

LEGAL MEMORANDUM

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Strengthening Property Rights and the U.S. Economy Through Federal Trade Secret Protection

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Abstract

Trade secrets are types of business information that confer value because of their secrecy, such as confidential formulae, manufacturing techniques, and customer lists. The theft of U.S. trade secrets is a growing problem, costing American businesses hundreds of billions of dollars per year. Electronic espionage by major foreign powers such as China is particularly serious. Unlike holders of other forms of intellectual property, owners of trade secrets cannot invoke a federal civil legal remedy. A federal trade secrets law would help victims recover damages and make it easier to stop thieves before they flee the country. Such a law, designed not to displace optional state law remedies, would both protect the rights of the owners of trade secrets and strengthen the economy.

Strong protection for intellectual property (IP) is vitally important to the health of the United States economy. IP industries account for more than 40 percent of U.S. economic growth and employment, and they create strong incentives for investments in innovation that drive future U.S. economic growth and innovation.¹

Currently, owners of three of the four major categories of IP rights—patents, trademarks, and copyrights—may invoke robust federal law remedies to compensate them for the theft of their valuable property. Owners of the fourth key category of IP rights—trade secrets—do not, however, enjoy such protection. Creation of a federal civil remedy for trade secret theft would remedy this shortcoming to the benefit of the U.S. economy and American holders of trade secrets. It might also help to spur stronger international protection of trade secrets.

This paper, in its entirety, can be found at <http://report.heritage.org/lm128>

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KEY POINTS

- Trade secrets are types of sensitive business information that create value because they are non-public, such as confidential formulae and industrial techniques. They are increasingly important in the emerging global high-tech economy.
- Trade secret theft costs American businesses hundreds of billions of dollars a year. Economic espionage from China and other countries is particularly serious.
- Unlike holders of other forms of intellectual property, such as patents, copyrights, and trademarks, trade secret owners do not have a federal remedy to help recover their losses. State trade secret laws are useful but limited in their effectiveness.
- A federal trade secret law would provide new tools to apprehend thieves before they flee the country and to seize thieves' assets. Existing state law remedies should not be displaced, giving trade secret owners a full set of options.
- Passage of a well-crafted civil federal trade secrets law would enhance the value of trade secrets and strengthen the economy.

What Is a Trade Secret?

A trade secret is business information that confers economic value on its owner by virtue of its secrecy. Common types of trade secrets include proprietary industrial and manufacturing techniques, business and sales methods, confidential formulae, and customer lists.

Trade secrets run the full gamut of business-sensitive information, from the formula for Coca-Cola and the KFC recipe for fried chicken to the Google proprietary search algorithm and the WD-40 formula (the cleaning spray used by 80 percent of Americans)² to Rockwell Graphic's drawings of its printing press replacement parts,³ to name just a few examples. Once trade secret information becomes public, it is essentially worthless because third parties—particularly competitors—can use it freely.

The Growing Problem of Trade Secret Theft

U.S. trade secret theft is a growing problem that stems not just from security breaches by firms' employees and business partners, but also from expanding electronic espionage by rival firms and foreign governments. Trade secret misappropriation imposes huge costs on the American economy. In 2012, the National Security Agency estimated that U.S. businesses lose \$334 billion per year due

to trade secret thefts and cyber breaches.⁴ If anything, this figure understates the problem because it does not include the significant costs that businesses absorb to protect their secrets. Moreover, the burden of trade secret theft will likely rise as China and other nations increasingly target U.S. business assets,⁵ as underscored by the recent U.S. Justice Department indictment of Chinese officers.⁶

The scale of business losses from individual thefts is huge. For example, Motorola spent over \$400 million in developing iDEN military telecommunications technology, which was stolen on behalf of a company that developed products for the Chinese military.⁷ This is not just a big-business problem. The loss of trade secrets is particularly significant for small-sized and medium-sized enterprises, which rely more heavily on such secrets than they do on other forms of IP to protect their information assets.⁸

Status of Legal Protection for American Trade Secret Owners

Unlike holders of the other three primary forms of IP—patents, trademarks, and copyrights—trade secret owners must depend on state law to protect their rights in the face of trade secret theft. State statutes based on the American Law Institute's Uniform Trade Secrets Act (UTSA) have largely supplanted state common law protection of trade

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1. See U.S. Chamber of Commerce, *Why Is IP Important?*, GLOBAL INTELLECTUAL PROPERTY CENTER, <http://www.theglobalipcenter.com/resources/why-is-ip-important/> (last visited June 11, 2014).
 2. Melanie Radzicki McManus, *10 Trade Secrets We Wish We Knew*, HOW STUFF WORKS (Oct. 10, 2013), <http://money.howstuffworks.com/10-trade-secrets.htm#page=10>.
 3. See *Rockwell Graphic Industries, Inc. v. Dev. Industries, Inc.*, 925 F.2d 174 (7th Cir. 1991) (Rockwell Graphic System's drawings of replacement parts for its printing presses were a trade secret that it had sought to protect in its contracts with makers of replacement parts).
 4. See Letter from Jeffrey I. D. Lewis, President, American Intellectual Property Law Association, to the Honorable Victoria A. Espinel, United States Intellectual Property Enforcement Coordinator, Executive Office of the President, Re Response to Request for Public Comments for Trade Secret Theft Legislative Review (April 22, 2013), available at <http://www.aipla.org/advocacy/executive/Documents/AIPLA%20Letter%20to%20IPEC%20on%20Trade%20Secrets%20-%204.22.13.pdf>.
 5. Seventeen of the 20 trade secret criminal prosecutions brought by the Justice Department between January 2009 and January 2013 involved China. See EXECUTIVE OFFICE OF THE PRESIDENT, ADMINISTRATIVE STRATEGY ON MITIGATING THE THEFT OF U.S. TRADE SECRETS, Annex B, 23–31 (2013), available at http://www.whitehouse.gov/sites/default/files/omb/IPEC/admin_strategy_on_mitigating_the_theft_of_u.s._trade_secrets.pdf.
 6. On May 19, 2014, the Justice Department indicted five Chinese military officials for hacking into computers and stealing valuable trade secrets from leading American firms in the steel, nuclear power, and solar power industries. The indictment alleges that the hackers stole trade secrets that would have been particularly valuable to Chinese companies. See Ellen Nakashima and William Wan, *Chinese Military Unit Charged with Cyber Espionage Against U.S. Firms*, THE WASHINGTON POST (May 19, 2014), http://www.washingtonpost.com/world/national-security/us-to-announce-first-criminal-charges-against-foreign-country-for-cyberspying/2014/05/19/586c9992-df45-11e3-810f-764fe508b82d_story.html.
 7. EXECUTIVE OFFICE OF THE PRESIDENT, *supra* note 5, at 25.
 8. See INTERNATIONAL CHAMBER OF COMMERCE, ENHANCING INTELLECTUAL PROPERTY MANAGEMENT AND APPROPRIATION BY INNOVATIVE SMEs, 13–15 (2013). In particular, the difficulty and costs of obtaining and maintaining a patent, coupled with the costs of patent litigation, often make it most attractive for smaller businesses to depend primarily on trade secrets.

secrets.⁹ At present, 47 of the 50 states and the District of Columbia have adopted it. New York, North Carolina, and Massachusetts have not yet done so, but their laws are substantially similar to the UTSA.

The UTSA defines a trade secret as information (including a formula, pattern, compilation, program, method, technique, or process) that (1) derives economic value from not being generally known or readily ascertainable using proper means by other persons and (2) is the subject of efforts to maintain its secrecy that are reasonable under the circumstances.

Misappropriation of a trade secret under the UTSA occurs when the secret has been acquired (1) through improper means, (2) under an obligation not to disclose or use it, (3) from someone who had an obligation not to disclose it, or (4) by accident or mistake if the accidental acquirer later learned that the information was a trade secret before using or disclosing it. “Improper means” include theft, bribery, misrepresentation, breach, inducement of a breach of duty to maintain secrecy, or espionage through electronic or other means. Reverse engineering and independent discovery of information embodied in a trade secret are not improper means.

Sanctions under the UTSA include preliminary and permanent injunctions for threatened and actual misappropriation; damages (including payments for unjust enrichment and up to double damages for willful and malicious misappropriation); and reasonable attorney’s fees (for bad faith or willful and malicious misappropriation).

Federal Criminal Penalties

The Economic Espionage Act of 1996,¹⁰ whose definitions track the UTSA, criminalizes misappropriation of trade secrets (1) intended to benefit foreign governments or agents and (2) for economic gain. Criminal fines include imprisonment, individual

fines of up to \$5 million, and fines directed at organizations of up to \$10 million or three times the value of the misappropriated trade secret, whichever is larger.

Trade secrets illicitly acquired through computer hacking (computers accessed “without authorization”) are subject to criminal and civil penalty under the Computer Fraud and Abuse Act.¹¹ Finally, various state laws impose criminal sanctions for certain types of trade secret thefts.¹²

Lack of a Federal Civil Remedy

The lack of a federal civil remedy for victims of trade secret theft precludes owners of trade secrets from vindicating their rights under certain circumstances. Enjoining and sanctioning trade secret thieves who cross state lines is often difficult. Procedural differences and jurisdictional issues inherent in a multistate system may complicate and render more costly efforts to achieve results in a non-local tribunal. Efforts to invoke federal diversity jurisdiction likewise are complicated by requirements of complete diversity of citizenship among the parties¹³ and choice-of-law questions. Despite the similarity among state civil laws, procedural and case law differences may arise.

Furthermore, although victims of trade secret theft can inform the Justice Department (and state attorneys general in some jurisdictions) of suspected criminal misappropriations, limited prosecutorial resources and conflicting demands on enforcers make obtaining federal (or state) action—which in any event does not directly compensate the victim—an uncertain proposition. For example, companies may find it particularly difficult to recoup losses from employees who steal a trade secret, immediately leave the state where the theft occurred, flee the United States, and subsequently turn the trade secret over to a competitor.

9. UNIF. TRADE SECRETS ACT (1985), http://www.uniformlaws.org/shared/docs/trade%20secrets/utsa_final_85.pdf.

10. 18 U.S.C. §§ 1831-1839.

11. 18 U.S.C. § 1030.

12. See COVINGTON & BURLING LLP, ECONOMIC ESPIONAGE AND TRADE SECRET THEFT: AN OVERVIEW OF THE LEGAL LANDSCAPE AND POLICY RESPONSES, 10-11 (Sept. 2013).

13. None of the plaintiffs can be from the same state as any of the defendants. See *Lincoln Property Co. v. Roche*, 546 U.S. 81 (2005). This creates difficulties for many holders of trade secrets. A corporation is treated as a citizen of the state in which it is incorporated and the state in which its principal place of business is located. See *Danjaq, S.A. v. Pathe Comm’ns Corp.*, 979 F.2d 772 (9th Cir. 1992). A partnership or limited liability company is considered to have the citizenship of all of its constituent partners/members. See *Johnson v. Columbia Properties Anchorage, LP*, 437 F.3d 894 (9th Cir. 2006). Thus, an LLC or partnership with one member or partner sharing citizenship with an opposing party will destroy diversity of jurisdiction.

In such situations, time is of the essence, and the requirement to seek a private remedy under another state's law can cause critical delays. Such delays may make the difference between stopping a rogue employee before he leaves the country and allowing him to get away.

The Benefits of Federal Trade Secret Legislation Without Offending Federalism

Unlike the current situation, a federal civil statutory remedy would make federal tribunals instantly available to aggrieved businesses that seek injunctions, which is particularly important when time is of the essence due to flight risks. As soon as a federal judge issues an injunction, federal marshals could act quickly to stop a rogue employee or other thief from leaving the country. A uniform federal damages standard would also benefit firms by reducing uncertainties that may arise due to differences in state-specific case law and procedural norms.

Furthermore, by creating a powerful new means of obtaining recompense for harmed businesses, strong federal civil trade secret legislation would at least marginally reduce the expected rewards and incentives of misappropriation of trade secrets. This would tend to slow the growth of trade secret theft to the benefit of both IP holders and the broader American economy.

Relatedly, an appropriate federal statute would have a salutary “demonstration effect” on major foreign jurisdictions, such as the European Union (EU), which is considering EU-wide regulation to protect trade secrets.¹⁴ Federal legislation could strengthen the hand of U.S. negotiators in pushing for the U.S. approach to trade secrets in ongoing U.S.–EU trade and economic liberalization negotiations on the Transatlantic Trade and Investment Partnership (T-TIP). The United States could also use a T-TIP accord to press other large jurisdictions with poor

records on trade secret protection—such as China—to improve their systems. In short, good federal legislation could yield significant domestic and international benefits for American holders of trade secrets.

Moreover, a new federal law need not undermine federalism. As long as the federal standard does not preempt state law remedies, it would retain the potential benefits of the states continuing experiments to write optimal civil trade secret laws, and harmed companies could pursue state remedies if they so desired. The ability of federal and state IP laws to coexist is well illustrated by the case of trademarks, where the federal Lanham Act and state laws protecting trademarks have long coexisted successfully.¹⁵

Additionally, in today's information economy in which trade secrets may be electronically transmitted across state lines and international boundaries quickly and seamlessly and as trade secret theft imposes a major and growing burden on interstate commerce, extending federal civil law to combat the theft of trade secrets would be a quintessentially appropriate exercise of Congress's authority to regulate interstate commerce.¹⁶

Proposed Coons–Hatch Bill

The Defend Trade Secrets Act of 2014 (S. 2267), a bill introduced on April 29, 2014, by Senators Christopher Coons (D–DE) and Orrin Hatch (R–UT), provides a civil right of action in federal district court for misappropriation of a trade secret that is related to or included in a product, process, or service used in, or intended for use in, interstate commerce. It suggests a possible template for federal trade secret legislation that draws on the UTSA and does not preempt state law, thereby respecting federalism. Key features of this bill include:

- Definitions of “misappropriation” and “improper means” derived from the UTSA;

14. See EUROPEAN COMMISSION, STUDY ON TRADE SECRETS AND CONFIDENTIAL BUSINESS INFORMATION IN THE INTERNAL MARKET (April 2013), http://ec.europa.eu/internal_market/ipenforcement/docs/trade-secrets/130711_final-study_en.pdf. This study, prepared for the European Commission, recommended enactment of European Union-wide trade secret legislation.

15. The Lanham Act, 15 U.S.C. § 1051 et. seq. (15 U.S.C. ch. 22), contains no preemption provision and is recognized as not displacing state trademark law. Indeed, federal courts have upheld state law remedies that go beyond federal trademark remedies. See, e.g., *Attrezzi, LLC v. Maytag Corp.*, 436 F.3d 32 (1st Cir. 2006).

16. U.S. CONST., art I, § 8, cl. 3 (empowering Congress “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes”).

- Provision for ex parte application for a court order to preserve evidence and seize property used to commit the misappropriation and to prevent irreparable harm (similar to provisions in federal trademark law);
- Remedies that include injunction, a reasonable royalty, and damages (with double damages and reasonable attorney’s fees available for willful or malicious misappropriation); and
- A three-year statute of limitations (victims of trade secret theft have three years to bring suit after the misappropriation is discovered or should have been discovered through “reasonable diligence”).

No Panacea, but a Step Forward

The growing theft of U.S. trade secrets is significantly harming the U.S. economy and the property rights of American businesses. While no panacea, appropriately crafted federal trade secret legislation that respects federalism principles could bolster the U.S. economy and protect important property rights both at home and abroad. Such legislation merits serious consideration.

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