Start-ups can never be too careful when protecting trade secrets

By Matthew J. Frankel

In *LightLab Imaging Inc. v. Axsun Technologies Inc.*, 469 Mass. 181, 182-84 (July 28, 2014)—a closely watched case within greater Boston’s bustling start-up sector—the Massachusetts Supreme Judicial Court affirmed a trial court ruling excluding expert testimony on lost-profit damages in a trade secret misappropriation case. The SJC’s decision in *LightLab* will make it harder for start-up companies to recover lost-profit damages in trade secret misappropriation cases, at least where the misappropriation occurs before the start-up is able to develop a track record of successfully developing products, making actual sales, and/or obtaining funding. Thus, the primary lesson of *LightLab* is that start-ups must take aggressive steps to prevent trade secret misappropriation before it happens, because a lawsuit may not provide an avenue for recovering meaningful damages after misappropriation has occurred.

The facts recited in the SJC’s decision paint a picture of egregious contract, tort and trade secret violations by the defendant companies, Axsun and Volcano. LightLab manufactured and sold optical coherence tomography (OCT) systems, which are used to image human coronary arteries for diagnosis and treatment. LightLab and Axsun entered into a joint development relationship, which included confidentiality agreements, to develop a laser that would overcome the limitations in existing OCT technology. This development relationship resulted in advances to the laser that “gave LightLab a valuable competitive edge in the field of imaging human coronary arteries.” During their relationship—and unbeknownst to LightLab—Axsun offered itself for sale to LightLab’s competitor, Volcano. After the sale went through, Axsun divulged LightLab’s confidential information to Volcano and ultimately refused to communicate with LightLab about further development or LightLab’s confidential information. Volcano also surreptitiously downloaded LightLab’s data from a third-party source, took over Axsun’s development facility, and induced Axsun to provide to LightLab an earlier version of the laser, rather than the most recently developed laser, as had been promised.1

1 469 Mass. at 182-84.
After a jury found that Axsun and Volcano had engaged in misappropriation, breach of contract and/or other tortious conduct, LightLab proffered testimony from a damages expert as to its future lost profits. The trial judge excluded much of the expert’s testimony, holding that it “was not based on a demonstrated reliable methodology capable of being validated and tested, particularly as to quantification of a ‘first mover’ advantage.” The trial judge also concluded that the expert’s opinion “was too speculative and conjectural as a matter of law” because (among other reasons) (1) LightLab’s prospective product had not obtained regulator approval; (2) LightLab had not had success in obtaining financing; (3) LightLab had no evidence that the defendants’ conduct caused a loss of sales for LightLab anywhere in the world; and (4) LightLab could not precisely identify the new product(s) for which it sought future lost-profits damages. Thus, LightLab was permitted to recover only six figures in economic damages, plus attorney’s fees, rather than the tens of millions of dollars in profits that its expert asserted it had lost.

The SJC affirmed the trial court’s ruling in all relevant respects, holding that the judge did not abuse her discretion in excluding the expert’s testimony. The SJC noted that LightLab had “cited no case in which an expert was permitted to testify about future lost profits based on an as-yet uninvented product.” The SJC also noted that in a prior case where lost profits were awarded for misappropriation of a developed-but-as-yet-unmarketed product, the lost-profit analysis was supported by market research—something LightLab had not presented at trial. The SJC summarized its holding as follows: “Where LightLab had no history of profitable sales and could point to no lost sales, where [the expert’s] opinion depended on as-yet undeveloped new products, where LightLab had no regulatory clearance for its future products, and where it had no guaranteed funding needed to launch a sales and marketing infrastructure for its new products, we conclude that the judge did not abuse her discretion in determining that [the expert’s] opinion should be excluded as grounded in speculation.”

Despite its holding, the SJC sought to “express [its] concern” that traditional lost-profits analysis was ill-suited for estimating damages where a start-up has been victimized by trade secret misappropriation. The SJC recognized that although “[s]uch businesses often operate for years without profit,” this “should not render them ‘damage proof,’” and suggested that “other theories of damages . . . may be ripe for testing in our courts.”

Although the SJC did not enumerate them, typical methods of estimating trade secret misappropriation damages other than lost-profits analysis include: “[1] the defendant’s actual profits from the use of the secret; [2] the value that a reasonably prudent investor would have paid for the trade secret; [3] the development costs the defendant avoided incurring through misappropriation; and [4] a ‘reasonable royalty’” for the defendant’s continued use of the secret. (In certain jurisdictions, a reasonable royalty will only be permitted where all other measures of

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2 469 Mass. at 185.
3 469 Mass. at 193.
4 469 Mass. at 193-94.
5 Melvin F. Jager, 1 Trade Secrets Law § 7:20 (Thomson Reuters 2014).
damages are inapplicable. It is not clear whether LightLab might have had more luck had it sought to recover under one of these alternative damage theories.

The real lesson of LightLab is that start-ups with little or no track record in product development, product sales, or procuring financing will likely have difficulty obtaining a meaningful damage award in any misappropriation case. Thus, such companies must aggressively and vigilantly protect their trade secrets from the beginning, since a post facto action for damages is unlikely to be a panacea in the event of actual misappropriation. Start-ups, in particular, should take extra care to identify their trade secret assets and to protect them through the use of airtight nondisclosure agreements (and, where appropriate, noncompetition and nonsolicitation agreements), limiting trade secret access on a need-to-know basis, using computer firewalls and passwords and marking documents and files with confidentiality legends. Start-ups may also need to be quick on the trigger in seeking preliminary injunctive relief when misappropriation appears imminent, so as to prevent or at least halt misappropriation before it causes damages that may be difficult to value and recover in court.

The egregious facts in LightLab suggest that perhaps no amount of extra effort would have kept the defendants there at bay. However, in light of the outcome of that case, start-ups—whose primary assets may be trade secret rights in a cutting-edge product, formula, or method—can never be too careful.

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6 Id. § 7:21.
7 Id. § 5:16.
8 Id. § 5:24.
9 Id. § 5:23.