

COMMENTS ON TRADE SECRET SHARING IN HIGH VELOCITY LABOR MARKETS

As excerpted from

ECONOMIC ANALYSIS OF LABOR AND EMPLOYMENT LAW IN THE NEW
ECONOMY:
PROCEEDINGS OF THE 2008 ANNUAL MEETING, ASSOCIATION
OF AMERICAN LAW SCHOOLS, SECTION ON LAW AND ECONOMICS

Professor Michael V. Risch:¹ Good Afternoon. I am thrilled to be here talking about what I think is a critically important but under-studied topic: information transfer in the labor market, which I view to be mainly a trade secret issue. I think that Law and Economics provides a really good intersection for labor and intellectual property policy. What you heard just now is mostly on the labor side. I am going to focus more on the intellectual property side, primarily because that's the angle I'm coming at it from, but also because I think the analysis comes together very nicely.

Points of Agreement

I generally agree with both the analysis and conclusions from Professor Hyde's book² and what he presented here as well. The two things I really liked in the book were: first, the accurate portrayal of Silicon Valley, which was admittedly stylized in the book. I've spent a lot of time in Silicon Valley and I thought the depiction was pretty accurate. It was nice to see that later studies confirmed the reality I saw; that's always a good thing.

Second, the point that was emphasized in the book, and that was made here as well, is the notion that trade secret law is not critical to innovation and productivity. I tell

¹ Associate Professor of Law and Project Director of the Entrepreneurship, Innovation, and Law Program, West Virginia University College of Law. Footnotes are material not included in the original presentation.

² ALAN HYDE, *WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET* (2003).

a slightly different reason why this is true, but it is nice to see support for that position both in theory and in the data we have seen, and I think that that is very helpful for the study of trade secrets.

So, given these points of agreement, what I want to focus on are three areas of comment for both extension and further study based on what Professor Hyde just talked about. The first is a little bit of discussion about trade secret law in California as discussed in the book. There wasn't much discussion of the law today and California's trade secret law was assumed to be very weak, even though that law is the same on the books as in every other state. Professor Hyde posits that the reason for weak law is to enhance productivity — I want to talk about that a little bit. Second, I want to talk about what we should do about trade secrets; I want to talk about some policy and areas for research. And number three, I want to talk about how some of the arguments and data we have just seen fit into what I think is a broader economic framework of how we look at protection of information, and I am not sure it necessarily relates to just high velocity markets.

The Vitality of Trade Secret Law in California

Starting with weak trade secret law, I think the rumors of trade secret law's demise in California are a bit exaggerated. A current update on the law there, however, is that trade secrets are under attack. California, just yesterday, came out with new trade secret jury instructions — so this will be the law of the land, of the state land — where the definition of trade secrets that will be told to juries is significantly stricter than the definition of trade secrets that is on the books.

I know this, unfortunately, from experience. I just lost an appeal this last summer on the definition of trade secrets where basically the Court of Appeal in Santa Clara County said, “Yeah, we know the statute says ‘economic value’ but what you really must have is ‘substantial benefit over your competitors.’” This requirement is not in the statute, but it is now going to be in the jury instruction, so I think to some extent we are seeing a weakening of protection.

Second, covenants not to compete are illegal *per se* in California. There is currently pending a case before the California Supreme Court where the court is deciding whether or not there should instead be a rule of reason despite the fact that for one hundred years the rule has been an absolute ban; we will see what happens with that.³ The inability to enforce non-competes, however, makes it harder protect trade secrets.⁴

That said, I am not sure that trade secret law is weak when it really matters. I have five quasi-empirical points from my fifteen years of experience with trade secrets and information management in California.⁵ I haven’t done an empirical study, but having conducted a lot of discovery in litigation and interviews, etc., I have seen what trade secrets are actually taken by ex-employees, both when there is a lawsuit and when there is not.

³ The California Supreme Court has since reaffirmed the absolute ban on covenants not to compete. *Edwards v. Arthur Andersen LLP*, 44 Cal. 4th 937 (2008).

⁴ Employers must prove that ex-employees misappropriated information, which is more difficult than simply proving that they are competing.

⁵ In the fifteen years I spent working at a Silicon Valley IP law firm before, during, and after law school, I had the opportunity to participate in countless trade secret matters, including litigation, threatened litigation, start-ups, IP audits, company policy drafting, and employee entrances and exits. In doing so, I have elicited or read thousands of witness statements gathered by interview, deposition, and trial. I have reviewed hundreds of thousands of pages of documents and source code. Finally, I have prosecuted or defended many trade secret claims from temporary restraining orders to summary judgment and through trial. The empirical basis for this information is decidedly unscientific, but I nonetheless draw the conclusions discussed from my experience.

Here are the five points. Number one, departing employees rarely directly compete when they come up with a start-up company. Usually they are developing some offshoot idea and they are exploiting something that is more akin to a corporate opportunity. It's something the old employer doesn't want to do and, therefore, the employee wants to spin-off. It is exactly at that point where you would expect to see high productivity from network information because you are really creating add-ons. You are coming up with complementary components rather than directly competing.

Second, and I think this is a critical point for the broader framework I will get to later, the information that is usually taken once you get down to the actual detailed facts is almost never as important and valuable as the employer fears it might be.⁶ Now, of course, what's in the head you don't know—but if you look at what's actually transmitted on paper and discussed in e-mails, etc., rarely do you see the “crown jewels” misappropriated.⁷ This is a neutral observation; I've seen it on the employer side as the plaintiff and I've seen it on the employee side as the defendant. I remember receiving extensive discovery in many cases where we were planned to find out just how much information the defendants took, only to look at the paper trail and say, “There is nothing here!” Of course, when you represent the employee, you say that nothing was taken from the beginning as a matter of course; when you actually receive your client's discovery and find out that the denials are true, it is quite helpful.

⁶ I suspect that when employers report in Professor Hyde's book that they routinely receive and use information that ex-employees bring from another company, such information is almost never core technology and instead is “soft” information about direction, marketing, experience, and failures.

⁷ To be sure, there are exceptions. The Cadence versus Avant! case is a notable exception where there was a large scale misappropriation and a directly competing product. *Cadence Design Sys. v. Avant! Corp.*, 125 F.3d 824 (9th Cir. 1997). Thus, “crown jewel” misappropriation does occur from time to time, including in my own experience. Those, however, are the easy cases.

For the third point, for the above two reasons and as Professor Hyde points out, it is extremely difficult for a plaintiff to win a case at trial and through appeal for a trade secret claim. That leads to point number four, which is that most trade secret cases are punitive in nature.⁸

This leads to point five: Does trade secret law still exist in California? The answer is “yes:” if there really is valuable, directly-competitive information that’s taken, then California provides a very strong remedy.⁹ If there is evidence, a plaintiff can certainly get past summary judgment and to a jury, so plaintiffs can get some sort of relief. In other words, if one shares a “real” trade secret improperly, California law provides a penalty.¹⁰

Points of Further Study

One area for further study that I would recommend here is to determine – if it is true that there is widespread sharing in high velocity labor markets even though trade secret remedies are available – what is the type of information that is being shared? The patent citation study¹¹ discussed by Professor Hyde shows there is some sharing of information. However, patents are public; the inference that is being made here is that there is a bunch of non-public information that gets shared with the patent information and, therefore, because of the regional clumping in patent citations we can assume that

⁸ Or perhaps they are strategic – designed to give the old employer time to enter the market now that it sees the opportunity for whatever the ex-employees are working on.

⁹ For example, while anti-competitive rules like “inevitable disclosure” are not available to plaintiffs, the fact that information is “readily ascertainable” does not negate such information’s trade secret status. Instead, a defendant who has misappropriated secret information must show that the information was in fact “readily ascertained” from some other source. *Abba Rubber Co. v. Seaquist*, 235 Cal. App. 3d 1 (1991).

¹⁰ Further, it is difficult to square a model of “lax protection” of information with the growing number of patent infringement lawsuits. Thus, even if the conclusion that trade secret law is alive and well is wrong, it could simply be that weak trade secrets law has been replaced by strong patent law. In other words, failure to protect secret information will not reduce the amount of information produced, just the type.

¹¹ ADAM B. JAFFE AND MANUEL TRAJTENBERG, *PATENTS, CITATIONS & INNOVATIONS* (MIT Press, 2002).

there is non-public information sharing that allows competitors to learn about local secret patenting activity. Instead, I think further study as to the quality, quantity, and type of information that is being transmitted will be very helpful, and I have my own theory that I will get to it in a minute.

Second, something that wasn't discussed much today is that one suggested way to address the high velocity labor market is to let employees own the information and then, after the fact, have employers negotiate to obtain rights to some of that information. The theory is that the implicit high velocity employment contract says that the employee will be gone in eighteen months¹³ and, therefore, should be able to take the information with him or her unless the employer negotiates to keep it. I think the areas for further study relate to what markets actually do with information ownership.

I can give four categories. The first group consists of idea people – some call them patent trolls. They come up with brilliant (or not so brilliant) inventions, and they may try to commercialize them. More likely, they try to sell them to people. Sometimes they are successful and sometimes they are not, but the idea is that they are doing it on their own dime. Second are founders of companies. These are people who work for very little money (sometimes for free) developing their ideas with the hope that their ideas will be commercialized and be a great product and make them lots of money. Third, we have professors who earn less than their industrial counterparts but typically get to keep 50% of the inventions they make without risking their own assets. Fourth, you have employees who right now don't get to keep any of their trade secrets.

I would say that we don't want to mess with these market categories without a lot of further study; the idea of saying employees should now have much more ownership of

¹³ That is, there is no promise of lifetime employment and thus the employment contract is less valuable.

the trade secrets they develop could significantly affect their wages.¹⁴ If employees want to take the risk of getting to keep information when they leave when that information is important and directly competitive to the employer, then the employer is not going to pay them very much.¹⁵ The employer might give them 100% stock and if the idea is successful, then great and if it is not, then all are taking that risk.

One analog I would want to look at is patent ownership. Currently, the default rule is that the employee gets to keep the patent. The employer gets a shop right usually, but employees can quit and keep the patent and do what they want with it.¹⁶ Of course, we all know that no employee gets hired unless he or she signs an assignment that says the employer owns all patents. So, if we had a rule that weakened trade secrets and said that employees get to keep the trade secrets, then employers will just ask them to sign an assignment, which they already do anyway for patents.¹⁷ In California, by the way, the statutory rule is that employers own all the information that is generated by employees;¹⁸

¹⁴ The *ex post* proposal is arguably not even necessary. Employees who want to own their ideas can take the risk at their own expense and reap the rewards. If they do not want to take a risk, they can become an employee and let the company take the risk and bear the reward. This ties to an earlier observation; many trade secret cases are really fallout from corporate opportunity issues, where the employee believes that the employer is not running with the idea, and wants to leave to take the risk of developing the idea.

¹⁵ Another consideration that needs more development is that the employer does not know which ideas will lead to profits. This is one reason we countenance exclusivity in patents - to induce research in areas that may fail, we must allow above market returns for ideas that succeed. Allowing employees to own everything and then doing an after the fact negotiation of only the valuable ideas would skew expected returns and thus fundamentally change the employment market.

¹⁶ Robert P. Merges, *The Law and Economics of Employee Inventions*, 12 *Harv. J. Law & Tech.* 1, 7 (1999).

¹⁷ With patents, default is *not* that the employer owns the invention, yet we see employers hiring only on assignment. Thus, if trade secrets were owned by the employee, there is no reason to expect anything different – signing of an assignment as a condition of employment. Even if there were no assignment, we must look at *ex ante* pricing of employment - employees would now be given a choice: current wages with the assignment, or small wages with bonus without the assignment, where the bonus is paid for actual production and assignment of information. This outcome could be even worse for the employee, as employees who fail to perform might get paid nothing.

¹⁸ Professor Hyde and I diverge on this. Hyde says it is "barbaric" for an employee to be forced to disclose what is in his or her head, while I say that such information is what the employee was paid for.

I believe the transaction cost of doing it the other way around would be prohibitive.¹⁹ So, my second point essentially is we have to do a lot more study about what would happen in the market if we changed the rules about who owns information.

Broader Framework

This leads to my last point, which is how can we fit the arguments that we have seen here into a broader economic framework? The framework I am going to discuss was first developed by Friedman, Landes & Posner.²⁰ I extended it in a recent article²¹ which is why, of course, I like it. In that article, I looked at remedies and attorney's fees because those are very important to the efficient operation of trade secret laws. The basic gist of the argument is to look at the cost of protection and the cost of attempts to discover information rather than at the incentive to create information.

Under a cost minimization theory, we should not simply protect information that would not have been created otherwise, which is a primary policy suggested by Professor Hyde. Professor Hyde's proposal is that if trade secrets are not necessary for innovation,²² then we should only protect that information which would never have been created without trade secret law.

The problem with this theory is that companies are going to continue to create as much information as they can and the only real question is what they will do to protect that information. In trade secret law, providing a remedy causes companies to spend less money protecting information. Sometimes that means secret information is improperly

¹⁹ As a practical matter, exit interviews are not a negotiation. Additionally, the more valuable the information is to the employer, the more likely there will be an inefficient "hold-up." Merges, *supra* note **, at 13.

²⁰ David D. Friedman, et al., *Some Economics of Trade Secret Law*, 5 J. ECON. PERSP. 61, 62 (1991), *reprinted and expanded*, WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW* 355 (2003).

²¹ Michael Risch, *Why Do We Have Trade Secrets?*, 11 MARQUETTE INT. PROP. L. REV. 1 (2007).

²² This is a point on which Professor Hyde and I agree, though we disagree on the implications.

shared. That's okay, because what trade secret law does is create a full internalization so that the amount of value to each of the parties will affect what happens.

So, for example, if the information value is low, we are not likely to see companies enforce their trade secret rights. That, I believe, is what is happening in the story that Professor Hyde tells about information sharing in high velocity labor markets. It is true that many companies don't enforce their trade secret rights and it is true that employees leave with trade secrets. I believe, however, if we actually looked at the type of information being shared, it is not high value information like source code. Instead, I think we would find that it is general experience-“plus.” And that “plus” is not valuable enough to warrant the filing of a trade secret case. But it really doesn't matter how much the value is; under full internalization, if the user of the information, the alleged misappropriator, believes that there is a high value then he or she will have to return some of that value back to the company that originated the information. And, if the value is high enough, the risk of trade secret damages is worth it to the employee and we will then have to consider more complex questions of enforcement, attorney's fees, etc.

Professor Hyde refers to some of this in his book. He points out that employers will choose not to sue; the question is whether that is an efficient protection of information and it probably is.

However, Professor Hyde dismisses the “reduced protection expenditures” theory in his book because there is not a lot of evidence to support it. However, I look at the lack of evidence like the train paradox. We know there is nobody standing on the platform at noon; therefore, we do not need a new noon train. Of course, there is no train scheduled at noon so obviously there is nobody standing on the platform. Thus, I think

the area of further study here is to look comparatively at what happens when we have no trade secret protection versus trade secret protection. The problem we have in the U.S. is that the default rule is trade secret protection. So, comparing behavior with low protection versus high protection is tough when there is no alternative regime.

I have a data point of one on this issue. I had an old client who was bragging to me about his company's new facility in China and how they had retinal scanners, how they have a setup like casinos with a catwalk and people looking down, how they have no USB ports on computers, locks on the CD ROMs, and very limited internet access. I was thinking to myself, "Boy, is that expensive!" The company does not have any of those precautions here in the U.S. I think the only thing that justifies the higher level of protection is that in China did not believe they had a remedy for misappropriation. So the company spent much more on protection.²³

I think looking comparatively at behavior in countries with high protection versus behavior in countries with low protection will flush out just how much of the story has to do with protection of information versus some other story.

Finally, with respect to covenants not to compete, one theory that Professor Gilson had many years ago is that companies would be more aggressive with trade secret litigation where covenants not to compete are disfavored.²⁴ I don't think we have good data on that, but I think it is something we want to study. I think that if the California

²³ Also, Robert Sherwood describes the costly efforts that businesses in Brazil and Mexico exert in an attempt to keep information secret in the absence of meaningful trade secret protection. ROBERT M. SHERWOOD, *INTELLECTUAL PROPERTY AND ECONOMIC DEVELOPMENT*, 117-119 (1990).

²⁴ Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*. 74 N.Y.U. L. REV, 575 (1999). The point is that lack of enforceable non-compete agreements does not mean that trade secret protection is weak; instead, it means that companies are more likely to enforce trade secret rights.

Supreme Court scales back covenant not to compete bars, which I think is unlikely,²⁵ we would actually have some comparison of the amount of trade secret enforcement actions before and after that turning point.²⁶ Those are my short comments-- which ran a little bit long -- on trade secret; thank you again for the opportunity to comment.

²⁵ And which it did not.

²⁶ This would also bear on another point Professor Hyde makes. Non-compete agreements should be disfavored *not* because they stop the sharing of trade secret information, but because they hinder start-up companies from exploiting tangentially competitive ideas that their former employers were unable or unwilling to pursue. Such a race to innovate is not possible with a non-competition agreement hanging over an ex-employee's head.