1st Circ. Ruling Is Cautionary Trade Secret Tale For Employers

By **Dawn Mertineit** (August 28, 2020)

In a rare appellate decision on enforceability of nondisclosure agreements and a plaintiff's burden to establish the existence of trade secrets, the U.S. Court of Appeals for the First Circuit recently overturned a district court summary judgment order and trial verdict in TLS Management and Marketing Services LLC v. Rodriguez-Toledo.[1]

Dawn Mertineit

This decision serves as an important reminder for both those who litigate trade secrets claims and those who draft restrictive covenants agreements.

Background

TLS Management and Marketing Services, a tax planning and consulting firm, sued its former employee, Ricky Rodríguez-Toledo, for alleged misappropriation of trade secrets under Puerto Rico's misappropriation law and breach of his NDA with TLS.

TLS claimed two trade secrets germane to the litigation: the so-called U.S. possession strategy — essentially a tax arbitrage strategy designed to help clients avoid higher mainland taxes; and capital preservation reports, or CPRs — client-specific reports with tax recommendations based on an analysis of applicable statutes and regulations.

TLS alleged that after leaving its employ, Rodríguez-Toledo used the U.S. possession strategy and certain CPRs without TLS' consent to service the client. In fact, Rodríguez-Toledo conceded that before he left TLS, he had downloaded information from TLS' Dropbox account without authorization, and later referred to TLS information in emails with clients.

On the parties' summary judgment cross-motions, the U.S. District Court for the District of Puerto Rico determined that Rodríguez-Toledo had breached the NDA by using the U.S. possession strategy after his departure from TLS. After a bench trial, the district court also found in TLS' favor on the misappropriation claim, holding that both the CPRs and the U.S. possession strategy were trade secrets, which Rodríguez-Toledo had misappropriated.

The court also issued a permanent injunction prohibiting Rodríguez-Toledo from "using or disclosing any of TLS's 'confidential information' or its trade secrets" as defined in the NDA.

Trade Secrets

On appeal, the First Circuit reversed the district court's trial verdict in TLS' favor, finding that it had failed to demonstrate the existence of trade secrets. In doing so, the court addressed the unique challenges of relying on trade secret protections, compared to other forms of intellectual property such as patents, copyrights or trademarks:

> [M]ost forms of intellectual property have boundaries that are defined before the commencement of litigation … Trade secrets are different. There is no requirement of registration and, by definition, there is no public knowledge of the trade secret in advance of litigation. Even the defendant is not necessarily on notice of the trade secret before litigation. This raises the possibility that the trade secret owner will tailor the scope of the trade secret in litigation to conform to the litigation strategy.

In light of the "potentially amorphous nature of trade secrets," the court noted that a trade secret owner bears the burden of proving the "existence and scope of the alleged trade secret."

Ultimately, the court determined that TLS had failed to carry its burden for either alleged trade secret. Despite TLS' claim that the compilation of its employee's knowledge and skill provided it with a competitive advantage in the form of the CPRs, the court observed that the reports included voluminous publicly available information, and TLS conceded that the individual client information contained in the reports was not a trade secret.

Given that TLS was unable to explain what portion of the CPRs contained information rising to the level of a trade secret, but rather resorted to general descriptions, the First Circuit held that TLS had not established that the CPRs were trade secrets.

Likewise, the U.S. possession strategy largely consisted of public knowledge, used openly by competitor firms. Moreover, even as to the parties' conflicting testimony as to one portion of the strategy that TLS contended was not known to its competitors, the First Circuit held that "TLS could not claim a trade secret protection simply because its loan strategy was not publicly known."

According to the First Circuit's opinion, "TLS also had to establish that this aspect of the strategy was not readily ascertainable from public sources." In other words, it was not enough that competitors did not know all aspects of the strategy; TLS would have had to show that even with reasonably diligent efforts, its competitors could not discover the strategy.

NDA

Perhaps to TLS' surprise and chagrin, the First Circuit likewise reversed the district court's summary judgment order on the breach of the NDA claim.

While practitioners in many jurisdictions may assume that NDAs, as opposed to more onerous restrictive covenants such as noncompetes and nonsolicits, are easily enforceable and not subject to judicial scrutiny, this decision is an important reminder that all restrictive covenants must be narrowly tailored and bear a reasonable relationship to an employer's legitimate business interests.

The court identified several instances in which an NDA might be overbroad, pointing out that an employer's interest "does not extend to prohibiting the employee from using general knowledge acquired by the employee," and clarifying that even where such knowledge and skill was developed during employment, that alone is insufficient to support a restrictive covenant.

The court also pointedly disapproved of NDAs prohibiting disclosure of information that is not, in fact, confidential, or prohibiting use of information "properly provided ... by third-party sources." The NDA between TLS and Rodríguez-Toledo, hit all these high (or low) notes, as it prohibited disclosure of virtually any information that Rodríguez-Toledo obtained while working for TLS, with extremely limited exceptions.

Perhaps the most surprising aspect of the court's order, however, was its decision not to reform the NDA by narrowing its scope to be reasonable and enforceable.

While the First Circuit pointed to the Puerto Rico Supreme Court's guidance, in the context of noncompetes, that the court may not modify overbroad covenants, it also highlighted in a footnote that "other mainland U.S. courts have reached the same conclusion as to nondisclosure agreements," and hinted that revising an overbroad covenant might be contrary to public policy — even in jurisdictions that typically allow reformation.

Takeaways

This rare decision from the First Circuit is instructive to trade secret and restrictive covenants practitioners, and offers several important takeaways.

First, it serves as a reminder that plaintiffs asserting misappropriation claims must be prepared to explain, in sufficient detail, why their alleged proprietary information meets the statutory definition of a trade secret, and cannot rest on generalities — especially when it relates to compilations of information that include both public and private information. This follows the general trend of defendants holding plaintiffs' feet to the fire in demanding that plaintiffs describe with particularity the trade secrets at issue.

The decision also confirms that it is also not enough to show that an alleged trade secret is not generally known in the industry; rather, a plaintiff must show that it cannot be readily discovered through public sources.

Additionally, this case highlights the need for employers to carefully draft their restrictive covenants agreements to be only as restrictive as necessary to protect a legitimate business interest. Even NDAs, typically considered the least scrutinized of all restrictive covenants, must still satisfy this basic requirement.

Finally, it serves as a cautionary tale that employers cannot simply rest on an assumption that a court will reform an overbroad covenant to render it reasonable. While the First Circuit rested primarily on Puerto Rico's nonreformation approach, its footnote hints at judicial disapproval and invalidation of excessively overbroad covenants, even in reformation jurisdictions.

Dawn Mertineit is a partner at Seyfarth Shaw LLP.

[1] TLS Mgmt. & Marketing Servs., LLC v. Rodriguez-Toledo, 2020 WL 4187246 (1st Cir. July 21, 2020).