

# THE TEXAS UNIFORM TRADE SECRETS ACT

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In this past legislative session, the Texas Legislature enacted the Texas Uniform Trade Secrets Act (“TUTSA”). On September 1, 2013, Texas will join 46 other states that are currently governed by some form of the Uniform Trade Secrets Act.<sup>1</sup>

Before enactment of TUTSA, Texas had no central law governing trade secrets. Instead, Texas law on trade secrets was cobbled together from Texas common law, the Restatement of Torts, the Restatement (Third) of Unfair Competition, and the Texas Theft Liability Act. Much of this law was outdated (the Restatement of Torts was drafted in 1939) and was simply not designed for the technological developments of the modern era. As a result, Texas businesses and those businesses looking to expand to Texas were left to guess as to what proprietary information Texas law would and would not protect.

TUTSA codifies and modernizes Texas law on misappropriation of trade secrets by providing a simple legislative framework for litigating trade secret cases. Among other things, TUTSA provides an unambiguous and updated definition of trade secrets, a simplified means for obtaining injunctive relief and sealing court records, and an attorneys’ fees provision for recovering fees from those parties who engage in willful and malicious activity.

What follows is a section by section analysis of TUTSA. Section 134A.002 of TUTSA contains a list of six new definitions, including definitions for “trade secret,” “misappropriation,” “improper means,” “proper means,” and “reverse engineering.”

*Definition of a Trade Secret.* TUTSA provides an expansive definition of protectable trade secrets. Under section 134A.002(6) of TUTSA, “trade secret” means information, including a formula, pattern, compilation, program, device, method, technique, process, financial data, or list of actual or potential customers or suppliers that:

- A. 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
- B. is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.<sup>2</sup>

This new statutory definition of a trade secret represents a significant change to Texas law.

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<sup>1</sup> Uniform Law Commission Enactment Status Map, <http://www.uniformlaws.org/Act.aspx?title=Trade%20Secrets%20Act> (last visited April 30, 2013).

<sup>2</sup> While the definition of “trade secret” includes lists of actual or potential customers or suppliers, in order to be protected, those lists must derive independent economic value from not being generally known or readily ascertainable by proper means and be the subject of efforts that are reasonable under the circumstances to maintain their secrecy. Thus, publicly available names of customers and suppliers would not meet the definition of a “trade secret” under TUTSA.

Before enactment of TUTSA, the definition of trade secrets was unchanged since it first appeared in the 1939 Restatement of Torts. Under Texas common law, a trade secret consisted of any formula, pattern, device, or compilation of information used in a business, which gives the owner an opportunity to obtain a competitive advantage over his competitors who do not know or use it.<sup>3</sup> To determine if a trade secret existed, courts applied Texas common law from an array of judicial opinions and weighed the six non-exclusive factors articulated in section 39 of the Restatement (Third) of Unfair Competition.<sup>4</sup>

Texas common law was unsettled as to whether there must be “continuous use” of a trade secret in order to afford that secret protection.<sup>5</sup> TUTSA, however, eliminates this “continuous use” requirement and extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use.<sup>6</sup> TUTSA thus results in a wider class of protected trade secrets, including trade secrets that have not yet been put to use or trade secrets that have been used but later abandoned.

Another change is the protection of “negative know-how.” At least one federal court concluded that under Texas common law, a defendant does not misappropriate a trade secret by using negative “what not to do” information.<sup>7</sup> The new definition in TUTSA, however, “includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will not work could be of great value to a competitor.”<sup>8</sup>

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<sup>3</sup> *In re Bass*, 113 S.W.3d 735, 739 (Tex. 2003); *Hyde Corp. v. Huffines*, 314 S.W.2d 763, 776 (Tex. 1958) (quoting RESTATEMENT OF TORTS § 757 cmt. b (1939)).

<sup>4</sup> *In re Bass*, 113 S.W.3d at 739–40 (citing RESTATEMENT OF TORTS § 757 cmt. b (1939)); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 reporters n, cmt. d (1995). The six factors from section 39 of the Restatement (Third) of Unfair Competition are:

- 1) the extent to which the information is known outside of the business;
- 2) the extent to which it is known by employees and others involved in the business;
- 3) the extent of the measures taken to guard the secrecy of the information;
- 4) the value of the information to the business and its competitors;
- 5) the amount of effort or money expended in developing the information; and
- 6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

<sup>5</sup> Compare *Hyde Corp.*, 314 S.W.2d at 776 (“A trade secret is a process or device for continuous use in the operation of the business”), with *Bertotti v. C.E. Shepherd Co.*, 752 S.W.2d 648, 653 (Tex. App.—Houston [14th Dist.] 1988, no writ) (“The mere fact that a company is not utilizing information at the present time does not prevent that information from being a trade secret subject to protection.”).

<sup>6</sup> See UNIF. TRADE SECRETS ACT § 1 cmt. 5 (amended 1985) [hereinafter UTSA]. Under section 134A.008 of TUTSA, the Act is to be “applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this chapter among states enacting it.” Tex. Unif. Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.008. Therefore, the comments to the UTSA and court decisions interpreting the Act constitute persuasive authority.

<sup>7</sup> *Hurst v. Hughes Tool Co.*, 634 F.2d 895, 899 (5th Cir. 1981).

<sup>8</sup> UTSA § 1 cmt 5.

Finally, TUTSA provides a different formulation of the secrecy requirement for trade secret protection. Under Texas common law, “[b]efore information can be termed a trade secret, there must be a substantial element of secrecy.”<sup>9</sup> A substantial element of secrecy exists when “except by use by improper means, there would be difficulty in acquiring the information.”<sup>10</sup> Under TUTSA, a “trade secret” means information that “is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”<sup>11</sup> This standard allows the fact finder to consider the nature of the trade secret and the facts and circumstances surrounding the efforts to maintain its secrecy in order to determine whether these efforts were reasonable under the circumstances.

*Definition of Misappropriation.* TUTSA specifically defines the conduct that constitutes misappropriation of a trade secret. Under TUTSA section 134A.002(3), “misappropriation” means:

- A. acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
- B. disclosure or use of a trade secret of another without express or implied consent by a person who
  - i. used improper means to acquire knowledge of the trade secret;
  - ii. at the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was
    - a. derived from or through a person who had utilized improper means to acquire it;
    - b. acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or
    - c. derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
  - iii. before a material change of the person’s position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

This definition is a significant improvement over existing Texas law. First, it specifies that prohibited conduct includes: (1) acquiring a trade secret by improper means; or (2) disclosing a

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<sup>9</sup> *Astoria Indus. of Iowa, Inc. v. SNF, Inc.*, 223 S.W.3d 616, 634 (Tex. App.—Fort Worth 2007, pet. denied).

<sup>10</sup> *McClain v. State*, 269 S.W.3d 191, 195 (Tex. App.—Texarkana 2008, no writ).

<sup>11</sup> Tex. Unif. Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.001(6).

trade secret without consent. Second, the definition makes clear that liability applies only to those *who know or have reason to know* a trade secret was acquired by improper means. Under Texas common law, this limitation was not explicit; in fact, only one federal court applying Texas law has indicated a willingness to apply it.<sup>12</sup> Thus, Texas common law imposed liability on defendants who obtained and used a trade secret by accident or mistake, such as a defendant who unknowingly acquires a competitor's trade secrets through a new employee, a customer, or the acquisition of an existing business.<sup>13</sup>

Under TUTSA, on the other hand, an employer is only liable for misappropriation if the employer knew or had reason to know that the trade secret was acquired by improper means. If, for example, an employee misappropriates a former employer's trade secrets and that employee uses those trade secrets in his new job, the new employer is not liable for misappropriation of trade secrets unless the employer had actual or constructive knowledge that the material was improperly obtained. Once the employer is put on notice (e.g., by a cease and desist letter or other means), the employer may be liable for continuing to use the misappropriated trade secret. Therefore, under TUTSA, the new employer is liable for damages for using the misappropriated trade secret only after acquiring knowledge of the employee's trade secret theft.

*Definition of Improper Means.* TUTSA's section 134A.002(2) provides a definition of improper means:

"Improper means" includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, to limit use of, or to prohibit discovery of a trade secret, or espionage through electronic or other means.

The definition of improper means clarifies that a license agreement may limit use of a trade secret by prohibiting reverse engineering. For example, many software license agreements specifically provide that a licensee may not reverse engineer, decompile, or disassemble software or attempt to obtain the source code. Under TUTSA, a breach of the duty to limit the use of trade secret information—a circumstance often imposed in license agreements dealing with computer software and other information—is included within the definition of "improper means." In contrast, the common law definition of "improper means" includes any instance where a person acts "below the generally accepted standards of commercial morality and reasonable conduct."<sup>14</sup>

*Definition of Proper Means.* Section 134A.002(4) provides a definition of proper means:

"Proper means" means discovery by independent development, discovery by reverse engineering unless prohibited, or discovery or observation by any other means that is not improper.

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<sup>12</sup> See *Metallurgical Industries, Inc. v. Fourtek, Inc.*, 790 F.2d 1195, 1204 (5th Cir. 1986) (applying a similar standard to the UTSA).

<sup>13</sup> See, e.g., *MGE UPS Sys. v. GE Consumer & Indus. Inc.*, 622 F.3d 361, 364 (5th Cir. 2010).

<sup>14</sup> *Alcatel USA, Inc. v. DGI Techs., Inc.*, 166 F.3d 772, 785 (5th Cir. 1999).

The language “unless prohibited” clarifies that TUTSA does not affect license agreements prohibiting reverse engineering.

*Definition of Reverse Engineering.* Section 134.002(5) of TUTSA provides a definition for reverse engineering:

“Reverse engineering” means the process of studying, analyzing, or disassembling a product or device to discover its design, structure, construction, or source code, provided that the product or device was acquired lawfully or from a person having the legal right to convey it.

*Injunctive Relief.* Section 134A.003 of TUTSA contains specific provisions for obtaining injunctive relief for actual or threatened misappropriation of trade secrets:

- a) Actual or threatened misappropriation may be enjoined. On application to the court, an injunction shall be terminated when the trade secret has ceased to exist, but the injunction may be continued for an additional reasonable period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.
- b) In exceptional circumstances, an injunction may condition future use upon payment of a reasonable royalty for no longer than the period of time for which use could have been prohibited. Exceptional circumstances include a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation that renders a prohibitive injunction inequitable.
- c) In appropriate circumstances, affirmative acts to protect a trade secret may be compelled by court order.

TUTSA eliminates the possibility of a perpetual injunction, particularly when the trade secret no longer exists because the information has become generally known.<sup>15</sup> Unlike Texas common law, TUTSA includes a specific provision permitting a court in exceptional circumstances to enter an injunction conditioning future use of the trade secret upon payment of a reasonable royalty.<sup>16</sup> Section 134A.003(c) also authorizes a court to order a party to return misappropriated trade secrets to the aggrieved party.

A handful of courts have interpreted the phrase “threatened misappropriation” found in this section to allow injunctive relief not only when a trade secret is disclosed but also when a trade secret will inevitably be disclosed.<sup>17</sup> Under the “inevitable disclosure” doctrine, a court

<sup>15</sup> See Elcor Chemical Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 214 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.).

<sup>16</sup> Texas Uniform Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.003(b).

<sup>17</sup> See, e.g., Bayer Corp. v. Roche Molecular Sys., 72 F. Supp. 2d 1111, 1117–20 (N.D. Cal. 1999) (collecting cases).

can enjoin a former employee from using or disclosing the former employer's trade secrets if the former employee performs duties in his new employment that would necessarily cause that employee to use or disclose the former employer's trade secrets.<sup>18</sup> TUTSA does not address the inevitable disclosure doctrine. Instead, TUTSA would allow the courts to develop this area of the law on a case-by-case basis.<sup>19</sup>

*Damages.* There are no differences between existing Texas common law and TUTSA regarding the economic damages available for trade secret misappropriation. Under Texas common law, the plaintiff was permitted to recover damages based on the value of what has been lost by the plaintiff (lost profits) or the value of what has been gained by the defendant (unjust enrichment).<sup>20</sup> The plaintiff also could recover a reasonable royalty for the defendant's use of the plaintiff's trade secret.<sup>21</sup> The same types of damages are available under section 134A.004(a) of TUTSA:

In addition to or in lieu of injunctive relief, a claimant is entitled to recover damages for misappropriation. 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.

Under TUTSA, actual damages are “[i]n addition to or in lieu of injunctive relief.” This language makes clear that an injunction does not foreclose the right to recover damages.

*Exemplary Damages.* Under section 134A.004(b) of TUTSA, if willful and malicious misappropriation is proven by clear and convincing evidence, the fact finder may award exemplary damages. TUTSA also includes a cap on the total amount of exemplary damages that can be recovered, limiting any exemplary damage award to an amount not exceeding twice the amount of actual damages. In contrast, Texas common law has no specific exemplary

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<sup>18</sup> *Cardinal Health Staffing Network v. Bowen*, 106 S.W.3d 230, 242 (Tex. App.—Houston [1st Dist.] 2003, no pet.).

<sup>19</sup> Based on existing precedent, it is unclear whether Texas courts would be inclined to adopt the “inevitable disclosure” doctrine. One Texas court of appeals, surveying Texas common law, has noted that “no Texas case [has] expressly adopt[ed] the inevitable disclosure doctrine, and it is unclear to what extent Texas courts might adopt it . . . .” *Bowen*, 106 S.W.3d at 242. However, other Texas courts of appeals have applied modified tests with similar attributes to the inevitable disclosure doctrine, holding that an employee could be enjoined from using a former employer's confidential information “when it is probable that the former employee will use the confidential information for his benefit (or his new employer's benefit) or to the detriment of his former employer.” *See, e.g.*, *Conley v. DSC Commc'n Corp.*, No. 05-98-01051, 1999 Tex. App. LEXIS 1321, at \*8 (Tex. App.—Dallas Feb. 24, 1999, no pet.) (emphasis in original); *see also T-N-T Motorsports v. Hennessey Motorsports*, 965 S.W.2d 18, 21–23 (Tex. App.—Houston [1st Dist.] 1998, pet. dism'd); *Rugen v. Interactive Bus. Sys., Inc.*, 864 S.W.2d 548, 552 (Tex. App.—Dallas 1993, no writ); *Williams v. Compressor Eng'g Corp.*, 704 S.W.2d 469, 470–72 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

<sup>20</sup> *Carbo Ceramics, Inc. v. Keefe*, 166 Fed. Appx. 714, 722 (5th Cir. 2006) (applying Texas law).

<sup>21</sup> *Calce v. Dorado Exploration, Inc.*, 309 S.W.3d 719, 738 (Tex. App.—Dallas 2010, no pet.).

damages cap for misappropriation of trade secrets.<sup>22</sup>

*Attorneys' Fees.* Under Texas common law, there was no right to recover attorneys' fees for misappropriation of trade secrets. Parties, however, often sought their fees by filing a claim under the Texas Theft Liability Act, which provides for the recovery of attorneys' fees to the prevailing party.<sup>23</sup> Section 134A.005 of TUTSA requires a finding that a claim for misappropriation was made in bad faith or that the misappropriation was willful and malicious misappropriation before the court may exercise its discretion to award fees:

The court may award reasonable attorneys' fees to the prevailing party if: (1) a claim of misappropriation is made in bad faith; (2) a motion to terminate an injunction is made or resisted in bad faith; or (3) willful and malicious misappropriation exists.

*Preservation of Secrecy.* Texas Rule of Evidence 507 provides that trade secret information is privileged and need not be disclosed absent protective measures imposed by the court. But prior to the enactment of TUTSA, there was no specific provision in Texas law for protecting the secrecy of a trade secret during court proceedings. Instead, parties ordinarily requested the court to enter a protective order under general discovery rules.<sup>24</sup> Parties would also seek to seal court records using the cumbersome procedures outlined in Texas Rule of Civil Procedure 76(a), which requires public notice and the public's opportunity to be heard.

Section 134A.006 of TUTSA provides a new rule governing the disclosure of trade secrets during a court proceeding:

In an action under this chapter, a court shall preserve the secrecy of an alleged trade secret by reasonable means. There is a presumption in favor of granting protective orders to preserve the secrecy of trade secrets. Protective orders may include provisions limiting access to confidential information to only the attorneys and their experts, holding in-camera hearings, sealing the records of the action, and ordering any person involved in the litigation not to disclose an alleged trade secret without prior court approval.

TUTSA thus provides the ability for aggrieved parties to pursue their legal rights in court without fear of having to disclose the very information they are trying to keep secret.

*Statute of Limitations.* The three-year statute of limitations for misappropriation of trade secrets claims found in Texas Civil Practice and Remedies Code section 16.010 is retained.

*Effect on Other Law.* TUTSA section 134A.007 provides that the chapter displaces conflicting tort, restitutionary, and other laws of this state, but does not affect (1) contractual

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<sup>22</sup> Texas common law, however, does generally limit an award of exemplary damages to the greater of the following: (1) twice the amount of economic damages, plus any noneconomic damages (up to \$750,000.00) found by the jury; or (2) \$200,000.00. TEX. CIV. PRAC. & REM. CODE § 41.008(b).

<sup>23</sup> TEX. CIV. PRAC. & REM. CODE § 134.005(b).

<sup>24</sup> See TEX. R. CIV. P. 192.6(b).

remedies, whether or not based upon misappropriation of a trade secret; (2) other civil remedies not based on misappropriation of trade secrets; or (3) criminal remedies, whether or not based upon misappropriation of a trade secret.

*Conclusion.* TUTSA modernizes the law of misappropriation of trade secrets in Texas by providing a consistent and predictable statutory framework for the protection of trade secrets and litigating trade secret cases. TUTSA also marks a clear departure from a common law approach and adopts updated statutory standards for trade secret protection, which are now consistent with those laws governing the vast majority of jurisdictions in the United States.