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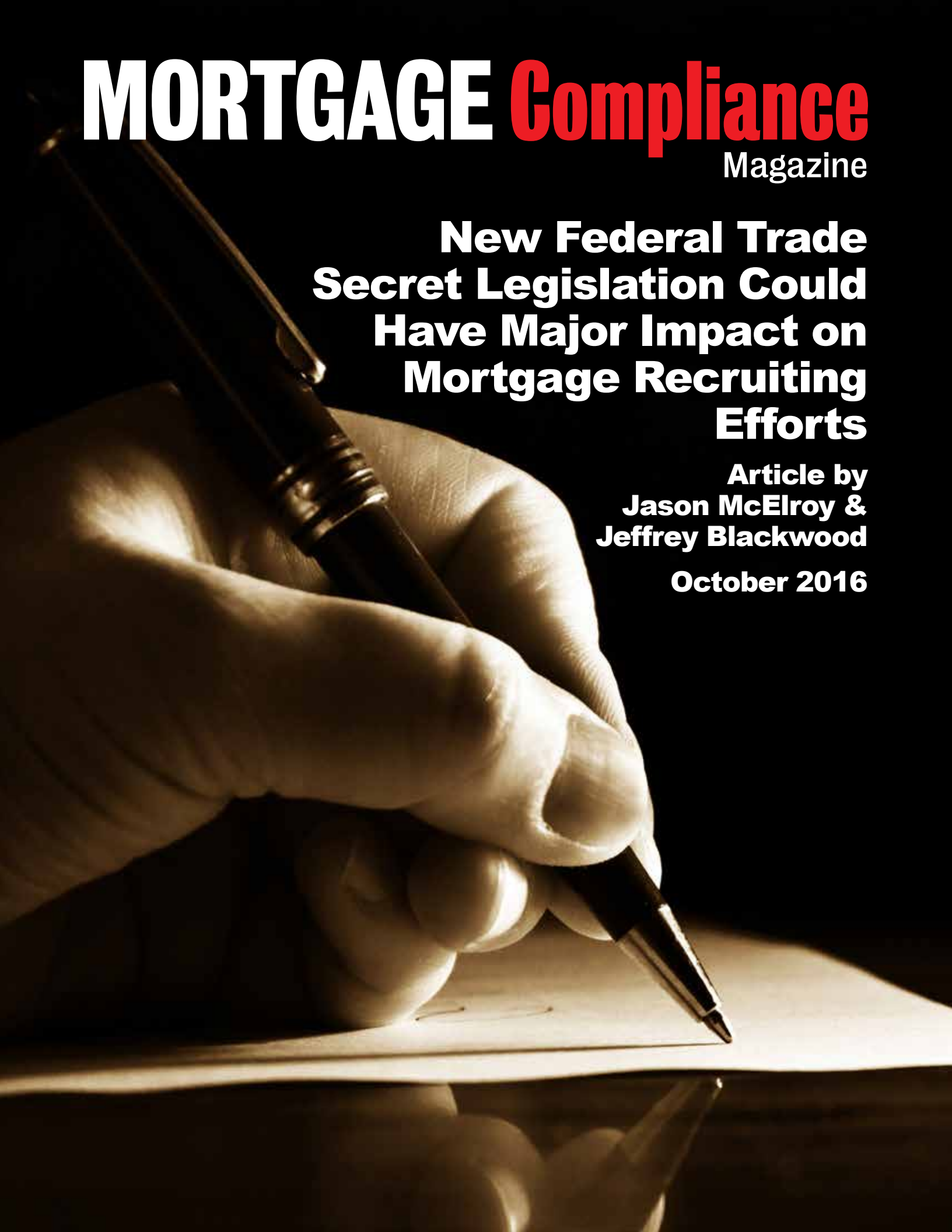

New Federal Trade Secret Legislation Could Have Major Impact on Mortgage Recruiting Efforts

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On May 11, 2016, President Obama signed into law the Defend Trade Secrets Act (DTSA), creating a private civil federal cause of action for the misappropriation of trade secrets. The act, passed with near unanimous bipartisan congressional support, will undoubtedly change the landscape of private trade secret litigation, which was previously relegated to various state law regimes.

This new statute follows on the heels of an increase in state-law-based litigation around the country pursuing state trade secrets act violations in the mortgage industry. Such actions have often followed a similar model: A loan officer leaves Company A to work for Company B; some other employees follow suit to go to work for Company B; Company A sues its former employee and Company B for stealing employees and trade secrets, including customer lists and loans that allegedly should have closed at Company A. A recent highly-publicized example of this is the litigation in California state court brought by Mt. Olympus Mortgage Company against Guaranteed Rate, where the jury awarded Mt. Olympus Mortgage Company more than $25 million in damages for violations of California state trade secrets laws and other claims, such as breach of fiduciary duty. *Mount Olympus Mortgage Company v. Anderson, et al.*, No. 2014-00729438 (Cal. Superior Ct, Orange County).

Given that loan officers often move from company to company, and that recruitment of high-production loan officers is highly competitive, the passage of the DTSA is likely to embolden companies to bring more of these types of suits in the future. The result in the Mt. Olympus California litigation is likely to underscore this. Thus, it is imperative for companies in the mortgage lending industry to be aware of the provisions of the new law, and ensure effective measures are taken in recruitment to protect themselves from potential large-scale liability.

THE DTSA, IN A NUTSHELL

A federal cause of action for trade secret misappropriation is notable in two respects. First, federal courts have more experience handling complex discovery issues, and thus may be better suited than state courts to oversee the nuanced technical issues in trade secret lawsuits. Second, a uniform body of federal law will develop, providing litigants with more certainty when deciding whether to file a misappropriation action. The DTSA does not preempt any state laws concerning trade secrets. Thus, litigants will still have the option to file claims in state court.

The DTSA provides that "an owner of a trade secret that is misappropriated may bring a civil action under this subsection if the trade secret is related to a product or service used in, or intended for use in, interstate or foreign commerce." See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2. The DTSA uses the Economic Espionage Act's broad definition of "trade secret," which includes:

> All forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing.

18 U.S.C.S. § 1839. To meet this definition under the DTSA, one must also take "reasonable measures to keep such information secret," and the information sought to be protected must have actual or potential "independent economic value."

The U.S. Court of Appeals for the Ninth Circuit recently ruled that the definition of trade secret may include compilations of publicly available data: "a trade secret may consist of a compilation of data, public sources or a combination of proprietary and public sources." *United States v. Nosal*, Case No. 14-10037 at 33 (9th Cir. July 5, 2016).[1] The Ninth Circuit went on to emphasize that it is the secrecy of the purported trade secret that is determinative of its status, and the fact that some or all of the information located within such compilations is public does not preclude it from protection: "a compilation that affords competitive advantage and is not readily ascertainable falls within the definition of a trade secret." *Id.* at 33-34.[2]

In the mortgage industry, several types of information may be susceptible to falling within this definition, including confidential customer lists, lead compilations, information concerning loan officer compensation models, or unique marketing methods or techniques used to identify potential customers. Due to the DTSA's broad definition of trade secret, courts tend to focus more on the value of the information at issue, and how that information creates a competitive advantage for the company. The U.S. Court of Appeals for the Eighth Circuit ruled 12 years ago that customer lists of a mortgage company met the definition of trade secrets under Missouri state law. *Conseco Fin. Services v. North American Mortgage*, 381 F.3d 811 (8th Cir. 2004). In that case, the defendant argued that the customer lists were not trade secrets because the information was publicly available, but the court found that they were trade secrets because they were the product of a highly-specialized and unique program designed to identify potential clients who may be interested in additional services. *Id.* at 819.

One federal court has already ruled that customer information combined with "buying patterns and marketing and pricing strategies" was sufficient to meet the definition of the "trade secret" under the DTSA. See *Henry Schein, Inc. v. Cook*, No. 16-cv-03166-JST, 2016 U.S. Dist. LEXIS 81369 (N.D. Cal. June 22, 2016).[3]

IMPORTANT DTSA PROVISIONS

Mortgage companies should familiarize themselves with the primary components of the DTSA, which includes: a broad "ex parte seizure" provision that allows law enforcement to seize misappropriated trade secrets property; unique remedies, including compensatory and exemplary damages; an amendment making theft of trade secrets a predicate act under federal racketeering law; whistleblower protection to employees that report suspected violations of law to the government; and specific notice requirements that companies must comply with if they seek exemplary damages.

Ex Parte Seizure. The DTSA includes detailed provisions setting forth the procedure under which federal courts may order the seizure of property. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(2). In "extraordinary circumstances," courts may now allow federal and/or state law enforcement officials to seize property, if "irreparable injury" is likely to occur, and if the seizure is "necessary to prevent the propagation or dissemination of the trade secret." See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(2)(A)(i). The misappropriated property is then transferred to the custody of the court, and a special master is appointed to facilitate the return of the property. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(2)(D)(iv).

Damages. The act provides compensatory damages for actual losses, and separately for any unjust enrichment that is not included in the calculation of damages for actual losses. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(3)(A)(i) & 2(b)(3)(B)(i)(II). In lieu of traditional compensatory damage measures, the DTSA also provides that "reasonable royalties" may be awarded. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(3)(A)(iii). Finally, if the misappropriation is found to be "willful and malicious," a litigant may recover up to two times the amount of compensatory damages. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 2(b)(3)(C).

RICO. The DTSA makes the theft of trade secrets a "predicate act" under the Racketeer Influenced and Corrupt Organizations Act (RICO). See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 3(b). This amendment will be particularly salient to companies facing the typical misappropriation case—when an employee leaves the company with trade secrets and works for a competitor. In such a case, the former employee and his or her new employer may now face allegations of a racketeering conspiracy to use and/or misappropriate the trade secrets. RICO provides for treble damages—a potentially heavy blow on top of the DTSA's double damages provision.

Whistleblower Protection and Notice Requirements. The act also provides immunity from federal and state trade secret laws if an individual discloses a trade secret to a law enforcement official or attorney, if the purpose of the disclosure is report a suspected violation of law. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 7(b)(1)(A)(ii). Notably, the DTSA sets forth a notice provision that employers must comply with if the employer seeks exemplary damages. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 7(b)(3)(C). The act states that any contract or agreement that governs the use of trade secrets must give notice of the DTSA's immunity provision, or must provide a cross-reference to a policy document providing the same. See Defend Trade Secrets Act of 2016, Pub. L. 114-153, § 7(b)(3)(A)–(B). Accordingly, employers should consider immediately updating all new employment contracts with a DTSA notice provision, and also distributing a policy document to current employees.

HOW DOES THE DTSA AFFECT THE MORTGAGE INDUSTRY?

As mentioned above, state trade secret action filings have seen a rise in popularity recently in the mortgage industry. Although the *Mount Olympus* case was decided before the DTSA was signed into law, the allegations of that case are instructive as to why the new federal legislation could prove impactful to the mortgage industry.

Mount Olympus revolved around allegations of improper recruiting—Mt. Olympus alleged that Guaranteed Rate utilized unethical recruiting tactics, including by encouraging the employees it hired away to take loan data and customer information off of Mt. Olympus' computers for use at the new company, in exchange for a large bonus. The jury found the company liable for illegally transferring hundreds of consumer loan files. According to the allegations, the employees performed many of these actions while still employed by Mt. Olympus.

The jury awarded $12 million in damages designed to compensate Mt. Olympus for its actual damages and $13 million in punitive damages to

punish Guaranteed Rate for its actions and send a message to other companies about such tactics.

While these findings were all made under state law, the new DTSA would likely increase the liability incurred in such a case. As mentioned above, the DTSA allows for up to two times the amount of compensatory damages to be issued for willful conduct and also makes a violation of its provisions a violation of the federal RICO statute. RICO carries with it treble damage provisions. Additionally, the inclusion of DTSA as an underlying violation of RICO also makes it easier to bring the new employer into a lawsuit, as RICO requires an "enterprise," which is necessarily made up of more than one person.

Moreover, while not all customer lists or similar compilations of data will ultimately be deemed to be trade secrets under the DTSA, these are necessarily highly fact-intensive determinations that are unlikely to be resolved early in litigation. *See, e.g., Apple Mortgage Corp. v. Barenblatt* Case No. 13-cv-9233, 2016 U.S. Dist. LEXIS 18456 (S.D.N.Y. Feb. 16, 2016) (declining to determine whether customer list meets the definition of a trade secret on a motion for summary judgment because the factual record had not been adequately developed).[4] Practically, this is likely to make winning a case under the DTSA on the merits an expensive endeavor, and one that may drag on for years. In the Apple Mortgage case cited above, for instance, that litigation was active for nearly three years before it was resolved on grounds unrelated to the DTSA.

CONCLUSION

The passage of the DTSA makes it clear that recruiting practices in the mortgage industry will now be subject to heightened scrutiny through the vehicle of potential federal trade secrets and RICO liability. Mortgage companies have undoubtedly addressed a larger compliance burden on their production operations the past few years due to the passage of Dodd-Frank and related regulations. The DTSA now places a greater emphasis on compliance during recruiting efforts. Companies should ensure that recruits know that taking or using confidential information from their prior mortgage company could subject them and the new company to substantial federal liability. Policies regarding the transition of new employees should be well-designed to avoid the transfer of information deemed to be a trade secret from a recruit's former employer. The consequences of not doing so are now higher than they ever have been before.

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NOTES

[1] The Nosal opinion is available at https://cdn.ca9.uscourts.gov/datastore/opinions/2016/07/05/14-10037.pdf.

[2] The Ninth Circuit also cites two previous Circuit Court opinions deeming customer lists to be trade secrets. Id. at 35 (citing Hollingsworth Solderless Terminal Co. v. Turley, 622 F.2d 1324, 1332-33 (9th Cir. 1980), and Hertz v. Luzenac Group, 576 F.3d 1103, 1114 (10th Cir. 2009)).

[3] Although *Henry Schein, Inc. v. Cook* involved the sale of medical and dental equipment to healthcare professionals, the rationale of the opinion could easily be applied to the financial services industry.

[4] The Court in this opinion did, however, grant summary judgment to the defendants on other grounds, effectively ending the litigation.