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Expert Analysis

Unfair Competition and Trade Secrets Damages Limited to Plaintiff's Losses

When a defendant avoids the cost of developing its own technology by stealing proprietary information, can that defendant be required to repay the cost it saved as compensatory damages?

Not under New York trade secret or unfair competition law. In *E.J. Brooks Co. v. Cambridge Security Seals*, No. 26, 2018 BL 157167 (N.Y. May 3, 2018), a divided New York Court of Appeals announced – over a lively dissent – that compensatory damages for misappropriation of trade secrets and unfair competition are limited to the plaintiff's own losses, and may not include the development costs avoided by defendants. The court further held that an accompanying claim for unjust enrichment does not provide a basis to expand the recovery beyond the plaintiff's own losses.

By **Muhammad U. Faridi**

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E.J. Brooks Company, operating as TyndenBrooks, manufactures plastic security seals. After several TyndenBrooks employees defected, taking with them a confidential automated process for manufacturing seals to rival Cambridge Security Seals, TyndenBrooks sued Cambridge in U.S. District Court for the Southern District of New York, alleging common law misappropriation of trade secrets, unfair competition, and unjust enrichment. Id. at *1. At trial, TyndenBrooks sought damages measured by the development costs Cambridge had avoided (i.e., "avoided costs") as a result of its theft of the manufacturing process. Cambridge was found liable on all three causes of action by a jury. It was awarded $3.9 million in compensatory damages, split evenly between the three claims. The jury declined to award punitive damages. Id. at *2.

Cambridge appealed the damages award (including the district court's assessment of prejudgment interest), arguing that damages based on avoided costs are not permitted under New York law. The Second U.S. Circuit Court of Appeals concluded that New York law was unsettled and that, particularly given the "careful policy judgments" implicated by the issues, certification to the N.Y. Court of Appeals was appropriate. *E.J. Brooks Co. v. Cambridge Security Seals*, 858 F.3d 744, 752 (2d Cir. 2017).

The Second Circuit certified two questions to the Court of Appeals: (1) "[w]hether, under New York law, a plaintiff asserting claims of misappropriation of a trade secret, unfair competition, and unjust enrichment can recover damages that are measured by the costs the defendant avoided due to its unlawful activity"; and (2) if so, whether prejudgment interest under New York CPLR Section 5001(a) is

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mandatory when damages are based on avoided costs. *E.J. Brooks Co. v. Cambridge Security Seals*, No. 26, 2018 BL 157167, at *3 (N.Y. May 3, 2018) (quoting *E.J. Brooks Co. v. Cambridge Security Seals*, 858 F.3d 744, 752 (2d Cir. 2017)).

New York Court of Appeals Decision

By a vote of 4 to 3, the Court of Appeals answered the first certified question "no" in an opinion by Judge Paul Feinman, joined by Chief Judge DiFiore and Judges Stein and Garcia.

The touchstone of the Court's holding was that the "[t]he fundamental purpose of compensatory damages is to have the wrongdoer make the victim whole." *E.J. Brooks Co.*, 2018 BL 157167, at *3 (internal quotation marks omitted). In the court's view, that principle could not support damages beyond the actual losses incurred by a plaintiff under any of the three causes of action.

Turning first to unfair competition, the court pointed to several rulings from the Appellate Division for the principle that unfair competition "[d]amages must correspond to 'the amount which the plaintiff would have made except for the defendant's wrong . . . not the profits or revenues actually received or earned' by the defendants." *Id.* at *4 (quoting *McRoberts Protective Agency, Inc. v. Lansdell Protective Agency, Inc.*, 61 A.D.2d 652, 655, 403 N.Y.S.2d 511 (1st Dep't 1978). Although courts "may award a defendant's unjust gains as a proxy for compensatory damages," the Court of Appeals emphasized that such a reference to defendant's gains required "'some approximate relation of correspondence, a causal relation not wholly unsubstantial and imaginary, between the gains of the aggressor and those diverted from his [or her] victim.'" *Id.* at *5 (quoting *Underhill v. Schenck*, 238 N.Y. 7, 17, 143 N.E. 773 (1924)). Ultimately, "the measure of damages in a trade secret action must be designed, as nearly as possible, to restore the plaintiff to the position it would have been in but for the infringement." *Id.* at *6.

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With respect to trade secrets, the court adopted the First Department's ruling in *Hertz Corp. v. Avis, Inc.* for the proposition that "trade secrets damages may not be measured by a defendant's increased profits, except to the extent that those profits are evidence of the plaintiff's own losses." *Id.* at *7 (citing *Hertz Corp. v. Avis, Inc.*, 106 A.D.2d 246, 485 N.Y.S.2d 51 (1st Dep't 1985). The court held that since trade secrets damages must be measured "by the losses incurred by the plaintiff," avoided costs were not an appropriate measure because they are "tied to the defendant's gains rather than the plaintiff's losses." *Id.* at *7-8.

Finally, the court held that avoided costs were not an appropriate measure of unjust enrichment damages because they are not saved "'at the plaintiff's expense,'" as required to recover for unjust enrichment. *Id.* at *8 (quoting *Mandarin Trading Ltd. v. Wildenstein*, 16 N.Y.3d 173, 182, 944 N.Y.2d 1104, 919 N.Y.S.2d 465 (2011)) (internal brackets omitted). The court emphasized that unjust enrichment is not a catch-all tort to address residual unfairness, but a narrow quasi-contract cause of action that applies only when the circumstances create "an equitable obligation running from the defendant to the plaintiff" that the law will recognize "to assure a just and equitable result." *Id.* at *8-9 (internal quotations omitted). Since a defendant's avoided costs are not taken or withheld from the plaintiff itself in the context of misappropriated trade secrets, the defendant's ill-gotten savings are not "at the plaintiff's expense" for the purposes of quasi-contract law.

Having concluded that avoided costs were not cognizable damages under each of the three theories, the Court of Appeals answered "no" to the Second Circuit's first certified question, and declined to address the second.

The Dissent

Judge Rowan Wilson wrote a lengthy dissent, joined by Judges Rivera and Fahey, voicing four fundamental disagreements with the majority opinion.

First, the dissent sharply criticized the majority's methodology in addressing certified questions. The majority opinion, it argued, took a bottom-up approach to the question that both shirked the court's duty to issue a "broad pronouncement of law" and usurped the federal court's jurisdiction over the underlying case. The dissent also faulted the majority for declining to engage with the policy considerations of its ruling, an omission the dissent found troubling because the Second Circuit had described the issue of trade secrets damages as an "unresolved policy decision." *Id.* at *10 (Wilson, J., dissenting) (quoting *E.J. Brooks*, 858 F.3d at 750).

Second, the dissent questioned the majority's interpretation of the existing New York law on each of the three damages issues. With respect to both trade secrets and unfair competition, the dissent argued that the cases relied upon by the majority stood only for the narrow proposition that damages *based on a lost profits theory* cannot rest solely on evidence of the defendant's gains. *Id.* at *16-17 (Wilson, J., dissenting). The dissent also framed a plaintiff's "loss" in a trade secrets case more broadly than the majority, arguing that loss included not only lost profits, but also lost potential licenses, the loss in the value of the secret itself, and "perhaps most importantly, the lost incentive for others to expend their time and efforts on innovation." *Id.* at *12 (Wilson, J., dissenting). Given this broader conception of "loss," the dissent contended that the majority had reached the wrong outcome even under the majority's own rule that damages must be limited to a plaintiff's loss. With respect to unjust enrichment, the dissent argued that the majority's reasoning was not an answer to the certified question, but was a reversal of the jury verdict on liability, since the jury had been instructed that unjust enrichment entails an improper enrichment "at the plaintiff's expense." *Id.* at *19 (Wilson, J. dissenting).

Third, the dissent raised the issue of whether the federal court's consolidation of law and equity rendered the majority's analysis incomplete. Common-law unfair competition is an action in equity, the dissent noted, which contemplates recovery of the defendant's profits. *Id.* at *18 (Wilson, J., dissenting) (citing *Winifred Warren, Inc. v. Turner's Gowns, Ltd.*, 285 N.Y. 62, 67, 32 N.E.2d 793 (1941)).

Lastly, the dissent expressed concern that the majority's reasoning places New York out of step with the prevailing jurisprudence on unfair competition and trade secrets. As the dissent noted, the Restatement (Third) of Unfair Competition and "nearly all other jurisdictions" allow plaintiffs to recover either the plaintiff's cost of development or the defendant's avoided costs upon a finding of unfair competition. *Id.* at *21 (Wilson, J., dissenting). This prevailing approach is better, in the dissent's view, because it takes into account the core purpose of trade secret law: the encouragement of innovation.

The ruling in *E.J. Brooks* places a major limit on compensatory damages for unfair competition and trade secrets in New York. Those damages are capped at the amount of loss incurred by the plaintiff. This ruling has particular force given the difficulty of establishing actual losses from the theft of intellectual property. Although a variety of factors – including avoided costs – may still be considered in ascertaining the proper damage award, avoided costs can only serve as evidence of, rather than as substitutes for, damages in the unfair competition and trade secrets context. And, as Judge Wilson noted in his dissent, the rule announced by the Court may open the door for entities found liable for misappropriation of trade secrets or unfair competition to nonetheless profit if they can make more efficient use of the stolen information than the rightful owners, so long as they do not trigger punitive damages.