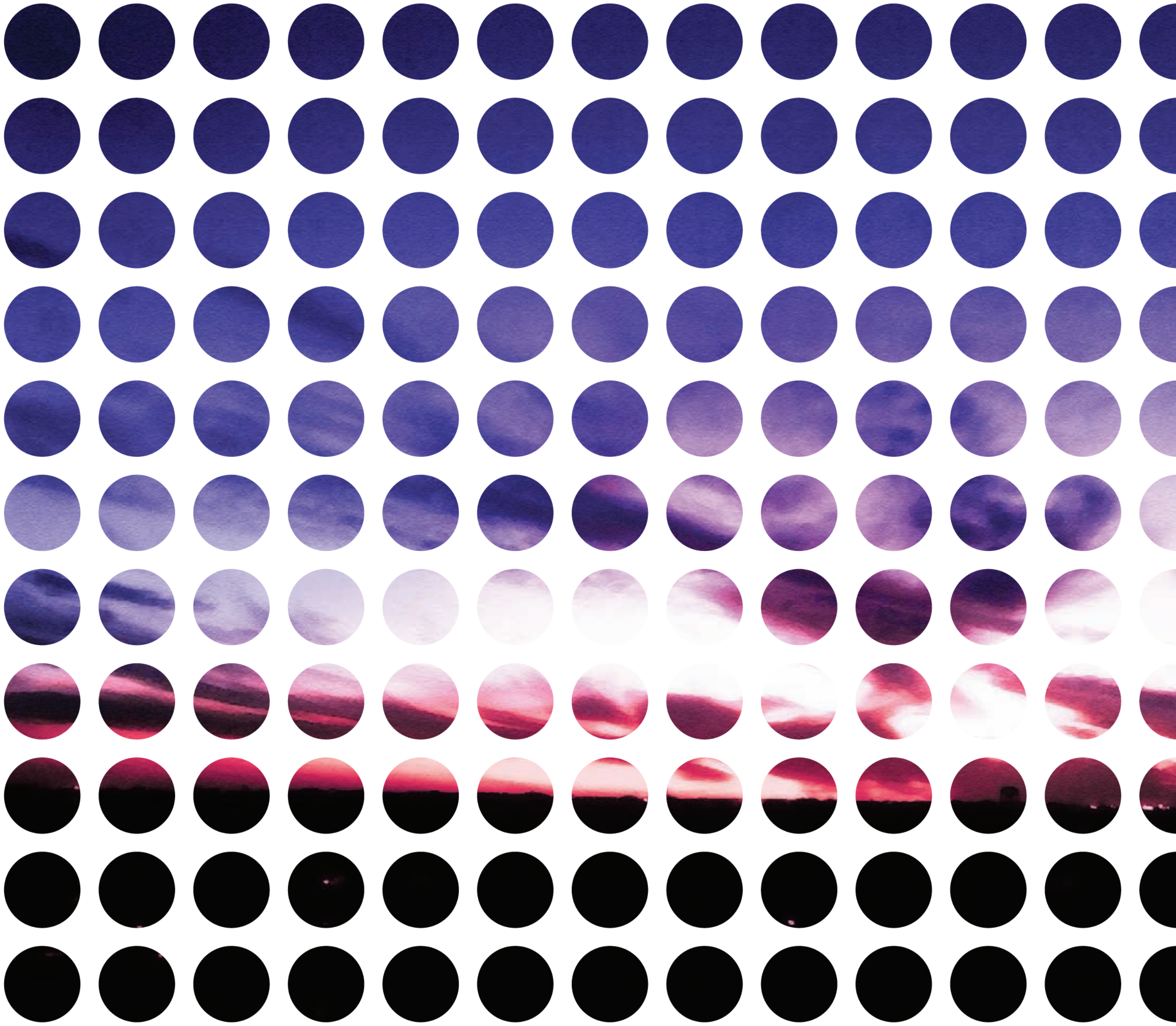

Pearson New International Edition

# Ethics and the Conduct of Business

John R. Boatright

Seventh Edition



PEARSON

# Pearson New International Edition

Ethics and the Conduct of Business
John R. Boatright
Seventh Edition

PEARSON

potential, from not being generally known to, and to being readily ascertainable through proper means by the public." Because of these definitions, many trade secret disputes between companies could be subject to criminal prosecution, and every company needs to be more careful in the acquisition of a competitor's information.

There are three major arguments for trade secret protection. One argument views trade secrets as a kind of property and attempts to apply common-law principles of *property* rights to them. In the second argument, cases involving trade secrets are considered in terms of the right to compete and the principles of *fair competition*. The third argument holds that employees who disclose trade secrets to others or who use them for their own gain violate an obligation of *confidentiality* that is part of the employer–employee relationship.

## Trade Secrets as Property

Imagine a lone inventor who, after years of hard work, develops an improved process for manufacturing a common product and builds a factory to turn out the product using the new process. Even if the innovations are not sufficiently original to be patentable, we can accept that he owns the results of his creative efforts, at least to the extent that it would be wrong for a worker in the factory to disclose the details of the manufacturing process to a competitor, especially if the employee had been sworn to secrecy.[3]

Trade secrets, along with patents, copyrights, and trademarks, are commonly regarded in the law as intellectual property that can be said to belong to an owner. Patents, copyrights, and trademarks, in particular, are like tangible property in that the owner has a right of exclusive use and the right to sell, license, or otherwise assign ownership to others. This right does not depend on keeping the information secret. Ownership of a trade secret, by contrast, does not confer a right of exclusive use but only a right not to have the secret misappropriated or wrongfully acquired by others. Once the information is widely known, it ceases to be a protectable trade secret. All forms of intellectual property are unlike tangible property, however, in that they are not inherently exclusive; that is, their use by one person does not preclude their use by another.

The question of who owns what becomes more complicated if the inventor is himself employed by a manufacturer of the product in question. As long as he gets his ideas while performing unrelated work for his employer, however, and conducts the experiments on his own time using his own materials and facilities, it seems only right that he be recognized as the sole owner of the improved manufacturing process and be permitted—perhaps after leaving his present employer—to sell the secrets of the process to another manufacturer or to go into business for himself. If, on the other hand, he is hired as an inventor to develop improved methods of manufacture or if he does his creative work on his employer's time with the resources of his employer, then some or all the rights of ownership could reasonably be claimed to belong to the employer.

**THE WEXLER CASE.** The case of *Wexler* v. *Greenberg* is instructive in this regard. Alvin Greenberg was employed as chief chemist for the Buckingham Wax Company, which manufactured floor cleaners, polishes, and other maintenance materials. One of his tasks as chief chemist was to analyze the products of competitors and to use the results to develop new formulas. After eight years with the company, Greenberg left to join Brite Products, which had previously purchased exclusively from Buckingham. With the formulas that Greenberg had developed while working for Buckingham, Brite was able to dispense with Buckingham as a supplier and become a manufacturer itself, whereupon Buckingham sued to prevent Greenberg and his new employer from using the formulas on the grounds that they were trade secrets which Greenberg had misappropriated.

According to the decision in this landmark case, an employer has the burden of showing two things: "(1) a legally protectable trade secret; and (2) a legal basis, either a covenant or a confidential relationship, upon which to predicate relief."[4] Information is protectable as a trade secret, in other words, only as long as it meets certain conditions, one of which is that it is genuinely a secret. Furthermore, the owner of a trade secret is protected against the use of this information by others only when it is disclosed by an employee in violation of an obligation of confidentiality, for example, or when a competitor obtains it by theft, bribery, industrial espionage, or some other impermissible means.

In overturning a lower court ruling that held that Greenberg had an obligation of confidentiality not to disclose the formulas, the Supreme Court of Pennsylvania ruled in favor of Greenberg citing the fact that the supposed trade secrets had not been disclosed to Greenberg by his employer but had been developed by Greenberg himself. The court explained,

> The usual situation involving misappropriation of trade secrets in violation of a confidential relationship is one in which an employer *discloses to his employee* a pre-existing trade secret (one already developed or formulated) so that the employee may duly perform his work. . . . It is then that a pledge of secrecy is impliedly extracted from the employee, a pledge which he carries with him even beyond the ties of his employment relationship. Since it is conceptually impossible, however, to elicit an implied pledge of secrecy from the sole act of an employee turning over to his employer a trade secret which he, the employee, has developed, as occurred in the present case, the appellees must show a different manner in which the present circumstances support the permanent cloak of confidence cast upon Greenberg.

The formulas, moreover, were not significant discoveries on Greenberg's part but were merely the result of routine applications of Greenberg's skill as a chemist. As such, they were, in the court's view, the kinds of technical knowledge that any employee acquires by virtue of being employed. Even though the formulas are trade secrets, which the Buckingham Wax Company is permitted to use, they properly belong to Greenberg, who has a right to use them in his work for a new employer. Society also makes an investment in the development of information; it is not the exclusive property of an individual or a firm. Because patentable ideas and other innovations are generally built on foundations that have been laid by others, even companies that have spent a great deal for research cannot claim sole right of ownership.

**THE BASIS FOR PROPERTY RIGHTS.** One source for the argument that patentable ideas, trade secrets, and the like are a form of property is the Lockean view that we own the results of our own labor.[5] Patent and copyright laws are based in part on the premise that inventors and writers who work with their minds and turn out such products as blueprints and novels should have the same right of ownership that is accorded to creators of more tangible objects. Insofar as intellectual property is created by individuals who have been hired by a company for that purpose and paid for their labor, it follows, in the Lockean view, that the company is the rightful owner. Just as the products made on an assembly line belong to the company and not to the workers who make them, so too do inventions made by people who are hired to invent. The company has paid them for their efforts and provided them with the wherewithal to do their work.

In addition, there are good utilitarian reasons for holding that companies have property rights to certain kinds of information. First, society generally benefits from the willingness of companies to innovate, but without the legal protection provided by patent and trade secret laws, companies would have less incentive to make the costly investments in research and development that innovation requires. Second, patent and copyright laws encourage a free flow of information, which leads to additional benefits. Patent holders are granted a period of 17 years in which to capitalize on their discoveries, but even during the period of the patent, others can use the information in their research and perhaps make new discoveries.

The existence of legal protection for trade secrets, patents, and other forms of intellectual property also has its drawbacks. A patent confers a legal monopoly for a fixed number of years, which raises the price that the public pays for the products of patent holders during that time. Trade secrets permit a monopoly to exist as long as a company succeeds in keeping key information out of the hands of competitors. Because there is no requirement that patents be used, a company could conceivably patent a large number of processes and products that rival its own and thereby prevent competitors from using them.[6] The owner of copyrighted material can prevent the wide dissemination of important information either by denying permission to print it or by charging an exorbitant price.

These drawbacks can be minimized by the optimal trade-off between the advantages and disadvantages of providing legal protection for patents, trade secrets, and the like. This trade-off is achieved, in part, by the limits on what can be patented or copyrighted or protected as a trade secret. Other means for achieving the optimal trade-off include placing expiration dates on patents and copyrights and defining what constitutes infringements of patents and copyrights. Thus, the Copyright Act of 1976 includes a provision for "fair use" that permits short quotations in reviews, criticism, and news reports.

**CLARIFYING THE OWNERSHIP OF IDEAS.** Many companies attempt to clarify the ownership of patentable ideas by requiring employees to sign an agreement turning over all patent rights to the employer. Such agreements are morally objectionable, however, when they give companies a claim on discoveries that are outside the scope of an employee's responsibilities and make no use of the employer's facilities and resources.[7] Courts in the United States have often invalidated agreements that force employees to give up the rights to inventions that properly belong to them. The laws in most of the other industrialized countries of the world provide for sharing the rights to employee inventions or giving additional compensation to employees, especially for highly profitable discoveries.[8]

The ownership of ideas is a difficult area, precisely because the contributions of employers and employees are so difficult to disentangle. Arguably, the law in the United States has tended to favor the more powerful party, namely, employers. Contracts or other agreements that spell out in detail the rights of employers and employees are clearly preferable to ambiguous divisions that often land in the courts. These arrangements must be fair to all concerned, however, and granting employees a greater share of the rewards might be a more just solution—and also one that benefits corporations in the long run by motivating and retaining talented researchers.

## Fair Competition

The second argument for trade secret protection holds that companies are put at an unfair competitive disadvantage when information they have expended resources in developing or gathering can be used without cost by their competitors. Even when the information is not easily classifiable as property and there is no contract barring disclosure or use of the information, it may still be protected on grounds of fairness in trade.

In *Wexler* v. *Greenberg*, the court considered not only who owns the formulas that Greenberg developed for the Buckingham Wax Company but also whether placing restrictions on Greenberg's use of the formulas in his work for another company unfairly deprived him of a right to compete with his former employer. According to the decision in *Wexler*,

> any form of post-employment restraint reduces the economic mobility of employees and limits their personal freedom to pursue a preferred course of livelihood. The employee's bargaining position is weakened because he is potentially shackled by the acquisition of alleged trade secrets; and thus, paradoxically, he is restrained because of his increased expertise, from advancing further in the industry in which he is most productive. Moreover . . . society suffers because competition is diminished by slackening the dissemination of ideas, processes and methods.

The problem of trade secrets, in the view of the court, is one of accommodating the rights of both parties: "the right of a businessman to be protected against unfair competition stemming from the usurpation of his trade secrets and the right of an individual to the unhampered pursuit of the occupations and livelihoods for which he is best suited."

**THE ASSOCIATED PRESS CASE.** A good illustration of the fair competition argument is provided by a 1918 case, in which the Associated Press complained that a news service was rewriting its stories and selling them to newspapers in competition with the Associated Press.[9] The defendant, International News Service, argued in reply that although the specific wording of a news story can be regarded as a form of property, like a literary work, which belongs to the writer, the content itself cannot belong to anyone. Further, there is no contract between the parties that International News Service had breached. In the words of Justice Louis D. Brandeis:

> An essential element of individual property is the legal right to exclude others from enjoying it. . . . But the fact that a product of the mind has cost its producer money and labor, and has a value for which others are willing to pay, is not sufficient to insure to it this legal attribute of property. The general rule of law is, that the noblest of human productions—knowledge, truths ascertained, conceptions, and ideas—become, after voluntary communication to others, free as the air to common use.

In this view, information that cannot be patented or copyrighted has the same legal status as trade secrets, so that a plaintiff must show that there is a breach of contract or some other wrongful means of acquisition. Accordingly, Brandeis continued,

> The means by which the International News Service obtains news gathered by the Associated Press is . . . clearly unobjectionable. It is taken from papers bought in the open market or from bulletins publicly posted. No breach of contract, or of trust and neither fraud nor force, are involved. The manner of use is likewise unobjectionable. No reference is made by word or act to the Associated Press. . . . Neither the International News Service nor its subscribers is gaining or seeking to gain in its business a benefit from the reputation of the Associated Press. They are merely using its product without making compensation. That, they have a legal right to do; because the product is not property, and they do not stand in any relation to the Associated Press, either of contract or trust, which otherwise precludes such use.

A majority of the justices of the Supreme Court sided with the Associated Press, however, arguing that the case should be decided not on grounds of property rights or breach of contract but on considerations of fair competition. Although the public may make unrestricted use of the information contained in news stories, the two parties were direct competitors in a business in which the major stock in trade is news, a product that requires the resources and efforts of a news-gathering organization. In selling news stories based on dispatches from the Associated Press, the International News Service was, in the words of the majority opinion, "endeavouring to reap where it has not sown, and . . . appropriating to itself the harvest of those who have sown." The opinion further held:

> We need spend no time, however, upon the general question of property in news matter at common law, or the application of the Copyright Act, since it seems to us the case must turn upon the question of unfair competition in business. . . . The underlying principle is much the same as that which lies at the base of the equitable theory of consideration in the law of trusts—that he who has fairly paid the price should have the beneficial use of the property. It is no answer to say that complainant spends its money for that which is too fugitive or evanescent to be the subject of property. That might . . . furnish an answer in a common-law controversy. But in a court of equity, where the question is one of unfair competition, if that which complainant has acquired fairly at substantial cost may be sold fairly at substantial profit, a competitor who is misappropriating it for the purpose of disposing of it to his own profit and to the disadvantage of complainant cannot be heard to say that it is too fugitive and evanescent to be regarded as property. It has all the attributes of property necessary for determining that a misappropriation of it by a competitor is unfair competition because contrary to good conscience.

**NONCOMPETITION AGREEMENTS.** Because of the difficulty of imposing legal restraints on employees after they leave, many companies require employees to sign a noncompetition agreement when they are hired. These agreements typically restrict an employee from working for a competitor for a certain period of time or within a given geographical territory after leaving a company. Agreements not to compete are a common feature of the sale of a business, and the courts have generally not hesitated to enforce them.

But there is little justification for restricting employees in this way. Noncompetition agreements are almost entirely for the benefit of the employer and inflict a burden on employees that is out of proportion to any gain. At least 12 states consider them so unfair that they are prohibited entirely.[10] Where noncompetition agreements are permitted by law, the courts have generally imposed a number of tests to determine whether they are justified.[11] These tests are that the restrictions contained in an agreement (1) must serve to protect legitimate business interests; (2) must not be greater than that which is required for the protection of these legitimate interests; (3) must not impose an undue hardship on the ability of an employee to secure gainful employment; and (4) must not be injurious to the public. Legitimate business interests include the protection of proprietary information or customer relations, but the purpose of an agreement cannot be merely to protect an employer against competition.

In determining whether restrictions are greater than those required to protect the legitimate interests of an employer, three factors are important. These are the time period specified, the geographical area, and the kind of work that is excluded. The value of trade secrets is reduced over time, so that a noncompetition agreement designed to protect trade secrets can justifiably restrain an employee only during the time that they have value. Without a time limit on an agreement, an employee could be prevented from working for a competitor even after formerly proprietary information becomes common knowledge. Similarly, an employer with a legitimate interest in protecting the customers it serves in New York City, for example, might be justified in preventing a sales representative from working for a competitor in that area but not elsewhere.

Noncompetition agreements that specify the kind of work too broadly also run the risk of hampering an employee unduly. In one case, a woman in Georgia signed a contract with an employment agency in which she agreed not to work in any capacity for a period of one year for any competitor within a 25-mile radius. The Supreme Court of Georgia ruled that the time period and the area were reasonable but that the phrase "in any capacity" was unreasonably broad, because it would bar her from doing any work for a competitor and not merely the work that she had done for her former employer.[12] Generally, agreements prohibiting employees from working on a particular project or soliciting specific clients, for example, are less likely to be objectionable than vague restrictions such as writing computer programs or selling insurance.

## The Confidentiality Argument

The third argument for trade secret protection is that employees who disclose trade secrets to others or use them themselves are guilty of violating an obligation of confidentiality. This argument is based on the view that employees agree as a condition of employment to become agents of an employer and be bound by the duty that agents have to preserve the confidentiality of certain information.[13] Section 395 of the *Restatement of Agency* states that an agent has an obligation

> not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency . . . to the injury of the principal, on his own account or on behalf of another . . . unless the information is a matter of general knowledge.

The obligation of confidentiality does not end with the employment relation but continues to exist after an employee leaves one job for another. Employees who sign an explicit confidentiality agreement may be bound by more stringent contractual obligations than those contained in the agency relation.

Companies can also have an obligation of confidentiality that prohibits them from misappropriating trade secrets. A company that inveigles trade secrets from another company under the guise of negotiating a license agreement or a merger, for example, might be charged with a violation of trade secret law, because the process of negotiation creates a relation of confidentiality. (It might also be charged with failing to negotiate in good faith.) It is also not uncommon for companies to reject ideas brought to them by outsiders, only to adopt them later as their own. The courts have ruled in many such instances that inventors and others have a right to expect that their ideas will be received in confidence and not misappropriated.

The argument for an obligation of confidentiality provides strong support for the right of employers to trade secret protection, but it too has a number of shortcomings. It assumes, for example, that the information was received from the employer and was not, as in the case of Alvin Greenberg, developed by the employee. The obligation of confidentiality is also limited by the right of employees to use their skill and knowledge in the pursuit of a trade or occupation.

**CONFIDENTIALITY AGREEMENTS.** Many employees sign a confidentiality agreement which creates an explicit contractual obligation that is often more stringent than the obligation of confidentiality that employees ordinarily have as agents. Although confidentiality agreements have some advantages for both employers and employees, they are open to the same objections as agreements to assign patent rights to employers and to refrain from postemployment competition. Because they are usually required as a condition of employment, employees are effectively coerced into giving up rights to which they might otherwise be entitled.

By relying on an enforceable obligation of confidentiality, companies often place unnecessary restraints on employee mobility and career prospects. Michael S. Baram contends that litigation rarely preserves either the secrecy of company information or the liberty of employees, and that both of these are better served by more sophisticated management.[14] Among the policies he suggests are improving security procedures in the workplace; securing the legal protection of patents, copyrights, and trademarks whenever possible; segmenting information so that fewer people know the full scope of a trade secret; limiting information to those with a need to know; and using increased pensions and postemployment consulting contracts to keep employees from taking competitive employment.

In addition, the incentive for employees to leave with valuable trade secrets can be reduced by greater recognition of employees for their contributions. Not infrequently, employees go to a competitor or set up a business of their own because of a feeling that they have not been fairly treated. Baram concludes that the key to protecting trade secrets lies in improved employee relations, in which both employers and employees respect the rights of the other and take their obligations seriously. And a key element in improving employee relations is an ethical climate of fair play. Employers might find that treating employees fairly provides more protection for trade secrets than relying on the law.

## COMPETITOR INTELLIGENCE GATHERING

Not all use of a company's trade secrets and other confidential business information is unethical or illegal. The systematic collection and analysis of competitor intelligence has become an accepted practice in the corporate world, and companies that do not avail themselves of this valuable tool may find themselves at a disadvantage. This is especially true in a global environment where some of America's competitors have long-established and highly efficient intelligence units.

Computers have greatly facilitated competitor intelligence gathering, first, by making immense volumes of information available in open-access databases and, second, by enabling companies to store and sort through the information they have compiled. Much of the information used for intelligence purposes is publicly available from news sources, trade publications, court records, regulatory filings, and presentations at industry meetings, and some is also obtained from employees' own contacts with customers, suppliers, and even