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Trade Secrets, Non-Competes, and Unfair Competition

Office of Continuing Legal Education at the University of Kentucky College of Law

UK
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TRADE SECRETS, NON-COMPETES AND UNFAIR COMPETITION

October 2001

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Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW

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THE LAW OF TRADE SECRETS

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SECTION A

THE LAW OF TRADE SECRETS

APPENDIX:

The Law of Trade Secrets

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INTRODUCTION

"Man has risen so far above all other species that he competes in ways unique in nature. He fights by means of complicated weapons; he fights for ends remote in time."

Charles A. Lindbergh, "The Reefs Of Biak."
Autobiography of Values (1978)

"Nothing is so burdensome as a secret."

French Proverb

"He that communicates his secret to another makes himself that other's slave."

Baltasar Gracián, The Art of Worldly Wisdom
(1647), 237, Tr. Joseph Jacobs

"Many a deep secret that cannot be pried out by curiosity can be drawn out by indifference."

Sydney J. Harris, On The Contrary (1962), 7

"It always hurts when you lose a secret."

Elie Wiesel, The Testament (1981), Tr.
Marion Wiesel

I. TRADE SECRETS

A. PHILOSOPHY

1. Policies of trade secret protection are the maintenance of standards of commercial ethics, good faith and honest fair dealing, the encouragement of invention, and protection of substantial investment in proprietary information.

2. Even though a discovery may not be patentable, its value is not destroyed to one who makes it, or advantage the competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without paying the price in labor, money or machines expended by the discoverer.

3. Trade secrets promote subsidization and encouragement of research and development and increased economic efficiency.

4. The theme of trade secret protection is "promotion of commercial ethics."

B. DEFINITIONS AND NATURE OF TRADE SECRETS

1. The protection accorded a trade secret holder is for an indefinite period of time.

2. Definitions

There are two different, but closely related, definitions of a trade secret:

a) Uniform Act—K.R.S. 365.880 <u>et</u> <u>seq.</u>

(1) **Trade secret** means information, including the whole or any portion or phase of any scientific or technical information, design, process, procedure, formula, pattern, compilation, program, device, method, technique, or improvement, or any business information or plans, financial information, or listing of names, addresses, or telephone numbers," that satisfies <u>both</u> of the following:

(a) it 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.

(b) it is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

(i) There is no presumption that any particular idea imparted to or acquired from an employee is a trade secret unless the possessor takes active steps to maintain its secrecy.

(2) **Improper means** includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means."

(3) **Misappropriation** means any of the following:

(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;

(b) disclosure or use of a trade secret of another without the express or implied consent of the other person by a person who did any of the following:

(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 the knowledge of the trade secret that the person acquired was derived from or through a person who had utilized improper means to acquire it, was acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use, or was derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use;

(iii) before a material change of their 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."

b) Prior law

(1) RESTATEMENT OF TORTS § 757, comment b definition: "a **trade secret** may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers."

(2) "**Trade secret**" means the whole or any portion or phase of any scientific or technical information, design, process, procedure, formula, or improvement, or any business plans, financial information, or listing of names, addresses, or telephone numbers, which has not been published or otherwise become a matter of general public knowledge.

(3) "A trade secret **is a process or device** for continuous use in the operation of the business. Generally it relates to the production of goods, as, for example, a machine or formula for the production of an article. It may, however, relate to the sale of goods or to other operations in the business, such as a code for determining discounts, rebates or other concessions in a price list or catalogue, or a list of specialized customers, or a method of bookkeeping or other office management."

c) The Uniform Act **replaces** all conflicting civil state law regarding misappropriation of trade secrets except for those relating to contractual remedies.

C. EFFECT OF UNIFORM ACT

1. Over forty states have adopted the Uniform Trade Secrets Act. Most comprehensive and recent discussion of Kentucky Uniform Trade Secret Act is in *Auto Channel, Inc. vs. Speedvision Network LLC, 144 F Supp. 2d 784 (W.D. Ky, 2001).* This decision will be widely cited in all future Kentucky trade secret litigation. The decision should be read carefully both because of its precedential value and for its value in advising clients in their business dealings.

D. SUBJECT MATTER OF TRADE SECRETS

1. A trade secret is almost anything and everything useful or advantageous in business activity that is not generally known or easily or immediately ascertainable to members of the trade.

2. There is no specific subject matter criterion for a trade secret. As long as the definitional elements are met, virtually any type of information can be a trade secret.

3. Trade secret laws are not those of property but the equitable principles of good faith applicable to confidential relationships. The employer who has discovered or developed trade secrets is protected against unauthorized disclosure or use, not because he has a property interest in the trade secrets but because the trade secrets were made known to the employee in a confidential relationship.

E. REQUIREMENTS FOR TRADE SECRET PROTECTION

1. Whether particular knowledge is a trade secret is **a question of fact**.

2. The **maintenance of secrecy** requirement:

    a) The information must be the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

    b) Absolute secrecy is not required.

        (1) Only relative secrecy is required.

    c) The test is "one of reasonable efforts under the circumstances."

    d) "Reasonable measures" must be taken to protect confidential information.

    e) The subject of a trade secret must be secret, and must not be of public knowledge or of general knowledge in the trade or business.

    f) Uniform Act requires the information be not generally known or readily ascertainable to the public.

        (1) Information is "readily ascertainable" if it is available in trade journals, reference books or published materials.

    g) A trade secret must be "secret" in the sense that it is known only to the employer and his employees, is unique in the trade, gives the employer a competitive advantage, and is protected by substantial security measures.

h) Factors showing requisite secrecy

(1) Factors to be considered in recognizing a trade secret include (1) the extent to which the information is known outside the business, (2) the extent to which the information is known to those inside the business (i.e. to employees), (3) the precautions taken to guard the secrecy of the information; (4) the savings effected and the value to the holder in having the information as against competitors, (5) the amount of effort or money expended in obtaining and developing the information, and (6) the amount of time and expense it would take for others to acquire and duplicate the information.

(2) Information is presumed to be secret when the owner takes measures designed to prevent it, in the ordinary course of business, from being available to persons other than those selected by the owner to have access thereto for limited purposes.

(a) A business or possessor of a potential trade secret must take some active steps to maintain its secrecy in order to enjoy presumptive trade secret status.

(3) Secrecy is not lost if the trade secret is revealed to another in confidence and under an implied obligation not to use or disclose it.

(4) Secrecy is not lost if information is known by other employees involved with using the information on behalf of the employer.

(5) Secrecy is not lost if supplier given access to trade secret to better fill purchaser's needs; disclosure deemed to be in confidence and implied duty by supplier not to disclose or use information.

(a) Secrecy is lost if information disclosed to potential or actual customers without confidential agreement.

(6) If trade secret patented, there is no further right to secrecy, even if patent subsequently declared invalid.

(7) Measures constituting internal and external controls on information

(a) Include (1) business security devices; (2) visitor screening procedures; (3) exclusion of general public and competitors from business; (4) control of dissemination of sensitive drawings to suppliers; (5) dissemination of drawings to employees having need to know; (6) proprietary restrictive disclosure markings on drawings; (7) shredders for destroying old computer printouts and pricing sheets; (8) nondisclosure agreements for key employees.

(b) Include denial of plant access to employees, limiting plant admittance, maintaining files in locked and secure area, restricting use and disclosure to outsiders, proprietary markings on information, periodic discussions and reminders of confidentiality, and a system of document retrieval.

3. The independent **economic value** requirement:

a) Uniform Act requires that the information have an independent economic value, either to the trade secret owner or a competitor.

4. The **competitive advantage** requirement:

a) A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.

5. The continuous **use in the operation of the business** requirement:

a) A trade secret is a process or device for continuous use in the operation of the business.

b) The "ephemeral event" limitation

(1) Information related to a single, ephemeral event in the conduct of a business does not meet the requirement that a trade secret be "a process or device for continuous use in the operation of the business."

c) However, there is protection for "negative experience," i.e. ideas that did not work.

6. **Novelty**

   a) Novelty in the patent law sense is <u>not</u> required, although some minimum novelty is required since that which does not possess novelty is usually known.

7. The **misappropriation** requirement:

   Protection is against disclosure or use when knowledge gained not by owner's voluntary act but by some improper means, e.g. theft, wiretapping or aerial reconnaissance.

F. SCOPE OF TRADE SECRET PROTECTION

1. An employer is only entitled to restrain former employee from disclosing and using **confidential** information developed as result of employer's initiative and investment and which employee learned as result of employment relationship.

2. A trade secret does <u>not</u> offer protection from discovery by fair and honest means, such as (1) independent development or invention; (2) accidental disclosure; (3) "reverse engineering" (starting with the known product and working backwards to divine the process which aided in its development or manufacture) where the product was acquired honestly such as purchase on the open market; (4) discovery under license from trade secret owner; (5) observation of the item in public use or on display; or (6) obtaining trade secret from published literature.

3. Reverse engineering

   a) Duplication of design features through reverse engineering in absence of confidential relationship will not support trade secret misappropriation claim.

   b) Once product is purchased on open market, reverse engineering may be undertaken with impunity.

4. Confidential relationship

   a) Trade secret law can only prevent dissemination that has been revealed in a confidential employer-employee relationship under substantial measures of security.

b) A confidential relationship may be implied where trade secret is disclosed in order to promote a particular relationship, e.g. to a prospective purchaser to enable appraisal of value of secret.

5. Threat of future use or disclosure of trade secrets

(1) Actual or threatened misappropriation may be enjoined.

(2) Court may restrain continued and future use, or threatened use, of misappropriated trade secrets.

G. EXAMPLES OF PROTECTED RELATIONSHIPS

1. Licensees.

2. Former employees.

3. Employer/employee.

4. Franchisor/franchisee.

5. Existing/prospective customers/suppliers (assuming that effective contracts with confidentiality, nondisclosure agreements are in place.)

II. CONFIDENTIALITY AGREEMENTS

A. PHILOSOPHY

1. Kentucky recognizes the enforceability of covenants not to disclose confidential information.

a) No absolute need for nondisclosure covenants, but clearly beneficial to have them

b) Inevitability doctrine - eight elements are:

- Is the new employer a competitor?
- What is the scope of the defendant's new job?
- Has the employee been less than candid about his new position?
- Has the plaintiff clearly identified the trade secrets that are at risk?
- Has the actual trade secret misappropriation already occurred?
- Did the employee sign a nondisclosure and/or non-competition agreement?

- Does the new employer have a policy against use of others' trade secrets?
- Is it possible to "sanitize" the new position?
  See, Maxium Med., Inc. vs. Michelson 51 F. Supp 2d.773 (S.D. Tex, 1999)

B. REMEDIES

1. Injunctions

   a) Injunction is available to prevent disclosure of confidential and/or trade secret information.
   cf Uniform Act

   b) Court may fashion a noncompete injunction conditioned upon payment of compensation to employee of inevitable disclosure
   cf Uniform Act

   c) Periodic affidavits confirming compliance with injunction—"self policing" and continuing jurisdiction by Court for term of injunction

2. Compensatory damages

   a) Lost profits of former employer.

   b) A reasonable royalty imposed for use of trade secret in future years.

3. Requirement of Bond

   a) If injunctions are sought/obtained, Rule 65 will require posting of adequate bond (requiring a high bond can be used defensively by new employer.)

C. LIABILITY OF NEW EMPLOYER

New employer may be liable for tortious interference of contract if the new employer knows of restrictive agreement and intentionally participates in use of confidential information of former employer

1. Have new employee sign acknowledgment with new employer that no proprietary information of former employer is to be used or disclosed. (*See* proposed employee acknowledgment at Attachment A)

2. New employer must enforce the standard of conduct contained in the acknowledgment.

III. TRADE SECRET PROGRAMS

A. Organized, comprehensive company program for identifying and protecting its trade secrets.

1. Why?

   a. Protects trade secrets (which are, by definition, commercially valuable)

   b. Increases employee awareness of trade secrets (employees tend to work with them every day - don't always appreciate what they are or their importance to company)

   c. Demonstrates to Court that company believes information to be important and protects it (remember the Uniform Act definition of trade secret)

2. Must be formal - must be institutionalized - must be followed

B. Key elements

1. Know and understand which company information constitutes trade secrets

   a. Must be confidential and commercially valuable

   b. Be realistic

   c. Periodic inventories of business/technical information

2. Mark trade secret information as confidential

   a. Use a "confidential" stamp (beware of paper with a pre-printed confidentiality notice)

   b. Can have different levels of confidentiality - different levels of access based on "need to know"

   c. Don't mark public information as confidential

3. Limit access to trade secret information

   a. "Need to know" - key concept

   b. Policies re locking desks, file cabinets and offices

   c. Policies re documents - clean desk policy - shredding documents

   d. Policies re taking information home - certain information must be signed out

   e. Policies re discussion of company information in public places (airplanes, airports, business trips)

   f. Access to information on computers (security levels, changing passwords)

4. Limit visitors' access

   a. Employee ID badges

   b. Receptionist to screen visitors

   c. Visitor sign-in/visitor badges

   d. Visitors must be escorted

   e. Visitors can only be in certain areas

   f. Visitors never taken through certain areas of the plant

   g. Conference rooms in reception area

5. Policies regarding new employees

6. Policies regarding departing employees

7. Controlling outside disclosures of company information

   a. Loss of control when you disclose to outside parties

   b. Discussions with suppliers

      (1) Particularly troublesome - they speak with your competitors, too

(2) How many times has a supplier told you interesting information about your competitor? - What do you think they say about you?

c. Disclosures at technical or trade association meetings

d. Require business and/or legal approval prior to disclosure

e. Use of confidentiality agreements

(1) provides legal remedies, if breached (BUT if this comes into play, the damage has already been done)

(2) emphasizes confidentiality of information to recipient

(3) comprehensive form (*see* Attachment B) – use this as a "template" for discussions/negotiations with prospective joint venture partners, etc.

(4) simple form (*see* Attachment C) – use this as a "template" for discussions/negotiations with prospective joint venture partners, etc.

f. BASIC RULE - disclose only the minimum information required to achieve business objective - no gratuitous disclosures

8. Technical information - best protected by patent or trade secret? – depends on facts of particular case

9. Periodic reminders to employees - inadvertent disclosures are as costly as intentional disclosures (company newsletters, video)

10. Periodic compliance audits

C. Sample outline of a very comprehensive corporate policies manual for combined "in-house" trade secrets and intellectual property program – *see* Attachment D.

IV. NEW EMPLOYEES

A. Treatment of confidential information/trade secrets should be part of new employee orientation

1. Discuss policy re: proper treatment of confidential information (trade secrets)

2. Discuss policy re: inventions

3. Employee Handbook is a handy way to provide such policies and other useful information to employee. If there is a handbook, provide a copy to employee and point out relevant portions - discuss trade secret policies, don't rely only on the handbook

B. Issue employee ID badge

C. Employment Agreement

1. Some companies have them; some don't

   Employer/employee relationship implies confidentiality relationship

2. Spells out basic rules governing employment

   a. Describe job - was employee hired to invent?

   b. Terms of employment (at will, salary, specific term, etc.)

   c. Policy re: absences, holidays (incorporate Employee Handbook?)

   d. Policy re: confidential and trade secret information

   e. Policy re: ownership of inventions

   f. Policy re: termination of employment

   g. Covenant not to compete

3. Consideration = employment

4. If no employment agreement, consider a simple confidentiality agreement.

   If no agreement at all, consider signed statement that employee has read and understands policies re: trade secrets and confidentiality.

5. Employee should read and sign - keep duplicate copy

V. CURRENT EMPLOYEES

A. Consistent application of company's trade secret/confidential information policy

B. Periodic reminders/reviews of policy for all employees (company newsletters, video)

VI. OTHER POTENTIAL THEORIES FOR PROTECTION OF TRADE SECRETS IN LITIGATION

All of these alternative theories are evaluated in *Auto Channel, supra.*

1. Unfair competition.
2. Idea misappropriation.
3. Express and/or implied contract
4. Covenant of good faith and fair dealing
5. Promissory estoppel
6. Fraud
7. Misrepresentation
8. Breach of fiduciary relationship

Mr./Ms. ____________________

____

____

Dear ________________:

This letter will serve to advise you as to our policy concerning the use or disclosure by you of any confidential or proprietary information or data you may possess by reason of your previous employment.

We have asked you to join our company because of your general skill and competence to perform the responsibilities which you will be assuming and not because of any knowledge you may have of a previous employer's confidential information. You shall maintain in confidence all matters to which you become exposed during your employment by this company. You shall likewise respect your obligations to previous employers not to utilize or disclose any matter you may have learned in confidence during such previous employment. Accordingly, you shall return to your previous employer any documentary material which you may have in your possession which such employer might regard as confidential, and shall not utilize or disclose to us any confidential matter relating to the business of your prior employer of which you may have knowledge.

Cordially,

I acknowledge receipt of a copy of the foregoing letter and confirm that I will act in accordance with the terms of the letter.

______________________________ ______________________________

Date Employee

<u>CONFIDENTIALITY AGREEMENT</u>

_______ *DRAFT FORM*

December, 2000

THIS AGREEMENT is made and entered into this _____ day of _____________, 200___ by and between _____ ("_____"), a ________ corporation and a subsidiary of , on behalf of _______ ("_____"), with ______'s main office at _________________, and ______________________ __________________________________, a ______________ corporation, with its main office at ____ ("Company").

<u>Recitals</u>

WHEREAS, _______ and Company wish to discuss with one another a possible business transaction, which may include a joint venture, buy-sell arrangement, manufacturing or supply arrangement, or any other business alliance (the "Proposed Transaction").

WHEREAS, in order to further these discussions, it may be necessary for ________and Company each to disclose certain Confidential Information, as that term is hereinafter defined, to the other.

WHEREAS, _______ and Company desire and mutually intend to maintain the proprietary or trade secret status of the Confidential Information.

<u>Now Therefore</u>:
The parties mutually agree to the following terms and conditions for the disclosure, control and protection of the Confidential Information:

1. Definitions.

   a. "Confidential Information" shall mean any and all information regarding a Disclosing Party or any of its affiliates, including but not limited to any product, design, specification or other technical information, manufacturing or other process information, financial information, customer information, general business information, or market information, received or obtained before, on or after the date hereof, <u>whether or not</u> marked or designated as "Confidential," "Proprietary" or the like, in any form, whether written, oral or otherwise, including electronic or optical data storage and retrieval mechanisms, and all forms of communication. "Confidential Information" shall include, but not be limited to, information of a Disclosing Party disclosed or observed in connection with physical demonstrations, in-person conversations or telephone conversations, and other means of information transfer such as facility tours. "Confidential Information" shall include all of the foregoing, regardless of whether any such information is protected by applicable trade secret or similar laws, and any analyses, compilations, reports, memoranda, notes or studies with respect to such information, prepared by or on behalf of a Receiving Party or its Representatives.

   b. The "Disclosing Party" shall mean either ____ or Company when disclosing or revealing its Confidential Information to the other.

c. The "Receiving Party" shall mean either _____ or Company when observing or receiving the Confidential Information of the other.

d. "Representatives" means any directors, officers, employees, agents, independent contractors, representatives, or advisors of a party to this Agreement, or any affiliate thereof, with affiliate including any entity controlling, controlled by, or under direct or indirect common control with such party.

2. Upon the transmission, disclosure, observation or receipt of Confidential Information by, for or to any party hereto:

a. A confidential relationship with respect to the Confidential Information will immediately be established between ________ and Company;

b. The Receiving Party will not disclose or release the Confidential Information to any third party, except with the Disclosing Party's prior written authorization and consent, and except to the Receiving Party's Representatives whose duties include evaluating the Proposed Transaction and who need to know the Confidential Information in order to evaluate the Proposed Transaction, and then only if those Representatives are subject to a legally enforceable obligation to maintain the Confidential Information according to the terms of this Agreement;

c. The Receiving Party shall be responsible for any disclosure of Confidential Information by its Representatives in violation of this Agreement and shall enforce confidentiality obligations against its Representatives with respect to Confidential Information to the fullest extent possible; and

d. Except with the Disclosing Party's prior written authorization and consent, the Receiving Party will not use any Confidential Information of the Disclosing Party for its own benefit or for the benefit of others, in any manner whatsoever, other than to evaluate and negotiate the terms of the Proposed Transaction.

3. Subject to the provisions of this Agreement, any Confidential Information given or received under the terms of this Agreement shall be considered to be the sole property, proprietary information and/or trade secret of the Disclosing Party.

4. This Agreement shall not apply to any Confidential Information which is described in subparagraphs a. through f. below:

a. The Receiving Party demonstrates through the use of business records that the Receiving Party possessed the Confidential Information prior to the date of disclosure hereunder;

b. The Confidential Information is or becomes available to the general public otherwise than through any act of the Receiving Party constituting a material breach of this Agreement or any other agreement, provided that the source is not, to the knowledge of the Receiving Party, bound by a confidentiality agreement with, or other legal or fiduciary or other obligation of secrecy or confidentiality to, the Disclosing Party or another party with respect to such information;

c. The Confidential Information has been lawfully obtained by the Receiving Party or its Representatives from a third party who is not, to the knowledge of the Receiving Party, bound by a confidentiality agreement with, or other legal or fiduciary or other obligation of secrecy or confidentiality to, the Disclosing Party or another party with respect to such information;

d. The Confidential Information is independently developed by the Receiving Party, as clearly and specifically demonstrated by business records prepared and maintained in the ordinary course of business;

e. The Confidential Information is approved in writing for release by the Disclosing Party; or

f. The Receiving Party is obligated to disclose the Confidential Information under an order of a court of competent jurisdiction, provided that the Receiving Party first gives the Disclosing Party thirty (30) days' notice of the Receiving Party's obligation under the court order, and the Disclosing Party shall be given an opportunity to oppose any such disclosure. In the event the court order does not allow for thirty (30) days' notice, the Receiving Party shall give the Disclosing Party as much notice as may be reasonably practical. If disclosure is required despite efforts to prevent it, the Receiving Party shall disclose only that portion of the Confidential Information which, in the opinion of its counsel, is required by law to be disclosed.

5. Upon the termination of this Agreement, or earlier at the written request of the Disclosing Party, the Receiving Party shall return to the Disclosing Party all documents, records, notes, computer media, and any other evidence of Confidential Information provided to the Receiving Party by the Disclosing Party, or observed by the Receiving Party, or otherwise in its possession or control, and which is in any tangible form, including all copies. At the same time, the Receiving Party shall also destroy any documents or other materials created by the Receiving Party that contain any reference to any Confidential Information which in their own right could be viewed as confidential, and the Receiving Party shall certify such destruction in writing to the Disclosing Party within fifteen (15) days of its completion.

6. The Receiving Party acknowledges and agrees that in the event of any breach or threatened breach of this Agreement by the Receiving Party or its Representatives, the Disclosing Party shall be entitled to specific performance and injunctive relief as a remedy for any such breach or threatened breach hereof without necessity of posting bond or other security, the requirement for which is expressly waived. The Receiving Party and its Representatives, as applicable, agree not to raise and hereby waive any defense to injunctive relief based on lack of irreparable harm or the insufficiency of monetary damages. Such remedy shall not be deemed to be the exclusive remedy for any breach of this Agreement, but shall be in addition to all other remedies available to the Disclosing Party at law or in equity. The Receiving Party hereby agrees to indemnify the

Disclosing Party for all reasonable costs and expenses, including attorney's fees, incurred by it in enforcing this Agreement with respect to any such breach.

7. This Agreement shall be governed by and construed in accordance with the laws of the State of __________, without regard to any conflicts of law provisions. The Receiving Party consents and agrees that all disputes arising out of or related to this Agreement, if brought by the Receiving Party, shall be heard and determined exclusively by federal or state trial courts located in __________ County, __________ or any appellate courts having jurisdiction over such trial courts. The parties agree that the Disclosing Party shall have the right to proceed against the Receiving Party in ___________ or in any other courts having jurisdiction.

8. Nothing in this Agreement will be deemed by implication or otherwise to convey to the Receiving Party any right or license under any patent, patent application, invention, copyright, trademark, trade name or other proprietary interest owned by the Disclosing Party; nor will this Agreement be deemed to provide a commitment of any kind by any party to enter into any further agreement with the other party.

9. This document contains the entire and complete Agreement between the parties, and no terms have been agreed upon except those expressly set forth herein. Any changes to this Agreement must be in writing, signed by both parties. This Agreement shall be binding on the parties, and upon their respective successors, assigns, agents and representatives.

10. The term of this Agreement shall be for ____ (__) years from the date first set forth above. After the term has expired, or following termination of this Agreement for any reason, all Confidential Information received by either party during the term of this Agreement shall remain subject to the confidentiality and non-use provisions of this Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date first set forth above.

______________________________	______________________________
______________________________	(Name of Company)
By:___________________________	By:___________________________
Print Name:____________________	Print Name:____________________
Title:_________________________	Title:_________________________
Date:_________________________	Date:_________________________

Re: ***<u>Confidential Disclosure Agreement</u>***

Dear ________________:

The purpose of this letter is to record the terms of a Confidential Disclosure Agreement between XYZ Company (hereinafter, together with its affiliates, referred to as "XYZ") and ____________________________ (hereinafter, together with its affiliates, referred to as "Recipient").

XYZ and Recipient are interested in holding discussions regarding ________________ ____. In the course of those discussions, it may be necessary for XYZ to disclose to Recipient technical and business information which XYZ considers proprietary and confidential. Such information which may be disclosed by XYZ will hereinafter be referred to as "Information". Said Information includes, but is not limited to, ________________[e.g., technology; equipment; equipment and component plans, specifications and prototypes; processes; methods of use; methods of manufacturing; trademarks; proposed trademarks; and business plans].

I. XYZ agrees to disclose Information to Recipient upon the following conditions which are understood to be acceptable to both parties:

(a) the disclosed Information will be received and held in confidence by Recipient;

(b) Recipient will take such steps as may be reasonably necessary to prevent the disclosure of Information to others; and

(c) Recipient will not commercially utilize Information without first having obtained the written consent of XYZ.

II. The commitments set forth in I(a), (b), and (c) above, shall not extend to any portion of Information:

(a) which is known (as demonstrated by prior written record) to Recipient prior to disclosure by XYZ, or is generally available to the public; or

(b) which, hereafter, through no act on the part of Recipient, becomes generally available to the public; or

(c) which corresponds in substance to that furnished to Recipient by any third party having a *bona fide* right to do so and not having any confidential obligation, direct or indirect, to XYZ with respect to the same; or

(d) which corresponds to that furnished by XYZ to any third party on a non-confidential basis; or

(e) which Recipient can demonstrate was developed independently of the disclosure of Information by XYZ.

III. Moreover, such commitments shall promptly and automatically terminate in their entirety upon the lapse of a period of (5) years commencing on the date of disclosure. Following termination of the commitments set forth in I(a), (b), and (c), above, with respect to the whole of the Information or upon termination thereof in connection with specific portions of the Information by operation of any of items II(a) through II(e), above, Recipient shall be completely free of any express or implied obligations hereof restricting disclosure and use of Information, subject to the patent or other intellectual property rights of XYZ.

IV. This agreement shall not carry with it any express or implied license under any patent, trademark or other intellectual property rights of XYZ or any obligation to negotiate any future agreements, nor does it obligate either party to purchase or supply equipment, materials, or services from the other party.

V. In this agreement, the term "affiliates" shall include any company, or other entity, controlling, controlled by, or under common control with Recipient or XYZ, respectively, including control through stock ownership, direct or indirect, and joint ventures.

If you are in agreement with the foregoing, please have a duly authorized member of

_________________________ management sign both copies hereof, and return one to me.

Very truly yours,

XYZ COMPANY

By ______________________________
____
____
____

Date: ______________________________

ACCEPTED:

By: ______________________________

Printed Name ______________________

Title ______________________________

Date ______________________________

XYZ

CORPORATE POLICIES MANUAL

Effective Date: __________, 2000

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COVENANTS NOT TO COMPETE

Keith Moorman
Frost Brown Todd LLC
Lexington, Kentucky

and

Thomas G. Grace
Frost Brown Todd LLC
Louisville, Kentucky

SECTION B

COVENANTS NOT TO COMPETE

Keith Moorman
Thomas G. Grace
Frost Brown Todd
Lexington, Kentucky

COVENANTS NOT TO COMPETE[1]

A. INTRODUCTION

Covenants not to compete, non-compete agreements and non-solicitation agreements (collectively referred to as "restrictive covenants"), under any name, restrain trade. *Johnson v. Stumbo*, 126 S.W.2d 165 (Ky. 1938). A non-compete agreement and a non-solicitation agreement serve the same general purpose, but in a slightly different way. A non-compete agreement restricts the covenantor from competing with covenantee (e.g., former employer) in any way, while a non-solicitation agreement permits competition, but prevents covenantor from contacting clients of the covenantee.

Restrictive covenants are most often seen in employment contracts. These provisions may also appear in connection with the sale of business and between investors or shareholders of closely held companies or partners in a partnership, as well as distribution or sales agreements. No matter where these agreements arise, the goal is to protect the intangible assets of a business enterprise.

[1] This paper is presented for educational purposes only, to contribute to the understanding of this particular area of law. Neither the author, Frost Brown Todd, nor their present or future clients can be bound by the comments and interpretations expressed herein.

B. LIMITED ENFORCEMENT – IMPORTANT PUBLIC POLICY CONSIDERATIONS

Restrictive covenants are "not favorites of the law and will not be enforced where they imperil individual rights which our fundamental laws have declared to be inalienable" *Calhoun v. Everman*, 242 S.W.2d 100, 103 (Ky. 1951). Although early cases were reluctant to restrain trade, they recognized that restrictive covenants could serve a legitimate purpose. Restrictive covenants "are sustained where the purpose is to prevent ***unfair competition*** by the employee or his subsequent employer, and the restraint of trade is ***no greater than reasonably necessary*** to secure the protection." *Crowell v. Woodruff*, 245 S.W.2d 447, 449 (Ky. 1952) (emphasis added). A restrictive covenant is reasonable if it does not interfere with the public's interests or impose undue hardship on the covenantee. *Ceresia v. Mitchell*, 242 S.W.2d 359, 364 (Ky. 1951); *Hammons v. Big Sandy Claims Services, Inc.,* 567 S.W.2d 313, 315 (Ky.App. 1978).

There is no hard and fast rule as to what is reasonable. Rather, the determination is made on an individual case by case basis and may turn on any one of many facts or circumstances. "Reasonableness is to be determined generally by the nature of the business or profession and employment, and the scope of the restrictions with respect to the character, duration, and territorial extent." *Hall*, 471 S.W.2d at 317. Restrictive covenants that do not define their duration or geographic scope, however, are not enforceable. *Calhoun*, 242 S.W.2d at 102. As will be discussed, however, courts may define the duration or scope.

C. Factors To Be Considered

The general rule of thumb is that a restrictive covenant will be enforced if it serves to protect the legitimate business interest of the covenantor. In other words, a restrictive covenant is enforceable to the extent it prevents unfair competition, and should not be enforced if it serves only to prevent the covenantor from earning a living. This naturally requires a review of the covenantee's business and the current business activities of the covenantor to determine if they are "competing." If the two are not truly competing, then the activities of the covenantor will be protected.

Whether competition is occurring is often a difficult and subtle question that requires counsel to become an instant expert in the area of business involved. For example, if a car salesman signs a restrictive covenant with a luxury car dealer, leaves his job and begins to sell used economy cars, is he competing with the former employer? Although lost in many of the cases in Kentucky, the analysis is one of equity and balance. Nevertheless, Kentucky courts have addressed certain issues that aid attorneys in their efforts to counsel clients.

1. Type of Employee

Restrictive covenants are not appropriate for all employees. Courts are more likely to enforce covenants involving professionals, or other highly trained employees with greater employment opportunities, than those that restrict an unskilled or semiskilled employee's right to earn a living. *Calhoun v. Everman*, S.W.2d 100 (Ky. 1951), and *Crowell v. Woodruff*, Ky., 245 S.W.2d 447 (Ky. 1952). In *Calhoun* and *Crowell* the employees had a very limited capacity to compete in the labor market, and it was considered unconscionable to deprive them of their livelihood merely to protect the comparatively insignificant interest of the employers who had required restrictive covenants of the employees. *See also Lareau v. O'Nan*, 355 S.W.2d 679, 680 (Ky. 1962); *Hall v. Willard and Woolsey*, 471 S.W.2d 316, 318 (Ky. 1971).

2. Duration

Many restrictive covenants include a term of 1 or 2 years. *Higdon Food Services v. Walker & Kesterson Meat Co.*, 641 S.W.2d 750 (Ky. 1982), *Hammons Central Adjustment Bureau, Inc. v. Ingram Associates, Inc.*, 622 S.W.2d 681, 685 (Ky.Ct.App. 1981). Nevertheless, Kentucky courts have enforced restrictive covenants that include a term of 5 years (*Martin v. Ratliff Furniture Co.*, 264 S.W.2d 273 (Ky. 1954)) and 10 years (*Ceresia*, 242 S.W.2d at 361; *Johnson v. Stumbo*, 126 S.W.2nd 165, 168 (Ky. 1939), *Durham v. Lewis*, 21 S.W.2d 1004 (Ky. 1929). The reasonableness of the duration depends on the business circumstances, but the longer the duration, the greater the burden on the covenantee to prove that the restriction is reasonable and necessary to protect its legitimate business interests.

3. Geographic Scope

Kentucky cases have enforced restrictive covenants that include a geographic scope of 50 – 200 miles from the covenatee's place of business. *Hammons,* 567 S.W.2d at 313 and *Hall*, 471 S.W.2d at 316. Again, however, the scope must be reasonable in the light of all relevant circumstances.

Courts will enforce agreements on a nationwide, even a worldwide basis if the covenantee can demonstrate that it does business on such a broad scope. To be successful, the covenantee must also demonstrate that the covenantor could compete on such a basis, or in other words, that the covenator poses some threat of unfair competition on a nationwide or worldwide basis. Some courts will limit the geographic scope of the restrictive covenant to the area in which the covenantee worked or to the customers with whom goodwill was developed. Again, the general principle is that the restrictive covenant must be limited to the protection of the covenantee's legitimate business interests. The restrictive covenant must be clear and unambiguous. The court in *Calhoun* refused to enforce an oral agreement that was not specific as to duration or geographic limitation.

4. Restriction on Customer Contact In Lieu of Defined Geographic Scope

Kentucky courts will enforce a restrictive covenant if a geographic scope is defined as a restriction on soliciting the covenantee's customers. In *Higdon Food Services v. Walker & Kesterson Meat Co.*, 641 S.W.2d 750 (Ky. 1982), the court enforced an agreement that restricted the former employee from calling upon or accepting inquiries and sales opportunities from the customers of the plaintiff-former employer.

A non-solicitation agreement often has a better chance of enforcement because it is more narrowly defined and is focused more on protecting the covenantee's customer goodwill. A careful reading of a non-solicitation provision may often reveal a loophole. On occasion, a non-solicitation agreement will restrict the covenantor from soliciting business from the covenantee's customers, but will not restrict *acceptance* of business from them. In that case, if the customer seeks out the covenantor, the covenantor may be in a position to accept it without violating the non-solicitation agreement. This can be a very troublesome area for the covenator's counsel, as discussed below.

5. Consideration

The continuation of employment, even at will employment, may be sufficient to constitute consideration. The continued employment must be for an "appreciable" length of time after the covenant is signed and in cases where the covenantor terminates the relationship with the covenantee. *Central Adjustment Bureau, Inc. v. Ingram Associates, Inc.*, 622 S.W.2d 681, 685 (Ky.Ct.App. 1981). Neither *Ingram* nor any other published Kentucky case has addressed the situation where the restrictive covenant is signed after employment begins and the employer terminates the relationship.

6. Assignment

Assignment of a restrictive covenant was raised by the parties in *Choate v. Koorsen Protective Servs., Inc.*, 929 S.W.2d 184 (Ky. 1996). In that case, the Jefferson Circuit Court enforced a restrictive covenant on behalf of an assignee. The employee appealed and the Kentucky Appellate Court affirmed, in an unpublished opinion. By the time the matter reached the Kentucky Supreme Court, the duration of the restrictive covenant had expired and the matter was moot.

The Sixth Circuit Court of Appeals addressed the issue in *Managed Health Care Assoc., Inc. v. Kethan*, 209 F.3d 923 (6th Cir. 2000). In that case, the Sixth Circuit reversed the district court and permitted the assignee to enforce the restrictive covenant. The Sixth Circuit reasoned that many other jurisdictions permit restrictive covenants to be assigned. Since the purpose of the restrictive covenant is to protect a business enterprise's legitimate interests, it follows that the restrictive covenant should be assigned to a purchaser. One legitimate business purpose of a restrictive covenant is to protect key employees and the trade secrets they possess to maximize the value of the business for sale. To hold that the restrictive covenant cannot be assigned would defeat that legitimate purpose. *See In Re Vison*, 2001 WL 1097741 (U.S. Bky. Sept. 12, 2001).

7. Alteration of Covenant

In the event that a Kentucky court finds that restrictive covenant is not enforceable as written, it may alter the terms to make it reasonable. In *Cersia*, the court concluded that a restrictive covenant that made no reference to duration or geographic scope was unreasonable. Rather that declare the agreement void, the court affirmed the trial's court's injunction which limited the restriction to 10 years. In *Hodges v. Todd*, 698 S.W.2d 317 (Ky.Ct. App. 1985), the Appellate Court remanded the matter to the trial court to determine a reasonable geographic scope. In *Calhoun*, however, the court determined that the alleged oral agreement lacked the necessary specificity to justify the remedy of specific performance and so the court refused to impose any restriction.

This leaves open the door for Kentucky courts to restrict or, in certain circumstances, expand the terms of a restrictive covenant. Most, if not all restrictive covenants in employment agreements state that the restricted period begins to run when the employment ends. If the covenantor violates the restrictive covenant simultaneously with the end of employment, an argument can be made that the covenantee is entitled to the benefit of the bargain, and the covenator should be enjoined from violating the restrictive covenant for the stated duration term beginning on the date an injunction is entered.

This appears to be the law in neighboring Ohio. The Supreme Court of Ohio granted trial courts the discretion to give injunctive relief for a period of time that is reasonable and necessary to protect a complaining parties' legitimate interest, even if it extends beyond the precise terms of the agreement between the parties. In *Raimond v. Van Vlerah* (1975), 42 Oh. St.2d 21, 28, 325 N.E.2d 544, 548, the Supreme Court of Ohio reviewed a trial court's entry of an injunction that lasted three years from the date of entry. The defendant employee appealed arguing that the plaintiff was limited to its prayer for relief and the terms of the contract which provides for injunction for three years from the date *the employment relationship ended.*

The Ohio Supreme Court rejected such a restriction on the plaintiff stating,

> Because this court holds, for the first time, that a trial court may enforce a covenant 'to the extent necessary to protect an employer's legitimate interest,' we direct that this cause be remanded to the Court of Common Pleas, so that the Court may ascertain if its initial findings conforms with the test established today. ***That Court is now specifically empowered to construct a reasonable covenant between the parties, and to grant injunctive relief, if appropriate, for a period of time to which the appellant may be entitled.***

Id., 42 Oh. St.2d at 28, 325 N.E.2d at 548-49. (emphasis added) The Ohio Supreme Court granted trial courts the discretion to grant injunctive relief sufficient to protect the legitimate business interest of the employer, even beyond the terms of the agreement between the parties.

The Ohio Supreme Court took similar steps more recently in *Rogers v. Runfola & Associates, Inc.* (1991) 57 Oh. St.3d, 565 N.E.2d 540. The original Non-Compete

Agreement included a duration term of two years, which would have expired before the Supreme Court entered its Order. Nevertheless, the Supreme Court of Ohio saw fit to grant injunctive relief despite the expiration of the agreement on its terms. In *Rogers*, the trial court determined that the terms of the covenant not to compete and the result and hardships on the former employees exceeded that which was reasonable to protect the plaintiff's legitimate business interest. The trial court, therefore, refused to enforce the Agreement or to grant the plaintiff injunctive relief. Soon after the trial court's decision, the defendants started their competing business, which remained in operation during the course of the appeal.

The appellate court affirmed the trial court's conclusion that the covenants not to compete were unreasonable and unenforceable, nevertheless the Supreme Court of Ohio granted the injunctive relief. In reaching its decision, the Supreme Court relied on its previous decision in *Raimonde* and enjoined the defendants from certain activities for a period of time and in a geographic area shorter and smaller than the terms stated in the original Agreement. The Supreme Court stated that the injunction would begin as of the date of the Order, and continue one year thereafter.

Therefore, in Ohio, the Court may toll the running of a restrictive covenant during the time of violation by the covenantor. Although there are no such published decisions in Kentucky, because Kentucky generally permits courts to fashion reasonable restrictions, Kentucky law may permit the same result.

8. Enforceability Against Employees Fired Without Cause

There is some support that a restrictive covenant cannot be enforced against an at-will employee who is terminated by the employer. Kentucky's highest Court stated in *Crowell*:

> The instant covenant is of dubious quality. There seems to be a lack of mutuality, for there is no corresponding or fair reciprocal obligation on the part of the employer. He did not bind himself to continue Crowell in his employment longer than thirty days, yet the employee bound himself to surrender his life trade in his home community for a period of one year.

245 S.W.2d at 449. The issue would be fact specific and would turn on the equities of the situation. Certainly, if the employee possessed confidential information or had developed strong ties to the employer's customers at the employer's expense, the Court may be persuaded that enforcement of the restrictive covenant would be inappropriate. Citing *Crowell*, the Western District of Kentucky refused to enforce a restrictive covenant against a news reporter who was terminated just after a year.

The enforceability of a restrictive covenant depends on the language of the covenant. For example, the covenant in *Daniel Boone Clinic, P.S.C. v. Dahhan*, 734 S.W.2d 488, 490 (Ky.Ct.App 1987) stated that the employee doctor could not compete with his employer for one and a half years "following the termination of employment" and the employee doctor argued that the restriction did not apply because his employment ended by expiration of his employment commitment, and not by any termination. 734 S.W.2d at 490. The Kentucky Court of Appeals concluded, however, after reviewing the contract as a whole, that "termination" simply meant any ending of employment, whether that ending came as a result of expiration of the contract, any action by the employer, or any action by the employee. *Id.*

In *Bates v. Aaron*, 317 S.W.2d 480 (Ky. 1958), however, Kentucky's highest court concluded that a covenant that precluded a doctor from certain competition with a clinic if he should "withdraw" from the clinic, only precluded competition after a voluntary termination of employment, and did not preclude employment following an involuntary dismissal. *Id.* at 482. Because the doctor had left his employment as a result of a dispute over bonus payment, his termination was construed to be involuntary -- so that the restrictive covenant did not apply.

9. Restrictive Covenants in The Corporate Setting

In *Ceresia v. Mitchell*, 242 S.W.2d 359, 364 (Ky. 1951), the Kentucky Supreme Court recognized the value of goodwill. In that case, the Court found that the agreement was unenforceable but nevertheless imposed a reasonable restriction because the purchaser was entitled to benefit of his bargain. Generally, courts are less strict in their enforcement of restrictive covenants executed in connection with the sale of a business. Kentucky courts will seek to enforce the intention of the parties at the time of the sale contract. *Hodges v. Todd*, 698 S.W.2d 317 (Ky.App. 1985).

D. Law in Other States

1. <u>Choice of Law</u>

Choice of law provisions can be very important and be a major factor in the advice given to the client, whether a covenantee or covenantor. Some courts will be reluctant to enforce the law of another state to enjoin an employee. If the client is the covenantee and the covenantor is in another state, any injunction received in Kentucky must be registered in the covenantor's state for enforcement. The registration process may cause some delay. If the law of the selected state is more restrictive than Kentucky, a Kentucky covenantor may consider filing a complaint for declaratory injunction in Kentucky and force the covenantee to come to Kentucky to defend the restrictive covenant. In the declaratory injunction action, the covenantor should argue that the more restrictive law of the other state violates Kentucky public policy and, for that reason, the choice of law provision should not be enforced.

2. Ohio

The law in Ohio is very similar to that of Kentucky. A restrictive covenant is enforceable if it is ancillary to an employment contract and is reasonable. *Briggs v. Butler*, 140 Ohio St. 499 (1942). Courts may fashion a reasonable covenant between the parties if the restrictive covenants as originally agreed to between the parties is unreasonable. *Rogers v. Runfola & Assoc., Inc.* 57 OhioSt. 3d 5, 8 (1991). The restrictive covenant should be reasonable in duration and geographic scope, *Raimonde v. Van Vlerach*, 42 OhioSt.21, 25 (1975), and supported by adequate consideration, *Copeco, Inc. v. Caley*, 91 Ohio App. 3d 474, 477 (Stark Co. 1992).

3. Tennessee

Tennessee will enforce restrictive covenants to protect the legitimate business interests of the covenantee. *Powell v. McDonnell Ins. , Inc.*, 1997 WL 589232 (Tenn. Ct. App. 1997). Covenantee's entitled to protect their investment in the specialized or unique skills or training of its employee, protect confidential information, and customer relationships. *CAM Inter'l. L.P. v. Turner*, 1992 WL 74567 (Tenn. Ct. App. 1992) (Tennessee courts should first determine whether the employer has a legitimate business interest entitled to protection and then whether the restrictive covenant goes beyond what is reasonably required to protect the employer's interests*); AmeriGas Propane, Inc. Crook*, 844 F.Supp. 379 (M.D.Tenn. 1993). Like Ohio, Tennessee has adopted the rule of reasonableness and courts will modify restrictive covenants to make them reasonable. *CAM Int'l.*

E. Application to Independent Contractors

This question has not been addressed in Kentucky. The legal and equitable considerations would be the same for an independent contract as with an employee. Many states have enforced restrictive covenants against independent contractors. *Hamilton Insurance Services, Inc. v. Nationwide Insurance Companies*, 714 N.E.2d 898 (Oh.Sup.Ct.1999); *Zellner v. Stephen D. Conrad, M.D., P.C.*, 589 N.Y.2d 903 (N.Y.Ct.App. 1992); *White v. Lance H. Herndon, Inc.*, 417 N.E.2d 383 (Ga.Ct. App. 1992); *Renal Treatment Centers – Missouri, Inc. v. Braxton*, 945 S.W.2d 557 (Mo.Ct.App. 1997); and *Fraser v. Nationwide Insurance Co.*, 135 F.Supp.2d 623 (E.D.Penn. 2001).

F. Other Restrictions

Confidentiality agreements usually accompany restrictive covenants. The simplest and often most effective confidentiality agreement prevents the employee from using confidential information gained from the employer for any reason other than the benefit of the employer. The confidential information to be protected must be worthy of protection and the restrictions must not unreasonably restrict the activities of the employee.

An employer can also protect its business by including a non-solicitation of employees clause in employment agreement. This type of non-solicitation agreement, or anti-raiding agreement, precludes an employee form leaving and trying to take other employees as well. *See also Glenn v. Diabetes Treatment Centers of America, Inc.*, 116 F.Supp. 1098 (S.D.Ia. 2000).

Another effective tool for protecting trade secrets is arbitration. Despite protective orders, there is always the risk that confidential information produced in a lawsuit will end up in the wrong hands. This risk is reduced in arbitration. Additionally, the more limited discovery procedures of arbitration can prevent information from ever being disclosed.

G. CONSIDERATIONS FOR THE EMPLOYER

1. Alternatives to the Restrictive Covenant

For the highly trained employee, the employer can take steps to recover some of its investment if the employee leaves prematurely. Employment agreements can include provisions that require an employee to pay a percentage of the cost of training or education in the event they leave. Most often, the amount to be repaid is reduced after each year of employment. These "repayment" provisions are common between new brokers and their broker-dealer.

Whenever an employee departs, an exit interview should be conducted. The interview should require the return of all property and a discussion of the terms of the restrictive covenant. The employer should carefully catalog that information and files that are returned and be careful to receive keys, identification badges and any other items relating to security. The company's information services department should take steps to make sure that the former employee cannot access information from out of the office. An exit interview should be conducted to determine that all information has been returned and to remind the employee about any obligations under a restrictive covenant or confidentiality agreement.

2. Hiring an Employee Subject to a Restrictive Covenant

a) The Client Knows of the Restrictive Covenant Before Hiring the Employee

The chance of a claim of tortious interference with contract and misappropriation of trade secrets should be a real concern. The client must understand that their interest in the potential new employee cannot be based on its desire to receive their competitor's confidential information, to capitalize on the competitor's special training of the potential new employee, or the potential new employee's relationships with the competitor's clients.

The new employee should be told up front that consideration for the position does not include the possibility of anything that could be interpreted as gaining an unfair competitive advantage. The new employee's agreement (and employee manual) should include direct instructions that employees are not to use the trade secrets or confidential information of a competitor, and are certainly should not bring any documents or computer files of any competitor into the clients offices.

b) The New Employer Learns of a Restrictive Covenant After New Employee Has Started Work/Old Employer Considering Filing Suit

Again, a tortious interference claim may be coming. This is a very difficult situation. The actions of the company and the new employee will be carefully scrutinized in any subsequent litigation. Of course, the safest course of action would be to pull the new employee from working until all issues can be resolved. Often, clients are reluctant
new employee from working until all issues can be resolved. Often, clients are reluctant
to take such action and, at the same time, want an assessment of their risk.

The analysis should focus on whether the old and new employers are competing and whether the new employee is giving the new employee an unfair competitive advantage through the use of confidential information or trade secrets. The new employee should be instructed not to use any documents or information that could in any way be considered the property of the former employer. If your engagement does not include the employee as a client, your conversations and instructions to the employee may be discoverable in any subsequent litigation. For that reason, be very careful what instructions are given to whom and what instructions are put in writing. Further, remind your client that conversations between officers of the new employer and the new employee may be discoverable as well.

3. <u>Avoid Raiding</u>

In December 1999, the National Association of Securities Dealers awarded Kinnard Investments $16.3 million against Dain Rauscher for raiding employees. The evidence also showed that some employees took substantial steps to compete before resigning from Kinnard. Dain recruited about 20% of Kinnard's brokers in a two year period and caused a corresponding drop in retail sales. Kinnard alleged the loss of so many brokers caused substantial morale problems and attributed for many of the problems it had suffered. The award consisted of $9.2 million in compensatory and $7.1 in punitive damages. The arbitration panel also awarded nearly $350,000 in Kinnard's legal fees.

4. <u>Focus on Servicing Customers</u>

Restrictive covenants designed to protect relationships between a business and its customer do not always reach the desired result. If a customer desires the services of the employee, then the customer may be alienated forever if the employer makes the customer relationship the subject of litigation. Customer's brought into court to testify will usually blame those responsible for the invasion. Under certain circumstances, a liquidated damages provision (along with a confidentiality agreement) may rescue some profits from customer's that would otherwise be lost forever.

H. ADVISING THE EMPLOYEE

Advising the exiting employee can be filled with traps and pitfalls for counsel. If the wrong advice is given, claims of aiding and abetting breach of fiduciary duty or misappropriation of trade secrets may be made against the attorney. In the worst case, a lawyer may be charged with a crime for the theft of a trade secret. For example, a lawyer should never advise a departing employee to take documents or computer files with them.

There is advice that the lawyer can give the departing employee.

1. Do Not Discuss Intention To Leave With Other Employees

a) Do not solicit other employees to join you;

b) Do not solicit input or advice from other employees

c) Do not solicit assistance from other employees

2. **Do Not Remove Employers Information**

a) Make sure that your replacement will not be handicapped because of anything you did

b) Absolutely do not delete computer files or destroy documents belonging to your employer

3. **Take Only Limited Steps to Prepare to Leave**

a) Do not hold customer orders to be directed to your new operation once you leave

b) Advise customers you are leaving - speak in terms of hypothetical if at all

4. **Do not Disparage Your Current Employer Either During or After You Exit**

5. **Fulfill All Your Job Responsibilities**

a) Continue to make best efforts

b) Continue current schedule

6. **Give Reasonable Notice of Intention to Leave**

7. **Do Not Disclose Confidential Information**

a) Document file with new employer that job offer was based on experience and background

b) Document that you do not intend to share confidential information with new employer

c) Do not compromise customers confidential information

8. **Exit Interview**

a) Provide resignation letter directing old employer to contact counsel with questions

b) Do not hide intentions but do not volunteer any information.

c) Confirm that you have returned all confidential information

DAMAGES IN TRADE SECRET LITIGATION

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SECTION C

DAMAGES IN TRADE SECRET LITIGATION

DAMAGES IN TRADE SECRET LITIGATION
Presented to Conference on Trade Secrets, Non-Competes and Unfair Competition
Friday, October 12, 2001
Presented by James A. Gravitt, CPA, ABV, CBA, CMA, CFE
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I. Measures of recovery in trade secret cases

A. Fair market value to plaintiffs

B. Plaintiffs' lost profits

C. Defendants' economic gain

D. Reasonable royalty

II. Fair Market Value to Plaintiffs

A. When applicable

Precision Plating & M. Fin., Inc. v. Martin-Marietta Corp., 435 F.2d 1262 (5th Cir. 1970). Subcontractor sued contractor for destruction of a trade secret. The Plaintiff sought damages for the value of the process at the time of destruction. The trial court stated:

> *There is no established market value in the present case in the sense that there were a number of transactions of the same or similar article, the consensus of which reflects the price at which willing buyers and sellers would act. Fair market value here is synonymous with the investment value of the trade secret; that is, what an investor judges he should pay for the return he foresees by virtue of owning the process, taking into account the facts, circumstances and information which is available at the time. Id.* at 1263.

University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518 (5th Cir. 1974). The Defendants paid an employee of the Plaintiff $2,500 to induce him to steal Plaintiff's copy of a computer system, and deliver the tapes and documents comprising that system to an employee of the Defendant.

In some instances courts have attempted to measure the loss suffered by the plaintiff. While as a conceptual matter this seems to be a proper approach, in most cases the defendant has utilized the secret to his advantage with no obvious effect on the plaintiff save for the relative differences in their subsequent competitive positions. Largely as a result of this practical dilemma, normally the value of the secret to the plaintiff is an appropriate measure of damages only when the defendant has in some way destroyed the value of the secret. The most obvious way this is done is through publication, so that no secret remains. Where the plaintiff retains the use of the secret, as here, and where there *has been no effective disclosure of the secret through publication, the total value of the secret to the plaintiff is an inappropriate measure. Id.* at 535.

B. Approaches to valuation:

1. Cost approach - seeks to measure the future benefits of ownership by quantifying the amount of money that would be required to replace the future service capability of the subject property. The assumption underlying this approach is that the price of new property is commensurate with the economic value of the service that the property can provide during its life. *See* Valuation of Intellectual Property and Intangible Assets, 2nd Edition, Gordon V. Smith and Russell L. Parr, John Wiley & Sons, Inc., 1994, p. 153.

2. Income approach - steps away from the cost of constructing or creating a new property and focuses on a consideration of the income-producing capability of the property. The underlying theory is that the value of property can be measured by the present worth of the net economic benefit (case receipts less cash outlays) to be received over the life of the property. *Id.* at 154.

3. Market approach - measures the present value of future benefits by obtaining a consensus of what others in the marketplace have judged it to be. There are two requisites: 1) an active, public market and 2) an exchange of comparable properties. *Id.* at 160.

C. Discovery issues

1. People to interview:

   a. Plaintiffs' research and development personnel
   b. Plaintiffs' operations managers
   c. Plaintiffs' financial personnel

2. Relevant records:

   a. Plaintiffs' research and development project cost records
   b. Plaintiffs' monthly operating cost reports

III. Plaintiffs' Lost Profits

A. When applicable

Sperry Rand Corporation v. A-T-O, Inc., 447 F.2d 1387 (Va. 1971)
Action by former employer against former employees and their subsequent employer to recover for misappropriation of trade secrets and bidding data.

The two basic methods for assessing damages for misappropriation of trade secrets are: (1) the damages sustained by the victim (the tradition of common law remedy), and (2) the *profits earned by the wrongdoer by the use of the misappropriated material (an equitable remedy which treats the wrongdoer as trustee ex maleficio for the victim of the wrongdoer's gains from his wrongdoing); ordinarily, a plaintiff may recover either, but not both, because to allow both would permit double recovery. Id. at 1392.*

Since the objective in allowing damages for misappropriation of trade secrets is to compensate plaintiff for the difference in his position before and after the misappropriation, his probable loss may be the more significant measuring rod than the misappropriator's actual gain. Id. at 1393.

B. State statutes

Illinois - Damages may 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.

Indiana - In addition to or in lieu of injunctive relief, a complainant may recover damages for the actual loss caused by misappropriation. A complainant also may recover for the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss.

Kentucky - Damages may 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.

Ohio - Damages may 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.

C. Lost sales volume and lost sales revenue

1. Factors impacting plaintiffs' sales volume and revenue

2. Relevant case law

Mangren Research & Development v. National Chemical Co., 87 F.3d 937 (7th Cir. 1996). Mangren, a manufacturer of mold-release agents, filed suit for misappropriation of customer lists and other things after sales of its mold release agent markedly declined in the three previous years.

Mangren sought to recover the profits it lost . . . including profits lost through sales of PTFE-based mold release agents by defendants and Bash, and profits lost when Mangren lowered its prices to meet defendants' competition. Id. at 941. *Mangren presented evidence at trial of the profits it lost on account of defendant's misappropriation, including profits lost when defendants and Bash sold their mold release agents to Masonite and others, and profits lost when Mangren lowered its prices to meet the competition from defendants. The jury accepted Mangren's evidence, which included $133,418 in profits lost due to sales by Bash. Id.* at 945.

Jackson v. Hammer, 653 N.E.2d 809 (Ill. App., 1995).
Buyer of hobby shop brought action against sellers and related party for using store's customer list.

Damages, however, to be recoverable, must not be merely speculative. Here, plaintiff offered only slight evidence concerning damages from the September 1989 mailing. Plaintiff noted that Mark Hammer did not keep complete records of sales at the Decatur store so it was possible that persons on the Whistle Post customer list who received the September 1989 flyer did go to the Decatur store and make purchases. In addition, plaintiff testified as to one instance where a person on the Whistle Post customer list had received Hammer's September 1989 flyer and told plaintiff that he subsequently had gone to the Decatur store and purchased items where within the two-year non-compete period. Plaintiff offered neither further evidence of damages, nor evidence of how much money this one customer spent. Thus, the trial court's decision against plaintiff was not against the manifest weight of the evidence. Id. at 814.

Harry R. Defler Co. v. Kleeman, 243 N.Y.S.2d 930 (1963). Action against former employees for injunction and damages arising from conspiracy to exploit, in competition with plaintiff, confidential information disclosed to them for purposes of their employment.

The accounting justice should determine what the plaintiff's margin of net profit would have been if it had retained the business which the defendants diverted. With respect to determining sales which the plaintiff could reasonably have expected to make but for defendant's disloyalties, there is in this case "a causal relation not wholly unsubstantial and imaginary, between the gains of the aggressor and those diverted from his victim." Id. at 937.

D. Collateral Sales

Sperry Rand Corporation v. A-T-O, Inc., 447 F.2d 1387 (VA. 1971).
Action by former employer against former employees and their subsequent employer to recover for misappropriation of bidding data.

Additionally, there was evidence that Sperry Rand could reasonably have expected a 25% follow-on spares order to supplement the basic contract. Id. at 1394.

E. Incremental Profits

1. Cost definitions

a. Fixed costs

b. Variable costs

c. Incremental costs

2. Examples of costs typically considered incremental

3. Relevant case law

<u>*Curtiss-Wright Corp. v. Edel-Brown Tool & Die*</u>, 407 N.E.2d 319 (Mass. 1980) Plaintiff brought action to recover damages for defendant's misappropriation of aircraft supplies drawings.

This court has recognized three acceptable methods of measuring damages in cases involving business torts such as the misappropriation of trade secrets: the defendant's profits realized from his tortuous conduct, the plaintiff's lost profits, or a reasonable royalty. Because Curtiss-Wright claimed a specific loss of such items as direct lost profits, loss of recoverable overhead and general administrative expenses, the appropriate measure of damages is this case was the greater of the plaintiff's lost profits or the defendant's gain.

<u>*Sperry Rand Corporation v. A-T-O, Inc.*</u>, 447 F.2d 1387 (VA. 1971)
Action by former employer against former employees and their subsequent employer to recover for misappropriation of bidding data.

. . . after computing the expected revenues and estimated costs derived from the follow-on spares order that it would have realized, additional profit of $23,989, recovery of additional general and administrative expenses of $19,648 and material overhead of $2,564. These six items total $231,012.00. Id. at 1394.

F. Increased Operating Costs

<u>*Dozor Agency, Inc. v. Rosenberg*</u>, 218 A.2d 583 (Pa. 1966)
Insurance agency filed suit against former employee and insurance company to enjoin them from using records taken from agency by former employee.

The out-of-pocket expenses sustained by the plaintiff company as a result of the defendant's improper conduct was clearly testified to by John Cooney, treasurer of the company, and amounted to $23,996.45. This sum included expenses for postage-printing, paper and special sales expenses incurred to reinstate the former policy holders and protect other policies; it included also the proportionate salary paid to certain employees while engaged in efforts to reinstate and protect policies carried by the plaintiff company. These figures were obtained from original records of the plaintiff company produced in court. Id. at 585.

G. Discovery Issues

1. People to interview:

   a. Plaintiff and defendant sales representatives and sales managers
   b. Defendant's customers (survey)
   c. Plaintiffs' financial personnel

2. Relevant records:

a. Plaintiff and defendant customer lists
b. Plaintiff and defendant sales records by invoice, date, customer
c. Plaintiffs' financial statements
d. Plaintiffs' manufacturing records and capacity reports
e. Plaintiff and defendant product literature

IV. Defendant's Economic Gain

A. Rationale/Theory

Carter Products, Inc. v. Colgate-Palmolive Company, 214 F. Supp. 383 (D. Md. 1963). In violation of an employment agreement, Fine revealed to Colgate a formula which enabled Colgate to produce various brands of shaving cream.

A misappropriation of trade secrets entitles the injured party not only to a reasonable royalty, but also to an award of profits on the basis of "unjust enrichment", because it is a "breach of confidence", a "species of fraud". In effect, the courts treat the wrongdoer as a trustee who must be made to hand over the proceeds of his wrong. As Justice Holmes said in a case of unfair competition involving the improper use of a trademark: "To call the infringer an agent or trustee is not to state a fact but merely to indicate a mode or approach and an imperfect analogy by which the wrongdoer will be made to hand over the proceeds of his wrong." L. P. Larson, Jr., Co. v. William Wrigley, Jr., Co. Id. at 394.

Jet Spray Cooler, Inc. v. Crampton, 385 N.E.2d 1349 (Ma. 1979).
Plaintiff sued former employees who entered into competing business allegedly using employer's trade secrets.

Of course, a plaintiff is not entitled to both the profits made by the defendant and his own lost profits. However, while a plaintiff is not entitled to a double recovery, "the plaintiff is entitled to the profit he would have made had his secret not been unlawfully used, but not less than the monetary gain which the defendant reaped from his improper acts." . . . Only in this way can we ensure that an unfair competitor will not be encouraged to proceed with his unfair methods in the hope "that his profits might exceed the injured party's losses." . . . Therefore, a plaintiff in an action involving the misappropriation of trade secrets may proceed in the alternative to determine whether the defendant's wrongful profits exceed the plaintiff's losses caused by the misuse of the plaintiff's trade secrets. Id. at 1356 - 1357.

B. When applicable

Greenberg v. Croydon Plastics Co., Inc., 378 F.Supp. 806 (E.D. Pa. 1974).
The Plaintiff sued Defendant for misappropriation of a trade secret concerning mouth-guards made of thermoplastic material worn by athletes for the protection of their teeth.

There are two basic methods for assessing damages for misappropriation of trade secrets: one, the damages sustained by the victim (the tradition of common law remedy), and the *other, the profits earned by the wrongdoer by the use of the misappropriated material (an equitable remedy which treats the wrongdoer as trustee ex maleficio for the victim of the wrongdoer's gains from his wrongdoing). Id.* at 816 - 817.

An accounting of Safe-Play's profits from its misuse of plaintiff's trade secret is appropriate here. Plaintiffs have not proved the actual damages they have suffered as a result of defendants' misappropriation and misuse of their secret flavoring method. Proof of actual losses sustained by the plaintiff is frequently difficult and speculative in trade secret cases; it is nearly impossible here. Id. at 817.

<u>Cherne Indus., Inc. v. Grounds & Associates</u>, 278 N.W.2d 81 (Mt. 1979).
Employer brought action against former employees seeking permanent injunction and damages for breaching terms of employment agreement.

Defendants argue that the trial court's use of defendants' profits, rather than plaintiff's loss, as a measure of damages was improper. Although damages for breach of contract are traditionally measured by the non-breaching party's loss of expected benefits under the contract, where an employee wrongfully profits from the use of information obtained from his employer, the measure of damages may be the employee's gain. Also, this court has specifically found that the violator of a covenant not to compete may be required to account for his profits, and such illegal profits may properly measure the damages. Id. at 94 - 95.

C. State Statutes

<u>Illinois</u> - *Damages may 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.*

<u>Indiana</u> - *In addition to or in lieu of injunctive relief, a complainant may recover damages for the actual loss caused by misappropriation. A complainant also may recover for the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss.*

<u>Kentucky</u> - *Damages may 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.*

<u>Ohio</u> - *Damages may 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.*

D. Types of Economic Gain

1. Increased revenue from

   a. Increased unit sales
   b. Increased price per unit

2. Reduced operating costs

3. Reduced research and development costs

E. Increased revenue from the sale of accused and collateral products

1. Plaintiffs' burden of proof

2. Accused products

Fremont Oil Company v. Marathon Oil Company, 192 N.E.2d 123 (C.P. Ohio, 1963). Former employer brought action for conspiracy of former employees and new employer to commit certain acts of unfair competition. Plaintiff sought an injunction and an accounting of profits.

[The] Exhibit indicates clearly how delivery by Marathon rose to unprecedented heights and deliveries by Fremont plummeted to unusual lows between March 4th and March 8th. The rise in deliveries for Fremont and the fall in deliveries for Marathon after March 8th was due to the temporary restraining order issued by this Court. Id. at 128.

3. Collateral products

Adolph Gottscho, Inc. v. American Marking Corporation, 139 A.2d 281 (N.J. 1958). Plaintiff instituted an action against its former employee and others for trade secret misappropriation. Plaintiff sought an injunction and an accounting. The judgment provided that Defendants account for "all avails or profits" received by them in the manufacture and sale of machines embodying the plaintiff's secrets.

The evidence discloses that in connection with the sale of the machines, which embodied some of plaintiff's trade secrets, the defendant, as ancillary to and part of the sale of the machines or subsequent to but in connection with the servicing of said machines also furnished the customer with type, ink, and solvents. While, strictly speaking, the sales of type, ink and solvents were not found by the court to be an infringement of the plaintiff's rights, they were so intimately connected with the defendant's illegal activities and ancillary thereto, that I feel that the defendant must also pay over to the plaintiff not only the profits on the sales of the illegally manufactured machines, but also the profit on the type, ink and solvents sold. Id. at 284 - 285.

F. Apportionment

1. Defendants' Burden of Proof

Westinghouse Elec. & Mfg. Co. v. Wagner Elec. & Mfg. Co., 225 U.S. 604 (1912). Pre-Aro patent infringement suit. Plaintiff sought recovery of Defendant's economic gain.

"The rule of law and equity is strict and severe on such occasion. . . . All the inconveniences of the confusion is thrown upon the party who produces it, and it is for him to distinguish his own property or lose it.". . . It may be argued that, in its last analysis, that is but another way of saying that the burden of proof is on the defendant. And no doubt such, in the end, will be the practical result in many cases. But such burden is not imposed by law; nor is it so shifted until after the plaintiff has provided the existence of profits attributable to his invention, and demonstrated that they are impossible of accurate or approximate apportionment. If then the burden of separation is cast on the defendant, it is one which justly should be borne by him, as he wrought the confusion. Id. at 621 - 622.

Carter Products, Inc. v. Colgate-Palmolive Company, 214 F. Supp. 383 (D. Md. 1963). In violation of an employment agreement, Fine revealed to Colgate a formula which enabled Colgate to produce various brands of shaving cream.

... the 12(c) secret formula was a fundamental element which permeated the product and made it saleable. Id. at 395. . . . *In other words, Colgate so commingled the elements that it was impossible for plaintiffs to make an apportionment, and Colgate failed to meet the burden which then shifted to it under the fourth Westinghouse rule to introduce evidence of a proper apportionment. Id.* at 398.

When a case of confusion does appear – when it is impossible to make a mathematical or approximate apportionment – then from the very necessity of the case one party or the other must secure the entire fund. It must be kept by the infringer, or it must be awarded, by law, to the patentee. On established principles of equity, and on the plainest principles of justice, the guilty trustee cannot take advantage of his own wrong. The fact that he may lose something of his own is a misfortune which he has brought upon himself. Id. at 397.

Jet Spray Cooler, Inc. v. Crampton, 385 N.E.2d 1349 (Mass. 1979). Plaintiff sued former employees who entered into competing business allegedly using employer's trade secrets.

Once the plaintiffs demonstrate that the defendants have made profits from sales of products incorporating the misappropriated trade secrets, the burden shifts to the defendants to demonstrate the portion of their profits which is not attributable to the trade secret. Id. at 1358, fn 14.

G. The Relevant Time Period

1. The "Head Start" Rule

Kilbarr Corp. v. Business Systems, Inc. B.V., 679 F.Supp. 42 (D.N.J. 1988).
A trade secret misappropriation claim was filed as an adversary proceeding in a bankruptcy case.

Regardless of when defendants might have been able to develop the secret process for manufacturing an electromechanical typewriter by legitimate business means such as reverse engineering or independent research, they learned them from its knowing misappropriation of plaintiff's trade secrets. Accordingly, the Court determines as a matter of law that head start is not available to these defendants on the facts in this case. Id. at 425.

Jet Spray Cooler, Inc. v. Crampton, 385 N.E.2d 1349 (Mass. 1979).
Plaintiff brought suit against former employees who entered into competing business allegedly using plaintiff's trade secrets.

Generally, the "head start rule" has been applied in cases where the plaintiff's product, including the trade secret, has been marketed. The marketing of the product gives competitors a legitimate opportunity to study the product and to learn the principles of the trade secret through reverse engineering or similar procedures. . . . In a petition for injunctive relief, we have indicated that the time necessary to engineer in reverse is one factor to be considered in determining the propriety of the duration of injunctive relief. We have not applied this theory in an action for damages. Id. at 1357, fn 11.

2. Defendants' burden of proof

Carboline Company v. E. Jarboe, 454 S.W.2d 540 (Mo. 1970).
Plaintiff brought action for misappropriation of trade secrets concerning processes for manufacturing numerous products used as non-corrosive protective coatings principally for steel, iron and concrete.

[Defendant] suggests that the injunction should not be made permanent, but should be limited in time by application of the "head start" rule: "That period of time which would have been required by defendants to reproduce plaintiff's products without wrongful appropriation." It was indicated . . . that this state would apply the "head start" rule . . . which precludes a defendant from using a misappropriated trade secret only for such time as it is not make public. Id. at 552.

[The Defendant] should be given the opportunity to establish the "head start" time as to these products, and the injunction should be limited to that period of time if shown. . . . If upon further proceedings the time within which [defendant] could have . . . by independent analyses determined Carboline's ingredients in the five-product series is established, damages, being [defendants] net profits from sales of the items, should be limited to such time. Id. at 553.

H. Cost Deductions

1. Incremental cost approach

__*Carboline Company v. E. Jarboe*__, 454 S.W.2d 540 (Mo. 1970)
Briefly, the incremental profit method means that no costs which the organization is already saddled with should be allocated to the new product. This is a widely-accepted theory that's used in management, by management, and in introducing new products, and I believe it would be the proper method to be followed here, also." . . . To the extent that such expenses were already on-going at the time the product was introduced, they should not be allocated to the new product, only the increase in such expenses that can be related to the new product should be allocated to the new product. . . . The general and administrative expenses (officer's salaries, rent, utilities, insurance, travel, legal and accounting, etc.) in existence when [Defendant] decided to produce the products should not be used to allocate costs proportionately to sales. Id. at 554.

__*Carter Products, Inc. v. Colgate-Palmolive Company*__, 214 F. Supp. 383 (D. Md. 1963). In violation of an employment agreement, Fine revealed to Colgate a formula which enabled Colgate to produce various brands of shaving cream.

If the manufacture and marketing of the infringing goods causes no increase in the general expense, no part of it is to be allocated to them, even though such a practice would be bad from the point of view of cost accounting or business policy. Only when the manufacture or marketing of the infringing goods increases the joint expenses is it proper to allocate a part of them to these goods. If the rule were otherwise, the defendant would be permitted to retain gains made by his own wrongdoing. The apportionment of joint expenses in the absence of such an increase would reduce the cost of the non-infringing goods and would thus permit gain for the defendant from his tortuous conduct. Id. at 401.

2. Defendants' burden of proof

3. Examples of incremental expenses

__*L. P. Larson, Jr., Company v. William Wrigley, Jr., Company*__, 277 U.S. 800 (1928) Trade dress case. Plaintiff sought defendant's profits from the sale of accused products. Defendant deducted its Federal income tax expense from the accused revenue and Plaintiff appealed.

Even if the only relief that the Wrigley Company can get is a deduction from gross income when the amount of its liability is finally determined, the Larson Company will have to pay a tax on the Wrigley profits when it receives them, and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction should not be allowed. Id. at 801.

__*Jet Spray Cooler, Inc. v. Crampton*__, 385 N.E.2d 1349 (Mass. 1979)
Plaintiff brought suit against former employees who entered into competing business allegedly using plaintiff's trade secrets.

An accounting of the defendant's profits is designed to strip them of their impermissible gains. Where a defendant has suffered bad debts resulting from sales of products which he has manufactured, the defendant has incurred manufacturing expenses and has reaped no profits. He should not be required to pay over as profits funds never received. Id. at 1360.

We think that the judge correctly allowed the defendant to deduct the salaries and fees in question from gross profits on the basis of the judge's conclusion that "there are no findings that the salaries or consultant's fees were excessive or a disguised distribution of earnings or that the corporate defendant to whom the services were rendered was a sham." The question of whether corporate officers are named as individual defendants should not determine whether their salaries may be deducted from a corporate defendant's profits. The determinative question should be whether their salaries and fees are reasonable in light of their positions as officers of the corporation "engaged in the conduct of the business and in the production of profits." Id. at 1360 - 1361.

I. Set-off

1. Same products, different time periods

Adolph Gottscho, Inc. v. American Marking Corporation, 139 A.2d 281 (N.J. 1958). Plaintiff instituted an action against its former employee and others for trade secret misappropriation. Plaintiff sought an injunction and an accounting. The judgment provided that Defendants account for "all avails or profits" received by them in the manufacture and sale of machines embodying the plaintiff's secrets.

An innocent plaintiff seeking an accounting from a defendant wrongdoer is confronted with serious practical difficulties in establishing undisclosed as well as disclosed profits, particularly where manipulative devices such as family corporations are involved, and it effectively urges that where, as here, the defendant wrongdoer has submitted calendar year figures of profits and losses, it is just and equitable that the plaintiff be permitted to accept the profitable years while rejecting the others. Id. at 287. *See Cardozo, J., in Duplate Corporation v. Triplex Safety Glass Co.*

Carter Products, Inc. v. Colgate-Palmolive Company, 214 F.Supp. 383 (D. Md. 1963). In violation of an employment agreement, Fine revealed to Colgate a formula which enabled Colgate to produce various brands of shaving cream.

The general rule that a plaintiff in an accounting for profits may pick and choose among accounting periods, and select those which are profitable, is subject to an important limitation: He may do so only if the periods or transactions with respect to a particular product are independent of each other. Id at 407.

2. Same time periods, different products

Adolph Gottscho, Inc. v. American Marking Corporation, 139 A.2d 281 (N.J. 1958). Plaintiff instituted an action against its former employee and others for trade secret misappropriation. Plaintiff sought an injunction and an accounting. The judgment provided that Defendants account for "all avails or profits" received by them in the manufacture and sale of machines embodying the plaintiff's secrets.

And the Restatement . . . § 747, comment (d), sets forth that a sale resulting in a loss may not generally be offset by an infringer against another and independent sale resulting in a gain, but it expressly recognizes that an offset may be allowed where the unprofitable sale was merely a necessary preliminary to the profitable sales. The burden of establishing that he is entitled to the offset for losses is on the wrongdoer and it is equitable that doubts be resolved against him; this is acknowledged by both the primary and secondary authorities. Id. at 286 - 287.

J. Reduced operating costs

International Indus., Inc. v. Warren Petroleum Corp., 248 F.2d 696 (3d Cir. 1957). Plaintiff compiled an economic study of the factors to be considered in the water transportation of liquefied petroleum gas, and possessed plans and specifications for the conversion of a dry cargo vessel into one that might be used in the transportation of the liquid gas. Plaintiff alleged that the defendant appropriated the trade secrets when disclosed to it under circumstances creating a confidential relationship.

The advantage enjoyed by defendant is to be measured by the standard of comparison method. This method contemplates the comparison of the cost of transportation by means of the use of the trade secret with a method of accomplishing the same result which would have been open to defendant had he not appropriated the trade secret. Id. at 699.

The attempted distinction between profits and savings is wholly without merit. The recovery in trade secret or infringement cases is denominated profits. Where the thing appropriated or infringed is a process rather than a manufactured article, the profits are simply measured by the savings determined by the standard of comparison computation. Id. at 702.

The interest on the capital the appropriator invests in his endeavor is allowed in an effort to arrive at a realistic determination of the actual costs in the standard of comparison analysis. This is a practical business problem to be solved by a method as accurate as possible, and the disallowance of interest would merely distort the actualities of the money expended. Id. at 702.

K. Reduced R&D costs

Salsbury Laboratories, Inc. v. Merieux Laboratories, Inc., 908 F.2d 706 (11th Cir. Georgia 1990). Poultry vaccine manufacturer brought action against competitor and two former employees for misappropriation of trade secrets. Initially the trial court awarded damages for plaintiff's lost profits, but later amended its order, instead basing the measure of damages on the $52,000 gain to Merieux. In addition, the district court found that Salsbury had spent over $1 million researching and developing MG-BAC and more than $2 million marketing and advertising the vaccine, for a total of $3 million. Of that amount, the court awarded Salsbury $1 million, representing the savings in research, development and marketing Marieux enjoyed as a result of misappropriating Salsbury's trade secrets.

On appeal, the appellate court vacated the $52,000 award, but upheld the $1 million award.

L. Defendants' Salary

Harry R. Defler Co. v. Kleeman, 243 N.Y.S.2d 930 (1963). Action against former employees for injunction and damages arising from conspiracy to exploit, in competition with plaintiff, confidential information disclosed to them for purposes of their employment.

An employee whose actions are disloyal to the interests of his employer forfeits his right to compensation for services rendered by him and if he is paid without knowledge of his disloyalty he may be compelled to return what he has improperly received. Id. at 938.

M. Discovery Issues

1. People to interview:

   a. Defendant's accounting personnel
   b. Defendant's sales managers
   c. Defendant's and plaintiff's research and development personnel

2. Relevant records:

   a. Defendant's monthly financial statements
   b. Defendant's sales reports and invoices
   c. Defendant's management cost reports
   d. Defendant's and plaintiff's research and development cost reports

V. Reasonable Royalty

A. When relevant

Vitro Corporation of America v. Hall Chemical Company, 202 F.2d 678 (6th Cir. 1961). Hall and Vitro discussed a proposed agreement for the use by Vitro of a process constituting a trade secret of Hall and thereafter "agreed in principle" to the terms of a proposed agreement. Later, after Hall disclosed its trade secrets to Vitro, Vitro notified Hall that it no longer wished to purchase any rights in the

Hall process and soon after commenced to use, with only slight variations, a portion of the Hall process.

To adopt a reasonable royalty as a measure of damages is to adopt and interpret as well as may be the fiction that a license was to be granted at the time of the infringement and then to determine what the license price should have been. In effect, the Court assumes the existence ab initio of and declares the equitable terms of a supposititious license and does this nunc pro tunc. It creates and applies retrospectively a compulsory license. The primary inquiry is what the parties would have agreed upon if both were reasonably trying to reach an agreement. Id. at 682 - 683.

Here, the master made findings to the effect not alone of the absence of proof of lost profits, for there were no profits, but found there was no proof of lost sales (because of lost invoices), and there were no standards of comparison. The proofs adequately support, as an equitable measure of damages, established royalties, the payments agreed upon in the "agreement in principle." This is the best evidence. It is but the utilization of what was agreed upon as compensation in the event that a firm contract would be executed. The cases hold that a reasonable royalty furnishes a basis for an award only when there are no solid conditions governing the application of an "agreement in principle. Id. at 683.

Laurie Visual Etudes v. Chesebrough-Pond's, 432 N.Y.S.2d 457 (N.Y. 1980). Plaintiff brought action for injunction and money damages based upon alleged misappropriation of trade secrets.

As for the appropriate measure of money damages, the cases have permitted recovery of the investment made. Because of the intensive marketing efforts of Chesebrough together with the additional improvements it provided, neither of these is proper here. Despite its own efforts, Laurie never had the capacity or knowledge profitably to market its device. Plaintiff's counsel conceded in summation that the fixation of a fair royalty would be acceptable relief. The court agrees, and fixed the proper royalty at 10% of gross sales. Id. at 463.

B. Factors considered in Determining a Reasonable Royalty

Vitro Corporation of America v. Hall Chemical Company, 202 F.2d 678 (6th Cir. 1961). *Pecuniary loss in any event can be determined only by reasonable approximation. The actual value of what has been appropriated is always the ultimate in appraisement. If actual value can be ascertained by a reasonable apportionment of profits and damages that course should be pursued. But if this cannot be accomplished the nature of the invention, its utility and advantages and extent of use involved are elements to be considered in determining a reasonable royalty. Id.* at 683.

Forest Laboratories, Inc. v. Pillsbury Company, 452 F.2d 621 (Wi. 1971). Action for misappropriation of Plaintiff's trade secret.

Both parties agree that the "reasonable royalty" method of computing damages was properly invoked. According to that method, the primary inquiry is fixing a reasonable royalty is "what the parties would have agreed upon, if both were reasonably trying to reach an agreement." Id. at 627

The basis for an award of damages should be as explicit as the method of calculating the damages permits, but the reasonable royalty method used in this case is not amenable to a completely mathematical articulation. Here the master considered the factors of Forest's loss of profits, its profits prior 1964, and its claimed cost of development, and to these factors he assigned values supported by ample evidence. But the master also correctly considered other factors not susceptible of precise valuation, such as Forest's ability to continue in the tablet-producing business, the nature of the trade secret, its utility, and advantages and extent of use. . . . And, of course, the commercial posture of the parties must have entered into the master's picture. Because of the type of factors considered and the necessarily judgmental process involved in constructing a hypothetical business agreement, we cannot fault any lack of specificity in arriving at what must necessarily be a reasonable approximation. Id.

C. Discovery Issues

1. People to interview:

a. Plaintiff's and defendant's accounting personnel
b. Plaintiff's and defendant's sales managers
c. Plaintiff's and defendant's research and development personnel
d. Defendant's customers (survey)
e. Plaintiff's operations managers

2. Relevant records:

a. Plaintiff's and defendant's customer lists
b. Plaintiff's and defendant's monthly financial statements
c. Plaintiff's and defendant's sales reports and invoices
d. Defendant's management cost reports
e. Plaintiff's and defendant's research and development cost reports
f. Plaintiffs' manufacturing records and capacity reports
g. Plaintiff's and defendant's product literature

VI. Other Issues

A. Interest

San Manuel Copper Corporation v. R. Redmond, 445 P.2d 162 (Az. 1968).
The plaintiff contends that he is entitled to interest on the amount and we agree, as a suit for unjust enrichment is based on the theory that the defendant has obtained or retained money that should have been paid over to the plaintiff. As part of the damages interest should run from the time of the infringement on the amount and the jury may be so instructed. Id. at 169.

Jet Spray Cooler, Inc. v. Crampton, 385 N.E.2d 1349 (Mass. 1979).
Here, the plaintiffs have been awarded the entirety of the defendants' net corporate profits from 1964 to 1975. This award is made because it is impossible for the defendants to segregate the portion of their profits which is attributable to the misappropriated trade

secrets from the portion of their profits which may be attributable to other factors. Thus, it is likely that Plaintiffs may recover more than his exact loss. In these circumstances, we do not think that the plaintiffs will be unfairly deprived of compensation or that the defendants will be "unjustly enriched if they are not required to pay interest on the total profits so awarded." Id. at 1363.

B. Punitive Damages

Mangren Research & Development v. National Chemical Co., 87 F.3d 937 (7th Cir. 1996) *The ITSA authorizes exemplary damages of up to twice the amount of compensatory damages if there was a "willful and malicious misappropriation." Although we have found no Illinois case interpreting that phrase, it surely must include an intentional misappropriation as well as a misappropriation resulting from the conscious disregard of the rights of others. The jury found a willful and malicious misappropriation here and awarded exemplary damages to the full extent permitted under the statute. Id.* at 946.

Davis v. Eagle Products, Inc., 501 N.E.2d 1099 (Ind. App. 1986) *Eagle's argument is that since a breach of trust was involved in this case, public policy would favor the imposition of punitive damages. . . . Those cases involved breaches of trust with members of the public by a building contractor and an insurance company. By contrast, the instant case did not involve a breach by one who occupies a position of trust with members of the public rather it was restricted to the employee and employer context. With that distinction in mind, the trial court's decision does not seem unreasonable, hence we will not disturb it. Id.* at 1109.

Fremont Oil Company v. Marathon Oil Company, 192 N.E.2d 123 (Ohio, 1963) *We are of the opinion that before the question of punitive damages may be submitted to a Jury, the fraud, malice or insult connected with the tort must be actual and not imaginative. . . . In the case at bar, the Court cannot find that there is sufficient evidence to indicate that the defendants acted through actual malice. And consequently, exemplary or punitive damages are not allowable and it further follows that Court cannot, therefore, award any allowance for attorney fees. Id.* at 130 – 131.

C. Attorney's Fees

Carter Products, Inc. v. Colgate-Palmolive Company, 214 F.Supp. 383 (D. Md. 1963). *In actions for unfair competition, attorneys' fees are assessed as an element of damages where the wrongdoers' action is unconscionable, fraudulent, willful, in bad faith, vexatious or exceptional. The many cases cited in the Local No. 149 opinion show that these principles have been applied in various types of cases. Id.* at 414.

Forest Laboratories, Inc. v. Pillsbury Company, 452 F.2d 621 (WI. 1971). *Except when overriding considerations of justice compel them, it is the policy of federal and state* *courts to deny attorneys' fees in the absence of statutory authorization or agreement. Id.* at 628.

Greenberg v. Croydon Plastics Co., Inc., 378 F.Supp. 806 (E.D. PA. 1974) *Thus, it is unquestioned that a federal court may award counsel fees to a successful party when his opponent has acted 'in bad faith, wantonly, or for oppressive reasons. Id.* at 817.

UNFAIR COMPETITION

Related Statutes and Common Law Business Torts

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UNFAIR COMPETITION
Related Statutes and Common Law Business Torts

UNFAIR COMPETITION

Related Statutes and Common Law Business Torts[1]

I. UNFAIR COMPETITION:

A. Strict definition under Kentucky law: "passing off, or attempting to pass off, upon the public the goods or business of one man as being the goods or business or another." *Newport Sand Bank Co. v. Monarch Sand Min. Co.,* 144 Ky. 7, 137 S.W. 784, 785 (1911); *Acy v. Whaley,* 281 Ky. 400, 136 S.W.2d 575 (1940).

1. Essentially, the law of trade mark and trade dress.

2. Purpose is "common business integrity"

    a. "to prevent person from deceiving the people by passing off on them some thing which they believe or might be led to believe is another thing – an article of commerce or a business of professional service"

    b. "to protect a developed property right and good will from appropriation or injurious invasion by deceptive methods" *Acy v. Whaley,* 281 Ky. 400, 402, 136 S.W.2d 575,577 (1940).

3. Limitations on "unfair competition" claims

    a. Reverse engineering of non-patented items. *Acy,* 281 Ky. at 405, 136 S.W.2d at 578

    b. Potential pre-emption of common law claims: K.R.S. 365.892: KUTSA "replaces conflicting tort, restitutionary, and other law of this state providing civil remedies for misappropriation of a trade secret." *Auto Channel, Inc. v. Speedvision Network, LLC,* 144 F. Supp. 2d 784 (W.D. Ky. 2001).

• "idea misappropriation" pre-empted
• claims based solely on the misappropriation of trade secret pre-empted
• disclosure/misuse of information under breach of contract remains. K.R.S. 365.892(a)

B. "Unfair Competition" often used to describe broader common law concepts

1. Trade secrets
2. Duties of loyalty
3. Tortious Interference
4. Unfair Trade Practices
5. Consumer Protection Act
6. Antitrust
7. Non-competition covenants
8. Employee raiding

II. EMPLOYEE'S FIDUCIARY DUTY

A. **Duty not to compete against employer.**

1. *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476 (1991):
   a. Under Kentucky law, generally, in the absence of a contractual provision to the contrary, corporation fiduciaries such as directors and officers, are free to resign and form an enterprise that competes with the corporation. However, directors and officers may not set up, or attempt to set up, an enterprise which is competitive with the business in which the corporation is engaged while still serving as directors and officers. *See also DSG Corp. v. Anderson*, 754 F.2d 678 (6^{th} Cir. 1985) (applying Kentucky law).

   b. Role as an employee, officer, and director is "an established basis of fiducial confidence." That duty includes a duty not to "act against the employer's interest."

   c. These findings were based upon policies of "honesty and fair dealing" in commercial competition.

2. *DSG Corp. v. Anderson,* 754 F. 2d 678 (6^{th} Cir. 1985) (applying Kentucky law): employee must disclose to the employer any information which could damage the company.

3. *Stewart v. Kentucky Paving Co.* 557 S.W.2d 435 (Ky. App. 1977): employee owes employer a duty of loyalty and faithfulness which precludes the use of information obtained while an employee for personal gain.

4. *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166 (Ky. 1974): employee cannot establish a competing business until after the employment relationship is terminated.

5. *Hoge v. Kentucky River Coal Co.,* 287 S.W. 226, 227 (Ky. 1926): "everyone – whether designated agent, trustee, servant or whatnot – who is under contract or other legal obligation to represent or act for another in any particular business or for any valuable purpose must be loyal and faithful to the interest of such other in respect to such business . . . . He may not use any information that he may have acquired by reason of his employment either for the purpose of acquiring property or doing any act which is in opposition to his principal's interest."

B. Duty of third parties

1. "a person who knowingly joins with or aid sand abets a fiduciary in an enterprise constituting a breach of the fiduciary relationship becomes jointly and severally liable with the fiduciary for any profits that may accrue. *Steelvest*, 807 S.W.2d at 485.

   • "a confidential relationship creates a fiduciary relationship." *Steelvest,* 807 S.W.2d at 486.

2. Attorneys advising employees, officers, directors: under some circumstances, the attorney-client privilege may not be available to shield discovery of materials related to an officer's for director's activities to formulate a competing company in violation of the officer/director's fiduciary duty. Steelvest, 807 S.W.2d at 487-88.

C. **Potential Damages**:

An employee may be liable to the employer for any gain derived by establishing a competing interest without full disclosure to the employer, even if the employer has suffered no loss. *DSG Corp. v. Anderson*, 754 F.2d 678, 682 (6^{th} Cir. 1985) (applying Kentucky law).

D. **Consider possible pre-emption by KUTSA**

III. TORTIOUS INTERFERENCE WITH BUSINESS AND CONTRACTUAL RELATIONS

A. Cause of action is recognized in Kentucky, following the elements set forth in Restatement (Second) of Torts §§ 766B, 767, & 773.

- *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476 (1991).
- *NCAA v. Hornung*, 754 S.W.2d 855, 857 (Ky. 1988).
- *Cullen v. South East Coal Co.*, 865 S.W.2d 187 (Ky. App. 1983).

B. Elements: "interference with a known contractual relationship if the interference is malicious or without justification, or is accomplished by some unlawful means such as fraud, deceit, or coercion."

- *Steelvest, Inc. v. Scansteel Service Center, Inc.* 807 S.W.2d 476 (1991).
- *Derby Road Building Co. v. Commonwealth*, 317 S.W.2d 891 (1958).
- *Brooks v. Patterson*, 234 Ky. 757, 29 S.W.2d 26 (1930).

C. Factors that Courts are to review in analyzing claims:

1. the nature of the actor's conduct,
2. the actor's motive,
3. the interests of the other with which the actor's conduct interferes,
4. the interests sought to be advanced by the actor,
5. the social interests in protecting the freedom of action of the actor and the contractual interests of the other,
6. the proximity or remoteness of the actor's conduct to the interference, and
7. the relations between the parties.
   4 Restatement of the Law 2d, Torts (1979), §767; *Hornung,* 754 S.W.2d at 858.

D. "Intent" and "Wrongful"

1. Plaintiff must show malice or some significantly wrongful conduct. *Hornung*, 754 S.W.2d at 859.

2. Breach of a fiduciary duty is equivalent to fraud for purposes of determining if actions were wrongful. *Steelvest*, 807 S. W.2d at 487.

3. "Malice" may be inferred from proof of lack of justification. *Hornung,* 754 S.W.2d at 859.

E. Burdens of Proof:

1. Plaintiff must prove that the interference was improper.

2. Defendant has burden of proof for defense that it acted in good faith to assert a legally protected interest of its own. *Hornung*, 754 S.W.2d at 858.

IV. UNFAIR TRADE PRACTICES ACT

A. Price discrimination -- K.R.S. 365.020

1. Prohibition: No person engaged in the production, manufacture, distribution or sale of any commodity, product, service, or output of a service trade, with the intent to destroy competition, shall discriminate in price between different sections, communities, cities, or portions or locations therein

2. Intent to destroy competition is key element. *Kentucky Utilities Co. v. Carlisle Ice Co.*, 279 Ky. 585, 131 S.W.2d 499 (1939).

3. Allowances in trade terms permitted for:
    a. grade or quality
    b. actual cost of transportation

B. Sales below cost – K.R.S. 365.030

1. Prohibition: No person engaged in business in Kentucky shall sell, offer for sale, or advertise for sale any article or product, or service or output of a service trade, at less then the cost thereof for the purpose of injuring competitors and destroying competition.

V. CONSUMER PROTECTION ACT -- K.R.S. 367.110 et seq.

A. Prohibition: Unfair, false, misleading or deceptive acts or practices in the conduct of any trade or commerce. K.R.S. 367.170(1).

1. Proof of actual deception is not required. *Telcom Directories, Inc.v. Commonwealth*, 833 S.W.2d 848 (Ky. App. 1991).

2. Pyramid schemes. *Date to Be Great, Inc. v. Commonwealth ex rel. Hancock*, 511 S.W.2d 224 (Ky. 1974).

B. Key definitions

1. "Person" = natural person, corporation, trusts, partnerships, incorporated or unincorporated association or any other legal entity. K.R.S. 367.110(1).

2. "Trade" or "commerce" = advertising, offering for sale, or distribution of any services and any property, tangible or intangible, real, personal or mixed, an d any other article, commodity, or thing of value, and shall include any trade or commerce directly or indirectly affecting the people of this Commonwealth." 367.110 (2).

3. "Unfair" shall be construed to mean "unconscionable." K.R.S. 367.170(2).

VI. ANTITRUST

A. Prohibitions:

1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce in this Commonwealth is unlawful. K.R.S. 367.175(1).

2. Monopolize or attempt to monopolize or combine or conspire with any other person or persons to monopolize any part of the trade or commerce of this Commonwealth. K.R.S. 367.175(2).

B. Case law interpretation: statute has been interpreted to be identical to the Sherman Antitrust Act.

- *Borg-Warner Protective Services Corp. v. Guardsmark, Inc.*, 946 F. Supp. 495 (E.D. Ky. 1996), *aff'd*, 156 F.3d 1228 (6th Cir. 1998).

C. Limitations on scope:

1. Restrictive covenants on land

2. Employee restrictive covenants

3. Compare California approach, wherein essentially same statutory language is used to void employee non-competes.

VII. COMPUTER FRAUD AND ABUSE ACT -- 18 U.S.C. §1030 et seq.

A. Prohibitions: accessing, transmitting, or altering computer information without authorization or in excess of the person's authorization. The computer being accessed must be used in interstate or foreign commerce.

B. Key terms:

(1) The term "**computer**" means "an electronic, magnetic, optical, electrochemical, or other high speed data processing device performing logical, arithmetic, or storage functions, and includes any data storage facility or communications facility directly related to or operating in conjunction with such device, but such term does not include an automated typewriter or typesetter, a portable hand held calculator, or other similar device." 18 U.S.C. §1030(e)(1).

(2) The term "**protected computer**" includes "a computer . . . (A) exclusively for the use of a financial institution . . . or (B) which is used in interstate or foreign commerce or communication." 18 U.S.C. §1030(e)(2).

(3) The term "**exceeds authorized access**" means "to access a computer with authorization and to use such access to obtain or alter information in the computer that the accesser is not entitled so to obtain or alter." 18 U.S.C. §1030(e)(6).

(4) The term "**damage**" means "any impairment to the integrity or availability of data, a program, a system, or information, that—

(A) causes loss aggregating at least $5,000 in value during any 1-year period to one or more individuals;
(B) modifies or impairs, or potentially modifies or impairs, the medical examination, diagnosis, treatment, or care of one or more individuals;
(C) causes physical injury to any person; or
(D) threatens public health or safety." 18 U.S.C. §1030(e)(8).

C. Remedies

1. Compensatory damages
2. Injunctions and "other equitable relief"
3. Criminal penalties include fines and up to 20 years in prison.

D. Recent case law interpretation:

1. *United States v. Middleton*, 231 F.3d 1207 (9th Cir. 2000): former employee's access to and alteration of accounts, billing system, and internal databases.

2. *Shurgard Storage Centers, Inc. v. Safeguard Self Storage, Inc.*, 119 F. Supp. 2d 1121 (W.D. Wash. 2000): employee, while planning to leave for a competitor, collected and disseminated information including sending e-mails with trade secret and proprietary information.

3. *YourNetDating, LLC v. Mitchell*, 88 F. Supp. 2d 870 (N.D. Ill. 2000): temporary restraining order issued against a computer programmer alleged to have hacked into his former employer's dating service website to divert customers to a sexually explicit website of his new employer.

VIII. OTHER RELATED CRIMINAL STATUTES

A. **Unlawful access to computers** -- K.R.S. 434.850

1. Prohibitions: "A person is guilty of unlawful access to a computer in the second degree when he **without authorization** knowingly and willfully, directly or indirectly accesses, causes to be accessed, or attempts to access any computer software, computer program, data, computer, computer system, computer network, or any part thereof." K.R.S. 434.850(1).

2. Private/civil cause of action not explicitly provided

3. Criminal penalties

4. Neighboring states have similar criminal statutes

   a. Ohio = O.R.C. §2913.04

   b. Tennessee = Tenn. Code Ann. §39-14-602.

B. **Economic Espionage Act,** 18 U.S.C. §1831-39

1. Prohibitions:
   (A) with **intent to convert a trade secret**, that is related to or included in a product
   (B) that is produced for or placed in **interstate or foreign commerce**,
   (C) to the economic benefit of anyone other than the owner thereof, and
   (D) intending or knowing that the offense will injure any owner of that trade secret,
   knowingly--
   (1) steals, or without authorization **appropriates, takes, carries away, or conceals, or by fraud, artifice, or deception obtains such information**;

(2) without authorization **copies, duplicates**, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys such information;

(3) receives, buys, or possesses such information, knowing the same to have been stolen or appropriated, obtained, or converted without authorization;

(4) attempts to commit any offense described in paragraphs (1) through (3); or

(5) conspires with one or more other persons to commit any offense described in paragraphs (1) through (3), and one or more of such persons do any act to effect the object of the conspiracy.

2. Remedies

A. Monetary fines or imprisonment of not more than 10 years, or both.

B. No private right of action is permitted.

C. The Attorney General has authority to seek injunctive relief.

IX. SOURCE AND RESEARCH MATERIALS

A. "Unfair Competition," by Business Laws, Inc. (loose leaf binder)

B. D. McClelland & J. Forgy, "Is Kentucky Law 'Pro-Business' in its Protection of Trade Secrets, Confidential and Proprietary Information? A Practical Guide for Kentucky Businesses and their Lawyers." 24 N. KY. L Rev. 229 (1997).

C. "Covenants Not to Compete, A State-by-State Survey," ABA Section of Labor and Employment Law.

D. Pooley et al, "Understanding the Economic Espionage Act of 1996," 5 Tex. Intellectual Prop. J. (1997).

THE LAW OF TRADEMARK IN TODAY'S BUSINESS WORLD

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SECTION E

THE LAW OF TRADEMARK IN TODAY'S BUSINESS WORLD*

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THE LAW OF TRADEMARK IN TODAY'S BUSINESS WORLD

PREFACE: Where Did Trademarks and Trademark Law Come From --

A. "A Page of History . . ."

B. Trademark Law As a Part of the Greater Law of Unfair Competition
And Who Cares, Anyway?

C. Impact Upon "General Business Practice"

1. Time is of the essence . . .
2. A rose is not a rose . . .

D. Significance of Trademark Matters

1. In the business context
2. In the legal context

1. WHAT (EXACTLY) ARE "TRADEMARKS"?

A. **Definitions (Short List)**

1. "Trademark" - word, name, symbol, or device used to indicate the source of goods (not the type or nature of the goods)

   a. Examples: OLD GRAND DAD bourbon; DELL computers; XEROX photocopiers; LUVS paper diapers; BEN & JERRY'S ice cream

2. "Service Mark" - word, name, symbol, or device used to indicate the source of services (not the type or nature of the services)

   a. Examples: SHOWCASE cinemas; GREYHOUND bus lines; CENTURY 21 real estate services; GIANT grocery stores; CINCINNATI REDS baseball entertainment services

3. "Trademarks" come in a variety of types – two-dimensional (ordinary formats or traditional packaging "trade dress"), three-dimensional (traditional packaging "trade dress" or modern product configuration "trade dress"), even non-dimensional (such as a single color, a particular scent, or a series of sounds).

4. "Trade Dress" – traditionally, the packaging and labeling of a product; now extends to the shape/design of the product itself

   a. The Metamorphosis to Modern Trade Dress

      (1) *Sears/Compco* stunned modern product simulation
      (2) The shifting sands of Lanham Act Section 43(a)
      (3) The expansion to "Service Dress"
      (4) The role of registration
      (5) The role/rule of inherent distinctiveness

   b. The Primacy of Functionality

      (1) The great sea of competition
      (2) Exceptional islands afloat in the great sea
      (3) Functionality as the equator

B. Functions of Trademarks/Service Marks

1. Identification of the source of goods and/or services

2. Guarantee of the constancy of the quality of goods/services sold under the mark

3. Repository of the good will and springboard for advertising of goods/services, including commercially significant collateral merchandising (licensing)

C. Requirements for Establishing Trademarks/Service Marks

1. Select a strong mark at the outset

   a. Consult with advertising personnel, name development firms, and, preferably, with a knowledgeable trademark lawyer

   b. Inherently strong marks are "fanciful" (coined): e.g., KODAK film, KLEENEX tissues, HUMANA hospital; or "arbitrary" (meaning is unrelated to chosen use): e.g., ARROW shirts, DOMINO's pizza, APPLE computers; or "suggestive" (imagination needed to be sure of meaning of reference): e.g., FRESHER COOKER restaurants, GREYHOUND bus lines, COPPERTONE tanning lotion

c. Initially weak marks are "descriptive" in one way or another: THRIFTY RENT-A-CAR, CHAPSTICK lip balm; or surnames or personal names: e.g., TAYLOR wine, FORD automobiles, JOE'S BAR; or geographical terms: e.g., AMERICAN AIRLINES, CINCINNATI INSURANCE, GEORGETOWN HOSPITAL; these become protectible (if at all) only upon acquisition of "secondary meaning" (acquired distinctiveness)

d. Generic terms directly name the product rather than its producer: e.g., "Shredded Wheat" cereal, "PC," for personal computers, "Murphy" beds; "Aspirin" analgesic; these are <u>no good</u>, either initially or later on, regardless of how much effort is invested

2. "Clear" the mark early on

a. In-office computer database search, e.g., TRADEMARKSCAN database (federal and state)

b. Internet search; e.g., SITECOMBER database, or search engines

c. Outside professional company database search (Federal Register, state registries, and/or common law and trade name searches)

d. Review and recommendation by a knowledgeable trademark lawyer

3. "Adopt" the Mark and Either Use It (Intrastate or Interstate) or Apply to Register It Federally

a. Apply the mark to labels on the goods (trademark) or include it in advertisements for the services (service mark) <u>and</u> use the mark in a true commercial fashion (at least intrastate) - it must be used "in commerce" (interstate) in order to be federally registered; <u>or</u>

b. File an application to register the mark on the federal Principal Register based on a "bona fide" intent to use the mark in "commerce" in the foreseeable future

2. FEDERAL REGISTRATION OF TRADEMARKS

A. Why Is It Done?

1. "Constructive Use" - temporary and conditional nationwide effect resulting from filing of an application for Principal Register in the U.S. Patent and Trademark Office - avoids claims of "innocent" later adoption by others *nationwide*

2. "Constructive Notice" - permanent nationwide effect occurring upon issuance of a Principal Register registration - avoids claims of "innocent" later adoption by others *nationwide*

3. Presumptions of validity, registration, ownership, and exclusive rights in registrant upon issuance of Principal Register registration

4. Increased ability to block registration of confusingly similar marks of competitors

5. Ability to block importation of goods bearing the same or confusingly similar marks

6. Eligibility for "incontestable" status (and resulting augmented presumptions, etc.)

7. Protection against *state* dilution laws per § 43(c)(3): Ownership of a valid federal registration completely bars an action, with respect to that mark, under a state's dilution statute or common law.

8. Appearance in others' search reports

B. How Is It Done?

1. Application

   a. heading information
   b. applicant's name, etc.
   c. mode of use
   d. description of goods/services
   e. dates of use (or statement of "bona fide" intent to use)
   f. specimens (except for ITU applications)
   g. power of attorney
   h. verification

2. PTO examination: Office Actions

3. Trademark Attorney Interviews

4. Responses and Amendments

5. Appeal, if necessary, to Trademark Trial and Appeal Board

6. Publication in Official Gazette

7. Opposition proceedings before Trademark Trial and Appeal Board, and appeal, if necessary, to a federal court

8. Notice of Allowance (ITU applications only)

    a. Amendment to Allege Use/Statement of Use
    b. Specimens

9. Issuance of registration and certificate thereof

C. How Is It Maintained - Legally?

1. Use of registration symbol (® or "Reg. U.S.P.T.O.")

2. Ten-year, renewable term (combined with Affidavit/Declaration of Use)

3. Affidavit/Declaration of Use - in 6th year

4. Incontestability Affidavit/Declaration - in 6th year or later

5. PTO cancellation proceedings (on any basis for 5 years)

6. Litigation in the courts

D. How Is It Maintained - Practically?

1. Avoid non-use of the mark coupled with an intent *not* to resume use of it

2. Use mark as a proper adjective <u>only</u>; use a generic noun along with it

3. Contract for and exercise "quality control" over licensees' use of mark and pertinent goods/services

4. Informally/formally police others' uses of mark/confusingly similar marks

3. ENFORCEMENT OF FEDERALLY REGISTERED MARKS

A. The Basic Standard - "Likelihood of Confusion"

1. Confusion of source or sponsorship is the focal point; confusion of goods/services rarely is involved – except regarding counterfeiting

2. Factors to be considered:

   a. strength of senior user's mark (inherent and marketwise)
   b. similarity of appearance, pronunciation, meaning and suggestion of the parties' marks
   c. similarity of the parties' goods/services
   d. closeness of use and manner of the parties' marketing/advertising
   e. degree of care likely to be exercised in the purchasing decision (herein of sophistication of purchases and speed/care of decision-making)
   f. similarity of "presentation" of the marks and of the trade dress accompanying the marks
   g. presence (or absence) of actual confusion – where relevant
   h. intent of junior user - to take a free ride? – to imitate marketable features? – to imitate functional features?

B. Geographical Overlap Situations

1. Complex common law rules still apply where constructive use or constructive notice do not resolve the problem

   a. Basically, senior user prevails ("prior in time is prior in right")
   b. Except as against a "remote and innocent" junior user
   c. Remoteness is based on market presence

2. Federal registrant is entitled to entire country

   a. Except where there's a prior user
   b. Except for limited enforcement per <u>Dawn Donut</u>

3. Concurrent registrations possible under Lanham Act § 2(d)

4. Caveat: Internet may change everything!

C. Available Remedies

1. Injunctive relief (interlocutory and/or permanent)

2. Damages (possibly trebled)

3. Profits (possibly augmented)

4. Effect of equitable defenses (even as against "incontestable" marks)

5. Attorney fees in "exceptional cases"

6. Court costs typically awarded

7. Destruction of infringing labels, etc.

8. Extraordinary injunctive and monetary remedies for "counterfeiting"

4. HOW ABOUT OTHER RIGHTS?

A. Lanham Act § 43(a) – as clarified by Trademark Law Revision Act in 1989

1. So-called "federal unfair competition law" clearly includes protection against infringement of unregistered marks

2. "False designation of origin" - broadly defined

3. Federal jurisdiction without "diversity" or minimum amount involved

4. Lanham Act test of "infringement" (likelihood of confusion) applies

5. Lanham Act remedies – injunctive and monetary; beware equitable defenses

6. No constructive notice, presumptions, incontestability, stoppage at borders

B. Federal Trademark Dilution Act - effective on January 16, 1996

1. New Lanham Act § 43(c); see also § 45, defining dilution as "the lessening of the capacity of a famous mark to identify and distinguish goods and services" –

   a. regardless of presence/absence of competition
   b. regardless of presence/absence of likelihood of confusion

2. "Famous" marks protected against blurring and tarnishment

   a. FTDA established factors for determining whether mark is "famous"

      (1) degree of inherent or acquired distinctiveness
      (2) duration and extent of use
      (3) geographical extent of trading area
      (4) channels of trade
      (5) degree of recognition of the mark
      (6) third party use
      (7) registration

   b. Factors frequently misconstrued as "dilution" factors

3. No registration required (remarkably)

4. Not preemptive of state laws, but not hampered by them, either

5. State dilution laws preempted as against federal registrations

6. Not actionable under § 43(c):

    a. fair use in comparative commercial advertising
    b. noncommercial use
    c. news reporting and commentary

C. State Statutory Law

1. Model State Trademark Bill (U.S.T.A./I.N.T.A.)

    a. spread: about 40 states
    b. approach: like Lanham act, but without its real advantages

2. Uniform Deceptive Trade Practices Act (N.C.C.U.L.)

    a. spread: about 10 states
    b. approach: somewhat like Lanham Act, but without its real advantages
    c. remedies: injunctive only

3. Dilution Laws

    a. spread: about 30 states by statute; only 1 state (Ohio), perhaps, by common law
    b. strength-based rather than confusion-based
    c. only famous and very strong marks are protected

D. State Common Law

1. "Old reliable"

2. Rarely relied upon

MONETARY RECOVERY IN TRADEMARK INFRINGEMENT DISPUTES

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SECTION F

MONETARY RECOVERY IN TRADEMARK INFRINGEMENT DISPUTES

PURSUANT TO 15 U.S.C. SECTION 1117(a)

COUNTERFEITING - 15 U.S.C. SECTION 1117 (b) and (c)

DOMAIN NAMES - 15 U.S.C. SECTION 1117(d)

Monetary Recovery in
Trademark Infringement Disputes

Pursuant to 15 U.S.C. § 1117(a)

I. Statutory Language

. . . the plaintiff shall be entitled . . . subject to the principals of equity . . . to recover (1) defendant's profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action. The court shall assess such profits and damages or cause the same to be assessed under its direction. In assessing profits the plaintiff shall be required to prove defendant's sales only; defendant must prove all elements of cost or deduction claimed. In assessing damages the court may enter judgment, according to the circumstances of the case, for any sum above the amount found as actual damages, not exceeding three times such amount. . . . If the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according to the circumstances of the case. Such sum in either of the above circumstances shall constitute compensation and not a penalty. The court in exceptional cases may award reasonable attorney fees to the prevailing party.

II. Defendants' profits

A. Theories of recovery

1. Compensatory damages

2. Deterrence

3. Unjust enrichment

B. Equitable considerations for the award of defendants' profits

1. Are plaintiff's damages measurable and adequate?

<u>BASF Corp. v. Old World Trading Co., Inc.</u>, 41 F.3d 1081 (C.A.7 1994). BASF brought action for false advertising for statements Old World Trading Co. made concerning the alleged high quality of its antifreeze. The District court awarded BASF $2.5 Million in lost profits, but refused to award BASF the profits of Old World Trading Co.

Disgorgement initially developed as a remedy to provide a plaintiff relief in equity, to serve as a proxy for damages, or to deter the wrongdoer from continuing his violations. . . . The variety of circumstances in which a court may award disgorgement by no means indicate that the district court is required to award disgorgement. Contrary to BASF's assertions that disgorgement is the "norm" in a Lanham Act case, disgorgement is most appropriate if damages are otherwise nominal. . . . While damages directly measure the plaintiff's loss, *defendant's profits measure the defendant's gain. Thus, an accounting may overcompensate for a plaintiff's actual injury and create a windfall judgment at the [defendant's] expense. Id.* at 1095 – 1096.

2. Is injunction a sufficient remedy?

<u>Square D Co. v. Sorenson</u>, 224 F2d 61 (C.A.7 1955). Action for damages and injunction relief against Sorenson's use, in connection with certain products, of a mark consisting of a capital D enclosed in a rectangle.

An accounting will not be ordered merely because there has been an infringement. . . . under the present act, an accounting has been denied where an injunction will satisfy the equities of the case. The same is true in the case of unfair competition. . . . From all the facts we find that the likelihood of damage to plaintiff or profit to defendants due to any misrepresentation seems slight, and that in view of these various circumstances the "injunction will satisfy the equities of the case." Id. at 65 – 66.

3. Was infringement willful or were defendant's actions malicious?

<u>WSM, Inc. v. Tennessee Sales Co.</u>, 709 F.2d 1084 (C.A.6 1983). WSM brought an action against a manufacturer of T-shirt transfers for infringement of a registered trademark and for unfair competition.

Wrongful intent need not, and ordinary cannot, be established by direct evidence, but may be inferred from defendant's acts. . . . Here, TS was aware of WSM's mark, yet with an infinite variety of non-similar designs available, it chose a virtually identical design, knowing that it intended to sell that design on identical goods in the same channels of trade as that in which WSM's mark moved. It is reasonable to infer therefrom that TS intended to deceive the public concerning the origin of the goods. The district court thus properly awarded profits to WSM. Id. at 1087.

<u>George Basch Co., Inc. v. Blue Coral, Inc.</u>, 968 F.2d 1532 (C.A.2 1992), certiorari denied 113 S.Ct. 510, 506 U.S. 991, 121 L.Ed.2d 445. George Basch Co., a manufacturer of metal polish brought action alleging trade dress infringement. The district court awarded the plaintiff $200,000 in defendant's profits and injunctive relief.

Compensatory Damages: *[U]nder the "damages" theory of profits, a plaintiff typically has been required to show consumer confusion resulting from the infringement. . . . Whether a plaintiff also had to show willfully deceptive conduct on the part of the defendant is not so clear. While some courts "reject good faith as a defense to an accounting for profits," . . . others have concluded that a defendant's bad faith is the touchstone of accounting liability. Id.* at 1539.

Deterrence: *[A] court may award a defendant's profits solely upon a finding that a defendant fraudulently used the plaintiff's mark. . . . The rationale underlying this holding is not compensatory in nature, but rather seeks to protect the public at large. By awarding the profits of a bad faith infringer to the* *rightful owner of a mark, we promote the secondary effect of deterring public fraud regarding the source and quality of consumer goods and services. Id.*

Unjust Enrichment: *[A] defendant becomes accountable for its profits when the plaintiff can show that, were it not for defendant's infringement, the defendant's sales would otherwise have gone to the plaintiff. At bottom, this is simply another way of formulating the element of consumer confusion required to justify a damage award under the Lanham Act. As such, it follows that a profits award, premised upon a theory of unjust enrichment, requires a showing of actual consumer confusion – or at least proof of deceptive intent so as to raise the rebuttable presumption of consumer confusion. Id.* at 1538.

Sporty's Farm L.L.C. v. Sportman's Market, Inc., 202 F.3d 489 (C.A.2 2000), certiorari denied 120 S.Ct. 2719, 147 L.Ed.2d 984. Sporty's Farm brought declaratory judgment action against Sportman's Market, a catalog company, seeking a declaration of its right to use the "sportys.com" domain name. Sportman's Market brought counterclaims for a number of actions including trademark infringement under the Federal Trademark Dilution Act (FTDA).

Under the FTDA, "[t]he owner of the famous mark shall be entitled only to injunctive relief unless the person against whom the injunction is sought willfully intended to trade on the owner's reputation or to cause dilution of the famous mark." . . . Accordingly, where willful intent to dilute is demonstrated, the owner of the famous mark is – subject to the principles of equity – entitled to recover (1) damages (2) the dilutor's profits, and (3) costs. Id. at 500.

4. Did trademark create demand for defendant's sales?

Mishawaka Rubber & Woolen Mfg. Co. v. S.S. Kresge Co., U.S. 1942, 62 S.Ct. 1022, 316 U.S. 203, 86 L.Ed. 1381, rehearing denied 62 S.Ct. 1287, 316 U.S. 712, 86 L.Ed. 1777. Plaintiff brought a trademark infringement action against defendant in connection with defendant's use of a red circular plug embedded into the heel of shoes.

If it can be shown that the infringement had no relation to profits made by the defendant, that some purchasers bought goods bearing the infringing mark because of the defendant's recommendation or his reputation or for any reason other than a response to the diffused appeal of the plaintiff's symbol, the burden of showing this is upon the poacher. The plaintiff of course is not entitled to profits demonstrably not attributable to the unlawful use of his mark. . . . The burden is the infringer's to prove that his infringement had no cash value in sales made by him. If he does not do so, the profits made on sales of goods bearing the infringing mark properly belong to the owner of the mark. Id. at 1024 – 1025.

5. Were parties competitors?

Monsanto Chemical Co. v. Perfect Fit Products Mfg. Co., 349 F.2d 389 (C.A.2 1965), certiorari denied 86 S.Ct. 1195, 383 U.S. 942, 15 L.Ed.2d 206. Monsanto Chemical Co. produces an acrylic fiber, which it marketed under the registered trademark "Acrilan." The defendant deliberately infringed this mark by selling mattress pads falsely labeled as Acrilan-filled.

We do not hold that it is irrelevant whether the parties are in direct competition; compensation for diverted trade is one important purpose which an accounting may serve. To restrict accountings to this single purpose, however, fails to take account of the other purposes served by the trademark law. Under the circumstances of this case, a judgment limited to an injunction is clearly inadequate to deter those who deliberately engage in commercial piracy which defrauds thousands of consumers and injures a trade name built up at considerable cost by legitimate means. Id. at 397.

6. Were sales in same geographic market?

Blue Bell Co. v. Frontier Refining Co., 213 F.2d 354 (C.A.10 1954). Frontier Refining Co. brought a trademark infringement action against Blue Bell for its unauthorized use of such trademarks as "Rarin' To Go," "Frontier" and "Gas."

Out of the welter of confusion occasioned by the judicial effort to fashion a remedy which would satisfy both legal and equitable concepts of appropriate relief for patent and trademark infringements, the courts have now settled on the theory that a trademark infringer is liable as a trustee for profits accruing from his illegal acts, even though the owner of the mark was not doing business in the consuming market where the infringement occurred. Id. at 362 – 363.

7. Did Plaintiff abandoned market?

Blue Bell Co. v. Frontier Refining Co., 213 F.2d 354 (C.A.10 1954). Frontier Refining Co. brought a trademark infringement action against Blue Bell for its unauthorized use of such trademarks as "Rarin' To Go," "Frontier" and "Gas."

Recovery is predicated upon the equitable principle of unjust enrichment, not the legal theory of provable damages. In the exercise of its discretion, the trial court may refuse to award profits of the infringer in unusual circumstances where the owner has abandoned the trade territory in which the profits were realized, and has shown no disposition to enter the field. Id. at 363.

C. Burdens of Proof

1. Plaintiffs: Defendants' sales

2. Defendants:

   a. No casual connection

   b. Apportionment

c. Cost allocations and deductions

D. Apportionment

Mishawaka Rubber & Woolen Mfg. Co. v. S.S. Kresge Co., U.S. 1942, 62 S.Ct. 1022, 316 U.S. 203, 86 L.Ed. 1381, rehearing denied 62 S.Ct. 1287, 316 U.S. 712, 86 L.Ed. 1777. Plaintiff brought a trademark infringement action against defendant in connection with the use of a red circular plug embedded into the heel of shoes sold by defendant.

There may well be a windfall to the trademark owner where it is impossible to isolate the profits which are attributable to the use of the infringing mark. But to hold otherwise would give the windfall to the wrongdoer. In the absence of his proving the contrary, it promotes honesty and comports with experience to assume that the wrongdoer who makes profits from the sales of goods bearing a mark belonging to another was enabled to do so because he was drawing upon the good will generated by that mark. Id. at 1025.

Hamilton-Brown Shoe Co. v. Wolf Bros. & Co., U.S. 1916, 36 S.Ct. 269, 240 U.S. 251, 60 L.Ed. 629. Plaintiff, a manufacturer of shoes, brought a trademark infringement action against defendant for its use of the phrase "American Lady."

[T]he profits recoverable should be limited to such amount as may be shown by direct and positive evidence to be the increment of defendant's income by reason of the infringement, and that the burden of proof is upon complainant to show what part of defendant's profits were attributable to the use of the infringing mark. . . . But, . . . there is a recognized exception where the plaintiff carries the burden of proof to the extent of showing the entire profits, but is unable to apportion them, either because of the action of the wrongdoer in confusing his own gains with those which belong to plaintiff, or because of the inherent impossibility of making an approximate apportionment. There, "on established principles of equity, and on the plainest principles of justice, the guilty trustee cannot take advantage of his own wrong." Id. at 272.

Anchor Stove & Range Co. v. Rymer, 97 F.2d 689 (C.A.6 1938), certiorari denied 59 S.Ct. 246, 305 U.S. 653, 83 L.Ed. 422, rehearing denied 59 S.Ct. 357, 305 U.S. 676, 83 L.Ed. 438. Plaintiff brought an unfair competition claim against defendant in connection with sales of heaters to Montgomery Ward & Company of Chicago.

As are pointed out, when equity jurisdiction is rested upon some equitable ground, such as the right to injunction, the court will retain it for the purpose of administering complete relief rather than send the injured party to a court of law for damages, and the infringer's profits are then allowed as an equitable measure of compensation on the theory of a trust ex maleficio, and it is not fatal that the plaintiff is unable to show what proportion of the profit is due to the trademark or the patent and what to the intrinsic value of the commodity, for . . . "it is more consonant with reason and justice that the owner of the trademark should have the whole profit than that he should be deprived of any part of it by the fraudulent act of the defendant." Id. at 690.

E. Cost Deductions

1. Cost of goods sold – deductions at prices paid

<u>Dickinson v. O.&W. Thum Co.</u>, 8 F.2d 570 (C.A.6 1925). Dickinson brought an unfair trade and competition action against Thum Company relating to such marks as "Tanglefoot."

Certain costs were deducted as to which no question arises. These consist of manufacturing costs, salesmen traveling expenses, commissions, discount, office salaries, collection expense, lost accounts, and rebates. Whether the method of ascertaining these costs or the amount thereof is correct is therefore immaterial. The master, however, wholly disallowed certain claimed items, viz. indirect labor, fuel, building repairs, cartage, storage, insurance, general expense, taxes, destroyed goods, and depreciation of buildings. Id. at 573 – 574.

He cast on the defendant the duty of proving these items and refused to allow them, because defendant had wrongfully and unnecessarily confused the goods on hand and the cost and expense of marketing them with its new goods and the cost and expense of its general manufacturing and selling operations during the accounting period. . . . By failing to . . . keep any records or accounts whereby the selling cost and expense attributable to these goods could be separated from his other operations, he brought himself with the principles of <u>Westinghouse v. Wagner</u>. . . . All the inconvenience and loss from the confusion is thrown upon the party who produces it; and this rule applies, even though the innocent victim's share in the property wrongfully and inextricably commingled may apparently be a small part of the total. Id. at 574.

2. Exception - internal transfer prices adjusted

3. Selling, general and administrative costs

   a. Rules of thumb

      1) All products infringe - full absorption approach
      2) Some products infringe - cost allocation
      3) Few products infringe – no deduction at all

   b. Allocation approaches

      1) "Sales ratio" method

<u>Wolf v. National Lead Co.</u>, 272 F.2d 867 (C.A.9 1959) certiorari denied 80 S.Ct. 860, 362 U.S. 950, 4 L.Ed.2d 868, rehearing denied 80 S.Ct. 1235, 363 U.S. 809, 4 L.Ed.2d 1151. National Lead sued Wolf for trademark infringement in connection with Wolf's use of the trademark "Dutch."

The records kept by Wolfe and made available to appellee did not contain data from which an accurate apportionment could be made. Appellee, in the District Court, therefore proposed the "sales-ratio" method: applying to the joint expense the ratio of receipts from the sale of infringing goods to the total receipts. Application of this ratio showed 64% of costs to be attributed to "Dutch" products. This method is recognized as proper where a more exact basis of apportionment is not available. Id. at 871 – 872.

2) The Tremolo line of cases

W.E. Bassett Co. v. Revlon, Inc., 435 F.2d 656 (C.A.2 1970). Action for trademark infringement and unfair competition in which plaintiff Bassett claims that defendant Revlon violated the Lanham Trademark Act of 1946 . . . and the laws of New York by using the mark "Cuti-Trim" for its cuticle trimmer.

Subject to a determination of the reasonableness of the claimed deductions, Revlon should be able to deduct from its net sales its overhead, most of its operating expenses, and the federal income taxes on the "Cuti-Trim" items. The only one of the claimed deductions which Revlon should not be allowed is the over-labeling expense, because Revlon should have to bear the cost of correcting its own wrongdoing. Id. at 665.

John B. Stetson Co. v. Stephen L. Stetson Co., 58 F.Supp. 586 (S.D.N.Y. 1944). This was a suit to enjoin trademark infringement and unfair competition. A final injunction decree was entered in favor of plaintiff, and thereafter, defendants were found in contempt of the decree.

As discussed hereafter, I find that defendant is entitled to a reasonable deduction for salary paid to a reasonable deduction for salary paid to Stephen L. Stetson, regardless of the fact that he is responsible for the violation of the decree. . . . It also appeared that the money paid to D. Bindelglass, aggregating $120, . . . was for services as an accountant and went, in part, into the production of profits. . . . And certainly some part of the expressage of $184.54 was similarly expended. Id. at 591.

Regis v. Jaynes, 77 N.E. 774 (Mass. 1906). Regis brought a trademark action against Jaynes for its use of the words "Rex" and "Rexall" in connection with the sale of medication.

The defendants in the case at bar appear to have been carrying on a large business, and they did not offer to show that their general expenses have been at all increased by their taking up the sale of

"Rexall" goods. Since the filing of the plaintiffs' bill, as we have already stated, their sale of these goods has been unlawful. To allow them to charge upon the gross profits from these goods any portion of the general expenses, which were not increased thereby, would be to allow them to derive a direct advantage from their own wrong. Id. at 777 – 778.

4. Cost of Capital

Lawrenceo-Williams Co. v. Societe Enfants Gombault Et Cie, 52 F.2d 774 (C.A.6 1931), certiorari denied 52 S.Ct. 406, 285 U.S. 549, 76 L.Ed. 940. Gombault brought a trademark action against Lawrenceo-Williams Co.

The master's report does not segregate this three months' period, and with one exception the criticisms made upon the whole accounting are, when restricted to this three months' period, not of enough importance to justify discussion. The exception is as to interest on capital. Under the facts interest should be allowed as an expense of operation. The entire invested capital was used in the unitary business which produced the profits. Id. at 778.

F. Setoff

1. Separate sales to separate customers

Jones Apparel Group, Inc. v. Steinman, 466 F.Supp. 560 (E.D.Pa. 1979). Plaintiff sued defendant for infringement of plaintiff's registered trademark "Jones New York."

It would be inequitable to saddle plaintiff with defendant's loss on the Singer transaction, for the reason that defendant sold at a loss to Signer in order to unload his inventory after belatedly realizing that the garments he had bought from May were probably not authentic Jones pantsuits. . . . And since a plaintiff in a trademark action "is not looked upon as a 'quasi-partner of the infringer;'" Jones should recover Steinman's $320 profit on the Dress Barn transaction without having to set off any party of Steinman's loss on the Singer transaction. Id. at 563.

2. Separate sales in different years

Wolf v. National Lead Co., 272 F.2d 867 (C.A.9 1959), certiorari denied 80 S.Ct. 860, 362 U.S. 950, 4 L.Ed.2d 868, rehearing denied 80 S.Ct. 1235, 363 U.S. 809, 4 L.Ed.2d 1151. National Lead sued Wolf for trademark infringement in connection with Wolf's use of the trademark "Dutch."

It is clear, however that in the making of an accounting an infringer is not permitted such a setoff. Mr. Justice Cardozo, in a case of a patent infringement . . . stated the principle as follows:

> *"The owner of the patent, in holding the infringers to an accounting, is not confined to all or nothing. There may be an acceptance of*

transactions resulting in a gain with a rejection of transactions resulting in a loss. Upon a statement of an account, a patentee is not looked upon as a 'quasi-partner of the infringers,' under a duty to contribute to the cost of the infringing business as a whole. . . . He is the victim of a tort, free at his own election to adopt what will help and discard what will harm. Id. at 870.

G. Recovery Period

1. Deterrence theory

W.E. Bassett Co. v. Revlon, Inc., 435 F.2d 656 (C.A.2 1970). Action for trademark infringement and unfair competition in which plaintiff Bassett claims that defendant Revlon violated the Lanham Trademark Act of 1946 . . . and the laws of New York by using the mark "Cuti-Trim" for its cuticle trimmer.

Revlon was found to have deliberately and fraudulently infringed Bassett's mark . . . Accordingly, a full accounting is proper as a deterrent . . . and since Judge Frankel did find deliberate infringement here, he should have granted Bassett an accounting for all of Revlon's profits on the "Cuti-Trim" items, not just on those sold after the preliminary injunction. It is essential to deter companies from willfully infringing a competitor's mark, and the only way the courts can fashion a strong enough deterrent is to see to it that a company found guilty of willful infringement shall lose all its profits from its use of the infringing mark. Id. at 664.

2. Unjust enrichment theory

Stark Bros. Nurseries & Orchards Co. v. Start, U.S. 1921, 41 S.Ct. 221, 255 U.S. 50, 65 L.Ed. 496. Plaintiff brought trademark infringement action against defendant for the use of the mark "Stark Trees."

The District Court found infringement and unfair competition, granted an injunction, and made a decree for an account of profits from March 11, 1914, when the infringement began, limiting the damages, however, to those suffered after August 26, 1916, that being the date when the plaintiff gave the defendant notice of the registration of the mark. Decree affirmed. Id.

H. Profits increased at courts' discretion.

III. Compensatory damages

A. Entitlement and equity

Otis Clapp & Son, Inc. v. Filmore Vitamin Co., 754 F.2d 738 (C.A.7 1985). Otis Clapp & Son, a seller of non-prescription pharmaceuticals in the institutional medical market, brought an action for trademark infringement and unfair competition.

The award of lost profits in the face of evidence that the defendant lost money was an exercise of the court's discretion and furthers the statute's goals by removing the profit trademark infringements. The plaintiff fails to cite authority for his proposition that, when increasing an award of lost profits to ensure that the aims of justice are fulfilled, the district court must follow a particular mathematical formula for determining the amount due. Id. at 744 – 745.

Broan Mfg. Co., Inc. v. Associated Distributors, Inc., 923 F.2d 1232 (C.A.6 1991). Broan Manufacturing Co., a manufacturer of trademarked bathroom fans brought trademark infringement action against alleged infringers.

The decision whether to grant a declaratory judgment and more generally the decision regarding the appropriate recovery to be afforded under the Lanham Act rests in the sound discretion of the District Court. Id. at 1241.

1. State of mind of defendant

Louis Vuitton S.A. v. Lee, 875 F.2d 584 (C.A.7 1989). Louis Vuitton brought action against retailer and its owners for trademark infringement, false designation of origin, and unfair competition. The district court denied Louis Vuitton's claim for monetary relief and Louis Vuitton appealed.

The principles of equity referred to in section 1117(a) do not in our view justify withholding all monetary relief from the victim of a trademark infringement merely because the infringement was innocent. . . . There is no evidence the Vuitton or Gucci engaged in predatory discovery or otherwise abused the litigation process. In these circumstances a plaintiff is entitled at the very least to simple damages or to the defendants' profits. "Equity" is not a roving commission to redistribute wealth from large companies to small ones. The Lanham Act was not written by Robin Hood. Id. at 588 – 589.

Aladdin Mfg. Co. v. Mantle Lamp Co. of America, 116 F.2d 708 (C.A.7 1941). Aladdin Manufacturing Co. brought an action against Mantle for alleged infringement of the trademark "Aladdin" upon portable electric lamps.

Courts have, in cases in which the action of the infringer was deliberate, fraudulent and wanton, allowed damages in addition to profits. . . In the present case the master concluded and we agree that the acts of the infringer were wanton, willful and intentionally fraudulent, not only in infringement but also in unfair competition. Id. at 716.

Nalpac, Ltd. v. Corning Glass Works, 784 F.2d 752 (C.A.6 1986). Nalpac brought a trademark infringement action against Corning Glass Works for its use of the trademark "Common Scents."

Defendant now has agreed to cease using the mark, has not distributed the jars for sometime and it seems to me that equity, subject to equity, the equitable principles here weigh in favor of granting the permanent injunction but denying monetary relief. Id. at 755.

2. Nature of goods.

Lambda Electronics Corp. v. Lambda Technology, Inc., 515 F.Supp. 915 (D.C.N.Y. 1981). Senior user brought suit against junior user alleging that the use of its trade names and logo constituted trademark infringement, false designation of origin and diluted the distinctive quality of its marks.

[A] more stringent standard must be satisfied to justify the Court's ordering an accounting or awarding damages or attorney's fees. In [cite], the Court of Appeals for this Circuit held that neither damages nor an accounting are proper in a case where the goods are noncompetitive unless (1) there was a diversion of trade, and (2) the junior user acted in bad faith. . . . There is nothing in the record to indicate that the requisite diversion of trade occurred here. Nor, as . . . does the Court find that Lambda Technology acted in bad faith or willfully. Accordingly, there is no basis for the Court to order an accounting or to award damages. Id. at 931.

B. Burden of Proof on Plaintiff

Anchor Stove & Range Co. v. Rymer, 97 F.2d 689 (C.A.6 1938), certiorari denied 59 S.Ct. 246, 305 U.S. 653, 83 L.Ed. 422, rehearing denied 59 S.Ct. 357, 305 U.S. 676, 83 L.Ed. 438. Plaintiff brought an unfair competition claim against defendant in connection with sales of heaters to Montgomery Ward & Company of Chicago.

"When a plaintiff in a trademark or unfair competition case seeks to recover damages, the burden is on him to prove by competent and sufficient evidence his lost sales, or that he was compelled to reduce prices as the result of his competitor's wrongful conduct. There is no presumption of law or of fact that a plaintiff would have made the sales that the defendant made." . . . Especially is this true when the alleged infringer sells his product at a substantially lower price, for "It does not follow, because a party makes a purchase at a lower price, that he would have bought the same article at a higher price." Id. at 691.

C. Components of Lost Profits

1. Lost unit sales

Playboy Enterprises, Inc. v. P.K. Sorren Export Co. Inc. of Florida, 546 F.Supp. 987 (S.D.Fla. 1982). Playboy Enterprises, Inc. (PEI) brought trademark infringement action against defendant for its dealing in counterfeit and genuine wearing apparel bearing or sold under the PLAYBOY and the RABBIT HEAD design marks.

In order to recover damages . . . the plaintiff must show that it suffered actual damages. . . . The mark owner's royalties are normally used as the measure of damages, . . . but the plaintiff must prove both lost sales and that the loss was caused by defendant's actions. . . . Loss of reputation alone is insufficient to justify a separate award of damages. . . . PEI has not demonstrated that it would have made any of the sales which defendants made, or that defendants would themselves have purchased authentic rabbit design shirts had they not acquired *counterfeit shirts. Thus, PEI is not entitled to an award of damages separate from an accounting for defendants' profits. Id.* at 998.

Borg-Warner Corp. v. York-Shipley, Inc., 2932 F.2d 88 (C.A.7 1961), certiorari denied 82 S.Ct. 381, 368 U.S. 939, 7 L.Ed.2d 338. Borg-Warner brought an action on account against York-Shipley. York-Shipley counterclaimed for trademark infringement for Borg-Warner's use of the term "York."

When defendant made its calculations as to damages, it gave no consideration as to the great proportionate increase in the sale of gas-fired furnaces. From 1948 to 1959, the period under consideration, sales of gas-fired units rapidly increased, while the sale of oil-fired furnaces remained relatively stable. . . . There is also on the record, evidence of several intervening causes of defendant's decline in business in 1953 attributable to defendant or to causes other than plaintiff. Consideration should be given to these factors. Id. at 95.

2. Lost market share

BASF Corp. v. Old World Trading Co., 41 F3d 1081 (C.A.7 1994). BASF, a producer of antifreeze, brought a claim against Old World Trading for false advertising under the Lanham Act.

The district court's choice of market share analysis logically follows from its findings that although prices drove some customers away from BASF, ordinary market forces would have pulled some sales back had Old World competed fairly in the market. We cannot conclude that the court erred by determining lost profits according to market share. Id. at 1094.

3. Price erosion

4. Incremental costs

5. Increased operating costs

Century Distilling Co. v. Continental Distilling Corp., 86 F.Supp. 503 (D.C.Pa. 1949), adhered to 89 F.Supp. 684. Continental Distilling Corp. sued Century Distilling Co. for trademark infringement.

However, Continental may be able to show that there was some additional margin of expenditure for advertising which was made necessary or advisable and was carried on for the purpose of counteracting the effect of the Dixie Dew infringement. This would be an element of damage and it may be shown. Id. at 505 – 506.

D. Period of Recovery

1. The first knowing infringing act for intentional infringement

2. The institution of the suit

Bulova Watch Co. v. Allerton Co., 328 F.2d 20 (C.A.7 1964). Bulova Watch company brought an action against Allerton for infringement of the trademark "Bulova."

Whatever infirmity might be urged as to the record in so far as a showing of defendants' awareness of plaintiff's objections to the use of the trademark "Bulova" in defendants' recasing and merchandising activities is concerned, it is clear that defendants were put on such notice by service of plaintiff's complaint in the instant action. . . . It was error for the District Court to limit plaintiff's claim to post-decree damages. It is entitled to proceed to trial on its claim of damages limited only to the post-complaint period. Id. at 24.

3. The registration of the trademark

City Messenger of Hollywood, Inc. v. City Bonded Messenger Service, Inc., 254 F.2d 531 (C.A.7 1958), certiorari denied 79 S.Ct. 45, 358 U.S. 827, 3 L.Ed.2d 66, 119 U.S.P.Q. 501. Plaintiff sued Defendant for unfair competition. Defendant filed four counterclaims on different dates. Count III was filed August 12, 1955 and alleged an infringement of a trademark, the registration of which had been issued a few days previous on July 26, 1955.

Count III of the counterclaim was filed August 12, 1955, eleven weeks after the commencement of the instant suit, and seventeen days after the date of the registration of defendant's mark. Paragraph 1 thereof re-alleged paragraphs 1, 2 and 3 of Count I of the counterclaim. . . . Id. at 534.

Count I alleges unfair competition by plaintiff with reference to defendant's unregistered mark, and the principal emphasis of Count III is as to the registered trademark. With such overlapping of claims we hold that the allowance for damages, if any, under Count I should extend no further than July 26, 1955, the date of the registration of defendants' mark. A cut-ff at this point is necessary to prevent a duplication of compensatory damages, if any are awarded. On the other hand, damages, if any, for the infringement of defendants' registered trademark, and the related claim for unfair competition, cannot extend further back than July 26, 1955. Id. at 535.

[D]amages, if any, for the infringement of defendants' registered trademark, and the related claim for unfair competition, cannot extend further back than July 26, 1955. . . . Also pertinent on the question of damages is 15 U.S.C.A. § 1111, which provides that unless a registrant gives notice that his mark is registered, no proceeds or damages shall be recovered unless the alleged infringer had actual notice of the registration. Id. at 535 – 536.

E. Royalties and license fees

KFC Corp. v. Lilleoren, 821 F.Supp. 1191 (W.D.Ky. 1993). KFC brought an action against Lilleoren for unauthorized use of its trademark after the termination of a franchise agreement.

[T]his court holds that KFC is entitled to recover the amount of royalties it would have received during the holdover period by the defendants. Defendants claim that as they paid 2.8 percent of the 4.0 percent of gross revenues owed KFC, the remaining balance is $8,815.20. Id. at 1193.

Sands, Taylor & Wood v. Quaker Oats Co., 34 F.3d 1340 (C.A.7 1994), on rehearing in part 44 F.3d 579. Sands, Taylor & Woods (STW), the holder of the registered trademark "Thirst-Aid," sued Quaker Oats for its use of the protected term in connection with advertisements for "Gatorade."

Accordingly, we held that the district court ought to begin with the one measure of actual damages that, if ascertained with reasonable certainty, could be said to reflect the actual loss of STW – the cost of a reasonable royalty. Id. at 1350.

More specifically, two aspects of an award of a reasonable royalty make it difficult to ensure that the Act's policy concern of deterrence had been adequately addressed. First, because the award seeks to mirror the bargain at which the parties would have arrived had negotiations taken place, it becomes for the malefactor simply the cost of doing business. There is no incentive to engage in protracted, expensive, and perhaps unsuccessful licensing negotiations when the consequence of getting caught for trade piracy is simply to pay what should have been paid earlier. Nunc pro tunc payment of the royalty fee becomes simply th "judicial expense" of doing business. Id. at 1351.

[I]n fashioning relief based on royalty payments, a court take special care to ensure that the royalty payment has not undercompensated the victim. Enhancement of the damages attributable to a lost royalty in order to ensure that the malefactor, and not the victim, bears the burden of any uncertainty in its calculation is a permissible way of achieving that goal. Id. at 1351.

A & H Sportswear Co., Inc. v. Victoria's Secret Stores, Inc., 967 F.Supp. 1457 (E.D.Pa. 1997), remanded 166 F.3d 197, on remand 57 F.Supp.2d 155. A & H Sportswear Co., a manufacture that used the trademark "Miraclesuit", brought trademark infringement action against Victoria's Secret Stores for use of "The Miracle Bra."

Under the circumstances of this case we believe the most appropriate and accurate damages remedy would be to award Plaintiffs a reasonable royalty. . . . In calculating a reasonable royalty a district court may also consider:

1) royalty rates received in prior licenses by the licensor;

2) prior rates paid by the licensee;

3) the licensor's licensing policies;

4) the nature and scope of the infringer's infringing use;

5) the special value of the mark to the infringer;

6) the profitability of the infringer's use;

7) the lack of viable alternatives;

8) the opinion of expert witnesses; and

9) *the amount that the licensor and licensee would have agreed upon in voluntary negotiations.*

The court's approach should take into account "what the parties 'would have agreed upon, if both were reasonably trying to reach an agreement." . . . "In applying the formulation, the Court must take into account the realities of the bargaining table and subject the proofs to a dissective scrutiny." Id. at 1479 – 1480.

F. Increased Damages

U.S. Structures, Inc. v. J.P. Structures, Inc. , 130 F.3d 1185 (C.A.6 1997). U.S. Structures brought a trademark infringement action against J.P. Structures for defendant's continued use of trademarks after the termination of a franchise agreement.

[D]efendants argue that the district court erred when it awarded plaintiff $6,465.00 in treble damages . . . in addition to the $2,155.00 based upon defendants' profits, because §1117 limits the overall potential recovery to three times the amount of profits. Id. at 1191. *This section should be read as vesting the district court with discretion to increase a damages award up to three times the actual damages sustained. Thus, the district court did not err in computing damages as an amount equal to four times actual damages. Id.* at 1191.

Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc., 874 F.2d 431 (C.A.7 1989). Gorenstein Enterprises sued Quality Care-USA for rescission of a franchise agreement. Quality care brought a counterclaim for breach of contract and trademark infringement.

There is considerable evidence that the Gorensteins were holding the trademark hostage as a bargaining tactic to pressure Quality Care into renegotiating the franchise or settling the suit. . . . So weak are the Gorensteins' arguments regarding their infringement of Quality Care's trademark, and so deliberate the infringement, that it might have been an abuse of discretion for the district judge not to have awarded Quality Care treble damages, attorney fees, and prejudgment interest. Id. at 435.

BASF Corp. v. Old World Trading Co., Inc., 41 F.3d 108 (C.A.7 1994). BASF, a producer of antifreeze, brought a claim against Old World Trading for false advertising under the Lanham Act.

BASF argues that the district court erred in refusing to enhance the damages award pursuant to the Lanham Act's provision allowing a district court to triple the amount of damages. . . . [T]his one equitable factor in BASF's favor does not require a conclusion that the district court's decision was an abuse of discretion. An in any event, the Act specifically provides the enhancement is only available to ensure that the plaintiff receive compensation, . . . and the district court found that BASF was adequately compensated by the damage award. Id. at 1095.

Badger Meter, Inc. v. Grinnell Corp., 13 F.3d 1145 (C.A.7 1994). Badger Meter brought trade dress infringement action against Grinnell Corporation with respect to a redesigned water meter.

The first discretionary method is to award up to three times the damages plaintiff can actually prove. This of course requires that the plaintiff be able to prove some damages... Second, the court determined that Badger could not recover under the first discretionary method of calculating an award because this method is premised on the plaintiff's proving some amount of actual damages. Id. at 1158.

IV. Costs

A. Court costs recoverable

B. Expert fees not recoverable

C. Plaintiffs' attorney fees

Frisch's Restaurants, Inc. v. Elby's Big Boy of Steubenville, Ohio, 849 F.2d 1012 (C.A.6 1988), rehearing denied. Frish's Restaurant brought trademark infringement action against Elby's for its use of the term "Big Boy" within the state of Ohio.

Despite the refusal of the District Court to award damages, Frisch's prevailed in this litigation by showing its entitlement to injunctive relief. However, we do not think this case is "exceptional" within the meaning of the statute. The District Court held that the infringement was not malicious, willful, fraudulent, or deliberate. Therefore, the Court was correct to deny an award of attorneys' fees. Id. at 1017.

Otis Clapp & Son, Inc. v. Filmore Vitamin Co., 754 F.2d 738 (C.A.7 1985). Otis Clapp & Son, a seller of non-prescription pharmaceuticals in the institutional medical market, brought an action for trademark infringement and unfair competition.

Exceptional cases that would justify an award of attorney's fees are ones in which the acts of infringement can be characterized as malicious, fraudulent, deliberate, or willful. Id. at 746.

BASF Corp. v. Old World Trading Co., 839 F.Supp. 528 (N.D.Ill. 1993), affirmed 41 F.3d 1081. BASF, a producer of antifreeze, brought a claim against Old World Trading for false advertising under the Lanham Act.

A decision to award attorneys' fees under the Lanham Act is firmly committed to the district court's discretion, . . . and we do not find that the district court abused its discretion here. Old World, . . . argues that a plaintiff must show "willfulness or bad faith" to be entitled to a fee award, and that the defendant's conduct "targeted" the plaintiff. But the law of this Circuit clearly allows the district court to award attorney's fees based upon the defendant's "malicious, fraudulent, deliberate or willful" infringement. . . . The district court concluded that although Old World's conduct was *not malicious, it was deliberate. . . . We will not disturb the district court's finding that BASF is entitled to "some" attorneys' fees. Id.* at 1099.

Hindu Incense v. Meadows, 692 F.2d 1048 (C.A.6 1982). Hindu Incense brought a trademark infringement action concerning the federally registered mark "Genie."

[T]he present case does not meet the requisite showing of intentional infringement for malicious, fraudulent, deliberate or willful purposes within the meaning of § 1117. Judge Boyle found that the conduct of appellant did not warrant an award of attorney fees. This holding does not constitute an abuse of discretion and we decline to overturn the ruling of the district court. Id. at 1052.

Sovereign Order of Saint John of Jerusalem, Inc. v. Grady, 119 F.3d 1236 (C.A.6 1997) amended on rehearing in part, certiorari denied 118 S.Ct. 1163, 522 U.S. 1147, 140 L.Ed.2d 174. Organization which held collective trademark "Sovereign Order of Saint John of Jerusalem" brought trademark infringement action against organization which used similar language in its title.

The Lanham Act authorizes the award of attorney fees to a prevailing party "in exceptional cases." . . . The primary purpose of this provision is to make plaintiffs whole in trademark cases where "the infringement was malicious, fraudulent, willful, or deliberate." . . . Trial judges have considerable discretion in handling § 1117 motions for attorney fees. . . . In the present case, the district court ruled that an award of attorney fees would not be appropriate despite the jury's explicit finding that the defendant had intentionally infringed the collective membership mark. . . . The court did not abuse its discretion. Id. at 1244.

D. Defendant's attorney fees

Otis Clapp & Son, Inc. v. Filmore Vitamin Co., 754 F.2d 738 (C.A.7 1985). Otis Clapp & Son, a seller of non-prescription pharmaceuticals in the institutional medical market, brought an action for trademark infringement and unfair competition.

Prevailing defendants may all recover attorney's fees in exceptional cases. . . . Provision was made for the recovery of defendant's attorney's fees to "provide protection against unfounded suits brought by trademark owners for harassment and the like." Id. at 746.

Dorr-Oliver Inc. v. Fluid Quip, Inc., 966 F.Supp. 718 (N.D.Ill. 1997), affirmed 132 F.3d 36. Dorr-Oliver brought trademark action against Fluid Quip in connection with the use of the term "clamshell."

Section [1117(a)] allows a possible exception to the "American Rule" if the court in the exercise of its discretion agrees to award fees. Just as this court deemed it inappropriate – when deciding to enter judgment for plaintiff on its trade dress claim – to award attorney's fees to plaintiff, it deems inappropriate any such award to defendants now that they have succeeded in their defense. In this court's judgment there would be no purpose served other than to penalize by hindsight a party that pursued its position aggressively but in good faith. Id. at 722.

Blau Plumbing, Inc. v. S.O.S. Fix-It, Inc., 781 F.2d 604 (C.A.7 1986). Blau Plumbing brought trademark infringement action concerning its "location box" in yellow pages' advertisement.

First, if the "exceptional cases" standard of section [1117] is not applicable in a case under section [1125](a) – if such a case is governed by common law rather than statutory standards for shifting attorney fees – it would mean of course that the judge could award attorney fees to a prevailing defendant only if the plaintiff's case were frivolous. . . . Although Blau's case is weak, the resolution of the case on S.O.S.'s motion for summary judgment, while proper, was sufficiently debatable to prevent us from deeming the appeal frivolous. Id. at 612.

Counterfeiting - 15 U.S.C. § 1117 (b) and (c)

I. Statutory Language

(b) . . . the court shall, unless the court finds extenuating circumstances, enter judgment for three times such profits or damages, whichever is greater, together with a reasonable attorney fee, in the case of any violation of section 1114(1)(a) of this title . . . that consists of intentionally using a mark or designation, knowing such mark or designation is a counterfeit mark . . . in connection with the sale, offering for sale, or distribution of goods or services. . . .

(c) . . . the plaintiff may elect, at any time before final judgment is rendered by the trial court, to recover, instead of actual damages and profits under subsection (a) of this section, an award of statutory damages for any such use . . . in the amount of –

(1) not less than $500 or more than $100,000 per counterfeit mark per type of goods or services sold . . .

(2) if the court finds that the use of the counterfeit mark was willful, not more than $1,000,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed, as the court considers just.

II. Increased damages and profits

A. Mandatory Nature of Statute

Louis Vuitton S.A. v. Lee, 875 F.2d 584 (C.A.7 1989). Louis Vuitton brought action against retailer and its owners for trademark infringement, false designation of origin, and unfair competition. The district court denied Louis Vuitton's claim for monetary relief and Louis Vuitton appealed.

To stop counterfeiting, a trademark owner must be able to invoke section 1117(b), the treble-damage (alternatively, at the plaintiff's option, treble-profit) provision that Congress added to the trademark law in 1984. Section 1117(b) is a severe statute. The trebling of the plaintiff's damages or the defendant's profits - whichever is greater - is mandatory . . . subject only to the statute's exception for "extenuating circumstances," which as we shall see is extremely narrow. . . . It is [limited to] cases in which "the imposition of treble damages would mean that [the defendant] would be unable to support his or her family. Id. at 588 – 589.

B. State of Mind of Infringer - Intent

General Electric Co. v. Speicher, 877 F.2d 531 (C.A.7 1989). General Electric brought trademark infringement action against Speicher, an industrial cutting tool insert fabricator. Speicher had sold its own low-quality inserts in G. E. boxes with "570" (a G. E. designation) etched on the inserts.

Apart from what we said earlier on this score, notice that all that good faith means in this context is that the infringer didn't know he was infringing someone's trademark. This means rather little. Suppose that the infringer, although acting in good faith, was also *acting negligently – a reasonable person in his position would have realized he was infringing, though he, being unreasonable, did not. Speicher was at least negligent, and probably grossly negligent or even reckless, in believing . . . that General Electric had authorized him to etch "570" on any old insert he decided to supply. Elementary prudence should have sparked inquiry on his part. Id.* at 536.

Whether Speicher's counterfeiting was intentional within the meaning of section 1117(b) is not foreclosed by the district judge's inadequate analysis of the issue of Speicher's good faith. This, together with the question whether there were any extenuating circumstances for his conduct, is a matter to be determined in the new trial that we are ordering on remand. Id. at 537.

Sadler-Cisar, Inc. v. Commercial Sales Network, Inc., 786 F.Supp. 1287 (N.D.Ohio 1991). Plaintiffs, whose patent, trade dress, and trademark concerning the device "Medi-Dot" were infringed, brought action seeking damages for corrective advertising, harm to business reputation, attorney fees, actual and exemplary damages, and costs.

Plaintiffs are entitled to damages for corrective advertising . . . the intentional copying of Plaintiffs' trade dress and palming off of its AccuTRAK product . . . harm to business reputation . . . actual and exemplary damages together with costs associated with this action. Id. at 1301.

Lindy Pen Co., Inc. v. Bic Pen Corp., 982 F.2d 1400 (C.A.9 1993). Lindy Pen brought trademark infringement action against Bic Pen for Bic Pen's unauthorized use of its "Auditor" mark.

Bic's infringement was not intentional. . . . Even assuming this court were somehow to find that Bic demonstrated the requisite intent, an award under § 1117(b) is never automatic and may be limited by equitable considerations. The statute specifically states that the district court may refrain from imposing the mandatory sanctions of § 1117(b) upon a finding of extenuating circumstances. Although the district court did not make a finding on this point other than to note that the record as a whole did not justify an award under § 1117(b), extenuating circumstances may be inferred. Id. at 1409.

Babbit Electronics, Inc. v. Dynascan Corp., 828 F.Supp. 944 (S.D.Fla. 1993). Babbit brought a fraudulent misrepresentation and a tortuous interference action against Dynascan. Dynascan filed a counterclaim for trademark infringement relating to Babbits unauthorized sale of cordless telephones bearing Dynascan's "Cobra" mark.

If the infringement is intentional, however, and the use of a counterfeit trademark has been proven, then § 1117(b) governs, and the Court is required to treble damages and award attorney's fees unless the Court finds extenuating circumstances. Dynascan has demonstrated . . . that Babbit intentionally infringed the Cobra trademark and used a counterfeit Cobra trademark. Consequently, the Court finds that a trebling of damages is required. Id. at 959.

Playboy Enterprises, Inc. v. P.K. Sorren Export Co. Inc. of Florida, 546 F.Supp. 987 (S.D.Fla. 1982). Playboy Enterprises, Inc. (PEI) brought trademark infringement action against defendant for its dealing in counterfeit and genuine wearing apparel bearing or sold under the PLAYBOY and the RABBIT HEAD design marks. (This case was decided prior to the enactment of § 1117 (b).)

PEI has demonstrated that the defendants deliberately infringed its trademark. Inevitably, there must have been some harm to PEI's goodwill and reputation, but this has not been sufficiently demonstrated or quantified to justify an award on that basis. In addition, defendants' records of their infringing sales are incomplete, and one could infer from the records of AIS and Rolex that the defendants actually sold more infringing shirts than can be shown from defendants' records. . . . I find that plaintiff is entitled to twice the amount of profits shown to have been made by defendants in the sale of counterfeit goods. Id. at 998 – 999.

C. Knowledge of Counterfeit Mark

<u>*Louis Vuitton S.A. v. Lee*</u>, 875 F.2d 584, (C.A.7 1989). Louis Vuitton brought action against retailer and its owners for trademark infringement, false designation of origin, and unfair competition. The district court denied Louis Vuitton's claim for monetary relief and Louis Vuitton appealed.

A further point is hat although section 1117(b) requires a showing that the defendant's violation involved "knowing such mark . . . is counterfeit," it is enough for these purposes that the defendant failed to inquire further because he was afraid of what the inquiry would yield. Willful blindness is knowledge enough. Id. at 590.

III. Attorneys Fees

<u>*Babbit Electronics, Inc. v. Dynascan Corp.*</u>, 828 F.Supp. 944 (S.D.Fla. 1993). Babbit brought a fraudulent misrepresentation and a tortuous interference action against Dynascan. Dynascan filed a counterclaim for trademark infringement relating to Babbits unauthorized sale of cordless telephones bearing Dynascan's "Cobra" mark.

This is an exceptional case because Babbit intentionally arranged to obtain counterfeit goods from Hyundai, intentionally avoided contractual obligations, and intentionally passed off such goods as Cobra products. Consequently, attorney's fees are awarded to Dynascan. Id. at 959.

<u>*Playboy Enterprises, Inc. v. P.K. Sorren Export Co. Inc. of Florida*</u>, 546 F.Supp. 987 (S.D.Fla. 1982). Playboy Enterprises, Inc. (PEI) brought trademark infringement action against defendant for its dealing in counterfeit and genuine wearing apparel bearing or sold under the PLAYBOY and the RABBIT HEAD design marks. (This case was decided prior to the enactment of § 1117 (b).)

In an exceptional case, this Court may award attorneys' fees. . . . This is an exceptional case as defendants have deliberately arranged to obtain counterfeit goods and to pass off such goods as genuine PEI goods. Attorney fees are awarded to to plaintiff. Id. at 999.

Domain Names - 15 U.S.C. § 1117 (d)

I. Statutory Language

In a case involving a violation of section 1125(d)(1) of this title, the plaintiff may elect, at any time before final judgment is rendered by the trial court, to recover, instead of actual damages and profits, an award of statutory damages in the amount of not less than $1,000 and not more than $100,000 per domain name, as the court considers just.

II. Recent Cases

<u>Sporty's Farm L.L.C. v. Sportman's Market, Inc.</u>, 202 F.3d 489 (C.A.2 2000) certiorari denied 120 S.Ct. 2719, 147 L.Ed.2d 984. Sporty's Farm brought a declaratory judgment action against Sportman's Market, a catalog company, seeking a declaration of its right to use the "sportys.com" domain name. Sportman's Market brought counterclaim for trademark infringment and other actions. Sporty's Farm registered the subject domain name prior to the enactment of the ACPA.

The statute provides that a party "shall be liable in a civil action by the owner of a mark" if it meets the statutory requirements. . . . Although the statute uses the term "liable," it does not follow that damages will be assessed. As we discuss below, damages can be awarded for violations of the Act but they are not "available with respect to the registration, trafficking, or use of a domain name that occurs [, as in this case,] before the date of the enactment of this Act." Id. at 500.

<u>Morrison & Foerster, LLP, v. Wick</u>, 94 F Supp.2d 1125 (D.Colo. 2000). Morrison & Foerster brought an action for injunctive relief against the owner of an Internet website domain names similar to the firm's trademarked names, alleging violation of Anticybersquatting Consumer Protection Act (ACPA) among other legal theories.

The ACPA permits a court to "order the forfeiture or cancellation of the domain name or the transfer of the domain name to the owner of the mark." . . . I then direct Mr. Wick to transfer, at his own cost, the two domain names with the correct spelling of the firm . . . to Morrison & Foerster. Id. at 1134. *Morrison & Foerster failed to present any evidence or testimony regarding actual damages it incurred as a result of Mr. Wick's use of the domain names and web pages. . . . Although the ACPA contains a provision allowing for a statutory award of damages for violation, Morrison & Foerster never "elected" this remedy as required by the statute. Id.* at 1136.

"WHERE THE RUBBER MEETS THE ROAD"

Protecting Confidential Business Information

Thomas G. Grace
Frost Brown Todd LLC
Louisville, Kentucky

SECTION G

"WHERE THE RUBBER MEETS THE ROAD"

PROTECTING CONFIDENTIAL BUSINESS INFORMATION

SECTION G

THOMAS G. GRACE
FROST BROWN TODD
LOUISVILLE, KY

"WHERE THE RUBBER MEETS THE ROAD"
Protecting Confidential Business Information[1]

The telephone call is never convenient. It may come on a Friday afternoon, but not before 6:15 p.m. ... Something bad is about to happen (or is already happening), and the client needs it stopped quickly – very quickly. ... Even the wait for a preliminary injunction is too long. So cancel your weekend plans. The sense of relaxation that was beginning to creep over you, the draining of adrenaline, must be put in full reverse. Call in the overtime secretary. Find as much help as you can. ***It is TRO time. ...***

Jack L.B. Gohn and Michael D. Oliver
In Pursuit of the Elusive TRO, Litigation
Vol. 19 No. 4 (Summer 1993)

Q. ... [T]hat cutoff between employees who sign noncompetes and those who don't, those employees who fall below that line, who don't sign a noncompetes, do you have them sign confidentiality agreements?

A. No. It's probably a good idea, though. Would you draft one for me.

Q. I think I have a conflict.

Recent deposition of plaintiff
in trade secret/non-compete case.

In war, you win or lose, live or die – and the difference is just an eyelash.

Gen. Douglas MacArthur, U.S. Army
In posthumous memoirs, "Reminiscences" ib 10 Jul 64

[1] This paper is presented for educational purposes only, to contribute to the understanding of this particular area of law. Neither the author, Frost Brown Todd, nor their present or future clients can be bound by the comments and interpretations expressed herein.

I. Introduction

The test of all the efforts to protect a company's confidential information and business are tested when a "misappropriation" occurs. Theft of trade secrets is a growing problem and litigation in this area is on the rise.

Those misappropriating the information are much more sophisticated and the means by which the information can be taken have dramatically increased. The web offers individuals a wealth of knowledge regarding the complexity of law and the methods to avoid trouble. One web site, www.breakyournoncompete.com comes right to the point and illustrates the flood of information available to those previously thought by companies to be easily intimidated. With major employment placement companies advertising that changing jobs is a great way to improve your personal and professional life, and offering assistance to make a move happen, departing employees are a constant threat.

On the other side, web sites directed to employers make available form non-compete and confidentiality agreements. This easy access to these forms have created a substantial upward swing in the number of companies using employment agreements as means to protect confidential information. It is not difficult to conclude that the increase in agreements has in turn caused an increase in litigation.

This litigation in not limited to small companies and their sales or account representatives, but have recently involved high level corporate officers. In either scenario, litigation of this kind has tremendous consequences for both sides. Enforcement of the agreement means that the defendant individual will often mean dramatic change in short term income and corresponding life changes, that may include finding a new job, relocating and loss of income. If the agreement is not enforced, competitive advantages and corresponding profits may be lost by the company, other employees might take a chance and leave and recruiting future employees may be impaired.

These consequences, and pressure of litigating under substantial time constraints, will test the attorney and the client alike. The fight over injunctive relief that occurs very early on in the case is "where the rubber meets the road." The momentum enjoyed by the party who wins this first confrontation may often be enjoyed for the remainder of the case.

II. Pre-Litigation Considerations

Success in trade secret and non-compete litigation may be determined well before the alleged misappropriation or breach has occurred. Many key decisions are made before the complaint is ever filed.

A. Know Your Client and The Business

1. Client Expectations

Clients often express their situation as "He took my stuff and you must stop him from using it." Or "There is nothing secret about what I do, everybody does it." While the expressions are concise, counsel must inquire carefully into the desires and motivations of the client.

Whether representing the plaintiff or defendant, counsel should advise the client that these cases turn on a particular judge's view of the situation and are dependant on the manner in which the judge exercises his discretionary and equitable powers. For that reason, predictions regarding the outcome of these cases, while requested by all clients, are difficult for counsel.

An important issue for plaintiffs is whether they desire monetary damages in addition to injunctive relief. Substantial costs can be incurred in connection with receiving injunctive relief and the goal is to do so before any real harm occurs. If the client expects to receive a monetary award, they will be disappointed when counsel delivers an injunction (a 2 or 3 page document) and a sizable legal bill. The pursuit of injunctive relief should not obstruct the standard cost/benefit evaluation of the case to avoid any surprises for the client.

2. Other Employees

The potential impact of litigation between an employer and a former employee on other employees cannot be ignored. These cases often dominate the conversations around the water cooler. The corporation should consider that the other similarly situated employees will be watching the litigation carefully, most likely with their own agreement in hand. If the court denies a request to enforce the agreement, others may jump ship believing that they are certain to receive the same result.

There are also the potential for "leaks," friends of the former employee who may provide information. While tight control must be maintained over disclosure of the company's intentions, often lower level employees must be interviewed. Who to interview and the explanation of why the interview is necessary are touchy issues that require substantial client involvement.

Once the lawsuit is filed, a formal announcement, carefully crafted by counsel and preferably delivered orally may be appropriate depending on the size of the company and the seriousness of the litigation. Counsel should expect that whatever is said will come out in depositions in the case.

3. Customers

It is possible to win the battle and lose the war in a non-compete case. The former employer may be enjoined from contacting customers, but the customers may be lost to either the plaintiff or the defendant. Discovery from customers may be critical to the development of damages. At the same time, the customer may be offended by the litigation or may be put off by the need to respond to discovery.

The plaintiff may attempt to quash the subpoena and argue that the same information is available from it and that the burden placed on the customers by subpoenas is unnecessary and serves only to harass plaintiff. In Native American Arts, Inc. et al. v. J.C. Penny, Inc. et al., 1999 U.S. Dist. Lexis 18181 (N.D.Ill. 1999), the court looked critically on a party's attempt to subpoena records without availing itself of other means of discovery from the other party in the case. In J.C. Penny, defendant J.C.Penny sought to depose the plaintiff's suppliers. Although the court found that the information sough was relevant, the court granted plaintiff's motion for a protective order under F.R.Civ.Pro. 26(b)(2) that provides that the court may limit discovery if the discovery sought is "obtainable from some other source that is more convenient, less burdensome, or less expensive." The court stated:

> However, at this point, J.C. Penny has not even deposed [plaintiff] NAA in regards to its alleged injuries. It may be that by deposing [plaintiff] NAA, J.C. Penny may find the answer it needs from a more convenient, less burdensome source. F.R.Civ.Pro. 26(b)(2). Deposing [plaintiff] NAA's suppliers at this point will be burdensome for the plaintiffs, and may needlessly interfere with [plaintiff] NAA's business relationships. However, if the necessary information is not forthcoming from the other means, J.C. Penny may then ask for leave to depose [plaintiff] NAA's suppliers.

The court went on to hold that J.C. Penny was obligated to exhaust its discovery options from the plaintiff, before unnecessarily burdening the plaintiff's suppliers and interfering with the plaintiff's business relationships.

4. Be An Expert In Your Client's Business

Counsel must know the intimate details of the client's business. Often, the lawyer who knows the business the best will win the case. At the first hearing in the case, the judge will want to hear about the business at issue to decide whether the claimed information is worthy of the designation of trade secret or justifies the protection of a "legitimate business interest" through enforcement of a non-compete agreement.

The significance of the defendant's actions must be understood in the context of the business at issue. For example, some industries have sales cycles dictated by buying seasons and the time it takes to bring new product to market. A former employee may take trade secrets to a competitor, but because of the business' sales cycle, the competing product created from the misappropriated information may not make it to market for several months. That explanation better role off counsel's tongue when the judge asks if plaintiff has lost any sales or customers.

B. The Cease and Desist Letter

Their usefulness is limited. If the conduct of the offending party is causing real damages, then a letter will most likely have little impact. Often, it will allow the other party retain counsel and be more prepared to respond to litigation. Most often, the best approach is to move as fast as possible and initiate the litigation.

A cease and desist letter (sample attached) can be helpful in cases that do not involve significant monetary value. In such cases, it is often helpful that the potential defendant get counsel making settlement discussions more productive.

C. Choice of Law and Forum Selection

If the agreement has no choice of law provision, Kentucky courts will apply the most significant relationship test. *Lewis v. American Family Insurance Group*, Ky., 555 S.W.2d 579 (1977).

If the agreement has a choice of law provision, the first attack on a choice of law provision is whether it covers the claims asserted by the plaintiff. A narrow choice of law provision[2] typically is held by courts to apply only to construction of the terms of the contract and may not be held to apply to tort claims or all contract claims. Conversely, broader language in the provision[3] has been found to apply to all claims between the parties to the contract, including fraud and negligent claims. *Baneck, Inc. v. Yogurt Ventures, USA, Inc.*, 6 F.3d 357, 363 (6th Cir. 1993) (choice of law clause found to apply to fraud and misrepresentation claims*); Moses v. Business Card Express, Inc.*, 929 F.2d 1131, 1139-40 (6th Cir. 1991) (choice of law clause found to apply to fraud and misrepresentation claims); *American Advertising Distributors v. American Cooperative Advertising, Inc.*, 639 S.W.2d 775 (Ky. 1982) (narrowly drawn form selection clause did not apply in action alleging fraud in the inducement to contract, as opposed to a claim arising out of the contract itself). See also, Restatement Second of

[2] *"This Agreement shall be construed in accordance with the laws of the Commonwealth of Kentucky"*

Conflict of Laws, Section 187 (1988). It is important to note that claims against the new employer are not subject to the choice of law provision since the new employer would not have been a party to the agreement.

The same is true for forum selection clauses. The clause should provide that the selected forum is exclusive, selects a forum which necessarily would have jurisdiction over the dispute, and precludes removal or transfer to another jurisdiction after the action is filed in selected forum. It should also include an express consent to jurisdiction selected forum. *M/S Brenen v. Supada Off Shore Company*, 407 U.S. 1, 10 (1972) (Seminal case establishing in federal court that a form selection clause is "prima facie valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances.") *Prezocki v. Bullock Garages, Inc.*, 938 S.W.2d 888 (Ky. 1997) (enforcing a forum selection clause as prima facie valid absent circumstances that would render the clause "unreasonable"*); Prudential Resources Corporation v. Plunkett*, 583 S.W.2d 97 (Ky. Ct. App. 1979) (similar case holding that Kentucky would follow Section 80 of the Restatement (2nd) of Conflict of Laws and force of form selection clause provided that suit in the agreed forum is not unfair or unreasonable.)

D. Arbitration

Arbitration agreements within non-competes can be very effective. The advantage is that the proceedings are not part of the public record. While documents may be filed with the court under seal, your client's secrets are at the mercy of the local court clerk and the potential for an inadvertent disclosure. This risk is eliminated by arbitration.

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[3] *"This Agreement, the construction of this Agreement, all rights and obligations between the parties to this Agreement, and any or all claims arising out of or relating to the subject matter of this Agreement (including all tort claims), shall be governed by the laws of the Commonwealth of Kentucky.*"

The drawbacks to arbitration include speed and cost. The court system, not known for its speed, can generally handle expedited requests for injunctive relief. While the American Arbitration Association has procedures and rules for injunctive relief, the process can be cumbersome. The other drawback is the cost. The filing fees for arbitration are substantially higher than court filings. A significant cost is also imposed on the defendant. This favors financial well off clients that can afford the fees and will place a significant burden on individual employees who choose to break their agreement.

III. The Complaint

A. Verification

Most often the complaint is verified by the client. This is recommended because of the time pressures associated with preparation of the materials. The client should review the complaint carefully with the understanding that he adopts the statements in the complaint as his own testimony. The Court will often expect that the complaint be verified by the plaintiff when considering a request for injunctive relief.

B. Not Too Vague, But Not To Specific

The complaint should have enough specificity to persuade the court that the plaintiff will prevail on trial of the merits (discussed below). Nevertheless, the verified complaint is not the place to speculate, presume or guess. Often clients, blinded by anger towards the departed employee, will try to blame the former employee for every lost sale or related problem that occurred since their departure. The complaint need only include a sample of the defendants actions and should include only those that are supported by objective proof. Clients often want to air all their differences in the Complaint, but that is not always the place to do it. A sample short complaint is attached.

If the defendant's actions are particularly egregious, and the client has gathered significant evidenced to support the claims, a more detailed complaint may be favored. A detailed complaint will show the judge that the plaintiff has done a significant investigation before seeking relief from the courts and may persuade it that injunctive relief is appropriate. An example of a detailed complaint is also attached. The danger with the detailed complaint is that the plaintiff is locked into the facts contained therein. Credibility is a key issue in these cases, and any attempt to amend the complaint to change the facts may cause damage to the plaintiff's credibility with the court.

IV. Getting Injunctive Relief

Simultaneously with filing the complaint, the plaintiff should file a motion for injunctive relief. The motion should be accompanied by an affidavit to supplement the verified complaint. The affidavit often mirrors the key allegations in the complaint but includes additional facts relating to the elements that must be established to obtain an injunction.

A. Kentucky State Court

The Kentucky Code of Civil Procedure speaks in terms of an "Restraining Order" and a "Temporary Injunction." CR 65.03 and 65.04. A restraining order can be obtained without notice but the plaintiff's attorney must certify to the court *in writing* the efforts, if any, which have been made to give notice and the reasons supporting his claims that notice should not be required. A Temporary Injunction will usually issue after an evidentiary hearing and, if granted, may remain in place during the remainder of the lawsuit or until dissolved by the court.

Kentucky courts apply a three-part test to determine if injunctive relief is appropriate.

> [F]irst, the trial court should determine whether the plaintiff has complied with CR 65.04 by showing irreparable injury. This is a mandatory prerequisite to the issuance of an injunction. Secondly, the trial court should weigh the various equities involved. Although not an exclusive list, the court should consider such things as possible detriment to the public interest, harm to the defendant, and whether the injunction will merely preserve the status quo. Finally, the complaint should be evaluated to see whether a substantial question has been presented.

Maupin v. Stansbury, Ky., 575 S.W.2d 695, 699 (1978). In trade secret cases, actual or threatened misappropriation may be enjoined. KRS 365.882(1).

The court will focus its attention on whether the plaintiff can show immediate and irreparable harm. In *Lareau v. O'Nan*, Ky. App., 355 S.W.2d 679 (1962), the court held that damages from a breach of a non-compete agreement were sufficient to merit injunctive relief.

B. Kentucky Federal Court

The vocabulary is different in federal court. F.R.Civ.Pro. 65 speaks in terms of Temporary Restraining Orders and Preliminary Injunction. A Temporary Restraining Order may be issued without notice but may not last for more than 10 days. F.R.Civ.Pro. 65(b). The court may not issue a Preliminary Injunction without notice to the adverse party and may last for the remainder of the litigation. A hearing on a motion for preliminary injunction may be combined with a trial on the merits. This is particularly useful in smaller cases.

The federal court looks to four factors, similar to those described in *Maupin*:

> Applying the test set forth in *In re DeLorean Motor Co.,* 755 F.2d 1223, 1228 (1985), four factors are important in determining whether a preliminary injunction is proper. Those factors are: (1) the likelihood of defendant's success on the merits; (2) whether the injunction will save the defendant from irreparable harm; (3) whether the injunction would harm the plaintiff; and (4) whether the public interest would be served by the injunction. As stated by the Sixth Circuit Court of Appeals, these four considerations are factors to be balanced, not prerequisites that must be met. The likelihood of success on the merits that needs to be shown will vary inversely with the degree of irreparable injury that the Defendant will suffer absent an injunction. *Id.* at 1229.

Wells v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 919 F.Supp. 1047, 1051 (E.D.Ky.,1994). Again, the issue of irreparable harm will be the most important.

V. Dot Each "i" And Cross Each "t"

A. The Injunction
The Single Most Important Piece of Paper In The Case

The injunction must be clear and concise and describe in detail the activity restrained. The injunction should be no broader than absolutely necessary. A restraining order issued under Kentucky CR 65.03 without notice must "define the injury and state why it is irreparable and why the order was granted without notice." CR 65.03(3). CR 65.04(5) provides that every Temporary Injunction shall set forth findings of fact and conclusions of law which constitute the grounds for the injunction.

The federal rules has a similar requirement that Temporary Restraining Orders issues without notice must include a statement as to the nature of the injury and why the order was granted without notice. F.R.Civ.Pro. 65(b). F.R.Civ.Pro. 65(d) requires that other details be included in all Temporary Restraining Orders and Preliminary Injunctions.

B. The Bond

Both the federal and state court rules require that an injunction be secured by a bond. Arrangements with a bonding company should be arranged before a hearing for injunctive relief so that the injunction and the bond can be filed soon after the hearing.

C. Notice of the Order

The Restraining Order must be served on the party enjoined. CR. 65.03(4). Temporary Restraining Order should be served on the parties, although F.R.Civ.Pro. does not specifically require it. It is also important to remember who is bound by the order. Under the Kentucky Civil Rules, the order is binding on the party enjoined. CR. 65.03(5) and CR 65.04(4). However, under the federal rules, a Temporary Restraining Order is binding on "the parties to the action, their officers, agents, servants, employees, and attorneys and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise." F.R.Civ.Pro. 65(d).

VI. The Defense

A. The Leaks

If the defendant can demonstrate that the information that the plaintiff seeks to protect in the lawsuit has been previously released to the public or has leaked out, then the defendant can argue that the information does not qualify as a trade secret under the Uniform Trade Secret Act. Further, the defendant may argue that there is no legitimate business interest for the plaintiff to enforce the non-compete agreement because all the information that the non-compete was designed to protect has been released and the defendant poses no threat of unfair competition.

1. Web Sites

The same company that files suit to protect its customer list may have voluntarily disclosed the same list to everyone and anyone who wants to see it. The internet is an amazingly powerful tool to distribute information. Many companies rushed to get a web site and get the company "on line." In an effort to demonstrate the successes of the company, a web page will include customer comments, recent client success stories using the company's product, and even a list of customers and pricing information.

2. Customers

Customers also receive significant confidential information and are never required to sign a confidentiality agreement. Customers may even tell competitor's the price another company has offered a product and discount schedules. These facts all undermine the plaintiff's claim that a customer list or pricing information qualifies as a trade secret.

3. Trade Associations

Often overlooked is the customer information that is available through trade associations. Plaintiff's will claim that while the individual names of the customers are not a trade secret, a list of the customers compiled in one place creates a economic benefit and qualifies as a trade secret. That same list of "customers" may be compiled by a local, or national, trade association. The trade association may also have other information about its members. Defendants may argue that the availability of the information to the public destroys any chance of the "customer list" qualifying as a trade secret.

4. Former Employees

The plaintiff's former employees also present a significant possible leak of information. If other employees with knowledge of the same information have left and the plaintiff did not pursue them to prevent disclosure, then the defendant may argue the information is already in the public domain and not a trade secret. This argument is especially persuasive if the other employee signed a non-compete or confidentiality agreement the same or similar as the one signed by the defendant.

B. "We Are Not Competing"

Any business can be sliced into different parts. For example, automobile sales can be divided into new and used car sales, any construction trade can be divided into residential and commercial, and insurance sales can be divided into commercial and personal lines. Any distinction between the exact nature of the plaintiff and defendant's business can form a defense of "we are not competing."

C. Declaratory Judgment

One tactic is to beat the former employer to the punch and file a declaratory judgment action. This can be done once a new job offer is made to the employee. The employee alleges that an actual controversy exists as to whether acceptance of the offered position would violate the non-compete agreement with the old employer. Naturally, this choice should be reserved for those cases where the chance of a court enforcing the non-compete agreement is very slim.

VII. Discovery

A. Motion for Expedited Discovery

Simultaneous with the request for an injunction hearing, the plaintiff should request an expedited discovery schedule. The plaintiff is often in the dark as to the full extent of the defendant's activities. That void should be filled before the evidentiary hearing on continued injunctive relief. The motion to expedite discovery should ask for production of documents within 7 days and that depositions proceed as soon as possible. Various courts and scholars have recognized that expedited discovery is important in an action where injunctive relief is sought. *See Albert Sauter Company, Inc. v. Richard S. Sauter Company, Inc.*, 57 F.R.D. 537 (E.D.Pa. 1972); Wright & Miller, *Federal Practice and Procedure*, Civil, Section 2104.

B. Document Requests and Interrogatories

Document Requests should be as narrow and precise as possible. Client participation in the preparation of the requests is often very helpful because the client knows the vocabulary and can identify specific documents that may be helpful. Interrogatories are often little help in the initial stage of the case. The depositions usually occur quickly and the limited number of interrogatories are better used for the remaining issue of the case, such as monetary damages.

C. Discovery From Third Parties

Discovery from non-litigants is especially helpful. Former employees are particularly useful, principally those who occupied a similar position as the defendant and left with the same or similar information but were not sued.

D. Get Your Expert Early

Like all commercial cases, retain an expert early. This is particularly important where substantial damages will be at issue. Experts can be particularly helpful with focusing discovery efforts. If settlement becomes an option, an expert already familiar with case will be critical with the valuation of the case and either forming or responding to a settlement offer.

VIII. The Evidentiary Hearing

The hearing on the Temporary Injunction or Preliminary Injunction is like a trial. Preparation should be similar and every effort should be made to ensure success. Many cases will settle after the issue of injunctive relief is resolved by the court, especially if denied. The ruling from the court may support adding defendants, additional claims for damages or eviscerate plaintiff's hopes and expectations.

While of critical importance, it is not quite as formal as a trial. As one court stated:

> The Court has concluded that the objections do not warrant exclusion of the evidence. The Court has, however, carefully considered the reliability of all the disputed evidence and will separately discuss the evidence as to which objections were made. The strict rules of evidence do not apply to a hearing on a motion for a preliminary injunction. *See, e.g.,* *Securities and Exch. Comm'n v. Cherif,* 933 F.2d 403, 412 n.8 (7th Cir.1991), *cert. denied,* 502 U.S. 1071 (1992); *Asseo v. Pan American Grain Co.,* 805 F.2d 23, 25-26 (1st Cir.1986); *Commodity Futures Trading Comm'n v. American Metal Exch. Corp.,* 693 F.Supp. 168, 173 (D.N.J.1988); *Delman Fabrics Inc. v. Holland Fabrics, Inc.,* 84 Civ. 2512, 1984 WL 367, at *5 (S.D.N.Y. May 17, 1984). The Court has, nevertheless, applied the Federal Rules of Evidence in determining the weight to be accorded the evidence that was introduced and has also assessed whether the evidence would be admissible under the Federal Rules of Evidence.

Zeneca Inc. v. Eli Lilly and Co., 1999 WL 509471 (S.D.N.Y.,1999). Despite the relaxed rules, counsel should make every effort to admit into evidence all key documents and build the basis for injunctive relief from competent evidence. Doing so will only benefit the case and increase the chance of success should the injunction be appealed.

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
CIVIL ACTION NO. 98-________

PREFERRED CREDIT, INCORPORATED **PLAINTIFF**

v. **VERIFIED COMPLAINT FOR EQUITABLE AND OTHER RELIEF**

PC HOLDINGS GROUP CORPORATION, PC MORTGAGE CORPORATION, PC COMMERCIAL LENDING CORPORATION, MICHAEL LIEBERMAN, JAMES R. TURNER, JASON TURNER, JERRY J. TIDMORE, ALETHA CONNER, and OTHER UNKNOWN DEFENDANTS.
DEFENDANTS

Plaintiff Preferred Credit, Incorporated, by its attorneys, complains against Defendants PC Holdings Group Corporation, PC Mortgage Corporation, PC Commercial Lending Corporation, Michael Lieberman, James R. Turner, Jason Turner, Jerry J. Tidmore, Alethea Conner, and other unknown defendants as follows:

JURISDICTION

1. This Court has jurisdiction of this action pursuant to 28 U.S.C. §§ 1331, 1332(a), 1338(a) and (b) and 1367, 15 U.S.C. §§ 1121 and 1125(a). Venue is proper in this district pursuant to 28 U.S.C. § 1391(b) and (c) and 28 U.S.C. § 1400.

PARTIES

2. Plaintiff Preferred Credit, Incorporated ("Preferred Credit") is a Kentucky corporation with its principal place of business in Lexington, Kentucky.

3. Upon information and belief, PC Holdings Group Corporation and the other corporate defendants are Delaware corporations. On information and belief, all of

the corporate defendants have offices in both Lexington, Kentucky and Dallas, Texas.

4. On information and belief, Michael Lieberman ("Lieberman") is a resident of Lexington, Kentucky.

5. On information and belief, James R. Turner ("J.R. Turner") and Alethea Conner ("Conner") are also residents of Lexington, Kentucky, and Jason Turner ("J. Turner") is a resident of Lawrenceburg, Kentucky.

6. On information and belief, Defendant Jerry J. Tidmore ("Tidmore") is a resident of Dallas, Texas.

FACTS

7. Plaintiff Preferred Credit was incorporated in 1994 by Paulette Klein. Preferred Credit has two officers: President - Paulette Klein; Vice President - Ken Klein.

8. Preferred Credit's main office is located in Lexington, Kentucky at 3650 Boston Road, Suite E, Lexington, Kentucky. Preferred Credit also has offices in Columbus, Ohio and Mt. Pleasant, South Carolina.

9. Since its inception, Preferred Credit has been in the business of brokering residential mortgage loans. Preferred Credit has never brokered a commercial loan. Preferred Credit is now licensed to broker loans in Kentucky, Indiana, Ohio, Georgia, North Carolina, South Carolina, Wisconsin, Minnesota, Michigan, Virginia and Louisiana. Preferred Credit also brokers mortgage loans in Colorado, West Virginia and Alabama, as these states do not require a mortgage brokerage license. Preferred Credit expends substantial sums of money to maintain its loan broker licenses.

10. Over the years, Preferred Credit has expended great time and effort to develop relationships with lenders through which it brokers loans. Preferred Credit's

ability to grow and expand the number of lenders through which it may broker loans is essential to Preferred Credit's ability to service its customers and its financial well-being.

11. Preferred Credit also expends a substantial amount of money each year to locate, identify, contact and develop potential customers for whom it may broker a loan. Preferred Credit does substantial repeat business for those customers for whom it brokers a loan. Preferred Credit repeatedly contacts the same customers to determine if their financial condition or situation has changed. These repeated efforts generate a significant portion of Preferred Credit's business. In addition, Preferred Credit engages in advertising, including radio and print media, and other marketing efforts.

12. As a result of many years of doing business, including servicing customers, working with lenders, as well as its advertising efforts, Preferred Credit's name has gained widespread and favorable public acceptance in Kentucky and many other states in which it does business. Preferred Credit now owns the valuable good will associated with its name and services it provides.

13. In or about May 1996, Defendant James R. Turner ("J.R. Turner") was hired by Preferred Credit as a loan producer in its Columbus office. While a producer in Columbus, J.R. Turner received a 36 percent commission on all revenues generated by loans he closed.

14. On or about August 26, 1997, Preferred Credit offered J.R. Turner the position of manager of its Lexington, Kentucky office. J.R. Turner accepted the offer and began work in the Lexington office the next day.

15. As a manager of the Lexington office, J.R. Turner received a 45 percent commission on revenues from all loans he closed, 5 percent commission on revenues

from all other loans closed in the Lexington office, and 20 percent of all profits realized by Preferred Credit in the Lexington office.

16. As a manager, Preferred Credit placed J.R. Turner in a position of trust and granted him the freedom to make certain decisions that impacted the entire Lexington office. Further, J.R. Turner received access to confidential and proprietary information of Preferred Credit.

17. Upon information and belief, J.R. Turner signed an employee non-compete agreement with Preferred Credit. The terms and provisions of the non-compete agreement executed by J.R. Turner are substantially the same to those in the form non-compete employment agreement regularly used by Preferred Credit attached hereto as **Exhibit 1**. Preferred Credit has searched for, but has been unable to locate, an executed non-compete employment agreement for J.R. Turner.

18. On or about November 24, 1997, Defendant Lieberman was hired by Preferred Credit in its Lexington office as a loan producer. As a loan producer, Lieberman had access to corporate information, including the lenders with whom Preferred Credit did business, how it generated new business and the methods by which Preferred Credit worked to close loans. Lieberman received $600.00/week draw against 36 percent commission on all revenue received from loans Lieberman closed.

19. Currently, Lieberman owes Preferred Credit $3,800 for draws that exceeded his earned commissions.

20. At the time Lieberman began to work for Preferred Credit, Lieberman executed a non-compete employment agreement. Attached hereto as **Exhibit 2** is a true and correct copy of Lieberman's non-compete employment agreement.

21. Prior to working for Preferred Credit, Lieberman was employed at Frisco Diversified Company in Dallas, Texas. Attached hereto as **Exhibit 3** is a true and correct copy of Lieberman's resume.

22. On or about December 31, 1997, J. R. Turner, as manager of Preferred Credit's Lexington office, hired his brother, Defendant Jason Turner, as a loan producer in the Lexington office. Preferred Credit paid J. Turner a 36 percent commission on all revenues from the loans that he closed as a loan producer. At that time, J. Turner executed a non-compete employment agreement. Attached hereto as **Exhibit 4** is a true and correct copy of J. Turner's non-compete employment agreement.

23. In or about February 1998, J. R. Turner, as manager of Preferred Credit, hired Defendant Alethea Conner ("Conner"). Attached hereto as **Exhibit 5** is a true and correct copy of the new hire salary confirmation sheet executed by Conner.

24. Between January 1, 1998 and the end of March 1998, the Lexington office generated less and less revenues, while its expenses steadily climbed. Between January 1, 1998 and the end of March 1998, the Lexington office suffered losses in excess of $20,000.00. The great majority of these losses resulted from draws paid to loan producers who failed to generate revenue for Preferred Credit.

25. In response to the downsizing in the Lexington office profits, on March 11, 1998, Preferred Credit changed J.R. Turner's compensation, which now included a guaranteed salary of $2,800.00/month plus a 30 percent commission on all profits from the Lexington office (the "March 11, 1998 Agreement"). On that same day, J.R. Turner accepted the offer.

26. On or about March 26, 1998, J.R. Turner requested an advance from Preferred Credit against his future commissions. When Preferred Credit rejected the request for an advance, Defendant J.R. Turner stated that he would not continue to work under the March 11, 1998 Agreement.

27. Preferred Credit offered Defendant J.R. Turner $3,000.00/month plus 35 percent commissions on the profits from the Lexington office. Defendant J.R. Turner accepted the offer from Preferred Credit ("March 26, 1998 Agreement"). Preferred Credit and J.R. Turner agreed that the new compensation terms would begin on April 1, 1998.

28. On April 15, 1998, Defendant J.R. Turner told Preferred Credit that he would not continue to work under the March 20, 1998 Agreement. Defendant J.R. Turner offered to continue to work for Preferred Credit as a loan producer only for 36 percent commission on all loans he closed and 9 percent commissions on all loans closed by his brother, J. Turner. Preferred Credit accepted Defendant J.R. Turner's offer ("April 15, 1998 Agreement").

29. On April 15, 1998, Preferred Credit's regional secretary, Linda Windish, noticed that telemarketing sheets and labels for 1,500 leads were missing.

30. On April 16, 1998, Defendant J.R. Turner admitted to officers of Preferred Credit that he had removed the telemarketing sheets and labels from Preferred Credit's office. He returned Preferred Credit's leads and corresponding labels later that afternoon.

31. On the evening of April 16, 1998, officers of Preferred Credit and other employees conducted a search of its Lexington office. During that search and several subsequent searches thereafter, Preferred Credit found documents which indicate, upon

information and belief, that employees of Preferred Credit, Defendants Lieberman, J.R. Turner, J. Turner and Conner committed the following acts:

(a) created new and competing companies under the name of PC Holdings Group Corporation, PC Mortgage Corporation, PC Commercial Lending Corporation and possibly others;

(b) rented office space in Lexington, Kentucky at 2250 Regency Road, Suite 100 under the name of PC Mortgage Corporation and negotiated with GTE for a telephone system for the office;

(c) attempted to broker commercial loans, using Preferred Credit's name, in states wherein Preferred Credit was not licensed;

(d) negotiated with GTE for a new phone system for their office;

(e) conducted regular and on-going business with individuals in Texas through a company called PC Holding Group Corp., d/b/a Preferred Credit with Defendant Jerry J. Tidmore including consulting and commercial loan brokering;

(f) copied and distributed business forms and marketing fliers created and used by Preferred Credit with other company names;

(g) distributed correspondence and other documents under another company's name with Preferred Credit's address and toll-free telephone numbers;

(h) distributed correspondence and other documents throughout the loan brokering industry which included "Preferred Credit" next to and alongside the names of other companies established by the Defendants creating an inference of association;

(i) solicited, accepted and diverted funds advanced by customers in direct contravention of Preferred Credit's established policies and business methods;

(j) issued a "loan commitment" in the name of Preferred Credit;

(k) misused, diverted and/or converted Preferred Credit funds to issue advances to other Preferred Credit employees, for activities believed to be associated with Defendant's new compensation [to employees of the] Defendants' new companies, pay expenses such as shipping and copying charges, and purchase supplies for their new companies while still employed at Preferred Credit;

(l) placed false advertisements in a local Lexington newspaper which misrepresented that Preferred Credit was "under new ownership;"

(m) Otherwise committed acts which jeopardize Preferred Credit's reputation in the residential loan brokerage industry, its licenses and business relationships.

32. On Monday, April 20, 1998, Preferred Credit terminated J.R. Turner and J. Turner.

33. On April 21, 1998 Preferred Credit terminated Lieberman.

34. Since that time numerous other employees have left their employment with Preferred Credit in Lexington.

35. On information and belief, some of Preferred Credits' former employees are working for the Defendants and/or the corporate defendants.

<u>FIRST CAUSE OF ACTION</u>

(Breach of Fiduciary Duty)

36. Plaintiff Preferred Credit hereby realleges and incorporates by reference the allegations contained in paragraphs 1 through 35 in this Verified Complaint.

37. Defendants Lieberman, J.R. Turner, J. Turner and Conner were placed in a position of trust with access to confidential and proprietary information belonging to Plaintiff Preferred Credit.

38. While employed by Preferred Credit and continuing thereafter, Defendants owed a fiduciary duty to Preferred Credit.

39. By the actions set forth herein, Defendants breached their fiduciary duty to Plaintiff by and through, among other things:

A. wrongfully using funds, assets, information, resources, and business relationships to begin their own competing companies while still employed with Preferred Credit;

B. wrongfully distributing materials which create a false association between Preferred Credit and the corporate defendants created and operated by Lieberman, J.R. Turner, J. Turner and Conner;

C. made numerous material misrepresentations of fact to officers of Preferred Credit.

40. Such breaches by Defendants have and will proximately cause substantial damages to Preferred Credit, including, but not limited to, lost profits. Further, Defendants have been and will be unjustly enriched by their breaches insofar as they have received compensation training and services from Preferred Credit for the period of their employment during which they engaged in acts constituting breaches of their fiduciary duties to Preferred Credit.

41. Defendants' breaches of their fiduciary duties were malicious, willful, wanton and done with intent to injure Preferred Credit and its business.

SECOND CAUSE OF ACTION

(Fraud and Conversion)

42. Preferred Credit hereby realleges and incorporates by references the allegations of paragraphs 1 through 41 of this Verified Complaint.

43. Defendants Lieberman, J.R. Turner, J. Turner and Conner have converted property of Preferred Credit to their own use and economic advantage and to the detriment of Preferred Credit through their unauthorized use of various business services including, but not limited to, Kinko's copy services, long distance telephone charges, Airborne Express delivery services, and credit reporting systems of Preferred Credit for

the use and development of their own company while in the employ of Preferred Credit.

44. Defendants made material misrepresentations of fact to officers of the corporation that they would fulfill their obligations as employees of Preferred Credit with integrity and honesty. Preferred Credit reasonably relied, to its detriment, on Defendants' misrepresentations as stated above. Preferred Credit's justifiable reliance on the Defendants' material misrepresentations of fact resulted in injury to Preferred Credit in the form of lost profits, conversion of property, and damage to its business name and reputation.

45. Defendants acts of fraud and conversion were malicious, willful, wanton and done with intent to injury Preferred Credit and its business. As set forth herein, Defendants executed a scheme to defraud Preferred Credit to convert business assets and information for their own benefit and to gain an unfair business advantage for the corporate defendants named herein.

THIRD CAUSE OF ACTION

(Unfair Competition in Violation of KRS 365.880, et seq.)

46. Plaintiff realleges and incorporates by reference the allegations of paragraphs 1 through 45 of this Verified Complaint.

47. The activities of Defendants' Lieberman, J.R. Turner, J. Turner and Conner, as described above, constitute unfair competition and are in violation of KRS § 365.880, et seq., Kentucky's Trade Secret Act.

48. Unless Defendants are temporarily restrained, and preliminarily and permanently enjoined, from continuing to engage in unfair competition in violating Kentucky's Trade Secret Act, Preferred Credit will suffer immediate and continued

irreparable injury, loss or damage for which there is no adequate remedy at law.

49. Preferred Credit has been and will continue to be damaged by Defendants' unfair competition and usurpation of Preferred Credit's trade secrets in an amount to be determined at trial.

50. Defendants' unfair competition and usurpation of Preferred Credit's trade secrets is malicious, willful, wanton and done with intent to injure Preferred Credit and its business. The receipt of Preferred Credit's trade secrets by Defendants Lieberman, J.R. Turner, J. Turner, Conner, PC Holdings Group Corporation, Mortgage Corporation and PC Commercial Lending Corporation constitutes misappropriation under Kentucky's Trade Secret Act, KRS 365.880, et seq. Pursuant to KRS 365.882, Preferred Credit is entitled to injunctive relief. In addition, pursuant to KRS 365.884, Preferred Credit is entitled to damages for any profits or benefits received by the Defendants from their misappropriation of Preferred Credit's trade secrets.

FOURTH CAUSE OF ACTION

(Breach of Confidentiality/Non-Compete Agreements)

51. Plaintiff realleges and incorporates by reference the allegations of paragraphs 1 through 50 of this Verified Complaint.

52. The Non-Compete Employment Agreements attached hereto as Exhibits 1, 2, 4 constitute valid, and binding agreements upon the Defendants J.R. Turner, J. Turner and Lieberman.

53. The Employee Non-Compete Agreements expressly provide that the Defendants agree not to disclose Preferred Credit's proprietary information and not to accept employment or serve in any other capacity either directly or indirectly with any

organization engaged in any activities related to mortgage business or compete with Preferred Credit, Inc. in any loan origination capacity with any other employer, including self employment, for a period of five (5) years following their termination from Preferred Credit.

54. J.R. Turner, J. Turner and Lieberman have breached their Non-Compete Employment Agreements as a direct and proximate result of their misuse, misdirection, and conversion of Preferred Credit proprietary information and other business services in connection with their creation of, and business conducted under the name of, PC Holdings Group Corporation, PC Mortgage Corporation, and PC Commercial Lending Corporation.

55. Unless Defendants J.R. Turner, J. Turner and Lieberman are temporarily restrained, and preliminarily and permanently enjoined from continuing to breach their Non-Compete Employment Agreements, Preferred Credit will suffer immediate and continued irreparable injury, loss, or damages for which there is no adequate remedy at law.

56. Preferred Credit has been and will continue to be damaged by Defendants J.R. Turner, J. Turner and Lieberman's breach of their Confidentiality Agreements in an amount to be determined at trial, but which is in excess of this Court's jurisdictional minimum requirements.

FIFTH CAUSE OF ACTION

(Aiding and Abetting Breach of Fiduciary Duty)

57. Plaintiff realleges and incorporates by reference the allegations of paragraphs 1 through 56 of this Verified Complaint.

58. Tidmore conspired with Lieberman, J.R. Turner, J. Turner and Conner to convert Preferred Credit assets and business opportunities.

59. At the time Tidmore engaged in the brokering of loans and other business activities with Lieberman, J.R. Turner, J. Turner and Conner and the corporate defendants, Tidmore knew that defendants Lieberman and Turner were acting in breach of their fiduciary duties owed to Preferred Credit.

60. Defendant Tidmore's actions induced and/or aided and abetted then current employees of Preferred Credit to breach their fiduciary duties owed to Preferred Credit. Specifically, Tidmore aided, abetted and otherwise induced Lieberman, J.R. Turner, J. Turner and Conner to convert Preferred Credit's confidential and proprietary information, other information or other business services, and business opportunities for the use of the corporate defendants and for themselves individually.

61. As a result of Tidmore's aiding and abetting the breaches of fiduciary duty by Lieberman, J.R. Turner, J. Turner and Conner, Preferred Credit has been and will continue to be damaged by their breaches of fiduciary duty and other agreements in an amount to be determined at trial, but in excess of this Court's minimum jurisdictional requirements..

62. As a direct and proximate result of Tidmore's aiding and abetting the breaches of fiduciary duties of Defendants' Lieberman, J.R. Turner, J. Turner and Conner, Preferred Credit will continue to suffer immediate and irreparable injury, loss, or damages for which there is no adequate remedy at law.

SIXTH CAUSE OF ACTION

(Intentional Interference with Existing and/or Prospective Contractual Relations)

63. Plaintiff hereby realleges and incorporates by reference the allegations contained in paragraphs 1 through 62 in this Verified Complaint.

64. Through the actions alleged herein, defendants Lieberman, Tidmore, J.R. Turner, J. Turner and Conner intentionally interfered with Preferred Credit's existing and prospective contractual and business relationships with existing and prospective customers of Preferred Credit, lenders and others involved in the residential mortgage brokering industry.

65. As a result of the defendants tortious conduct and the continuation of their activities, customers and potential customers were induced not to enter into or continue their relationship with Preferred Credit.

66. As a result of the defendants tortious conduct and the continuation of their activities, the defendants prevented customers and potential customers from entering into or continuing their relationship with Preferred Credit.

67. As a direct and proximate result of Tidmore's aiding and abetting the breaches of fiduciary duties of Defendants' Lieberman, J.R. Turner, J. Turner and Conner, Preferred Credit will continue to suffer immediate and irreparable injury, loss, or damages for which there is no adequate remedy at law.

SEVENTH CAUSE OF ACTION

(Breach of Implied Covenant of Good Faith and Fair Dealing)

68. Plaintiff hereby realleges and incorporates by reference the allegations contained in paragraphs 1 through 67 in this Verified Complaint.

69. Under Kentucky law, every contract imposes upon each party a duty of

good faith and fair dealing in its performance and its enforcement.

70. The actions by Defendants Lieberman, J.R. Turner, and J. Turner, constitute a breach of the implied covenant of good faith and fair dealing included by Kentucky law in their respective Non-Compete Employment Agreements attached hereto as Exhibits 1, 2 and 4.

EIGHTH CAUSE OF ACTION

(Violation of § 43(a) of the LanhamAct)

71. Plaintiff hereby realleges and incorporates by reference the allegations contained in paragraphs 1 through 70 of this Verified Complaint.

72. Since at least 1990, and long prior to the acts of the Defendats described herein, Preferred Credit has continuously used (and continues to use) in interstate commerce its name in connection with its business of brokering residential mortgage loans to individuals in numerous states.

73. Since long prior to the acts of the Defendants as alleged herein, Preferred Credit has expended substantial sums of money promoting and advertising its services throughout the numerous states in which it brokers loans.

74. As a result of Preferred Credit's long and continuous use of its name in interstate commerce, its extensive promotion and advertisements of its mortgage brokering services under the its name, the care and skill exercised by Preferred Credit in its industry, and its outstanding reputation with lenders and other service providers in the residential mortgage brokering industry, its name has gained widespread and favorable public acceptance and association with Preferred Credit in this district and throughout the other states in which Preferred Credit does business.

75. As a result of the aforementioned use, promotion and advertisements of its name and services, Preferred Credit has built up and now owns valuable goodwill which is recognized by its name. By their use of its name, toll-free telephone numbers and Lexington office address, in association with illegal and unlicensed activities in various states, including but not limited to, Texas, Tennessee, Indiana, Nevada and Massachusetts, and in association with the names and marks of PC Holdings Group Corporation, PC Mortgage Corporation, and PC Commercial Lending Corporation, and in association with commercial loan brokering and other activities in which Preferred Credit does not do business, the Defendants have, or are likely to, cause confusion or mistake or deceive consumers as to the affiliation, connection or association of the Defendants and their illegal corporations with Preferred Credit.

76. As a result of the aforesaid acts, Preferred Credit has suffered, and will continue to suffer, irreparable damage to its name, good will, and numerous business relations, lost sales, lost profits, and market confusion and loss of market. Unless Defendants are temporarily restrained and preliminarily and permanently enjoined from continuing their violations of § 43(a) of the Lanham Act, Preferred Credit will suffer immediate and irreparable injury, loss or damages for which there is no adequate remedy at law.

NINTH CAUSE OF ACTION

(Action for an Accounting)

77. Plaintiff hereby realleges and incorporates by reference the allegations contained in paragraphs 1 through 76 of this Verified Complaint.

78. Upon information and belief, Defendants continue to receive revenue and/or commissions from leads, customer relations, and business contacts established while employees for Preferred Credit.

79. Upon information and belief, Defendants have in their possession loan file folders which were created while they were employed with Preferred Credit. Further, upon information and belief, Defendants continue to work on, develop, or process loans which originated while they were employed with Preferred Credit.

80. Defendants possess all documentation which is needed to calculate any profits that Defendants may have gained as a result of misappropriation of trade secrets, proprietary information, and other business information and services while employed at Preferred Credit.

81. Monetary damages are inadequate in this case without a complete accounting of profits received by Defendants as a result of their breach of fiduciary duties and other activities as alleged herein. Without such a determination by the Court based upon the documents and other records which Defendants now control, Preferred Credit has no method of calculating the true amount of damages owed to it.

PRAYER FOR RELIEF

THEREFORE, Plaintiff Preferred Credit, Incorporated demands judgment against Defendants PC Holding Group Corporation, PC Mortgage Corporate, PC Commercial Lending Corporation, Michael Lieberman, James R. Turner, Jason Turner, Jerry Tidmore, Aletha Conner and other unknown defendants, as follows:

A. A complete accounting of, and an award against all defendants, jointly and severally, for all profits or income obtained by the Defendants earned through their use of information, funds, or services wrongfully converted from Plaintiff;

B. An award of damages against defendants Michael Lieberman, James Turner and Jimmy Turner for all compensation received from Plaintiff during the period that they engaged in acts which constitute a breach of their fiduciary duties owed to Plaintiff in an amount to be determined at trial, but in excess of this Court's jurisdictional limits of this Court;

C. An award of punitive damages against all defendants for their malicious, willful and wanton activities complained of in this Verified Complaint in an amount to be determined at trial, but in excess of this Court's jurisdictional limits of this Court;

D. An award of damages in an amount as may be determined at trial to reimburse Plaintiff for all damages including lost revenues and profits, loss of goodwill, market, all costs associated with defendants' breach of their fiduciary duties, and customer confusion and the cost of all remedial advertising, suffered by reason of the violation by Defendants of the Lanham Act, to be trebled in accordance with 15 U.S.C. §1117;

E. An award against all defendants for all costs of this action, together with reasonable attorneys' fees and disbursements incurred by Plaintiff herein pursuant to the Lanham Act, 15 U.S.C. §1117(b), Section 7 of the Non-Compete Employment Agreements, and applicable Kentucky statutes and common law;

F. And an award for injunctive relief as set forth in Plaintiff's Motion for a Temporary Restraining Order filed in conjunction with the Verified Complaint.

Respectfully submitted,

GREG E. MITCHELL
SUSAN C. SEARS
THOMAS G. GRACE
FROST & JACOBS
1100 Vine Center Tower
333 West Vine Street
Lexington, Kentucky 40507-1634
(606) 254-1100

COUNSEL FOR PLAINTIFF

VERIFICATION

I, Paulette Klein, under oath, state that I am President of Preferred Credit, Incorporation, and that I have read the foregoing Verified Complaint and that the facts set forth in the Verified Complaint are true and accurate to the best of my knowledge and information.

____

PAULETTE KLEIN

STATE OF WEST VIRGINIA)

COUNTY OF ____________)

The foregoing was subscribed and sworn to before me by Paulette Klein this day of May, 1998.

(SEAL)

Notary Public

My commission expires

39778.01

Commonwealth of Kentucky
Fayette circuit court
__ Division
Case No.: ____________________

COMPANY Plaintiff, v. Ex-Employee, Defendant.	: : : : : : : : : : : : :	**VERIFIED COMPLAINT**

For its Complaint against Defendant Ex-Employee ("Ex-Employee"), Company states as follows:

1. Company brings this action to enforce Ex-Employee's Agreement dated October 15, 1993 that includes non-competition and non-disclosure provisions ("Agreement") (attached as Exhibit A) and to prevent Ex-Employee from unfairly competing against Company through his disclosure and/or misappropriation of Company's confidential and proprietary information and trade secrets.

THE PARTIES

2. Company is a corporation organized and existing under the laws of the State of Ohio with its headquarters and principal place of business in Cincinnati, Ohio.

3. Ex-Employee currently resides in and is a citizen of Hamilton County, Ohio and is a former employee of Company.

4. Through his employment with Company, Ex-Employee acquired extensive knowledge of Company's confidential and proprietary information and trade secrets.

5. Ex-Employee left his employment with Company.

6. This Court has jurisdiction over all parties to this litigation.

7. Venue of this litigation is properly lodged in this Court.

8. Ex-Employee's breach of his Agreement and his disclosure and misappropriation of Company's trade secrets have resulted in both irreparable harm as well as damages.

9. Company designs, manufactures and distributes important stuff. Company maintains it manufacturing facility and main offices in Lexington, Kentucky. Central to Company's business are its: (1) innovative and well-developed computer-aided methods of designing and manufacturing its stuff; and (2) methods for manufacturing other stuff.

10. Ex-Employee began his employment with Company in March 1977.

11. During the course of his employment, Ex-Employee received, developed on behalf of Company and regularly used a significant amount of confidential, proprietary information and trade secrets, including but not limited to information concerning computer-aided design of the stuff.

12. On or about October 15, 1993, Ex-Employee signed the Agreement dated October 15, 1993.

13. As consideration for the Agreement, in an effort to further support Ex-Employee's efforts at Company and the computer aided design area in which Ex-Employee worked, Company agreed to continue investing capital into that area, raise Ex-Employee's salary, and allow him to participate in Company's bonus program.

14. Pursuant to the Agreement, Ex-Employee agreed to keep confidential certain information to which he had access at Company. The Agreement provided as

follows:

[Quote Agreement]

15. Pursuant to the Agreement, Ex-Employee agreed to certain non-compete provisions. The Agreement provides as follows:

[Quote Agreement]

16. Company fully performed under the Agreement.

17. While at Company and after execution of the Agreement, Ex-Employee worked with models and molds of the stuff with the aid of computers at Company.

18. Company has undertaken efforts that are reasonable under the circumstances to maintain the secrecy of its confidential and proprietary information and trade secrets. Company gains a competitive advantage because of its confidential and proprietary information and trade secrets.

19. Throughout his employment with Company, Ex-Employee was permitted access to and gained intimate, detailed and comprehensive knowledge of Company's confidential and proprietary information and trade secrets.

20. In August 1999, Ex-Employee left the employ of Company.

21. Ex-Employee has and continues to violate the confidentiality and non-competition portions of his Agreement. More specifically, Ex-Employee has:

a. First bad act

b. Second bad act.

c. Third bad act.

COUNT I - BREACH OF CONTRACT

22. Company incorporates by reference the allegations contained in

Paragraphs 1 through 21 above as if fully rewritten herein.

23. Ex-Employee's actions and threatened actions as described above constitute material breaches of his Agreement.

24. As a result of the intentional and willful breaches of Ex-Employee's Agreement, Company is entitled to damages and injunctive relief.

COUNT II - MISAPPROPRIATION OF TRADE SECRETS

25. Company incorporates by reference the allegations contained in Paragraphs 1 through 24 above as if fully rewritten here.

26. Ex-Employee's activities described above constitute actual and/or threatened misappropriation of Company's trade secrets, in violation of the Kentucky Uniform Trade Secrets Act, KRS 365.880, et seq., and the common law of Kentucky, and for which Company is entitled to injunctive and monetary relief.

27. Ex-Employee's actual or threatened misappropriation of Company's trade secrets was willful and malicious, done with intent to injure Company and its business.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff demands the following relief:

1. Enter a preliminary and permanent injunction:

    a. Enjoining Ex-Employee from disclosing any of Company's confidential and proprietary business information and trade secrets to any third party;

    b. Enjoining Ex-Employee misappropriating or threatening to misappropriate any of Company's confidential and proprietary business information and trade secrets;

c. Ordering Ex-Employee to return all of Company's confidential and proprietary business information and trade secrets, and all copies, thereof, to Company immediately;

d. Enjoining Ex-Employee from further breaching his Agreement.

2. An award of compensatory damages of more than $25,000 against Ex-Employee; and

3. An award of punitive and exemplary damages against Ex-Employee for his willful and malicious conduct; and

4. An award of prejudgment and post-judgment interest; and

5. An award of Company's reasonable attorney's fees and costs incurred in this matter; and

6. Any other relief the Court may deem just and proper.

Respectfully submitted,

VERIFICATION OF COMPLAINT

STATE OF OHIO)
) ss:
COUNTY OF HAMILTON)

I, Company President, being duly cautioned and sworn, state that I am President of the Company., the Plaintiff in this action, and that I am authorized to act as an agent of

Plaintiff for the purpose of verifying the Complaint herein. To the extent I have personal knowledge of the matters alleged in the Complaint, the information is true and accurate to the best of my knowledge and belief. As to any matters for which I do not have personal knowledge, I am authorized by Plaintiff to state that Plaintiff is informed and believe that the allegations of the Complaint are true and accurate to the best of its knowledge and belief.

President _____________

Subscribed and sworn to before me this __ day of _________, 2001.

Notary Public

THOMAS G. GRACE Tgrace@fbtlaw.com (502) 568-0227 400 West Market Street
32nd Floor Louisville, Kentucky 40202-3363 (502) 589-5400 Facsimile (502) 581-1087
www.frostbrowntodd.com October 10, 2001

President George W. Bush
600 Pennsylvania Avenue
Washington, D.C. 20500

RE: Company

Dear President Bush:

This office represents Company.

We understand that New Employer recently hired one of Company's former employees, Mr. John Doe. We are informed, however, after Mr. Doe left Company, he did not return all of the Company's property, including its confidential and proprietary information. In addition, we understand that Mr. Doe has recently been soliciting Company's customers on behalf of New Employer.

We are writing to demand that New Company immediately intervene here and Mr. Doe to cease and desist from soliciting Company's customers. We also request New Company's assistance in requiring Mr. Doe to return all of the Company's property, including its confidential and proprietary information, and mandating that he not disclose or use Company's confidential and proprietary information in connection with his duties for New Company.

In July 1998, while Mr. Doe was employed by Company, he signed an Agreement Concerning Non-Disclosure of Company Information (the "July 1998 Agreement"), pursuant to which he agreed "to hold in strictest confidence, and not to use, except for the benefit of Company, or to disclose, transfer or reveal, directly or indirectly to any person or entity, any Confidential Information without the prior written authorization of Company." The July 1998 Agreement defined "Confidential Information" to mean, "any and all information which is not generally known and which is proprietary to Company or any of its clients, consultants, licensors, licensed dealers or distributors" including "business plans, *customer lists*, consultants, financial information, and trade secrets about Company[.]"

Mr. Doe also agreed in the July 1998 Agreement that, upon the termination of his employment with the Company, he would "immediately deliver to [his] immediate supervisor at Company all papers, notes, data, reference materials, sketches, drawings, memoranda, documentation, *software*, tools, apparatus and any other materials furnished to [him] by Company or which were prepared or made, in whole or in part, by [him] at any time during [his] association with or employment by Company[.]" In July 2000, Mr. Doe signed an AT-Will Employment and Confidentiality Agreement (the "July 2000 Agreement"), pursuant to which he agreed to preserve the Company's confidences, to return the Company's property and not to solicit the Company's customers.

In addition to his obligation under the July 1998 and July 2000 Agreements, Mr. Doe is required to adhere to obligations imposed by applicable state law regarding, among other things, returning the Company's property, maintaining the confidentiality of the Company's proprietary information, including its trade secrets, and refraining from soliciting or interfering with the Company's customers.

Although Mr. Doe returned some of the Company's property upon termination, we are informed that he has not returned *all* of Company's property. However, he is not and was not authorized to retain any of the Company's property and he certainly was not permitted to retain, disclose or use any of the Company's software or its confidential information including Company's customer database that was maintained on the Goldmine software or any information obtained or derived from that database.

Mr. Doe's wrongful retention of/refusal to return this property and confidential information to the Company and his use and/or disclosure of this property and confidential information violates the July 1998 and July 2000 Agreements as well as his obligations under applicable state law. Likewise, Mr. Doe's improper solicitations of the Company's customers also violates the July 1998 and July 2000 Agreements and applicable state law, including the Uniform Trade Secrets Act. Because Mr. Doe appears to be acting on behalf of New Company, New Company may be held liable here too.

This situation must be immediately corrected and Mr. Doe must immediately return all of the Company's property to Company, affirm in writing that he has done so, permit the Company to inspect his computer(s) to ensure that he has retained no copies (or any part thereof) of such information, and cease and desist from soliciting and interfering with the Company's customers. Furthermore, Mr. Doe and New Company must take appropriate measures to ensure that he does not disclose or use Company's confidential and proprietary information in the future.

While Company has no intention or desire to interfere with Mr. Doe's employment or other relationships with New Company, this situation must be remedied immediately. If New Company and Mr. Doe immediately agree to the foregoing, Company is willing to amicably resolve this matter. If, however, Mr. Doe and New Company fail or refuse to do so, Company reserves the right to pursue all available legal remedies including, without limitation, filing a lawsuit in the United States District Court, seeking a temporary restraining order and a preliminary injunction. In this regard, if the Company is forced to commence litigation here, Company will not only seek an injunction barring his unlawful disclosure or use of the Company's confidential information, including its customer information, and the return of its property, but Company will also seek to recover damages and attorney's fees.

After you have received and reviewed this letter, please call me at your earliest convenience to discuss this matter further.

Sincerely,

Thomas G. Grace

1650:cky
LOUIMDMS/97047.1

BUSINESS VALUATIONS AND TRADE SECRETS

William D. Probus, CPA, ABV
Crowe Chizek
Louisville, Kentucky

SECTION H

BUSINESS VALUATION AND TRADE SECRETS

APPENDIX

SECTION H

Business Valuation and Trade Secrets
Trade Secrets, Non-Competes and Unfair Competition
University of Kentucky College of Law
October 12, 2001

1. Types of intangible assets

   a. Marketing and sales related – Trademarks, trade names, brand names, logos, customer lists, customer relationships, backlog, open purchase orders

   b. Technological – Patents, technical know-how, proprietary software, trade secrets, proprietary processes

   c. Artistic – literary works, copyrights, compositions, maps, engravings

   d. Contractual – Licenses, franchise agreements, noncompete agreements, supplier contracts

   e. Geographical – Leasehold interests, easements, air rights, water rights

   f. Human resources – assembled workforce

   g. Goodwill – Going concern value

2. Intellectual property – Intangible asset with legal protection

   a. Marketing – Trademarks and service marks

   b. Technology - Patents, industrial designs and trade secrets, computer software copyrights

   c. Artistic – literary and musical copyrights

3. Reasons for valuation of intangible assets

   a. Purchase price allocation for financial accounting - Statements on Financial Accounting Standards number 141 & 142

   b. Purchase price allocation for income tax accounting – Internal Revenue Code Sections 1060 & 197

   c. Preacquisition planning

d. Financing

e. Reorganization and Bankruptcy analysis

f. Establishment of royalty rates

g. Intercompany transfer pricing - internal revenue code section 482

h. Income tax planning and compliance - Charitable donations, S corporation elections, Intangible property holding company royalty rates

i. Ad Valorem Property Taxes

j. Litigation Support

k. Business Formations

l. General business planning

4. Defining the Appraisal Assignment

a. Objective

i. Asset to be appraised

ii. Ownership interest to be appraised

iii. Standard and premise of value

iv. The as of date of the appraisal

b. Purpose

i. Use of the appraisal

ii. Parties relying on the appraisal

c. Description of the assets to be appraised

i. Physical description

ii. Functional description

iii. Technical description

iv. Legal description

5. Valuation approaches - Basically the same as for any business appraisal
   a. Cost approach
   b. Market approach
   c. Income approach
6. Cost approach -
   a. Principle of substitution - An investor would pay no more for an intangible asset that what it would cost to obtain an asset with comparable utility.
      i. Reproduction cost - developing, constructing or purchasing an exact replica
      ii. Replacement cost - recreate the utility of the intangible asset
   b. Adjusted for obsolescence
7. Market approach
   a. Comparable transactions selected
      i. Asset type
      ii. Asset use
      iii. Industry in which the asset is applied
      iv. Timeliness of transactions
   b. Analysis of market condition
   c. Pricing multiples developed (price per unit)
      i. Physical units such as
         1. per customer
         2. per unit of production
         3. per line of computer code

ii. Financial units such as

1. per revenue
2. per net income
3. per dollar invested

d. Methods

i. Sales transactions method

ii. Relief from royalty method

iii. Comparative income- additional income generated over and above a comparable company as a result of the intangible

iv. Rules of Thumb

8. Income approach

a. Expected benefits or cash flow from the intangible asset

i. Excludes income from other tangible or intangible assets

ii. Excludes income from goodwill

b. Required rate of return

c. Estimated projection period – remaining useful life considerations

i. Legal life

ii. Contractual life

iii. Physical life

iv. Functional analysis – Changes in technology

v. Operational analysis – Changes in management or regulations

vi. Economic analysis – Changes in demand

vii. Analytical/statistical

d. Methods for measuring income

   i. Incremental levels of income because of the intangible asset

      1. Increased revenue based on price

      2. Increased revenue based on volume

      3. Increased period of revenue recognition

      4. Decreased costs based on efficiency

      5. Decreased cost based on production levels

      6. Other decreased costs

   ii. Amount by which income would decline without the intangible asset

   iii. Relief from royalty because the intangible asset was owned and not licensed

   iv. Difference in value of a business with and without the intangible

   v. Residual value of a business over other tangible and intangible assets

e. Valuation methods

   i. Incremental Income Analyses

   ii. Profit Split Analyses

   iii. Royalty Rate Analyses

9. Valuation adjustments

   a. Marketability -Since intangible assets are not readily traded on an open exchange, there is little empirical data to support adjustments, however, the liquidity of the asset must be considered

   b. Minority or Fractional interests - unlike valuations of closely held stock, there are very few transactions of intangible assets on a minority or fractional interest basis.

c. Other adjustments - When comparable transactions are located, adjustments may be warranted when the price paid is in terms other than a cash equivalent price.

10. Differences between business valuation and intangible asset valuation

    a. Intangibles generally have a finite life

    b. Generally, risk is higher for a single intangible asset than for an entire business enterprise.

    c. Only income associated with the intangible asset is considered net of related cost.

FINANCIAL ACCOUNTING STANDARDS BOARD

Summary of Statement No. 141
Business Combinations
(Issued 6/01)

Summary

This Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, *Business Combinations,* and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. All business combinations in the scope of this Statement are to be accounted for using one method, the purchase method.

Reasons for Issuing This Statement

Under Opinion 16, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial statement results. Consequently:

- Analysts and other users of financial statements indicated that it was difficult to compare the financial results of entities because different methods of accounting for business combinations were used.

- Users of financial statements also indicated a need for better information about intangible assets because those assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes all intangible assets acquired in a business combination (either separately or as goodwill), only those intangible assets previously recorded by the acquired entity are recognized when the pooling method is used.

- Company managements indicated that the differences between the pooling and purchase methods of accounting for business combinations affected competition in markets for mergers and acquisitions.

Differences between This Statement and Opinion 16

The provisions of this Statement reflect a fundamentally different approach to accounting for business combinations than was taken in Opinion 16. The single-method approach used in this Statement reflects the conclusion that virtually all business combinations are acquisitions and, thus, all business combinations should be accounted for in the same way that other asset acquisitions are accounted for-based on the values exchanged.

This Statement changes the accounting for business combinations in Opinion 16 in the following significant respects:

- This Statement requires that all business combinations be accounted for by a single method—the purchase method.

- In contrast to Opinion 16, which required separate recognition of intangible assets that can be identified and named, this Statement requires that they be recognized as assets apart from goodwill if they meet one of two criteria—the contractual-legal criterion or the separability criterion. To assist in identifying acquired intangible assets, this Statement also provides an illustrative list of intangible assets that meet either of those criteria.

- In addition to the disclosure requirements in Opinion 16, this Statement requires disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount of the purchase price assigned to each major intangible asset class.

This Statement does not change many of the provisions of Opinion 16 and Statement 38 related to the application of the purchase method. For example, this Statement does not fundamentally change the guidance for determining the cost of an acquired entity and allocating that cost to the assets acquired and liabilities assumed, the accounting for contingent consideration, and the accounting for preacquisition contingencies. That guidance is carried forward in this Statement (but was not reconsidered by the Board). Also, this Statement does not change the requirement to write off certain research and development assets acquired in a business combination as required by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.*

How the Changes in This Statement Improve Financial Reporting

The changes to accounting for business combinations required by this Statement improve financial reporting because the financial statements of entities that engage in business combinations will better reflect the underlying economics of those transactions. In particular, application of this Statement will result in financial statements that:

- *Better reflect the investment made in an acquired entity*—the purchase method records a business combination based on the values exchanged, thus users are provided information about the total purchase price paid to acquire another entity, which allows for more meaningful evaluation of the subsequent performance of that investment. Similar information is not provided when the pooling method is used.

- *Improve the comparability of reported financial information*—all business combinations are accounted for using a single method, thus, users are able to compare the financial results of entities that engage in business combinations on an apples-to-apples basis. That is because the assets acquired and liabilities assumed in all business combinations are recognized and measured in the same way regardless of the nature of the consideration exchanged for them.

- *Provide more complete financial information*—the explicit criteria for recognition of intangible assets apart from goodwill and the expanded disclosure requirements of this Statement provide more information about the assets acquired and liabilities assumed in business combinations. That additional information should, among other things, provide users with a better understanding of the resources acquired and improve their ability to assess future profitability and cash flows.

Requiring one method of accounting reduces the costs of accounting for business combinations. For example, it eliminates the costs incurred by entities in positioning themselves to meet the criteria for using the pooling method, such as the monetary and nonmonetary costs of taking actions they might not otherwise have taken or refraining from actions they might otherwise have taken.

How the Conclusions in This Statement Relate to the Conceptual Framework

The Board concluded that because virtually all business combinations are acquisitions, requiring one method of accounting for economically similar transactions is consistent with the concepts of representational faithfulness and comparability as discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* In developing this Statement, the Board also concluded that goodwill should be recognized as an asset because it meets the assets definition in FASB Concepts Statement No. 6, *Elements of Financial Statements,* and the asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises.*

The Board also noted that FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that helps in assessing the amounts, timing, and uncertainty of prospective net cash inflows to an entity. The Board noted that because the purchase method records the net assets acquired in a business combination at their fair values, the information provided by that method is more useful in assessing the cash-generating abilities of the net assets acquired than the information provided by the pooling method.

Some of the Board's constituents indicated that the pooling method should be retained for public policy reasons. For example, some argued that eliminating the pooling method would impede consolidation of certain industries, reduce the amount of capital flowing into certain industries, and slow the development of new technology. Concepts Statement 2 states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but rather, provide information about those combinations that is fair and evenhanded. The Board concluded that its public policy goal is to issue accounting standards that result in neutral and representationally faithful financial information and that eliminating the pooling method is consistent with that goal.

The Effective Date of This Statement

The provisions of this Statement apply to all business combinations initiated after June 30, 2001. This Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later.

This Statement does not apply, however, to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises.

Summary of Statement No. 142
Goodwill and Other Intangible Assets
(Issued 6/01)

Summary

This Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets.* It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

Reasons for Issuing This Statement

Analysts and other users of financial statements, as well as company managements, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions. As a result, better information about intangible assets was needed. Financial statement users also indicated that they did not regard goodwill amortization expense as being useful information in analyzing investments.

Differences between This Statement and Opinion 17

This Statement changes the unit of account for goodwill and takes a very different approach to how goodwill and other intangible assets are accounted for subsequent to their initial recognition. Because goodwill and some intangible assets will no longer be amortized, the reported amounts of goodwill and intangible assets (as well as total assets) will not decrease at the same time and in the same manner as under previous standards. There may be more volatility in reported income than under previous standards because impairment losses are likely to occur irregularly and in varying amounts.

This Statement changes the subsequent accounting for goodwill and other intangible assets in the following significant respects:

- Acquiring entities usually integrate acquired entities into their operations, and thus the acquirers' expectations of benefits from the resulting synergies usually are reflected in the premium that they pay to acquire those entities. However, the transaction-based approach to accounting for goodwill under

Opinion 17 treated the acquired entity as if it remained a stand-alone entity rather than being integrated with the acquiring entity; as a result, the portion of the premium related to expected synergies (goodwill) was not accounted for appropriately. This Statement adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated (those units are referred to as reporting units).

- Opinion 17 presumed that goodwill and all other intangible assets were wasting assets (that is, finite lived), and thus the amounts assigned to them should be amortized in determining net income; Opinion 17 also mandated an arbitrary ceiling of 40 years for that amortization. This Statement does not presume that those assets are wasting assets. Instead, goodwill and intangible assets that have indefinite useful lives will not be amortized but rather will be tested at least annually for impairment. Intangible assets that have finite useful lives will continue to be amortized over their useful lives, but without the constraint of an arbitrary ceiling.

- Previous standards provided little guidance about how to determine and measure goodwill impairment; as a result, the accounting for goodwill impairments was not consistent and not comparable and yielded information of questionable usefulness. This Statement provides specific guidance for testing goodwill for impairment. Goodwill will be tested for impairment at least annually using a two-step process that begins with an estimation of the fair value of a reporting unit. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of a reporting unit.

- In addition, this Statement provides specific guidance on testing intangible assets that will not be amortized for impairment and thus removes those intangible assets from the scope of other impairment guidance. Intangible assets that are not amortized will be tested for impairment at least annually by comparing the fair values of those assets with their recorded amounts.

- This Statement requires disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required. Required disclosures include information about the changes in the carrying amount of goodwill from period to period (in the aggregate and by reportable segment), the carrying amount of intangible assets by major intangible asset class for those assets subject to amortization and for those not subject to amortization, and the estimated intangible asset amortization expense for the next five years.

This Statement carries forward without reconsideration the provisions of Opinion 17 related to the accounting for internally developed intangible assets. This Statement also does not change the requirement to expense the cost of certain acquired research and development assets at the date of acquisition as required by FASB Statement No. 2, *Accounting for Research and Development Costs,* and FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the*

Purchase Method.

How the Changes in This Statement Improve Financial Reporting

The changes included in this Statement will improve financial reporting because the financial statements of entities that acquire goodwill and other intangible assets will better reflect the underlying economics of those assets. As a result, financial statement users will be better able to understand the investments made in those assets and the subsequent performance of those investments. The enhanced disclosures about goodwill and intangible assets subsequent to their acquisition also will provide users with a better understanding of the expectations about and changes in those assets over time, thereby improving their ability to assess future profitability and cash flows.

How the Conclusions in This Statement Relate to the Conceptual Framework

The Board concluded that amortization of goodwill was not consistent with the concept of representational faithfulness, as discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* The Board concluded that nonamortization of goodwill coupled with impairment testing *is* consistent with that concept. The appropriate balance of both relevance and reliability and costs and benefits also was central to the Board's conclusion that this Statement will improve financial reporting.

This Statement utilizes the guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* for estimating the fair values used in testing both goodwill and other intangible assets that are not being amortized for impairment.

The Effective Date of This Statement

The provisions of this Statement are required to be applied starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. This Statement is required to be applied at the beginning of an entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements at that date. Impairment losses for goodwill and indefinite-lived intangible assets that arise due to the initial application of this Statement (resulting from a transitional impairment test) are to be reported as resulting from a change in accounting principle.

There are two exceptions to the date at which this Statement becomes effective:

- Goodwill and intangible assets acquired after June 30, 2001, will be subject immediately to the nonamortization and amortization provisions of this Statement.

- The provisions of this Statement will not be applicable to goodwill and other intangible assets arising from combinations between mutual enterprises or to not-for-profit organizations until the Board completes its deliberations with respect to application of the purchase method by those entities.

§ 1060. Special allocation rules for certain asset acquisitions

(a) General rule.—In the case of any applicable asset acquisition, for purposes of determining both—

(1) the transferee's basis in such assets, and

(2) the gain or loss of the transferor with respect to such acquisition,

the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338(b)(5). If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.

(b) Information required to be furnished to Secretary.—Under regulations, the transferor and transferee in an applicable asset acquisition shall, at such times and in such manner as may be provided in such regulations, furnish to the Secretary the following information:

(1) The amount of the consideration received for the assets which is allocated to section 197 intangibles.

(2) Any modification of the amount described in paragraph (1).

(3) Any other information with respect to other assets transferred in such acquisition as the Secretary deems necessary to carry out the provisions of this section.

(c) Applicable asset acquisition.—For purposes of this section, the term "applicable asset acquisition" means any transfer (whether directly or indirectly)—

(1) of assets which constitute a trade or business, and

(2) with respect to which the transferee's basis in such assets is determined wholly by reference to the consideration paid for such assets.

A transfer shall not be treated as failing to be an applicable asset acquisition merely because section 1031 applies to a portion of the assets transferred.

(d) Treatment of certain partnership transactions.—In the case of a distribution of partnership property or a transfer of an interest in a partnership—

(1) the rules of subsection (a) shall apply but only for purposes of determining the value of section 197 intangibles for purposes of applying section 755, and

(2) if section 755 applies, such distribution or transfer (as the case may be) shall be treated as an applicable asset acquisition for purposes of subsection (b).

(e) Information required in case of certain transfers of interests in entities.—

(1) In general.—If—

(A) a person who is a 10-percent owner with respect to any entity transfers an interest in such entity, and

(B) in connection with such transfer, such owner (or a related person) enters into an employment contract, covenant not to compete, royalty or lease agreement, or other agreement with the transferee,

such owner and the transferee shall, at such time and in such manner as the Secretary may prescribe, furnish such information as the Secretary may require.

(2) 10-percent owner.—For purposes of this subsection—

(A) In general.—The term "10-percent owner" means, with respect to any entity, any person who holds 10 percent or more (by value) of the interests in such entity immediately before the transfer.

(B) Constructive ownership.—Section 318 shall apply in determining ownership of stock in a corporation. Similar principles shall apply in determining the ownership of interests in any other entity.

(3) Related person.—For purposes of this subsection, the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the 10-percent owner.

(f) Cross Reference.—

For provisions relating to penalties for failure to file a return required by this section, see section 6721.

(Added Pub.L. 99-514, Title VI, § 641(a), Oct. 22, 1986, 100 Stat. 2282, and amended Pub.L. 100-647, Title I, § 1006(h)(1), (2), (3)(B), Nov. 10, 1988, 102 Stat. 3410; Pub.L. 101-508, Title XI, § 11323(a), (b)(1), Nov. 5, 1990, 104 Stat. 1388-464; Pub.L. 103-66, Title XIII, § 13261(e), Aug. 10, 1993, 107 Stat. 539.)

§ 197. Amortization of goodwill and certain other intangibles

(a) General rule.—A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

(b) No other depreciation or amortization deduction allowable.—Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

(c) Amortizable section 197 intangible.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 intangible—

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

(2) Exclusion of self-created intangibles, etc.—The term "amortizable section 197 intangible" shall not include any section 197 intangible—

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(3) Anti-churning rules.—

For exclusion of intangibles acquired in certain transactions, see subsection (f)(9).

(d) Section 197 intangible.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the term "section 197 intangible" means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(2) **Customer-based intangible.**—

(A) **In general.**—The term "customer-based intangible" means—

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) **Special rule for financial institutions.**—In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) **Supplier-based intangible.**—The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

(e) **Exceptions.**—For purposes of this section, the term "section 197 intangible" shall not include any of the following:

(1) **Financial interests.**—Any interest—

(A) in a corporation, partnership, trust, or estate, or

(B) under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract.

(2) **Land.**—Any interest in land.

(3) **Computer software.**—

(A) **In general.**—Any—

(i) computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and

(ii) other computer software which is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

(B) **Computer software defined.**—For purposes of subparagraph (A), the term "computer software" means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

(4) **Certain interests or rights acquired separately.**—Any of the following not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof:

(A) Any interest in a film, sound recording, video tape, book, or similar property.

(B) Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof.

(C) Any interest in a patent or copyright.

(D) To the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right—

(i) has a fixed duration of less than 15 years, or

(ii) is fixed as to amount and, without regard to this section, would be recoverable under a method similar to the unit-of-production method.

(5) Interests under leases and debt instruments.—Any interest under—

(A) an existing lease of tangible property, or

(B) except as provided in subsection (d)(2)(B), any existing indebtedness.

(6) Treatment of sports franchises.—A franchise to engage in professional football, basketball, baseball, or other professional sport, and any item acquired in connection with such a franchise.

(7) Mortgage servicing.—Any right to service indebtedness which is secured by residential real property unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.

(8) Certain transaction costs.—Any fees for professional services, and any transaction costs, incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C.

(f) Special rules.—

(1) Treatment of certain dispositions, etc.—

(A) In general.—If there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained—

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under clause (i).

(B) Special rule for covenants not to compete.—In the case of any section 197 intangible which is a covenant not to compete (or other arrangement) described in subsection (d)(1)(E), in no event shall such covenant or other arrangement be treated as disposed of (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into.

(C) Special rule.—All persons treated as a single taxpayer under section 41(f)(1) shall be so treated for purposes of this paragraph.

(2) Treatment of certain transfers.—

(A) In general.—In the case of any section 197 intangible transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of applying this section with respect to so much of the adjusted basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

(B) Transactions covered.—The transactions described in this subparagraph are—

(i) any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

(3) Treatment of amounts paid pursuant to covenants not to compete, etc.—Any amount paid or incurred pursuant to a covenant or arrangement referred to in subsection (d)(1)(E) shall be treated as an amount chargeable to capital account.

(4) Treatment of franchises, etc.—

(A) Franchise.—The term "franchise" has the meaning given to such term by section 1253(b)(1).

(B) Treatment of renewals.—Any renewal of a franchise, trademark, or trade name (or of a license, a permit, or other right referred to in subsection (d)(1)(D)) shall be treated as an acquisition. The preceding sentence shall only apply with respect to costs incurred in connection with such renewal.

(C) Certain amounts not taken into account.—Any amount to which section 1253(d)(1) applies shall not be taken into account under this section.

(5) Treatment of certain reinsurance transactions.—In the case of any amortizable section 197 intangible resulting from an assumption reinsurance transaction, the amount taken into account as the adjusted basis of such intangible under this section shall be the excess of—

(A) the amount paid or incurred by the acquirer under the assumption reinsurance transaction, over

(B) the amount required to be capitalized under section 848 in connection with such transaction.

Subsection (b) shall not apply to any amount required to be capitalized under section 848.

(6) Treatment of certain subleases.—For purposes of this section, a sublease shall be treated in the same manner as a lease of the underlying property involved.

(7) Treatment as depreciable.—For purposes of this chapter, any amortizable section 197 intangible shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.

(8) Treatment of certain increments in value.—This section shall not apply to any increment in value if, without regard to this section, such increment is properly taken into account in determining the cost of property which is not a section 197 intangible.

(9) Anti-churning rules.—For purposes of this section—

(A) In general.—The term "amortizable section 197 intangible" shall not include any section 197 intangible which is described in subparagraph (A) or (B) of subsection (d)(1) (or for which depreciation or amortization would not have been allowable but for this section) and which is acquired by the taxpayer after the date of the enactment of this section, if—

(i) the intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

(ii) the intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

(iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of this subparagraph, the determination of whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary. For purposes of this subparagraph, deductions allowable under section 1253(d) shall be treated as deductions allowable for amortization.

(B) Exception where gain recognized.—If—

(i) subparagraph (A) would not apply to an intangible acquired by the taxpayer but for the last sentence of subparagraph (C)(i), and

(ii) the person from whom the taxpayer acquired the intangible elects, notwithstanding any other provision of this title—

(I) to recognize gain on the disposition of the intangible, and

(II) to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest rate of income tax applicable to such person under this title,

then subparagraph (A) shall apply to the intangible only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized under clause (ii)(I).

(C) Related person defined.—For purposes of this paragraph—

(i) **Related person.**—A person (hereinafter in this paragraph referred to as the "related person") is related to any person if—

(I) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

(II) the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)).

For purposes of subclause (I), in applying section 267(b) or 707(b)(1), "20 percent" shall be substituted for "50 percent".

(ii) **Time for making determination.**—A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

(D) **Acquisitions by reason of death.**—Subparagraph (A) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a).

(E) **Special rule for partnerships.**—With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under this paragraph shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.

(F) **Anti-abuse rules.**—The term "amortizable section 197 intangible" does not include any section 197 intangible acquired in a transaction, one of the principal purposes of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A).

(g) **Regulations.**—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise.

(Added Pub.L. 103-66, Title XIII, § 13261(a), Aug. 10, 1993, 107 Stat. 532.)

§ 482. Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

(Aug. 16, 1954, c. 736, 68A Stat. 162; Oct. 4, 1976, Pub.L. 94–455, Title XIX, § 1906(b) (13) (A), 90 Stat. 1834; Oct. 22, 1986, Pub.L. 99–514, Title XII, § 1231(e)(1), 100 Stat. 2562.)