

Lessons On Trade Secret Claims From Possessor, Not Owner

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It is not often that a federal appeals court issues a decision on trade secrets, much less one involving the review of a bench trial that drew legal conclusions on the scope of trade secret law and the propriety of compensatory and punitive damages.

But on April 30, in *Advanced Fluid Systems Inc. v. Huber*,^[1] the [U.S. Court of Appeals for the Third Circuit](#) did just that when it affirmed a Pennsylvania federal court's ruling that (1) lawful possession, as opposed to traditional ownership, of a trade secret is sufficient to maintain a trade secret misappropriation claim and (2) awarded \$3.1 million damages, including \$2 million in punitive damages, for misappropriation of trade secrets, breach of fiduciary duty, and aiding and abetting breach of fiduciary duty.

Along the way, the Third Circuit also commented upon the implications of tactical decisions during the litigation and trial, which contributed to the rejection on procedural grounds to several challenges to the award.

This decision is particularly important for companies in very typical vendor relationships whereby vendors create, use or apply confidential information and trade secrets to develop solutions and/or manufacture products for other entities pursuant to a contract.

Factual Background

The fact pattern underlying this lawsuit is a relatively common one in the trade secret misappropriation world. Advanced Fluid Systems manufactures hydraulic fluid systems used to move heavy machinery for complex operations and engineering projects. In September 2009, AFS entered into a contract with the Virginia Commonwealth Space Flight Authority to maintain a hydraulic system for a [NASA](#) rocket launch facility on Wallops Island, Virginia.

The contract specified that all materials generated during contract performance were the "exclusive property" of the Space Flight Authority. Thereafter, AFS developed and produced documents related to the operations and projects, all of which included confidentiality stamps identifying it as AFS work product.

In September 2012, [Orbital Sciences Corporation](#) acquired control of the launch system,

including AFS' hydraulic system, from the Space Flight Authority. Orbital then started the process of bidding out the work that AFS had been doing for the Space Flight Authority.

During this time frame, Kevin Huber, an AFS sales engineer, began communicating with an AFS competitor, Livingston & Haven LLC. Among other things, Huber sent AFS' confidential documents and engineering drawings related to AFS' hydraulic system to L&H's president, Clifton V. Vann IV, and L&H regional sales manager (and former AFS employee), Thomas Aufiero. Thereafter, Huber helped L&H prepare a bid and win a contract with Orbital using AFS' confidential engineering drawings.

But Huber not only double-crossed AFS, he also double-crossed L&H by forming his own business called Integrated Systems and Machinery LLC, which, in turn, won a separate contract from Orbital over both AFS and L&H. Before resigning from AFS and for good measure, Huber downloaded approximately 98 gigabytes of AFS's proprietary files.

Procedural History

On Dec. 24, 2013, AFS commenced this action against Huber, Integrated Systems and Machinery, L&H, Vann, Aufiero and Orbital claiming, inter alia, (1) trade secret misappropriation under the Pennsylvania Uniform Trade Secrets Act, which mirrors the Uniform Trade Secrets Act; (2) breach of fiduciary duty and duty of loyalty; and (3) aiding and abetting a breach of fiduciary duty. Eventually, AFS dismissed Orbital from the action pursuant to a settlement agreement whereby Orbital agreed to subcontract certain work on the hydraulic system to AFS.

On summary judgment, the [U.S. District Court for the Middle District of Pennsylvania](#) held that Huber and INSYSMA were liable for misappropriating AFS's trade secrets under the Trade Secrets Act. After a six-day bench trial, the court found that L&H, Vann and Aufiero were jointly and severally liable for trade secret misappropriation, and L&H, Huber, and Vann were liable for breach of fiduciary duty or aiding and abetting that breach.

It also awarded compensatory damages in the amount of \$1,096,009 against all defendants, \$1,000,000 in punitive damages against Huber individually, and another \$1,000,000 in punitive damages against L&H, Huber and Vann.

AFS's Misappropriation of Trade Secret Claim

On appeal, the appellants raised three arguments in support of their position that AFS could not maintain a trade secret misappropriation claim under Pennsylvania law. The Third Circuit rejected each argument.

First, the appellants argued that AFS did not "own" the trade secrets as the contract specified that the trade secrets belonged "exclusively" to the Space Flight Authority. As a textual matter, the Third Circuit noted that neither the language nor commentary to the UTSA nor the Trade Secrets Act specifically references legal ownership of the trade secrets as a prerequisite to a cause of action.

The Third Circuit also found the [U.S. Court of Appeals for the Fourth Circuit's](#) decision in *DTM Research LLC v. AT&T Corp.*[2] persuasive.

In *DTM*, the Fourth Circuit held that a party asserting a misappropriation claim under Maryland's Uniform Trade Secrets Act, which also largely follows the UTSA, only needed to show lawful possession of a trade secret and not "ownership in its traditional sense." The Third Circuit agreed and explained that "while ownership of the sort traditionally associated with real or personal property is sufficient to maintain a trade secret misappropriation claim because the complete bundle of rights related to trade secrets includes the right to enjoy the value of the information's secrecy, it is not a necessary condition."

The Third Circuit concluded that a "per se ownership requirement for misappropriation claims is flawed since it takes account neither of the substantial interest that lawful possessors of the secrets have in the value of the secrecy, nor of the statutory language that creates the protection for trade secrets while saying nothing of ownership as an element of a claim for misappropriation." Accordingly, the Third Circuit rejected the per se ownership rule suggested by the appellants.

Second, the appellants contended that AFS still lacked standing because it did not "lawfully possess" the trade secrets. While recognizing that better drafting of the contract would have included a licensing provision allowing AFS to use the trade secrets it was

creating for the Space Flight Authority, the court did not deem the absence of such a clause to mean that AFS did not lawfully possess the trade secrets.

The court noted that the record established that AFS physically retained the engineering drawings and other information, and AFS was required to use, and did use, the trade secrets to fulfill its contractual obligations with the Space Flight Authority and its later contracts with Orbital. Finally, the Space Flight Authority, as the owner of the trade secrets, did not object to AFS's retention or use of those secrets. Thus, the court concluded that AFS lawfully possessed the trade secrets, which was sufficient to bring suit.

Third, the appellants argued that the information was not a protectable trade secret based on inadequate measures taken to ensure its continued secrecy. The appellants first highlighted AFS' failure to have employees sign confidentiality agreements, which suggested that AFS did not have legitimate trade secrets to protect. As a general matter, the Third Circuit rejected this contention and agreed with the district court's conclusion that the overall facts of the case weighed in favor of finding the information was a trade secret.

The appellants then pointed to the fact that AFS provided the information to the Space Flight Authority (and to Orbital) without a formal nondisclosure or confidentiality agreement, and the Space Flight Authority, as a public entity, was subject to a state open-records law. The appellants emphasized that the contract's lack of a nondisclosure or confidentiality agreement was particularly significant as the information provided to the Space Flight Authority was theoretically subject to disclosure.

The Third Circuit agreed with the district court that the reality of the treatment of the information was more important than the theoretical challenges posed by the appellants. Even if the Space Flight Authority did not contractually bind itself to do so, the Space Flight Authority believed it had an obligation to preserve the confidentiality of the information and conducted itself in a manner consistent with that belief. Moreover, the appellants did not show that the Space Flight Authority was ever subject to an actual records request relating to the trade secrets at issue.

Finally, the Third Circuit declined to address an argument raised by the appellants for the first time in a reply brief — namely, that AFS could not bring a misappropriation claim because it would not incur a loss if the trade secrets were misappropriated. The right to raise this argument was deemed waived given the failure to assert or otherwise raise this argument at any prior point in the proceedings.

Set-Off of Orbital Settlement

The Third Circuit rejected the appellants' argument that the compensatory damages award should have been set-off by the value of AFS' settlement with Orbital, as a joint-tortfeasor, under the Pennsylvania Uniform Contribution Among Joint Tortfeasors Act. The Third Circuit agreed with the district court that the appellants were not entitled to a set-off because they had failed to plead or even raise the set-off issue at any point in the litigation.

Punitive Damages Award Against L&H and Vann

The Third Circuit found that the record contained sufficient evidence to sustain a punitive damages award against L&H and its president, Vann. The court noted that Vann approved a compensation package for Huber that incentivized him to damage AFS.

Furthermore, Vann knew that Huber was still employed by AFS when he was working against AFS's interest by steering business toward L&H. For example, Vann attended in-person meetings with Huber and was aware that L&H employees were working with Huber and sharing documents with him on Dropbox while Huber was still employed by AFS.

Conclusion and Important Takeaways

Thus, the Third Circuit joined the Fourth Circuit in holding that a misappropriation of trade secrets claim may be maintained even without a traditional ownership interest in the trade secrets at issue. Some of the more important takeaways from this decision include the following:

- If a contract contains an explicit provision licensing the use of trade secrets, it will likely avoid any later dispute as to whether the licensee lawfully possesses the trade secrets. As noted by the court, the lawful possession dispute would have been moot if the contract between AFS and the Space Flight Authority included a licensing provision.
- An organization should always require employees who are privy to trade secret information to sign a confidentiality agreement. While the Third Circuit agreed with the district court that the fact that AFS did not require its employees to sign confidentiality agreements did not preclude a finding of trade secret status, missing these key documents did weigh heavily against the finding and could result in a different conclusion under different factual circumstances.
- Similarly, an organization should only provide trade secret information to outside parties pursuant to a formal nondisclosure or confidentiality agreement. The Third Circuit noted that AFS did not execute such an agreement with either the Space Flight Authority or Orbital, which, again, was troubling although not dispositive of the issue of protecting trade secrets.
- Even during early stages of litigation, defendants should evaluate possible challenges to a potential damages award. As an essential element of a misappropriation of trade secrets claim, defendants must thoroughly explore discovery on the issue of damages. Furthermore, the failure to raise relevant arguments related to damages during the litigation and at trial may result in the waiver of such arguments. The Third Circuit dismissed two such challenges to the district court's damages award because they had not been timely raised by the appellants: (1) the set-off of compensatory damages by the value of AFS' settlement agreement with Orbital and (2) the argument that AFS would suffer no loss if the trade secrets were misappropriated.

This decision illustrates important best practices that should be followed when (1) drafting contracts involving the development, use or application of trade secrets for third parties (which is a classic vendor relationship) and (2) identifying key points going to liability and damages in trade secret litigation.

[1] [Advanced Fluid Sys., Inc. v. Huber](#), et al., Nos. 19-1722, 19-1752 (3d Cir. Apr. 30, 2020).

[2] [DTM Research, L.L.C. v. AT & T Corp.](#), 245 F.3d 327 (4th Cir. 2001).

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