Trade Secrets/Non-Compete QUARTERLY UPDATE

2022-04

Happy New Year! We hope you and your family enjoyed the holidays. Q4 of 2022 did not see significant new state legislation enacted. The FTC, however, issued a strong notice about where it intends to go in the restrictive covenant space in 2023 (and beyond) and several trade secret verdicts deserve attention. In addition, could a Washington restrictive covenant class action be a harbinger of things to come? Below is our Q4 update and we invite our readers to attend our January 13th webinar, "2022 Trade Secret and Restrictive Covenant Year in Review," to learn more about what happened in 2022 and what to expect in 2023.

In This Issue:

No Significant Activity From State Legislatures in Q4 but the FTC Issues Additional Warnings and Looks Ready to Take Action.

Approximately 95 restrictive covenant bills were introduced in 27 different state legislatures in 2022, but none of these bills were introduced in the 4th quarter of 2022. Hence, the most significant 2022 restrictive covenant legislation came out of Illinois (effective January 1, 2022), Colorado (effective August 10, 2022) and Washington, D.C. (effective October 1, 2022). Companies need to make sure that they comply with these new statutes as all three statutes carry significant penalties for non-compliance. It is also worth noting that the two most significant pieces of legislation we followed in the second half of 2022, bills that would impose drastic limitations on the enforcement of restrictive covenants in New York and New Jersey, did not make it out of committee and, naturally, did not become law. It remains to be seen, however, if the New York and New Jersey legislatures pick up restrictive covenant legislation in 2023 (We expect that they will).

On the Federal side, there was little meaningful activity in Congress with respect to restrictive covenants. Instead, the most significant activity coming out of Washington, D.C. (outside of the District's restrictive covenant statute) was from the Federal Trade Commission (FTC). As readers of our updates and client alerts know, the FTC, pursuant to President Biden's Executive Order, is considering using its statutory rule making authority "to curtail the unfair use of non-compete clauses

continued on next page

and other clauses or agreements that may unfairly limit worker mobility." On November 10th, right before Veteran's Day weekend, the FTC issued a "policy statement regarding the scope of unfair methods of competition under Section 5 of the Federal Trade Commission Act." The policy statement broadens the FTC's enforcement powers beyond just anti-trust laws and, according to FTC Chairwoman Lina Khan (a loud opponent of restrictive covenant agreements), allows the FTC to engage in "more legal challenges against businesses engaging in alleged coercive or deceptive conduct that undermines competition." Although the FTC has not taken any "restrictive covenant action" against a specific corporation or industry, the saber rattling from the FTC and its Chairwoman likely means that the FTC is preparing to do so in 2023. This is significant not only because it puts companies on notice that the FTC may come knocking on its door, but also because, before the November 10th policy statement, most watchers (us included) thought that the FTC's most likely action would be issuing policies/guidelines/rules regarding restrictive covenants. In addition, if the FTC continues along this path, it will be interesting to see the response from Congress, State legislatures, and companies as there are significant questions as to whether the FTC does, in fact, have jurisdiction over restrictive covenants. We will continue to monitor the situation and provide any updates where possible.

A Delaware Court Strikes Down Seller Non-Competition Restrictions, the Automotive Industry Gets Tagged in its Own Backyard, and Broccoli Trade Secrets Cost a Competitor $7M

It has long been the perception—mostly a correct perception—that restrictive covenants in a sale transaction will receive little scrutiny and generally be enforceable except in the most egregious of circumstances. This is why the Delaware Chancery Court's decision in the case of *Kodiak Building Partners, LLC v Adams* stands out. In *Kodiak*, Adams and his three partners sold their business to Kodiak. In connection with the sale, Adams entered into several restrictive covenant agreements and then proceeded to violate the covenants. Kodiak, as is the case with most buyers who feel wronged by a seller violating his/her non-competition agreement(s), sued Adams and sought to enjoin his competition. To the surprise of Kodiak (and perhaps everyone), the court refused to enforce the non-competition covenants because the covenants covered all of Kodiak's business lines instead of just the business lines and locations that Adams sold to Kodiak. In an additional surprise, the Delaware court chose to **not** blue pencil the restrictions in Adams' non-competition agreement because, in large part, Kodiak had the opportunity to "get it right the first time." Since many corporations use Delaware law and forum provisions in their restrictive covenant agreements, the *Kodiak* decision is and should be a reminder to both buyers and sellers that sale agreement(s) should be reviewed by restrictive covenant counsel before the sale closes in order to ensure that the restrictive covenants in the sale agreement(s) are enforceable.

On the jury verdict side, the two most notable cases involve automotive industry companies losing trade secret trials in their own backyard. A Federal Jury in Akron, Ohio found that Goodyear misappropriated technology trade secrets from CODA Development relating to self-inflating tire technology. The jury awarded $2.8 million in compensatory damages and $62.1 million in punitive damages. Although the court will likely reduce the punitive damages award, the jury also found that Goodyear's misappropriation was "willful and malicious." Consequently, Goodyear will likely have to pay several million dollars in legal fees as the case has been hotly contested since 2015 and has already made one trip to the Appellate Court.

Like Goodyear, Ford suffered a trade secret trial loss in its hometown of Detroit, Michigan in Q4. Versata, a software configuration company, alleged that Ford breached a licensing agreement with Versata and stole Versata trade secrets. A Detroit jury agreed and awarded Versata $105 million. Interestingly, the jury did not find Ford's misappropriation to be "willful

continued on next page

and malicious." As a result, Ford will not have to pay Versata's attorneys' fees pursuant to the Michigan and/or Federal Trade Secrets Act (although it may have to pay Versata's attorneys' fees if there is an attorneys' fees clause in the licensing agreement). The Goodyear and Ford jury verdicts are a not-so-pleasant reminder to corporations that requiring lawsuits be brought in the corporation's backyard does not always guarantee a friendly jury, especially when a jury believes that trade secrets were stolen.

Lastly, a diet supplement maker's $7 million trade secret verdict against a former executive who stole R&D information relating to broccoli seeds and sprouts was upheld by the Sixth Appellate Circuit. Caudill Seed and Warehouse Company alleged that its former director of research left the company and took R&D information about its broccoli seeds and sprout products to competitor Jarrow Formulas. In response, Jarrow argued that the majority of stolen information was public information that could not achieve trade secrets status and, at worse, Jarrow only used "some" of the stolen information. The Sixth Appellate Circuit rejected Jarrow's contentions and upheld the jury verdict. In doing so, the Sixth Appellate Circuit specifically noted that "it would not make a good deal of sense" to maintain that a trade secret victim could not recover damages from a defendant unless the defendant used *all* of the stolen trade secrets and that publicly available information can be a trade secret if the public information is used and/or compiled in a confidential manner. Thus, as long as Jarrow used *any* portion of Caudill's trade secrets (which Jarrow did), then Jarrow was responsible for the jury's $7 Million trade secret verdict.

The First Restrictive Covenant Class Action Surfaces in Washington

85% of all trade secret and/or restrictive covenant cases are brought against a former employee or business partner. In the past, these cases were typically brought in the forum selected by the agreement between the company and its employee/business partner and governed by the laws of that forum. Yet, as more and more states enact legislation that negates choice of law and forum provisions in restrictive covenant agreements and, instead, requires their own state law apply to these agreements, trade secret attorneys have been on the look-out for proactive filings by employees seeking to void restrictive covenant agreements. Such proactive filings would not be surprising since some new statues, like the Illinois Restrictive Covenant Statute enacted in January, allow for the recovery of an employee's attorney's fees if the employee is successful in striking down a restrictive covenant agreement.

The first such action appears to have been filed in Washington state court against E-Financial. In the Washington state court Complaint, the plaintiff is seeking a class action based upon E-Financial's alleged practice of having its employees sign a non-competition agreement that fails to comply with the Washington Non-Competition statute. The case has just been filed so there is little to go on other than the Complaint, but this case needs to be monitored given that, if successful, similar class actions could follow either in Washington or other states.

A Chinese Spy Receives Significant Jail Time for Trying to Steal General Electric's Trade Secrets

Over the past couple of years, the Department of Justice has been active with respect to trade secret theft arising from or relating to individuals with ties to the Chinese government. In Q4 of 2022, a Chinese spy was sentenced to two decades in federal prison for trying to steal trade secrets from General Electric ("GE"). The spy approached a GE aviation engineer to steal GE's trade secrets. The engineer alerted the FBI to the spy's overtures and the FBI then took over talking to the spy and arrested the spy after the spy gave the engineer instructions on how to download and bring GE trade secrets to China. The 20 year sentence is the largest sentence for trade secret theft involving a Chinese nationalist.

continued on next page

Conclusion

Benesch's Trade Secret, Restrictive Covenants and Unfair Competition Group will continue to monitor important activities in, and changes to, the trade secret and restrictive covenant space; and we encourage all clients to attend the Group's January 13th webinar, "2022 Trade Secret and Restrictive Covenant Year in Review," to learn more about what happened in 2022 and what to expect in 2023. In addition, the Group will provide periodic updates regarding new statutes, government actions, and case opinions that may impact the ability to enforce restrictive covenants or protect trade secrets. For the first quarter of 2023, the Group is offering a flat fee review of restrictive covenant agreements in order to ensure that the agreements comply with the 2022 changes to restrictive covenant law, and CLE seminars on best practices for handling a trade secrets audit, drafting restrictive covenant agreements, and preparing for, or defending against, a restrictive covenant and/or trade secret case. Please contact any member of the Group if you would like to hear more about these offerings and/or SCOTT HUMPHREY at 312.624.6420 or shumphrey@beneschlaw.com.