

# Intellectual Property Claims – Fitting a Square Peg Into a Round Hole

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## ***I. Introduction***

Intellectual property often comprises some of the most vital assets of a business. Patents, trademarks, copyrights, and trade secrets quickly have become “the central resource for creating wealth in almost all industries.”<sup>1</sup> Thus, it should not come as a surprise that intellectual property assets could be the object of dishonest conduct by employees, and that this conduct then leads to fidelity bond claims.

Fidelity bond provisions, however, demonstrate that the standard form commercial fidelity bond’s application to loss of intellectual property assets is limited. Fidelity bonds offer coverage to “tangible” property. Of the four types of intellectual property, only trade secrets may fit this definition. Fidelity bonds also require that the property owner be “deprived” of the asset. The theft of a trade secret would not seem to satisfy this requirement. Finally, the predominant element of damage sought when a trade secret is misappropriated is lost profit. This type of damage is specifically excluded by the standard form bond.

The purpose of this article is to analyze whether an insured’s loss of intellectual property rights is covered under the standard form fidelity bond. This article first discusses the four common categories of intellectual property – patent, copyright, trademark, and trade secrets, and discuss why only trade secrets may be the subject of fidelity bond coverage. Second, the article discusses why coverage may be lacking even for a majority of the claims that involve trade secrets. Third, the article discusses why, even if such a claim is covered, the insurer’s exposure may be limited.

## ***II. Is the Lost Asset the Type of Property Potentially Covered by the Bond?***

The typical commercial fidelity bond provides coverage for loss of “money,” “securities” or “other property” resulting directly from “theft committed by an employee” or “employee dishonesty.”<sup>2</sup> “Other property” is defined as “any tangible property other than ‘money’ and ‘securities’ that has intrinsic value . . . .”<sup>3</sup> The courts have defined “tangible property” as “property that can be felt or touched, or property capable of being

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<sup>1</sup> GORDON V. SMITH & RUSSELL L. PARR, VALUATION OF INTELLECTUAL PROPERTY AND INTANGIBLE ASSETS 1-3 (John Wiley & Sons, Inc. eds., 3d ed. 2000).

<sup>2</sup> See ISO Commercial Crime Policy (Discovery Form) CR 00 22 03 00 (1998) [hereinafter ISO 1998] A(1); ISO Crime General Provisions CR 10 00 06 95 (1994) [hereinafter ISO 1994] C(3).

<sup>3</sup> *Id.* at F(14) (emphasis added).

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possessed or realized.”<sup>4</sup> The reader should compare this definition to that of “intangible property,” which is “property that does not have intrinsic value but which is merely representative of evidence of value, like stock certificates.”<sup>5</sup>

Four main areas comprise the spectrum of “intellectual property”: patents, trademarks, copyrights, and trade secrets. As discussed below, only a trade secret may meet the bond’s definition of covered “other property.”

### A. PATENTS

A patent is a creature of law, awarded to protect new and useful inventions by granting to an inventor the exclusive right to make, use, and sell an invention anywhere in the United States for a limited period of time.<sup>6</sup> Patents are designed to encourage public disclosure of new and useful inventions, in exchange for a limited monopoly.<sup>7</sup> There are three types of patents available, each of which affords different protections for inventions. Utility patents, by far the most common type of patents, protect new and useful inventions, including “any new and useful process, machine, manufacture, composition of matter, or any new and useful improvement thereof...”<sup>8</sup> The term of protection of a utility patent extends twenty years from the date of filing of the patent.<sup>9</sup> Design patents protect the ornamental appearance of an object, such as the ornamental design of a container, and are effective for fourteen years from the date of issuance.<sup>10</sup> Plant patents protect asexually reproduced varieties of plants, and provide a term of protection extending twenty years from the filing date of the application for patent.<sup>11</sup>

When a patent application is filed with the United States Patent and Trademark Office,<sup>12</sup> the application is preserved in confidence for eighteen months.<sup>13</sup> After this time, the application is published on the United States Patent Office website.<sup>14</sup> The application undergoes a formal examination by a USPTO examiner, and one or more office actions may be issued rejecting all or some of the patent claims. The applicant may respond to the office action, disputing the rejections or amending the claims. Quite often, due to the complex procedural and substantive rules associated with the preparation and prosecution of a patent application, these services are often provided by a patent attorney registered to practice before the USPTO.

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<sup>4</sup> *Lucker Mfg. v. Home Ins. Co.*, 23 F.3d 808, 818-19 (3<sup>rd</sup> Cir. 1994).

<sup>5</sup> *Id.*

<sup>6</sup> See generally 35 U.S.C. §§ 1-376 (2002).

<sup>7</sup> See, e.g., U.S. CONST., Art. I, § 8, Cl. 8.

<sup>8</sup> See 35 U.S.C. § 101.

<sup>9</sup> See 35 U.S.C. § 154(a)(1).

<sup>10</sup> See 35 U.S.C. § 171; see also 35 U.S.C. § 173.

<sup>11</sup> See MANUAL OF PATENT EXAMINING PROCEDURE § 1601 (8th ed. 2001) [hereinafter MPEP].

<sup>12</sup> Hereinafter USPTO.

<sup>13</sup> See MPEP § 101 (8th ed. 2001); see also 35 U.S.C. § 122.

<sup>14</sup> Hereinafter USPTO; see 37 C.F.R. § 1.211 (2002).

When the USPTO has determined that the application meets the statutory requirements for patentability,<sup>15</sup> and is in condition for allowance, a patent will be granted. A patent will not be granted if the invention has been publicly used or offered for sale in the U.S. more than one year before the filing of the application.<sup>16</sup> Further, if patent protection is desired in certain foreign countries, the invention cannot be publicly disclosed prior to filing an application.

Since a patent cannot be “felt or touched” and is not capable of being “possessed or realized,” patents are not “tangible” property<sup>17</sup> and thus should not be subject to coverage. In addition, a patent cannot be the subject of “theft,”<sup>18</sup> A patent cannot be stolen or misappropriated, as it is a matter of public record upon issuance. Rather, a patent is infringed by an individual or entity that makes, uses, or sells a patented invention without the authorization of the patent’s owner.<sup>19</sup> The remedies prescribed by the patent laws are awarded only by way of “civil action for infringement,”<sup>20</sup> and include: injunctive relief to prevent another from infringing a patent,<sup>21</sup> damages,<sup>22</sup> reasonable royalty for the use made of the invention by the infringer,<sup>23</sup> and in exceptional cases, an award of attorneys fees to the prevailing party.<sup>24</sup> Property covered by a fidelity bond thus typically will not include an insured’s patents.

## B. COPYRIGHTS

Copyrights subsist in original works of authorship, such as writings, musical works, recordings, computer programs, and architectural works, and grant to an author or assignor the exclusive right to reproduce the work, prepare derivative works, and distribute copies of the work.<sup>25</sup> Copyrights automatically attach when a work is fixed in a tangible medium of expression, such as on paper, audio tape, computer disk, or other media.<sup>26</sup> Thus, basic copyright protections are available at the time of creation of the work and reduction thereof to a tangible medium. A work may be registered with the

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<sup>15</sup> An invention must be novel (*i.e.*, no single prior art reference, such as a patent, discloses each element of the claimed invention), non-obvious (*i.e.*, the invention would not have been obvious to one of ordinary skill in the art at the time the invention was made), and possess some utility, in order for a patent to issue on the invention. *See* 35 U.S.C. §§ 101-103. Further, the patent must provide an adequate written description of the invention that discloses the best mode of the invention and enables one of ordinary skill in the art to practice same without undue experimentation. *See* 35 U.S.C. § 112.

<sup>16</sup> *See* 35 U.S.C. § 102(b).

<sup>17</sup> *See, e.g.*, *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 556 (1993) (referring to patents and copyrights as intangible property); *Sierra Club Inc. v. Comm’r Internal Revenue Serv.*, 86 F.3d 1526, 1531 (9<sup>th</sup> Cir. 1996) (patents, copyrights, and trademarks are intangible property).

<sup>18</sup> A patent application preserved in confidence prior to either issuance or publication after eighteen months, however, could qualify as a trade secret and may be entitled to coverage, as discussed later in this article.

<sup>19</sup> *See generally* 35 U.S.C. §§ 271-297 (2002).

<sup>20</sup> *Id.* § 281.

<sup>21</sup> *Id.* § 283.

<sup>22</sup> *Id.* § 284.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* § 285.

<sup>25</sup> *See* 17 U.S.C. §§ 102, 106.

<sup>26</sup> *Id.* § 102(a).

United States Copyright Office, which affords the owner of the work additional benefits, such as the possibility of recovering statutory damages in the event of infringement.<sup>27</sup> However, registration is not required.<sup>28</sup>

Like a patent, a copyright is a creature of law, not something that can be felt or touched, and thus not a tangible asset.<sup>29</sup> Copyrights exist the moment a work is reduced to a tangible medium expression, and registered copyrights are a matter of public record. Further, a copyright is not “stolen”; it is infringed” by another’s violation of the copyright holder’s exclusive rights. Similar to patent remedies, the remedies for copyright infringement include an award of damages and injunctive relief.<sup>30</sup> Additionally, criminal penalties may be levied in the event of willful infringement for purposes of commercial advantage, financial gain, or reproduction and distribution, “during any 180-day period, of 1 or more copies or phonorecords, or more copyrighted works, which have a total retail value of more than \$1,000.”<sup>31</sup>

Therefore, copyrights, like patents, do not satisfy a bond’s definition of covered property. However, other types of insurance may be available to protect against copyright infringement.<sup>32</sup>

### C. TRADEMARKS

Trademarks protect marks that identify the source of goods or services used in commerce.<sup>33</sup> Trademark rights are obtained by using a mark in commerce, or by filing an intent-to-use application with the USPTO followed by subsequent use of the mark. A trademark owner can prevent another person or entity from using any mark that is confusingly similar to the registered mark. Examples of trademarks include ORACLE<sup>®</sup> for databases and software applications, owned by Oracle, Inc., and EBAY<sup>®</sup> for Internet auction service, owned by Ebay, Inc. Federally registered trademarks provide important

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<sup>27</sup> A copyright owner asserting a claim of infringement may be entitled to either actual damages and lost profits, or statutory damages. Statutory damages in the amount of \$750 to \$30,000 may be awarded for each act of infringement. *See* 17 U.S.C. § 504. In cases of innocent (unknowing) infringement, statutory damages may be reduced to a sum not less than \$200. *Id.* For cases of willful infringement, statutory damages may be increased to \$150,000 for each act of infringement. *Id.*

<sup>28</sup> *See, e.g.*, 17 U.S.C. § 504(c)(1).

<sup>29</sup> *Newark Morning Ledger*, 507 U.S. at 556; *Sierra Club*, 86 F.3d at 1531. The Copyright Act of 1976 expressly recognizes the difference between ownership of a copyright and ownership of an item protected by copyright:

Ownership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied. Transfer of ownership of any material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object; nor, in the absence of an agreement, does transfer of ownership of a copyright or of any exclusive rights under a copyright convey property rights in any material object.

17 U.S.C. § 202 (2002).

<sup>30</sup> *See generally* 17 U.S.C. §§ 501-506 (2002).

<sup>31</sup> *See* 17 U.S.C. § 506.

<sup>32</sup> *See, e.g.*, *Firemen’s Fund Ins. Co. v. Nat’l Bank for Coops.*, 849 F. Supp. 1347, 1359 (N.D. Cal. 1994) (copyright infringement subject of “advertising injury” coverage).

<sup>33</sup> *See generally* 15 U.S.C. §§ 1051-1072 (2002).

advantages, such as a presumption of trademark rights and notice of the mark to potential competitors.

In order to obtain a federal trademark registration, an application is filed and prosecuted with the USPTO. Not all marks, however, can be registered. For example, any mark that is generic, such as “Milk” for milk, can never be registered. Further, any mark that is confusingly similar with any other existing mark may not be registered. A USPTO examiner can reject a trademark application based upon a likelihood of confusion between the mark sought to be protected and one or more existing marks. An applicant has the right to contest any rejection. The services of a trademark attorney are useful in advising as to whether a mark is available prior to use and filing, for filing an application that will comply with the laws, minimizing the possibility of rejection, and overcoming any rejections that may result.

The preceding analysis with regard to patents and copyrights applies to trademarks, as well. Trademarks are intangible assets. They cannot be felt, touched, or possessed. Remedies are provided only for infringement of a trademark.<sup>34</sup> Thus, as with patents and copyrights, trademarks are not “tangible” property and thus also are not covered “other property.”

#### D. TRADE SECRETS

Concern about fidelity bond claims related to intellectual property assets should focus on trade secrets. Trade secrets are the province of state law with the definition of a trade secret varying from jurisdiction to jurisdiction. In general, a trade secret is “any formula, pattern, device, or compilation of information which is used in one’s business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.”<sup>35</sup> By their very definition, trade secrets require that they be confidential; matters “of public knowledge cannot be appropriate by one as his secret.”<sup>36</sup>

Trade secrets generally are classified into two groups: technical/scientific processes, and business information.<sup>37</sup> Business information includes items such as customer lists, marketing strategies, proposed advertising campaigns, computer accounting programs, and investigative materials.<sup>38</sup> Technical/scientific processes include, “recipes and products of a simpler nature ... [that] usually lead to the creation of a product or service.”<sup>39</sup> For example, the formulas for certain soft drinks are properly classifiable as technical/scientific processes, because they lead to the creation of products consumed by the public.

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<sup>34</sup> See, e.g., *Sierra Club*, 86 F.3d at 1531; *Lucker*, 23 F.3d at 819; *Palmolive Co. v. Conway*, 43 F.2d 226, 227 (D. Wis. 1930), *aff’d*, 56 F.2d 83 (7<sup>th</sup> Cir.), *cert. denied*, 287 U.S. 601 (1932).

<sup>35</sup> ROGER M. MILGRAM, MILGRAM ON TRADE SECRETS § 2.01 (Matthew Bender & Co. eds. 1993).

<sup>36</sup> *Id.*

<sup>37</sup> Don Wiesner & Anita Cava, *Stealing Trade Secrets Ethically*, 47 MD. L. REV. 1076, 1084 (1988).

<sup>38</sup> See *id.* at 1084-85.

<sup>39</sup> *Id.*

There appears to be a difference of opinion as to whether a trade secret can be “tangible property” as required for potential coverage by the standard commercial fidelity bond.<sup>40</sup> One federal district court, in what appears to be the only reported decision on the issue, held that a fidelity bond does not cover an employee’s theft of trade secrets because a trade secret is not tangible property.<sup>41</sup> This court appears to have based this conclusion upon its reading of Ohio law, holding that all trade secrets are intangible property as a matter of law.<sup>42</sup> Unfortunately, the court did not discuss why the specific trade secrets at issue there were actually tangible or intangible. Other courts, in other contexts, have noted that a trade secret can be either tangible or intangible.<sup>43</sup>

An argument can be made that, for purposes of coverage under a fidelity bond, a trade secret may be tangible property. Certainly a trade secret can be intangible, but once that confidential intangible information is put into tangible form, such as a writing, this writing could satisfy the bond’s requirement of “tangible property” with “intrinsic value.”<sup>44</sup> It may be more accurate to say that what is covered is not the trade secret itself but the tangible embodiment of the trade secret.<sup>45</sup> This arguably is an overly technical argument, however, because the value of that “tangible” property is in the confidential information it contains, so referring to the covered property as a trade secret under such circumstances does not seem inaccurate.

Even if a trade secret can be considered to be covered “other property,” a bond’s terms and conditions will present other hurdles that an insured may have difficulty clearing.

### ***III. Does the Loss Satisfy the Applicable Terms and Conditions?***

Assuming that a trade secret can, under certain circumstances, be covered “other property,” the next question is whether the theft or dishonest conduct “deprived” the insured of the asset. The typical commercial crime policy defines “theft” as “the unlawful taking of ‘money,’ ‘securities’ or ‘other property’ to the deprivation of the insured.”<sup>46</sup> Employee dishonesty coverage also appears to require a deprivation by requiring that the employee have acted with the manifest intent to cause the insured to sustain a “loss” (as well as obtain a financial benefit for the employee or a third party).<sup>47</sup>

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<sup>40</sup> “Tangible property” is “property that can be felt or touched, or property capable of being possessed or realized,” while “intangible property is defined as property that does not have intrinsic value but which is merely representative of evidence of value, like stock certificates.” *Lucker Mfg. v. Home Ins. Co.*, 23 F.3d 808, 818-19 (3d Cir. 1994).

<sup>41</sup> *Holloway Sportswear, Inc. v. Transp. Ins. Co.*, 177 F. Supp. 2d 764, 772 (S.D. Ohio 2001).

<sup>42</sup> *Id.*

<sup>43</sup> *See, e.g., United States v. Martin*, 228 F.3d 1, 11 (1st Cir. 2000).

<sup>44</sup> “Intrinsic value” means independent, marketable value. Property types that do not have “intrinsic value” include stock certificates and promissory notes, which are “merely representative or evidence of value.” *Lucker*, 23 F.3d at 819.

<sup>45</sup> *See KV Pharm. Co. v. Harland (In re Harland)*, 235 B.R. 769, 781 (Bankr. E.D. Pa. 1999) (recognizing difference between trade secrets, which are intangible property, and laboratory books in which trade secrets were recorded, which are tangible property).

<sup>46</sup> ISO 1998 at F(19) (emphasis added).

<sup>47</sup> *See* ISO 1994 at D(3)(A).

A loss “requires an actual depletion of funds or diminution in assets.”<sup>48</sup> An insured does not, therefore, sustain a loss if he is not deprived of an asset with value. One way to determine whether there has been a deprivation is with the “balance sheet” test; that is, whether the insured’s balance sheet does not change as a result of the theft, there has not been a deprivation.<sup>49</sup>

This language presents a substantial obstacle to an insured because the typical “theft” of a trade secret is not a theft at all as defined by the bond. In the usual case, the confidential information is copied or otherwise used by an employee or third party without authorization. The owner is not actually deprived of the trade secret information. Moreover, in order for there to be a deprivation, all copies of the document would have to be taken. If the owner has other copies, there has not been a deprivation.

A wrinkle, however, is where the trade secret is stolen and then so publicized that its value is destroyed. One could argue that this is a “constructive” deprivation as, by virtue of the publicizing, the asset becomes worthless.<sup>50</sup> It is as if the trade secret was taken completely from the owner. This theory may have some attraction because, as discussed below, fidelity bonds are designed to protect against the direct pecuniary loss resulting from employee theft or dishonesty. In fact, one decision indicates that such a theory may have merit.<sup>51</sup> On the other hand, the application of such a theory to fidelity bonds containing a manifest intent requirement may be questionable, because there may be an issue as to whether the thief intended to obtain a financial benefit for himself or a third party, as opposed to simply seeking to damage the employer.

The requirement of a deprivation goes hand-in-hand with the bond’s express exclusion for lost income and profit from the types of damage covered by the bond.<sup>52</sup> If the insured has not actually been deprived of the asset, its damages can only be (a) the income it lost because it no longer had the sole benefit of the confidential information and the resulting competitive advantage, or (b) the lost opportunity to obtain income by selling the confidential information. A mere cursory review of trade secret cases reveals how plaintiffs frequently quantify their damages primarily in terms of lost income or profit.<sup>53</sup> The two bond provisions requiring a deprivation and excluding lost profits thus may be some of the best evidence of the general inapplicability of fidelity bonds to intellectual property assets. This is illustrated in two of the three reported decisions addressing claims for such losses under fidelity bonds.<sup>54</sup>

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<sup>48</sup> Bradford R. Carver, *Loss and Causation*, in *HANDLING FIDELITY BOND CLAIMS* 335 (Michael Keeley & Timothy Sukel eds., 1999).

<sup>49</sup> *Id.* at 336 (best way to determine if a loss has occurred “is to utilize a balance sheet analysis”).

<sup>50</sup> *See Religious Technical Ctr. v. Netcom On-Line Comm’n Servs.*, 923 F. Supp. 1231, 1256 (N.D. Cal. 1995) (trade secret posted on the internet loses its value).

<sup>51</sup> *United States Gypsum Co. v. Ins. Co. of N. Am.*, 813 F.2d 856 (7th Cir. 1987). Research, however, did not locate any reported decisions in which such a theory was pursued.

<sup>52</sup> ISO 1998 at D(1)(d)(1).

<sup>53</sup> *See, e.g., Brandenburg v. All-Fleet Refinishing, Inc.*, 555 S.E.2d 508 (2001); *Basic Am., Inc. v. Shatila*, 992 P.2d 175 (1999).

<sup>54</sup> The third decision, *Holloway*, simply held that a fidelity bond did not cover the misappropriation of a trade secret because the trade secret did not constitute tangible property.

In *United States Gypsum Co. v. Insurance Co. of North America*,<sup>55</sup> U.S. Gypsum was the only manufacturer of a sealant called “BISCO.” In addition to its formula for BISCO, U.S. Gypsum had another confidential formula for a product similar to BISCO. An employee of U.S. Gypsum misappropriated this formula and shared it with a competitor. The competitor used the misappropriated formula to sell a product similar to BISCO, grossing nearly \$140,000.

U.S. Gypsum asserted a claim under its commercial crime policy, alleging that it sustained a loss of \$140,000 from the theft of the confidential formula by Banks. The trial court awarded the insurer summary judgment, and the Seventh Circuit Court of Appeals affirmed. One of the grounds for dismissal of U.S. Gypsum’s claims was the court’s conclusion that the employee’s action did not constitute a theft:

[T]heft is not the correct analogy. Banks did not deprive Gypsum of the trade secret. It is not as though Gypsum had a BISCO making machine and Banks stole it; it is as though Banks used the BISCO machine in his garage after work and sold the illicitly made BISCO. Gypsum still had the formula and the rights to it. Gypsum did not allege that the events caused Gypsum to lose the formula or the rights, through the formula becoming public, for example.<sup>56</sup>

Note the last sentence, indicating that, had the BISCO formula been made public, thereby losing its confidential nature and the related competitive advantage, the court may have been receptive to an argument that U.S. Gypsum had been deprived of the formula. This statement appears to indicate support for the concept of a “constructive” deprivation.

The court also rejected U.S. Gypsum’s contention that the \$140,000 was an actual loss, a diminution in the value of the formula. What U.S. Gypsum was alleging, in effect, was that the formula’s value was based upon the income the formula would generate in the future, and by virtue of Banks’ misappropriation of the formula, its value was now decreased. This argument failed because, as the court correctly reasoned, the actual value of the formula as an income-producing asset was not changed: “Gypsum has the same rights in the formula as it had before.”<sup>57</sup> Moreover, had U.S. Gypsum, rather than the competitor, sold the \$140,000 of product, the alleged diminution in value of the formula would have been the same, and this \$140,000 would have been income to U.S. Gypsum. No matter how U.S. Gypsum tried to describe it, the \$140,000 was lost income, which the bond specifically excluded.

A similar case is *Diversified Group, Inc. v. Van Tassel*.<sup>58</sup> In *Diversified*, two employees of the plaintiff used confidential information<sup>59</sup> obtained in the course of their

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<sup>55</sup> 813 F.2d 856 (7th Cir. 1987).

<sup>56</sup> *Id.* at 858. The court simply assumed that the formula constituted covered property. *Id.*

<sup>57</sup> *Id.* at 859.

<sup>58</sup> 806 F.2d 1275 (5th Cir. 1987).

<sup>59</sup> It is not at all clear whether this confidential information was covered, tangible property, as this issue is not discussed.

employment with the plaintiff to have their own companies underbid the plaintiff for a particular contract. The employees' lower bid won the contract, and the plaintiff sued after its employee dishonesty claim was denied on the ground of the income exclusion. There was no contention that the plaintiff had actually been deprived of the confidential information and, consequently, its damage claim focused upon the profits it claimed it would have earned had its employees not interfered with the bid process.<sup>60</sup> The Fifth Circuit affirmed the trial court's award of summary judgment to the insurer dismissing the claim as a request for lost profits, which was barred by the income exclusion.<sup>61</sup>

Thus, if the insured is not deprived of the trade secret – that is, if the insured's balance sheet does not reflect a reduction in its assets as a result of the theft – then the bond's conditions will not be satisfied. A review of cases involving the misappropriation of trade secrets in general further demonstrates that the most common occurrence is that there is no deprivation and that, concomitantly, the damages sustained are lost income or profit. In addition to the cases discussed above, for example, *Computer Print Systems, Inc. v. Lewis*<sup>62</sup> involved the misappropriation of a confidential computer program by an employee. In awarding the plaintiff damages in the amount for which the plaintiff could have sold its program to the entity that, instead, received the program from the employee, the court referenced the fact that the plaintiff “was not actually deprived of the programs and was free to utilize them in serving other customers.”<sup>63</sup>

In *Brandenburg v. All-Fleet Refinishing, Inc.*,<sup>64</sup> the defendants, former employees of the plaintiff, stole computer software containing confidential operations information and took it to a competitor, their new employer. The plaintiff established that this theft gave the competitor an unfair advantage over the plaintiff in bidding for jobs and dealing with customers. The court awarded the plaintiff its lost profits, plus punitive damages. The plaintiff did not even bother to seek recovery of the cost of the stolen software.

Similarly, in *Basic American, Inc. v. Shatila*,<sup>65</sup> the defendant took trade secrets related to the preparation of potatoes to his new employer, a competitor of the plaintiff, which used them in a new product. The plaintiff was awarded its lost profits by virtue of the competitor's use of the confidential information in creating and marketing the new product. Again, there was no claim for the cost of developing the confidential information.

The above is not to suggest that the theft of a trade secret never deprives an owner of the asset. Such cases exist. They are, however, much more infrequent than cases like those described above. In one such reported decision, *Thermofil, Inc. v. Fenelon*,<sup>66</sup> the

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<sup>60</sup> *Id.* at 1277.

<sup>61</sup> *Id.* at 1278.

<sup>62</sup> 422 A.2d 148 (1980).

<sup>63</sup> *Computer Print Systems*, 422 A.2d at 157.

<sup>64</sup> 555 S.E.2d 508 (2001).

<sup>65</sup> 992 P.2d 175 (1999).

<sup>66</sup> No. 80-CV-40453-FL, 1989 U.S. Dist. LEXIS 16948 (E.D. Mich. Aug. 22, 1989), *vacating* No. 80-CV-40453-FL, 1988 U.S. Dist. LEXIS 17409 (E.D. Mich. Oct. 4, 1988) (facts set forth in earlier opinion only).

defendants were found to have taken a laboratory book that contained confidential test results from the plaintiff, their then-employer, to be given to a competitor – a business owned by the defendants. Evidently, the plaintiff did not have another copy of this book. The court found that the theft actually deprived the plaintiff of the trade secrets contained in the book and awarded it the relative modest sum of \$11,000, representing the costs incurred in producing the book.

#### *IV. Demonstrating Reimbursable Damage*

As discussed above, in the majority of suits concerning trade secret theft, the damages sought are income and/or opportunity lost as a result of the theft. Such damages, however, are expressly excluded from fidelity bonds.<sup>67</sup> A commercial crime policy's valuation provision limits the insurer's obligation to the replacement cost of the property.<sup>68</sup> If the property is not replaced, the insurer will pay actual cash value.<sup>69</sup> Another bond form allows the insurer to decide whether to pay "actual cash value" or the replacement cost.<sup>70</sup>

There are no reported decisions addressing valuation of intellectual property under fidelity bonds. It would appear, however, that these provisions significantly limit the damages that an insured can recover under a bond, as compared to the damages that an insured could recover in a suit against the defalcators for lost profits. Replacement cost would appear to be exactly what its title indicates, the cost to replace the lost asset, such as labor, research, etc.<sup>71</sup> There are three recognized methods for putting an "actual cash value" on a trade secret (or any other form of intellectual property): the income method, the market method, and the cost method.

Under the income method, a trade secret is valued by determining the income or profits that the trade secret would have generated had it not been stolen.<sup>72</sup> While this method of valuing intellectual property assets has been described as the most accurate method of valuation,<sup>73</sup> it does not appear to have a place in the world of fidelity bonds, which specifically exclude lost income/profits from coverage. Computing an asset's value based upon the profits it would have generated would render the lost income exclusion meaningless.

The market method values an asset based upon what a willing buyer would pay a willing seller for the asset or something similar.<sup>74</sup> The problem with the market method with respect to trade secrets is that because the trade secret is a "secret," there likely will

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<sup>67</sup> ISO 1998 at D(1)(d)(1).

<sup>68</sup> ISO 1998 at E(1)(y)(1)(c).

<sup>69</sup> *Id.*

<sup>70</sup> ISO 1994 at A(20)(a)(3).

<sup>71</sup> *Cf.* Mohammad S. Rahman, *Patent Valuation: Impacts on Damages*, 6 U. BALT. INTEL. PROP. L.J. 145, 151 (1998).

<sup>72</sup> *Id.* at 151-52.

<sup>73</sup> *Id.* at 151.

<sup>74</sup> *Id.* at 153.

not be a market for the asset or for anything similar – and if something similar did exist, then the status of the asset as a “trade secret” itself would be called into question.<sup>75</sup>

Under the cost method, the value ascribed to the asset is the cost of recreating it, including all labor, overhead, research, etc.<sup>76</sup> This approach looks simply at the cost of creating the asset and does not factor in the economic benefits derived from it. It thus appears to fit within the definition of bond’s definition of “valuation” and, in fact, seems to be the equivalent of the bond’s limitation on the insurer’s liability – to pay the actual cost of replacement. Note that, while the cost method allows for the consideration of depreciation,<sup>77</sup> the bond’s valuation provision may provide that the insurer will pay the cost of replacement “without deduction for depreciation.”<sup>78</sup> Of the three methods described above, the cost method appears to be the one most applicable to fidelity bonds.

Either “replacement cost” or “actual cash value” as computed by the cost method should be substantially less than the lost profits that the insured will allege to have sustained. For example, in *Thermofil*, the plaintiff recovered \$11,000 as the “cash value” of the stolen asset, while alleging lost profits of more than \$100,000.<sup>79</sup> Moreover, “replacement cost” may be much less than “actual cash value”, no matter which method is used. It may be the rare case where the stolen item containing the confidential information cannot be replaced relatively inexpensively and quickly. The insured should be expected to have notes, records, documents, and other information available to it that will allow it to recreate the stolen item, perhaps with relative ease. Indeed, in this day and age, it is difficult to imagine that a business sophisticated enough to obtain fidelity insurance would not protect its valuable trade secrets in such a fashion.

The case that may cause the most concern is where the trade secret is made public, destroying its value. Since under those circumstances the asset cannot be replaced, the insurer may be obligated to reimburse the insured for the “actual cash value” of the asset. Because the income method should not be applicable and the market method will be difficult to employ, the insurer’s obligation may be to pay the cost of creating the asset. While this amount could be substantial, depending upon the asset, it still may be far less than the lost profits that the insured may seek to recover and that the bond expressly excludes.

## V. Conclusion

The typical claim arising from the theft of an intellectual property asset does not give rise to coverage under a fidelity bond. Either the misappropriated asset will not fit the definition of covered property, the underlying activity will not fit the bond’s definition of “theft” or “dishonesty,” or the bond will specifically exclude the type of loss incurred. In the unlikely event that a claim satisfies all of the bond’s conditions, it

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<sup>75</sup> See *id.* (market approach can be very difficult to apply).

<sup>76</sup> *Id.* at 151.

<sup>77</sup> *Id.*

<sup>78</sup> ISO 1998 at E(1)(y)(1)(c).

<sup>79</sup> *Thermofil*, 1988 U.S. Dist. LEXIS 17409.

appears that the insurer's most likely obligations will be for the cost of replacing or recreating the stolen asset, assuming the bond at issue allows recovery for such replacement cost. The realities of business should prevent this exposure from being significant, at least when compared to the lost income and profit that the insured will claim to have sustained as a result of the theft.