

## In This Issue:

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The Tenth Circuit Court of Appeals in *Hertz v. The Luzenac Group* has clarified how to determine whether compilations are trade secrets. The court held that whether a manufacturing process constitutes a trade secret must be considered in the aggregate. The court further clarified under what circumstances customer information would be considered a protectable trade secret.

## Whether a Manufacturing Process is a Trade Secret Must Be Considered in the Aggregate

By Darren E. Nadel and Katherine S. Dix

Six years after the United States Court of Appeals for the Tenth Circuit held that compilations of information could constitute trade secrets, the Tenth Circuit squarely addressed how to determine whether compilations are trade secrets in *Hertz v. The Luzenac Group* (No. 06-1324, 06-1358, Aug. 11, 2009). The appellate court clarified that a manufacturing process must be considered in the aggregate, but the components of the process may also be individually considered. Moreover, in considering whether an entity took adequate steps to protect its secrets, the court must focus on the steps the entity took instead of those it did not take. The *Hertz* court further held that a breach of confidentiality agreement action may lie even where the agreement does not protect trade secrets.

## Colorado Trade Secrets Law – A Refresher

In Colorado, a *trade secret* is defined as:

the whole or any portion or phase of any scientific or technical information, design, process, procedure, formula, improvement, confidential business or financial information, listing of names, addresses, or telephone numbers, or other information relating to any business or profession which is secret and of value.<sup>1</sup>

In addition to having protectable information, an owner of a trade secret must take “measures to prevent the secret from becoming available.”<sup>2</sup> Although a company is not required to engage in extreme or unduly expensive procedures to protect its trade secrets, at a minimum, a company must take reasonable precautions to maintain the secrecy of its trade secrets.<sup>3</sup>

The determination of whether information is a trade secret is a fact-specific inquiry. The following *Colorado Supply*<sup>4</sup> factors are utilized in determining whether a trade secret exists:

- the extent to which the information is known outside the business;
- the extent to which it is known to those inside the business (*i.e.*, by employees);
- the precautions taken by the holder of the trade secret to guard the secrecy of the information;
- the savings effected and the value to the holder in having the information as against competitors;
- the amount of effort or money expended in obtaining and developing the information; and
- the amount of time and expense it would take for others to acquire and duplicate the information.

Notably, compilations of otherwise public information can constitute a trade secret in Colorado, provided that the compilation has unique value.

## **Factual and Procedural Background of *Hertz***

Luzenac America, Inc. (Luzenac) is a producer and seller of talc, a soft mineral used as an additive in many commercial products. From 1994 until about 2002, Luzenac sold various formulations of vinyl silane-treated talc, which is used as an additive in rubbers, paints, and coatings. Beginning in 1995, that product was known as Mistron 604AV or 604AV. Since 2002, 604AV has been produced by one of Luzenac's distributors, Van Horn, Metz & Co., Inc. (VHM), under license.

In 1994, Luzenac hired Sanford Lee Hertz to direct the technical aspects of developing and marketing the product that later became 604AV. Luzenac fired Mr. Hertz in January 1998, but Mr. Hertz successfully sued Luzenac under Title VII. Lane Lighthart, another Luzenac employee, testified on Mr. Hertz's behalf in the Title VII case and left Luzenac in June 2001.

A few years after Luzenac fired Mr. Hertz, IMI Fabi, LLC contracted with Mr. Hertz's consulting company to develop and market a vinyl silane-treated talc called "Genera." Mr. Hertz in turn contracted with Mr. Lighthart to provide a list of prospective customers for Genera. Mr. Lighthart allegedly provided customer lists he obtained at Luzenac.

When Luzenac learned of Mr. Hertz's contract with IMI Fabi, it sent a cease-and-desist letter to Mr. Hertz. IMI Fabi then reduced its efforts to market Genera.

Three days later, Mr. Hertz commenced litigation against Luzenac in Colorado state court. Luzenac counterclaimed against Mr. Hertz and Mr. Hertz added Mr. Lighthart as a counterclaim defendant. The action was later removed to the United States District Court for the District of Colorado.

As relevant here, the district court granted summary judgment for Mr. Hertz and Mr. Lighthart, and against Luzenac, on Luzenac's claims for misappropriation of trade secrets, misappropriation of customer information, and breach of contract. The district court reasoned that the manufacturing process of 604AV was not a secret and Luzenac did not take sufficient steps to maintain its secrecy. Likewise, it held that Luzenac's customer and prospective customer lists were not trade secrets because the customer information was derived from public sources. The district court further concluded that because Luzenac did not take the proper steps to protect the confidentiality of 604AV and its customer information, Mr. Hertz's disclosure of this information did not constitute a breach of his confidentiality agreement.

## **Manufacturing Processes Must Be Considered in the Aggregate**

On Luzenac's appeal, the United States Court of Appeals for the Tenth Circuit first evaluated whether the district court properly concluded that the production process of 604AV did not qualify as a trade secret.

The appellate court determined that the district court made three mistakes by holding, as a matter of law, that the production process was not a trade secret: (1) it did not consider the production process in the aggregate; (2) it failed to view the evidence in the light most favorable to Luzenac, the party opposing summary judgment; and (3) in considering whether Luzenac adequately protected the secrecy

of 604AV, the district court focused on the steps that Luzenac *did not take*, rather than on the reasonableness of the measures it *did* take.

The appellate court was quick to note that in evaluating whether a manufacturing process is a trade secret, the district court must consider the production process as a whole, not each component separately. This is because information can be a trade secret even if some of its components are well known: “[A] trade secret can exist in a combination of characteristics and components each of which, by itself, is in the public domain, but the unified process, design and operation of which, in unique combination, affords a competitive advantage is a protectable secret.”

Accordingly, through its failure to engage in any substantive analysis of the production process as a whole — shown in the district court’s statement that the process as a whole could not be found in one discrete, public repository was “both true and irrelevant” the district court failed to apply the appropriate standard.

## **Manufacturing Processes Must Be Reviewed in the Light Most Favorable to the Non-Moving Party**

The *Hertz* court next reviewed the district court’s finding that each element of the manufacturing process of 604AV was publicly disclosed. This is significant because while the finder of fact is required to consider the claimed trade secret as a whole, it may also consider whether the individual components are publicly known. A finding that some of the elements are secret would suggest that the entire process is protected.

In *Luzenac*, the parties disputed whether the amount of vinyl silane in 604AV was public knowledge. A publicly available data sheet lists the silane content as less than 1% by weight of the product. Luzenac argued that there was a significant difference between knowing that the content is less than 1% and knowing the exact amount. Mr. Hertz’s own evidence supported a finding that a small change in silane content could make a significant difference. Even in light of this evidence, the district court determined the vinyl silane content was public knowledge because Luzenac stated the content in a letter to its customers. The *Luzenac* panel held that the letter, without an explanation of its context, did not prove as a matter of law that the precise amount of vinyl saline was public knowledge.

Similarly, the parties disputed whether the type of silane was public knowledge. Luzenac disclosed the fact that the coating is a vinyl silane, however, the type of vinyl silane was not disclosed. Mr. Hertz maintained that this could be determined through logical deduction—only two types of vinyl saline exist and one has toxic byproducts. However, Luzenac’s evidence showed that there were three types of vinyl saline. Accordingly, the type of vinyl saline also presented a genuine question of material fact that the district court should not have overlooked.

The parties also disputed whether the third element of the manufacturing process, a quality control test, was public knowledge. Luzenac’s senior technical manager testified that the test is “highly confidential.” Conversely, in an affidavit submitted by Mr. Hertz, a technical manager stated that he routinely demonstrated the test to potential customers. As such, the issue could not be resolved without weighing the credibility of the witnesses, a matter that the district court should not have considered in deciding a motion for summary judgment.

As such, the district court erred in making multiple, material determinations of fact on a motion for summary judgment.

## **Focus on the Reasonableness of the Measures Taken to Maintain Secrecy, Not the Measures that Could Have Been Taken**

The Tenth Circuit next disapproved of the district court’s evaluating the steps that Luzenac did not take to maintain the secrecy of its production process, instead of evaluating whether the steps that Luzenac did take were reasonable: “Just because there is something else that Luzenac *could* have done does not mean that their efforts were unreasonable under the circumstances.”

Luzenac took a series of steps to protect the secrecy of the manufacturing process, including: (1) posting signs warning employees to

keep the production process confidential; (2) requiring key employees, including Mr. Hertz, to sign confidentiality agreements; (3) barring visitors to the plant from viewing the production process; (4) marking certain documents about the production process confidential; and (5) requiring contractors like VHM to sign confidentiality agreements. These precautions were enough to overcome a motion for summary judgment.

## Whether the Record Should Be Sealed Is a Separate Question from Whether a Trade Secret Exists

In a footnote, the Tenth Circuit chastised the district court for denying Luzenac's motion to seal a majority of its documents and the district court's order: "We are concerned that the district court took steps in apparent confidence in the correctness of its decision that could cause potential litigants to lose some degree of faith in the courts as an appropriate forum for resolving trade secret or like business disputes. . . . According to Luzenac, the district court's order contains sufficient information for someone to replicate the production process of 604AV. If true, the district court's actions could have the regrettable effect of discouraging parties from resolving similar disputes through court litigation."

In so doing, the appellate court implicitly held that the issue of liability is a distinct inquiry from the issue of sealing the record. To preserve the secrecy of potential trade secrets on appeal, a lesser showing is necessary for sealing the record than for finding a trade secret exists. Accordingly, it may be appropriate to seal the record even if no trade secrets are found.

## When Customer Information Is a Protectable Trade Secret

The Tenth Circuit next held that both actual and prospective customer lists can be trade secrets. In analyzing whether an actual or prospective customer list is a trade secret, the *Colorado Supply* factors should be applied. This includes a review of whether employees knew customers' names from general experience; whether customers commonly dealt with more than one supplier; whether customer information could be readily obtained from public directories; and whether the owner of the customer list expended great cost and effort over a considerable period of time to develop the files.

On appeal, the Tenth Circuit found that this was a matter for the jury because: (1) no readily available source contained the identities of Luzenac's actual and prospective customers; (2) general information about each company in the customer list was publicly available, but Luzenac claims to have created the list of fewer than twenty customers from a universe of a thousand or more potential customers; (3) Luzenac spent anywhere from a few week to years developing the relationships, including identifying the appropriate contact person; (4) at least some of the information contained on Luzenac's customer list may not have been publicly available, including the status of 604AV testing and Luzenac's contact person; and (5) there is a disputed question of fact whether the project volume of purchases of each contact was public.

The Tenth Circuit also rejected Mr. Hertz's claim there was no evidence that IMI Fabi benefited from Luzenac's customer information. Under Colorado trade secrets law, there need not be actual use or commercial implementation of the misappropriated trade secret for damages to accrue.

## A Breach of Contract Action May Lie Even If No Trade Secrets Exit

The Tenth Circuit also held that a breach of contract regarding an employee who was bound by a confidentiality agreement exists even when no trade secrets claim lies.

In the *Luzenac* case, Mr. Hertz entered into a confidentiality agreement in which he agreed not to divulge or appropriate for his own use any secret or confidential information obtained during his employment. Because the district court concluded that Luzenac did not take any steps to protect the confidentiality of 604AV and its customer information, the court did not conduct a factual analysis of the claim.

The Tenth Circuit overturned this ruling, noting that while the analysis of the claim would not take the same form as the trade secret claim

– meaning it would not apply the *Colorado Supply* factors – it would still look to whether the steps taken by Luzenac were sufficient to convey that the manufacturing process of 604AV was confidential. On remand, the Tenth Circuit instructed the district court to consider: (1) whether Luzenac made it clear that the manufacturing process and customer information were confidential; and (2) whether the information used by Mr. Hertz was exclusively in the public domain or known to him prior to his employment with Luzenac.

## Recommendations for Employers

In light of *Hertz*, employers should consider:

- how and under what circumstances to provide trade secret information to customers;
- establishing measures to protect the secrecy of trade secrets, such as posting signs warning employees to keep physical secrets confidential and password protecting electronic secrets;
- requiring employees and vendors with access to confidential information to sign confidentiality agreements; and
- redrafting confidentiality agreements to explicitly recite the types of confidential information covered by the agreement, such as manufacturing processes and customer information.

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1 C.R.S. § 7-74-102(4).

2 *Id.*

3 *Harvey Barnett, Inc. v. Shidler*, 143 F. Supp. 2d 1247, 1252 (D. Colo. 2001), rev'd on other grounds, 338 F.3d 1125.

4 See *Colorado Supply Co. v. Stewart*, 797 F.2d 1303, 1306 (Colo. App. 1990).