New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 260—NO. 62
THURSDAY, SEPTEMBER 27, 2018

Outside Counsel

The End Is Near: Trade Secret Cases In the New York State Court System

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On May 3, 2018, in a 4-3 split decision, the New York Court of Appeals in *E.J. Brooks Company v. Cambridge Security Seals* (the E.J. Brooks case) held that plaintiffs cannot recover damages in trade secret cases based on development costs that defendants avoided by misappropriating trade secrets. 2018 WL 2048724, at *1 (N.Y. May 3, 2018). In doing so, the court determined that a plaintiff's damages must be specifically tied to the plaintiff's losses and not gains by the defendant. Id. at *6. This decision runs contrary to the Defend Trade Secrets Act (DTSA), which Congress passed in 2016 and which provides for federal jurisdiction. The DTSA provides a menu of damage calculation options including recovery of a defendant's unjust enrichment, which courts have interpreted to encompass the avoided cost methodology explicitly rejected by the Court of Appeals. Plaintiffs in trade secret cases that seek to measure damages by defendant's avoided costs, defendant's gains, or anything other than plaintiff's losses will now be incentivized to bypass the New York state court system for federal court. This may encompass a large swath of cases, as damages are notoriously difficult to calculate in trade secret actions.

> The New York Court of Appeals in 'E.J. Brooks' may very well have driven trade secret litigation from New York courts to federal courts, as plaintiffs will prefer the flexible damages options provided by the DTSA.

The path to the New York Court of Appeals' decision began almost exactly three years before it was issued. On May 4, 2015, a jury in the U.S. District Court for the Southern District of New York rendered a unanimous verdict in favor of E.J. Brooks Company d/b/a Tydenbrooks (Tyden) on all three of its claims against the defendant Cambridge Security Seals (CSS)—misappropriation of trade secret, unfair competition, and unjust enrichment—for stealing Tyden's manufacturing processes. Id. Only one damages expert (Tyden's) testified at trial, and he calculated damages based on an avoided cost methodology, by determining the amount of money CSS avoided spending to get its manufacturing processes up and running as a result of its theft of Tyden's proprietary information. Id. at *1. In her charge to the jury, Judge Loretta Preska

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explained that the jury could calculate damages based on the "benefits derived by the defendant" and the "costs avoided by the defendant" by misappropriating Tydenbrooks' manufacturing process. *E.J. Brooks Co. v. Cambridge Security Seals*, 2015 WL 9704079, at *6 (S.D.N.Y. Dec. 23, 2015). She further explained that the jury should "compare actual costs incurred by the defendant … with costs it would have incurred to produce the same products without the use and knowledge of TydenBrooks' manufacturing process" and that the difference between these costs should be awarded as damages. Id. After trial, Judge Preska rejected CSS's challenge to the avoided cost methodology. CSS appealed Judge Preska's decision to the U.S. Court of Appeals for the Second Circuit. After affirming the district court as to liability, the Second Circuit certified to the New York Court of Appeals the question of whether, under New York law, a plaintiff can recover damages measured by "the costs the defendant avoided due to its unlawful activity" for claims of misappropriation of a trade secret, unjust enrichment, and unfair competition. *E.J. Brooks Co. v. Cambridge Security Seals*, 858 F.3d 744, 746 (2d Cir. 2017).

Writing for the majority in a 4-3 split decision, Judge Paul Feinman answered the question in the negative. E.J. Brooks case at *1. Acknowledging that the court had not yet "definitively stated" whether misappropriation of trade secret actions could be measured by an avoided cost methodology, the court determined that henceforth "damages in trade secret actions must be measured by the losses incurred by the plaintiff, and that damages may not be based on the infringer's avoided development costs." Id. at *5-6. In doing so, the court reasoned that the avoided cost methodology is "almost universally" considered a measure of a defendant's unjust gains, rather than plaintiff's losses, which is "not a permissible measure of damages." Id. at *6.

All hope for the New York state system may not be lost. The New York legislature could join the 49 other states that have adopted a version of the UTSA. Two draft bills to do so have been pending in the state legislature for over a year.

In a scathing dissent, Judge Rowan Wilson criticized the majority's approach for relying on inapposite case law to employ a "misguided bottoms-up attempt to decide this plaintiff's case rather than a top-down approach announcing principles of law." Id. at *8. In particular, Judge Wilson noted that trade secret cases require an especially "'flexible and imaginative approach to the problem of damages,'" and the majority's decision breaks from the court's rich history of flexible and imaginative jurisprudence. Id. at *9. Thus, he pointed out that the majority "forsakes New York's historic role as the vanguard," and, "[w]here [the New York Court of Appeals] should lead, [it] now refuse[s] even to follow." Id. at *8.

The decision in the E.J. Brooks case runs counter to the DTSA. The DTSA gives plaintiffs the ability to sue for monetary and equitable relief in federal court for the misappropriation of a trade secret. H.R. Rep. No. 114-529, at 196 (2016). It hews closely to the Uniform Trade Secrets Act (UTSA), a version of which has been adopted by 49 states. Indeed, on Aug. 10, 2018, when Massachusetts adopted the UTSA, New York became the only state that has not yet done so, although two bills to adopt a version of the statute are pending in the state legislature. Aaron Nicodemus, "Massachusetts Adopts Uniform Trade Secrets Law," Intellectual Property on Bloomberg Law (Aug. 16, 2018). In the House Judiciary Committee Report recommending the passage of the DTSA, the Committee

indicated that subparagraph B of the DTSA, which governs how to award damages under the Act, was "drawn directly from S 3 of the UTSA." H.R. Rep. No. 114-529, at 205 (2016). "Specifically, it authorizes an award of damages for the actual loss and any unjust enrichment caused by the misappropriation of the trade secret … ." H.R. Rep. No. 114-529, at 205 (2016). Indeed, the DTSA permits a plaintiff to seek damages calculated in one of three ways: (1) actual loss caused by the misappropriation; (2) "for any unjust enrichment caused by the misappropriation … that is not addressed in computing damages for actual loss;" or (3) "in lieu of damages measured by any other methods, the damages caused by the misappropriation measured by imposition of liability for a reasonable royalty for the misappropriator's unauthorized disclosure or use of the trade secret." 18 U.S.C. §1836(b)(3).

Federal courts interpreting the DTSA have held that an avoided cost measure of damages is an appropriate way to calculate damages, as a measure of "unjust enrichment" under the Act's second damages calculation option. For example, in *Steves and Sons*, the U.S. District Court for the Eastern District of Virginia recently explained that a damages expert's avoided cost calculations were "appropriately considered as part of [the alleged misappropriator's] unjust enrichment damages" under the DTSA. 2018 WL 2172502, at *6 (E.D. Va. May 10, 2018). Similarly, in *VIA Technologies v. ASUS Computer International*, the U.S. District Court for the Northern District of California explained that "[w]here the plaintiff's loss does not correlate directly with the misappropriator's benefit … [a] defendant's unjust enrichment might be calculated based upon cost savings or increased productivity resulting from use of the secret" in a trade secret misappropriation case brought under the DTSA and California's version of the UTSA. 2017 WL 3051048, at *4 (N.D. Cal. July 7, 2017).

As many, including Judge Preska and Judge Wilson, have acknowledged, "computing damages in a trade secrets case is not cut and dry." *Steves & Sons*, 2018 WL 2172502, at *3. See also *Mar Oil Co. v. Korpan*, 973 F. Supp. 2d 775, 782 (N.D. Ohio 2013) (noting the difficulty of calculating trade secret damages); *Avery Dennison v. Four Pillars Enter.*, 45 F. App'x 479, 485 (6th Cir. 2002) ("Damages in trade secret cases are difficult to calculate, because the offending company has mixed the profits and savings from increased quality and quantity of products, as well as savings from reduced [] costs of research and production, with its own natural profits."). In attempting to make it so by limiting recovery to plaintiff's losses, the New York Court of Appeals in *E.J. Brooks Co. v. Cambridge Security Seals*, may very well have driven trade secret litigation from New York courts to federal courts, as plaintiffs will prefer the flexible damages options provided by the DTSA. However, all hope for the New York state system may not be lost. The New York legislature could join the 49 other states that have adopted a version of the UTSA. Two draft bills to do so have been pending in the state legislature for over a year.