

MEASURING DAMAGES IN MISAPPROPRIATION OF TRADE SECRETS MATTERS



OUR **AUTHORS**



SHAWN FOX
CPA, ABV, CFA, ASA
MANAGING DIRECTOR

T: 312.648.6655
E: shawn.fox@sikich.com



DAVID WHARTON
CPA, CFE, CFF
SENIOR MANAGER

T: 816.673.7534
E: david.wharton@sikich.com



ALEX BRANDON
ASA
SENIOR MANAGER

T: 314.590.2427
E: alex.brandon@sikich.com

MEASURING DAMAGES IN MISAPPROPRIATION OF TRADE SECRETS MATTERS

A Cluttered Landscape

Some of the many issues damages experts need to navigate include quantifying future damages, analyzing the impact of apportionment, estimating reasonable royalty, establishing a time-frame for measuring damages, allocating expenses in quantifying defendant's profits, avoiding double-counting, and valuing complex early-stage trade secrets.

The number of trade secrets cases filed in the U.S. is growing rapidly.

According to Lex Machina's Trade Secrets Litigation Report 2018, that number stayed steady at approximately 900 cases per year until 2017 when the number of trade secrets filings increased by 30 percent to 1,134.ⁱ

In trade secrets litigation, damages experts must navigate many issues (see "A Cluttered Landscape"). It is important for plaintiffs and defendants in these cases to understand their options for damages remedies and the role of the damages expert. The assignment for a plaintiff's damages expert is to estimate the plaintiff's actual loss (making the plaintiff "whole"), defendant's unjust enrichment (measuring the financial gains realized by the defendant), and/or reasonable royalty (based on the royalty income that the plaintiff would have earned had it entered into a hypothetical license agreement for the alleged misappropriated trade secrets).

WHY TRADE SECRET MATTERS ARE SO COMPLEX

Many factors contribute to the growing volume and complexity of trade secrets cases. Among them are continued expansion of digital technology; the enactment of laws aimed at punishing misappropriation, including the U.S. Defend Trade Secrets Act of 2016 (DTSA) and the Uniform Trade Secrets Act (UTSA); and the flexible definition and characteristics of trade secrets that enable enforcement officials and plaintiffs to cast a wide net.

Adding to the complexity are the numerous legal claims that often accompany misappropriation of trade secrets matters, which include unjust enrichment, Computer Fraud and Abuse Act (CFAA) and Stored Communications Act (SCA) violations, unfair competition, conversion, breach of contract, tortious interference, breach of fiduciary duty, copyright infringement, patent infringement, and whistleblower allegations.

University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518 (5th Cir. 1974) "stressed that 'each case is controlled by its own peculiar facts and circumstances,' and that courts should remain 'flexible and imaginative'" when estimating the plaintiff's proper damages.ⁱⁱ That flexibility can be a two-edged sword, on one hand giving plaintiffs considerable room to maneuver while at the same time creating significant complexity that can be challenging.

For example, merely defining the terms "trade secret" and "misappropriation" in each case is no simple matter. The three most commonly used definitions of trade secrets are from the DTSA, the UTSA and the U.S. Economic Espionage Act (EEA). While the DTSA and EEA definitions are virtually identical, the UTSA definition is more detailed. Variations of the UTSA definition have been adopted by 48 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands – New York and North Carolina use other definitions – creating a maze to be navigated by litigants and damages experts.

There are also differences at the state court jurisdiction in the definition of "improper," exemplary damages, awarding of attorneys' fees, statutes of limitations, definition of a person, differences in damages measured by a reasonable royalty, and adoption of inevitable disclosure doctrine. Some states have chosen not to enact all provisions of the UTSA, while others enacted unique statutory provisions.ⁱⁱⁱ

A RANGE OF TRADE SECRET DAMAGES REMEDIES AVAILABLE TO PLAINTIFF

The remedies available to a plaintiff include equitable relief (preliminary injunction or permanent injunction), monetary damages (compensatory, unjust enrichment or restitution damages), and legal fees. As with definitions of terms relating to trade secrets cases, the damages provisions of the federal and various state statutes vary widely, so it is generally recommended that damages be measured on an individual trade secret basis and disaggregated among trade secrets or other legal claims by a damages expert.

That process can be challenging because of the complexities of measurements associated with plaintiff's remedies, including "actual loss," "unjust enrichment" and/or "reasonable royalty."

ACTUAL LOSS – MAKING THE PLAINTIFF WHOLE

A common goal when estimating plaintiff's actual loss damages in a trade secrets litigation matters is to attempt to make the plaintiff "whole" after the alleged damages event. Actual loss damages may include:

- Profits that the plaintiff would have received in the absence of the defendant's act of misappropriation, including lost sales on convoyed and ancillary products or services that would be sold together with the product or service using the trade secret
- Plaintiff's increased costs caused by defendant's act of misappropriation
- The value of the trade secret to the plaintiff as of the date of the misappropriation if the trade secret had been destroyed, or otherwise its diminution
- A decline in the value of the plaintiff's business
- Price erosion because the plaintiff had to lower prices to compete with the defendant's use of the trade secret
- Plaintiff's costs of research and development of the trade secret
- Plaintiff's cost to restore and remedy the effects of the misappropriation of the trade secret

The common denominator between these types of damages, as established in various cases and the AICPA's Guide to Intangible Asset Valuation is restoring the plaintiff to an economic position that reflects where plaintiff would have been had the misappropriation not occurred. Lost profits and the trade secret's fair market value are important components of the actual loss calculations.

LOST PROFITS

The plaintiff's lost profits are calculated first by determining lost revenue and then deducting the incremental costs that would have been incurred in producing the lost revenue. Typically, lost revenue is calculated using the "before and after" method, "yardstick" or benchmark method, "but for" or sales projection method, or an approach based on the terms of the underlying agreement, such as confidentiality, non-compete or non-disclosure agreement.

Whichever method is used, the calculation includes the projected "but for" revenue, minus the plaintiff's actual revenue during the loss period. The "but for" method may consider adequately supported company financial projections, budgets and forecasts prepared prior to the harmful event; the market share the plaintiff would have attained but for the misappropriation of trade secrets – an estimate of revenue based on market trends; economic modeling; and impact of changes in price and volume.^{iv}

After determining the amount of lost revenue, the damages expert must calculate the costs associated with the generation of lost revenue, using several methods of cost estimation in the analysis. Key considerations include:^v

- Analysis of cost structure for cost of goods sold and operating expenses (direct costs and indirect costs) in the determination of fixed versus variable (costs may be fixed, variable, or semi-variable)
- Use of non-statistical methods of cost estimation, such as account analysis, direct assignment, accounting estimates, cost accounting allocations, ratio analysis, graphical approaches and industrial engineering, or statistical methods of cost estimation, such as regression analysis, attribute sampling and survey data.

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Historical and future lost profits may be calculated in misappropriation of trade secrets matters.^{vi} However, it is important for the plaintiff's attorney and damages experts to review the relevant state's statutes and substantive case law for situations in which the damages expert is calculating future lost profits. It is also important for the damages expert to consider the portion of profits attributable to the trade secret.

The plaintiff is generally only entitled to lost profits that are attributable to the subject trade secret. Thus, in situations involving complex technology, a damages analysis may need to include an apportionment analysis. One of the key considerations is whether the misappropriated trade secret features drive the demand for the product. The apportionment process is evolving and still faces many uncertainties. Due to the complexity of apportionment issues, standardization will take many years.

A risk-adjusted discount rate is applied to the plaintiff's future lost profits. The discount rate includes a component for the time value of money (inflation) and risk inherent in future lost profits. The future lost profits are generally discounted back to the date of the misappropriation of trade secrets or the current date (such as date of report or trial).^{vii} The discount rate should include an analysis of the risk of the misappropriated trade secret(s).

There are some states that limit the loss period to a "head-start" period. There are also situations in which a court may award the monetary damages to compensation for the defendant's past use of the trade secret in addition to a permanent injunction to prevent the defendant's future use of the trade secret. Both an award of future lost profits and permanent injunction may be considered an impermissible double recovery.^{viii}

Fair Market Value

According to an article published in *Inside Counsel*, "Where the market is damaged due to defendant's disclosure of the trade secret, the plaintiff may also recover certain provable future profits based on historical data or the fair market value of the trade secret if the defendant had disclosed the trade secret publicly."^{ix}

The valuation analysis should generally be calculated for each trade secret identified within the lawsuit. The compensatory damages in the trade secrets matter of *Wellogix, Inc. v. Accenture, L.L.P.*, (U.S. Court of Appeals, No. 11-201816) were estimated based on the lost business value due to the misappropriation of trade secrets. The plaintiff's damages expert used a market approach to value the company based on prior transaction of a venture capital group's 31-percent equity interest in the plaintiff near the date of the misappropriation.^x

In situations in which a plaintiff's damages expert has estimated the damages based on entire fair market value of a company, this method is generally more appropriate when the entire value of the company is based on the misappropriated trade secret. This can be especially relevant in situations when there are multiple trade secrets held by the plaintiff.

The standard of value usually used is a fair market value type standard based on what a reasonable investor would have paid for the trade secrets. Fair market value is defined in the American Society of Appraisers (ASA) Business Valuation Standards' Glossary as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."^{xi}

Three generally accepted approaches are used to value trade secrets:

- Cost approach, based on the economic principle of substitution, under which a prudent investor would pay no more for a trade secret than the cost necessary to replace and/or protect the trade secret. The value of the trade secret is determined by aggregating the costs involved in its development.
- Market approach, based on an analysis of trade secret acquisition transactions or trade secret licenses to value the subject trade secret.
- Income approach, used to estimate the value of a trade secret if the trade secret produces any measure of either operating income or license income.

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UNJUST ENRICHMENT - MEASURING DEFENDANT'S FINANCIAL GAIN

In misappropriation of trade secrets cases, “unjust enrichment” generally “requires a showing that a plaintiff conferred a benefit on a defendant that the defendant knew about and that allowing the defendant to retain the benefit without payment would be unjust.”^{xii}

The goal of calculating unjust enrichment in trade secrets litigation matters is to attempt to eliminate the benefit of the unlawful misappropriation of the ill-gotten benefits, profits, or advantages acquired by the defendant, which may include:^{xiii}

- Defendant's profits on sales attributable to use of the trade secrets through increased revenue
- Defendant's saved research and development
- Defendant's time savings and/or acceleration to market (head-start damages)
- Defendant's cost efficiencies and increased operating profits
- Defendant's risk reduction and increased business value from lower risk associated with future cash flows
- Value of the alleged trade secrets taken by the defendant as of the date of the misappropriation

The UTSA states that, “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.”^{xiv} Thus, the damages expert cannot use the same lost sales for calculating plaintiff's lost profits and unjust enrichment of defendant's profits.

The plaintiff typically has the burden of proving the defendant's revenue and then the defendant generally has the burden to prove deductions and offsets from revenue. Typically, the misappropriator will need to prove that the expense item was paid, and it was attributable to the sales using the misappropriated trade secrets. Certain allowable deductions may include cost of materials, services, and labor incurred in producing the goods or services; insurance premiums; building repairs; allocated percentages of overhead costs; and selling, marketing, and advertising costs.

There are some jurisdictional differences on which expenses can be deducted from revenue. It is important for the plaintiff's attorney to review the relevant state's statutes and substantive case law for situations in which the damages expert is calculating an accounting of the defendant's profits to determine which expenses should be deducted from revenue.

In general, a plaintiff's lost profits calculation subtracts incremental expenses from revenue; whereas, an accounting of the defendant's profits may be calculated by either (1) subtracting incremental expenses from revenue; or (2) subtracting fully allocated expenses (incremental and fixed expenses) from revenue. For example, U.S. courts are split on the issue of overhead allocation in an accounting of the defendant's profits for an unjust enrichment calculation.^{xv, xvi}

It is important for the plaintiff's attorney to review the relevant state's statutes and substantive case law for situations in which the damages expert is calculating future unjust enrichment for defendant's profits. According to a recent Business Valuation Resources program titled “Measuring Unjust Enrichment,” this program stated that “Future unjust enrichment is becoming more common.”^{xvii}

REASONABLE ROYALTY

When damages cannot be calculated based on plaintiff's actual loss or defendant's unjust enrichment, a reasonable royalty can be used to calculate damages, although this approach is employed relatively less frequently than the other two methods. The reasonable royalty is generally based on the royalty income that the plaintiff would have earned had it entered into an agreement to license the misappropriated trade secrets to the defendant.

There is a relatively small amount of case law on quantifying reasonable royalty in trade secrets cases. Some experts may look at case law for reasonable royalty on patent infringement legal cases, which is far more developed.

The reasonable royalty rate method generally calculates what a third-party licensor would pay to a third-party licensee for an arm's length use license related to the misappropriated trade secret(s). Additionally, the royalty rate may be based on documentation between the parties showing the value the parties placed on the misappropriated trade secrets, or it may be based on other existing licensing agreements with other third parties for the trade secrets.

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A reasonable royalty considers the royalty base and the royalty rate. A royalty rate can generally be based as a percentage of gross revenue, percentage of net revenue, percentage of cost savings, per unit, lump sum, or some other basis agreed to by the parties. Trade secrets are generally licensed either on an individual stand-alone basis, or as a component of a patent or a broader IP license agreement.

Royalty rate methods include the “incremental profit” method, “differential income” method, “comparable uncontrolled transaction” method, and “comparable profit margin” method. Cost savings may be another consideration in analyzing reasonable royalty.

DEFENDANT’S REBUTTAL STRATEGIES TO PLAINTIFF’S DAMAGES EXPERT’S OPINIONS

Below is a list of rebuttal strategies that a damages expert should generally consider:

- The plaintiff has not proved that its damages were caused by defendant’s misappropriation of trade secrets and there is no nexus between the misappropriation and actual loss.
- The plaintiff’s damages expert’s opinions are speculative and do not meet the reasonable certainty threshold.
- The plaintiff’s loss period is not reasonable (compared to the time needed to independently develop the trade secret).
- The remaining economic useful life of the trade secret is lower than the period asserted by the plaintiff’s damages expert.
- Some portion of the plaintiff’s damages is comprised of an impermissible double-recovery.
- The defendant did not use the trade secret information (example may include the doctrine of inevitable disclosure, which is an inference that the former employee will inevitably use former employer’s trade secrets in carrying out the same duties for new employer – state laws vary significantly on this issues).
- The plaintiff only included a damages model based on misappropriation of all of the trade secrets and failed to disaggregate damages among trade secrets or other legal claims.
- The alleged trade secret information does not provide a competitive advantage or economic benefit.
- The plaintiff’s losses to the business were caused by changes in consumer demand for a product or service incorporating the trade secret or alternative products.
- The plaintiff’s damages expert does not have the requisite qualifications.
- The plaintiff’s damages expert relied upon unreliable data or employed unreliable or untested methods.
- The plaintiff’s damage expert’s damages opinions included errors or omits key information.

CONCLUSION

Quantifying damages in a trade secrets case is significantly different from other types of litigation matters. Many approaches can be employed to measure damages in such cases, and the differences are significant between federal and state laws, laws in the states themselves, and in case law covering misappropriation of trade secrets.

With trade secrets litigation on the rise and likely to continue to increase in the future, it is important that counsel retains an experienced damages expert who can tie the damages remedies to the unique facts and circumstances of the case and exercise professional judgment in the approach to quantifying damages.

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CITATIONS

ⁱ *Lex Machina Trade Secret Litigation Report 2018*, July 2018.

ⁱⁱ *University Computing Co. v. Like's-Youngstown Corp.*, 504 F.2d 518 (5th Cir. 1974).

ⁱⁱⁱ "Anything but Uniform: A State-By-State Comparison of the Key Differences of the Uniform Trade Secrets Act, Snell & Wilmer L.L.P., Sid Leach.

^{iv} "Current Trends in Trade Secret Valuation and Damages, Business Valuation Resources, LLC, Barry Werbin and Craig Jacobson, July 28, 2015, slide 47.

^v *Ibid*, pp. 29-30.

^{vi} *Current Trends in Trade Secret Valuation and Damages, Business Valuation Resources, LLC, Barry Werbin and Craig Jacobson, July 28, 2015, slide 44.*

^{vii} "Calculating Lost Profits," AICPA Practice Aid 06-4, pp. 35-36.

^{viii} "Understanding and Litigating Trade Secrets Under Illinois Law: An Outline For Analyzing The Statutory and Common Law of Trade Secrets In Illinois, Jenner & Block LLP, Debbie L. Berman, Daniel J. Winters, April A. Otterberg, 2011, pp. 81-82.

^{ix} "The 3 types of trade secret misappropriation damages claims an expert can help prove," *Inside Counsel*, Devon Zastrow Newman, April 24, 2015.

^x <https://caselaw.findlaw.com/us-5th-circuit/1631352.html>.

^{xi} http://www.appraisers.org/docs/default-source/discipline_bv/bv-standards.pdf?sfvrsn=0.

^{xii} *Quality Auto Painting Ctr. Of Roselle, Inc. v. State Farm Indem. Co.*, 870 F. 3d 1262, 1277 (11th Circuit 2017).

^{xiii} "Trade Secret – Value and Damages Considerations," *OverMont Consulting, LLC*, September 6, 2012.

^{xiv} *Uniform Trade Act with 1985 Amendments*, p. 10.

^{xv} "Measuring Unjust Enrichment," *Business Valuation Resources, LLC*, George Roach, slides 79-80.

^{xvi} "Causation In Disgorgement," *Boston University Law Review*, Mark P. Gergen, p. 843

^{xvii} "Measuring Unjust Enrichment," *Business Valuation Resources, LLC*, George Roach, slide 23.