation of its computer system and seeking trade secret damages.\textsuperscript{75} Because the defendants had not succeeded at making a profit off the system and there was no evidence of sales lost by the plaintiff, there were no actual profits or losses by which the court could determine the value of the misappropriation.\textsuperscript{76} Therefore, the court held that the reasonable royalty theory of damages was appropriate and calculated what a fair licensing price would have been between the parties had they reached a successful agreement.\textsuperscript{77} To calculate such an amount, the court urged triers of fact to look at the following factors:

- the resulting and foreseeable changes in the parties' competitive posture;
- that prices past purchasers or licensees may have paid; the total value of the secret to the plaintiff; including the plaintiff's development costs and the importance of the secret to the plaintiff's business; the nature and extent of the use the defendant intended for the secret; and finally whatever other unique factors in the particular case which might have affected the parties' agreement, such as the ready availability of alternative processes.\textsuperscript{78}

Accordingly, the appellate court affirmed the district court’s jury charge to consider factors including the plaintiff’s development costs, the defendants’ sale price, and expert testimony as to what would constitute a reasonable royalty rate in determining the royalty.\textsuperscript{79}

The reasonable royalty theory of damages discussed in Section 3(a) of the UTSA is distinguishable from the royalty order injunction permitted by Section 2(b) of the UTSA.\textsuperscript{80} Section 2(b) royalty order injunctions are appropriate only in certain exceptional circumstances; in contrast, reasonable royalty damages are a generally available measure of damages.\textsuperscript{81}

\textsuperscript{74} Univ. Computing Co., 504 F.2d at 537.
\textsuperscript{75} Id. at 526-28.
\textsuperscript{76} Id. at 536.
\textsuperscript{77} Id.
\textsuperscript{78} Id. citing Hughes Tool Co. v. G. W. Murphy Indus., Inc., 491 F.2d 923, 931 (5th Cir. 1973).
\textsuperscript{79} Id. at 550.
\textsuperscript{80} UTSA § 3 cmt.
\textsuperscript{81} Id.
Additionally, Section 2(b) royalty order injunctions regulate misappropriators’ future conduct while Section 3(a) damages are awarded for misappropriators’ past conduct; therefore, both remedies cannot be awarded for the same conduct. 82

V. CONCLUSION

While trade secrets damages law continues to evolve, this article sheds light on both the typical and atypical damages issues counsel may experience. Knowing the law and the different theories of recovery will help counsel navigate this complex area of the law and effectively assist their clients with damages claims.

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82 Id.