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DUE DILIGENCE AS A TWO-EDGED SWORD: POTENTIAL LIABILITY OF VENTURE CAPITALISTS FUNDING HIGH-TECH START-UPS

by James J. Marcellino
Dexter L. Kenfield*

I. INTRODUCTION

In most jurisdictions in the United States, trade secret law is grounded in tort principles.\(^1\) Trade secret law is intended both to maintain commercial morality and to encourage research and innovation by affording protection to trade secrets.\(^2\) These twin objectives are often at variance with each other and with other strong public policies. For example, there is a strong emphasis on the encouragement of competition\(^3\) and the free and relatively unfettered exchange of information, even commercial information, so that the public will not be deprived of the use of valuable, if not quite patentable, inventions.\(^4\) Moreover, as a matter of public policy, individuals are encouraged to utilize, to the maximum extent possible, their

\(^1\) See generally MILGRIM, TRADE SECRETS § 2.01 (various portions of comment b to RESTATEMENT OF TORTS § 757 (1939) have been cited with approval in 29 jurisdictions); JAGER, TRADE SECRETS LAW HANDBOOK § 3.01 (RESTATEMENT OF TORTS § 757 has become an almost universal starting point for defining the rights and liabilities of the parties in trade secret cases), and § 4.01[2].
\(^3\) Brunswick Corp. v. Outboard Marine Corp., 76 Ill.2d 475, 207 U.S.P.Q. 1039, 1041 (1980).
general knowledge, skill and experience in earning a living. In the same vein, mobility in the employment marketplace is encouraged.

Throughout the country, state and local governments have actively engaged in programs to stimulate the development of high-technology businesses. The assistance provided may include low-interest loans or other "seed" financing. Most of the capital invested in start-up and emerging high-technology companies, however, is provided by venture capital firms. These firms, together with their principals, may be sued in litigation involving alleged misappropriation of trade secrets and confidential information used by the financed companies. In fact, we expect that venture firms will be named as additional defendants in many future actions. Aggrieved possessors of trade secrets and their counsel may take advantage of existing legal theories developed in analogous situations, may bring before the court a "deep pocket" defendant able to respond in damages, and may create a tactical business advantage by naming venture capital firms as additional defendants. Proper resolution of these actions necessarily will require close analysis and a careful balancing of the competing public policies on which trade secret law is grounded.

This article will present a typical case and possible theories of liability which may be advanced against venture firms that provide funds to start-up and emerging high-technology companies. Of particular concern will be venture firms that invest in companies

7. For example, the Massachusetts Technology Development Corporation, an independent public agency, was formed in 1978 to promote early stage, high risk technology-based companies in Massachusetts. MASS. GEN. LAWS ANN. ch. 40G, § 1 et seq. (West 1979).
8. Seed financing is the initial financing from outside sources and is typically used to fund operations in the first few months of the new venture, or for a limited purpose such as composing a detailed business plan or conducting a comprehensive market analysis.
9. The VENTURE CAPITAL JOURNAL, in a May, 1985 Special Report, estimates that venture capital investments in the five year period from 1980 to 1984 were 10.1 billion dollars, with the heaviest investment in technology-based industries. Approximately 34% of the estimated 3 billion dollars invested in 1984 was for seed, start-up and other early stage financings.
10. In March 1983, IBM sued Cybernex, Inc. and two venture capital firms in an action entitled IBM v. Cybernex, No. C-83-1277RPA-SJ (N.D. Cal. filed March 1983), in the United States District Court for the Northern District of California. IBM also named as defendants two employees of the venture capital firms who serve on the Board of Directors of Cybernex. The action has not yet proceeded to a trial.
11. We have been unable to find any reported decisions dealing directly with the liability of a venture capital firm in situations like the one presented here. Accordingly, we will draw upon case law and commentary in analogous situations.
founded by former employees of the company asserting, as plaintiff, the alleged misappropriation, and how the venture firms' due diligence might be used against them. Finally, we will recommend a legal standard of liability against venture capital firms in these situations.

II. THE PROTOTYPICAL CASE

The issues discussed in this article can arise in a wide variety of factual settings. They can be illustrated, however, with a single, prototypical fact situation. Close variants of this situation will represent most situations in which these matters will arise.

Alphabetics Corporation is the industry leader in the development of computer software for artificial language work. As the world has gradually come to realize that government bureaucrats will never be able to utilize English or any other human language, focus has shifted to the development of artificial languages for use specifically by government agencies. Alphabetics marketed the first computer system for the automatic generation of government reports in a new artificial language, all but incomprehensible to the general public. It has thus pioneered a largely untapped and potentially lucrative market.

Bob Basic and Carol Cobol were high-level programmers for Alphabetics. They designed and supervised the development of the new Alphabetics system, and wrote much of the computer code. Dan Doolittle was the marketing manager for the project. He performed the market research which convinced Alphabetics of the potential for the new market, organized the marketing program, assembled the sales force, and actually made the first sale. Dan is without question the most knowledgeable person in the country with respect to this market. All three have worked for Alphabetics for ten years, since graduation from their respective college or postgraduate institutions.

Early in the artificial language project, Alphabetics decided, against the advice of Bob, Carol and Dan, that the Alphabetics system would be designed as a hardware/software system, with new hardware dedicated and designed solely for this application. As the project lagged, they became increasingly disenchanted, convinced that a better and quicker course would be to produce software to run on existing general purpose computers. They also believed that

12. The facts presented and the names used do not reflect an actual case and are not intended to identify any companies or individuals.
a smaller, more streamlined company could produce better quality, more efficient and more error-free programming. As the first Alphabetics system was about to be shipped to a customer, they began discussing among themselves the possibility of setting up a new business to compete with Alphabetics. They began to draft business plans. Two months later, the three resigned their employment on the same day and organized Elfspeak, Inc. Two weeks later, they appeared at the office of Fantastic Ventures, a venture capital firm, organized as a limited partnership with an emphasis on computer-related companies.

After a few weeks of negotiations, Elfspeak and Fantastic Ventures executed a term sheet\textsuperscript{13} describing the terms of prospective investment by Fantastic Ventures. The term sheet was subject to final documentation, and completion of Fantastic Ventures' due diligence.\textsuperscript{14} Several weeks later, the due diligence was completed, the financing documentation was executed, and Fantastic Ventures became a major equity participant in the new venture.

Two weeks later, Alphabetics filed an action seeking a temporary restraining order, preliminary and permanent injunctive relief, damages, and attorneys' fees. The defendants named were Bob Basic, Carol Cobol, Dan Doolittle, Elfspeak, Fantastic Ventures and George Gopher, the general partner of Fantastic Ventures. The complaint alleged that the new venture was based upon the wrongful use and disclosure of trade secrets and confidential information of Alphabetics; that the former employees violated their contracts with and fiduciary and loyalty duties to Alphabetics; that the proposed Elfspeak product will, and to the extent it already exists, does infringe Alphabetics' copyrights and other proprietary rights; that the Elfspeak venture constitutes the misappropriation of a corporate opportunity of Alphabetics; and that Fantastic Ventures and Gopher induced, aided, abetted, participated in and stand to benefit from all of the foregoing.\textsuperscript{15} Legal claims were asserted based upon common law and numerous federal and state statutes. If successful, Alphabetics may be entitled to treble damages, attorneys' fees, and possibly punitive damages, in addition to any injunctive relief which may be afforded.

\textsuperscript{13} See infra Part III for the definition and discussion of a term sheet.
\textsuperscript{14} See infra Part IV for the definition and discussion of due diligence.
\textsuperscript{15} We will focus here only on the alleged common law misappropriation of trade secret and confidential information.
III. THE TERM SHEET

As will be seen, the term sheet will provide critical foundation for the arguments by which Alphabetics will seek to impose liability on Fantastic Ventures. Accordingly, the function, nature and content of the Elfspeak term sheet must be considered in detail.

A term sheet is the typical first step in the process of obtaining venture capital funding for a new enterprise. In form, it is a brief outline of the basic terms under which the venture capitalist may be willing to provide funds to the venture. It is typically contingent on the completion of due diligence; other contingencies may be included as well.

The primary terms involve the amount of money to be invested, and the extent and nature of participation in the corporation which the venture capitalist will receive in return. In the simplest situation, the venture capitalist merely buys a given number of shares of common stock. More commonly, the venture capitalist is also entitled to certain preferential rights as to dividends, liquidation, and other matters, and is also entitled to representation on the board of directors.

Very often, the financing is accomplished in a series of phases. Each phase is contingent upon the company's meeting specific milestones of achievement following prior phases, and each phased investment may be optional on the part of the venture capitalist. There may be some circumstances under which the company can force additional financing, and other contingencies may be provided for. For example, if a milestone is not met, the company might be obligated to arrange other equity or debt financing before the venture firm must make a further investment.

The term sheet may contemplate and broadly describe collateral agreements which the venture capitalist may require, such as shareholder voting agreements or anti-dilution agreements. The term sheet may also require that the company obtain longterm employment contracts, non-competition agreements and nondisclo-

16. It is beyond the scope of this article to analyze the liability of Gopher other than as he is the general partner of Fantastic Ventures. But see Donsco, Inc. v. Casper Corp., 587 F.2d 602, 606 (3d Cir. 1978) (under ordinary principles of unfair competition participating officers and directors may be personally liable).

17. Anti-dilution agreements provide protection to investors against later issuance of common stock or securities convertible or exercisable into common stock, where the issue, conversion, or exercise price of the later issue is below the price stipulated in the earlier security or below the market price. 2 HAFT, VENTURE CAPITAL AND SMALL BUSINESS FINANCING, § 1.03[4] (1985); Kaplan, Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities, 33 UNIV. CHICAGO L. R. 1 (1965).
sure/assignment of invention agreements from key employees, and that the company either engage or refrain from engaging in various other activities. Although an attempt is made in the term sheet to set forth the critical terms of the financing, there is no effort made to set forth a complete and enforceable financing contract; that effort is made only near or at the completion of due diligence.

In our prototypical case, the founders, Bob, Carol and Dan, initially proposed to sell twenty-five percent of the common stock of Elfspeak to Fantastic Ventures in exchange for $250,000. Elfspeak had already been incorporated in the founders' home state, and Bob, Carol and Dan had each been issued 250 shares of the 1,000 shares authorized in the standard, short form articles of incorporation.

Gopher thereupon began a process of educating the founders as to the financial requirements of a start-up company, as well as the general practice in venture financing. Within a matter of weeks, agreement was reached on the term sheet. It provided for immediate investment of $250,000 in exchange for twenty-eight percent of the common stock, each founder to hold twenty-four percent. It provided for two of the five directors to be nominated by Fantastic Ventures. Should Elfspeak reach the beta test phase for its new product within six months, the second phase of financing will be provided, under which Fantastic Ventures will pay $500,000 for 500,000 shares of convertible preferred stock. Should the beta test phase be reached in five months, Elfspeak may elect to force the $500,000 investment at that time, in exchange for common stock rather than convertible preferred. Should the company actually sell its product to two customers within one year, Fantastic Ventures is required to invest an additional one million dollars in exchange for one million shares of convertible preferred stock. Fantastic Ventures was granted the right to veto any major transaction, including reorganization, or sale of assets or stock. In the event Elfspeak defaults in any of its obligations, Fantastic Ventures is entitled to replace all directors with its own nominees. Fantastic Ventures was also granted a right of first refusal with respect to any acquisition of the company or its product line, and was granted participation rights in any public offering of securities of Elfspeak.

In order to permit these transactions, Elfspeak was reincorporated as a Delaware corporation, under articles of incorporation.

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18. Beta tests are operational product tests conducted at end user sites using actual as opposed to simulated data. Alpha tests precede beta tests and are conducted by the manufacturer at its facilities with simulated data.
drafted by Fantastic Ventures' counsel. On Gopher's recommendation, Elfspeak retained new corporate counsel. The founders met with new counsel for the first time one week before the lawsuit was filed.

IV. DUE DILIGENCE

The due diligence performed by Fantastic Ventures will form an additional key link in Alphabetics' proof at trial. It must therefore be described in detail.

The term "due diligence" is familiar to attorneys who engage in major securities transactions, such as the initial public offering of stock in a company. In that connection, the term applies primarily to lawyers, referring to the vast amount of legal "tire kicking" which must be done, including a rather broad factual investigation with respect to the company's business and financial position.

The term "due diligence" itself is derived from the so-called "due diligence defense" available under section 11(e) of the Securities Act of 1933."19 Although section 11 imposes liability upon a wide range of individuals and entities (e.g., directors, underwriters and counsel) for material errors or omissions from prospectuses or other such documents in a public offering, a defense is generally available, except for the issuer itself, only to those who "had, after reasonable investigation, reasonable grounds to believe and did believe" that the offering materials were accurate and complete.

The term in practice has come to have a broader meaning, including not only the investigation of a securities issuer by underwriters and counsel, but also the broader business and financial investigations and considerations of a prospective investor in almost any enterprise. It is this broader sense in which the term is used here.

Accordingly, in the venture capital context, "due diligence" refers to the process conducted by a venture capital firm prior to making a final decision regarding whether or not to invest in a particular enterprise."20 Whereas the securities due diligence can be characterized as a search for facts of legal significance in order to establish compliance with legal requirements, the venture capital due diligence is a search for facts, with business or financial significance, in order to determine the "fit" of the proposed venture with the ven-

ture capital firm's own policies and objectives. (This is not to say that legal aspects are irrelevant, as pointed out below.)

Broadly speaking, the venture capitalist seeks to evaluate three factors: the people, the proposed product, and the market. Specifically, a venture capital firm's due diligence focuses on independent verification of claims made by the entity seeking financing, as well as investigation of the individuals involved. The starting point typically is information provided by the venture's founders, either in a business plan or through personal interviews. This will include background information on the proposed product and its market, the experience and background of the individuals involved, provision of some data concerning the underlying market, and the provision of market and personal references.

Working from this raw data, the venture capitalist can begin its due diligence. Market references will be contacted and, within a shield of confidentiality, the proposed venture will be discussed. Market data provided by the new venture will be checked for accuracy by the venture capitalist, and additional market research or surveys may be conducted. The venture capitalist may retain outside consultants for the purpose of providing marketing information, or verifying or supplementing information provided by the venture. Personal references will be contacted with a view to evaluating the likely success of the individuals as entrepreneurs. In addition, where the venture capitalist has prior experience in the particular industry involved, that experience will be brought to bear upon evaluating the potential for success of the new venture. Each of these steps, of course, may produce further leads and the development of additional sources and information requiring investigation by the venture capitalist.

Throughout the due diligence process, the venture capitalist is also in close contact with its counsel. Any confidentiality, noncompetition or other agreements which may be relevant will be examined. Counsel for the venture firm may directly interview the founders of the new venture. Counsel will investigate and consider the likelihood and strength of claims by former employers, competitors or others which may hinder or block the new venture. Counsel may have some role in the venture firm's consideration of the general character and reputation of the principals of the venture.21

21. More than one venture capital firm has been "burned" either because it failed to ask the right questions, or because it failed to recognize the legal significance of the answers it received. Assistance of counsel can be invaluable in both areas. In addition, both the venture firm and its counsel must recognize the inherent risk that the principals, whether as a result
nally, counsel must prepare and/or review all documentation concerning the proposed financing, bearing in mind corporate and securities law requirements, potential litigation and other legal matters.

At the conclusion of the due diligence process, the venture capitalist, advised by counsel, is in a position to make a final decision on funding the venture. If the decision is to go ahead, then a closing is scheduled at which the final documents are executed. Only at or after the closing does the venture capitalist actually invest and become a formal participant in the new venture.

In our prototypical case, the founders, Bob, Carol, and Dan, provided a number of market and personal references to Gopher, including customers and potential customers with whom they had dealt while employed by Alphabetics. These references told Gopher that the founders were the key personnel to the success of the Alphabetics product. They were universally described as hard-driving, “take charge” individuals highly likely to succeed in an entrepreneurial environment, without regard to obstacles which might be thrown in their paths. They were described as being exceptionally bright, and able to keep all necessary information and decision factors in their heads without the need to refer constantly to backup documentation.

Gopher, on behalf of Fantastic Ventures, retained an independent consultant who told him that the new Alphabetics product was opening up an entirely new market, but that once the existence of the market was firmly proven, many large computer companies would rapidly enter it. Accordingly, in the consultant’s opinion, there was only a narrow window of opportunity; the new venture would be highly likely to succeed if and only if it introduced a product within the next eight to twelve months.

The due diligence revealed that the former Alphabetics employees, Bob, Carol and Dan, had no written noncompetition agreements with Alphabetics, but each had signed a standard employee confidentiality/assignment of invention agreement.22 They in-

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22. A typical Employee Patent and Confidential Information Agreement may provide:

“At no time either during his employment, on either a part or full-time basis with the Company or subsequent to termination of such employment will Employee divulge to any person, firm or corporation, or use (other than as required by the Company in the course of his employment) any privileged or confidential information, trade secret or other proprietary information including, but not limited to, information relating to the experimental and research
formed Gopher and Fantastic Ventures’ counsel that they had taken no documents or other Alphabetics materials with them when they left the company. Upon the suggestion of Fantastic Ventures’ counsel, Gopher had each employee sign a separate document representing that to the best of his or her knowledge, information and belief, he or she was not, and no planned activities of Elfspeak would place him or her, in violation of any employment, confidentiality or other agreement with Alphabetics.

On the basis of its due diligence, Fantastic Ventures proceeded with the financing.

V. THE LEGAL FRAMEWORK

A. Trade Secrets

The Restatement of Torts section 757, sets forth the generally recognized common law rule for misappropriation of trade secrets: 23

One who discloses or uses another’s trade secret, without a privilege to do so, is liable to the other if (a) he discovered the secret by improper means, or (b) his disclosure or use constitutes a breach of confidence reposed in him by the other in disclosing the secret to him, or (c) he learned the secret from a third person with notice of the facts that it was a secret and that the third person discovered it by improper means or that the third person’s disclosure of it was otherwise a breach of his duty to the other, or (d) he learned the secret with notice of the facts that it was a secret and that its disclosure was made to him by mistake 24 (emphasis added).

In the employment context, most courts have recognized that a confidential relationship exists between an employer and an employee. 25 The general rule is that:

In a situation where there has been no express contract of an

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24. We will focus on subparagraph (c) and those situations where the initial disclosure was made to the employees in a lawful manner and discovery was not by improper means.
25. MILGRIM, supra note 1, at § 5.02(1).
employee not to use or disclose confidential information entrusted to him during his employment, . . . although an employee may carry away and use general skill or knowledge acquired during the course of his employment, he may be enjoined from using or disclosing confidential information so acquired.' . . . The above stated rule is based upon 'basic' principles of equity . . . and upon an implied contract, growing out of the nature of the employer-employee relation\(^{26}\) (emphasis added).

To the extent that the venture capital firm, in its due diligence, learns that the former employees, now principals of the new company, disclosed or used a trade secret in the business of the new company in breach of their duty to their former employer, the venture firm may also be liable to the possessor of the trade secret under section 757.

Comment (c) to section 757 specifically states that one has notice of facts under the rule stated in the section when he knows of them or when he should know of them, citing to the Restatement of Trusts section 297:

> He should know of them if, from the information which he has, a reasonable man would infer the facts in question, or if, under the circumstances, a reasonable man would be put on inquiry and an inquiry pursued with reasonable intelligence and diligence would disclose the facts.\(^{27}\)

In addition, the comment makes specific reference to notification of a fact. The comment refers to the Restatement of Agency section 9, wherein a person is given notification of a fact by another if the latter informs him of the fact “or of other facts from which he has reason to know or should know the fact.”\(^{28}\)

Section 758 of the Restatement of Torts deals with the inno-


\(^{27}\) See Anaconda Co. v. Metric Tool & Die Co., 485 F. Supp. 410, 424 (E.D. Pa. 1980) (a reasonable man would be aware that certain disclosures were a breach of the confidential relationship between employer and employee).

\(^{28}\) RESTATEMENT (SECOND) OF TORTS § 12 (1965) defines "reason to know" and "should know." The comment to § 12 notes that the two phrases differ: in that 'reason to know' implies no duty of knowledge on the part of the actor whereas 'should know' implies that the actor owes another the duty of ascertaining the fact in question . . . ‘Should know’ indicates that the actor is under a duty to another to use reasonable diligence to ascertain the existence or non-existence of the fact in question and that he would ascertain the existence thereof in the proper performance of that duty.
cent discovery of a secret and the effect of subsequent notice and change in position by the recipient of the secret:

One who learns another's trade secret from a third person without notice that it is secret and that the third person's disclosure is a breach of his duty to the other, or who learns the secret through a mistake without notice of the secrecy and the mistake, (a) is not liable to the other for a disclosure or use of the secret prior to receipt of such notice, and (b) is liable to the other for a disclosure or use of the secret after the receipt of such notice, unless prior thereto he has in good faith paid value for the secret or has so changed his position that to subject him to liability would be inequitable.

The issue, then, is whether the venture firm had notice of the facts (1) that the subject information was a secret and (2) that the former employees breached their duty to their former employer in disclosing or using the trade secret. As a practical matter, the two prongs may collapse into a single inquiry; it is difficult to imagine a high-technology, start-up company which rightfully uses another's trade secrets or confidential information.

B. Joint or Contributing Tortfeasor

The Restatement (Second) of Torts section 875 sets forth the general rule for contributing tortfeasors.

Each of two or more persons whose tortious conduct is a legal cause of a single and indivisible harm to the injured party is subject to liability to the injured party for the entire harm.

Indeed, as one court noted, the general rule is that "[o]ne who knowingly participates in or joins in an enterprise whereby a violation of a fiduciary obligation is effected, is liable jointly and severally with the recreant fiduciary."
The Restatement (Second) of Agency section 312, states that: "[A] person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal, is subject to liability to the principal." Comment (c) to section 312 states that "[A] person who, with notice that an agent is thereby violating his duty to this principal, received confidential information from the agent, may be enjoined from disclosing it and required to hold profits received by its use as a constructive trustee." Accordingly, a venture firm may be liable for misappropriation as a joint or contributing tortfeasor.

C. Aiding and Abetting

The venture capital firm may also be liable on an aiding and abetting theory of liability. As noted in the Restatement (Second) of Torts section 876, liability attaches, as an aider and abettor, for tortious conduct of another if the person "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself." Under the Restatement standard, a plaintiff must demonstrate three elements in order to impose aider and abettor liability: (1) a breach of fiduciary duty; (2) knowledge of this wrongdoing by the defendant; and (3) substantial assistance or encouragement provided by the defendant.

In *Terrydale Liquidating Trust v. Barness*, the court was confronted with plaintiff's claim that certain trustees of a real estate investment trust were liable on an aiding and abetting theory as a result of the sale of real property to them, allegedly in violation of the seller's fiduciary duties and declaration of trust. In rejecting the plaintiff's claim, the court held that actual knowledge of a breach of duty is required; mere suspicion or even recklessness as to the existence of a breach is insufficient, citing, among other authority, the Restatement (Second) of Torts section 876, comment (b). In concluding that defendants' recklessness was insufficient to establish the element of knowledge, the *Barness* court distinguished between reckless conduct as a form of knowing conduct in the context of

33. In *Armenian Hotel Owners, Inc. v. Kulhanjian*, 96 So. 2d 146, 147 (Fla. 1957), the court, while concluding that the evidence showed a "guilty participation" by the defendant in a conspiracy to deprive the plaintiff corporation of its principal asset, held that the defendant was accountable as a constructive trustee, citing the RESTATEMENT OF AGENCY § 314 (1933). The defendant was not jointly liable, however, for the "damages" assessed against the co-conspirators.


35. *Id.* at 1027.
misrepresentation and the imposition of secondary aider and abettor liability for one's role as a purchaser in an alleged tortious sales transaction.\textsuperscript{36} The \textit{Barness} court also noted that the plaintiff had cited no cases, nor could the court locate any, that imposed or even considered a claim of aider and abettor liability on a showing of less than actual knowledge of wrongdoing in circumstances like those presented.\textsuperscript{37}

Comment (b) to section 876 of the Restatement (Second) of Torts sets forth the factors for evaluating the degree of assistance required as the third element for finding liability for aiding and abetting:

The assistance of or participation by the defendant may be so slight that he is not liable for the act of the other. In determining this, the nature of the act encouraged, the amount of assistance given by the defendant, his presence or absence at the time of the tort, his relation to the other and his state of mind are all considered.\textsuperscript{38}

The issue of aider and abettor liability often arises in the securities area. In \textit{S.E.C. v. Coffey}, the court set forth the elements of liability for aiding and abetting:

Without meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.\textsuperscript{39}

In determining whether reckless conduct generally will satisfy the \textit{scienter}\textsuperscript{40} requirement of Rule 10b-5 under the Securities Exchange Act of 1934, the court in \textit{Frankel v. Wyllie & Thornhill, Inc.}\textsuperscript{41} noted that:

\begin{itemize}
  \item[36.] \textit{Id.} at 1027, n. 37.
  \item[37.] \textit{Id.} Also, the burden of demonstrating actual knowledge is a heavy one especially where the alleged aider and abettor owes no fiduciary duty to, or has no confidential relationship with, the injured party. \textit{Cf.} Armstrong v. McAlpin, 522 F.2d 84, 97 (5th Cir. 1975); H.L. Federman & Co. v. Greenberg, 405 F. Supp. 1332, 1336-37 (S.D.N.Y. 1975).
  \item[39.] 493 F.2d 1304, 1316 (6th Cir. 1974), \textit{cert. denied}, 420 U.S. 908 (1975). \textit{See also} Admiralty Funds v. Tabor, 677 F.2d 1297, 1299 (9th Cir. 1982).
  \item[40.] The term "\textit{scienter}" refers to a mental state embracing intent to deceive, manipulate, or defraud. \textit{See} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 (1976).
  \item[41.] 537 F. Supp. 730, 743 (W.D. Va. 1982), quoting Woodward v. Metro. Bank of Dallas, 522 F.2d 84, 96 (5th Cir. 1975), in turn quoting Ruder, \textit{Multiple Defendants and
If all that is required in order to impose liability for aiding and abetting is that illegal activity under the securities laws exists and that a secondary defendant, such as a bank, gave aid to that illegal activity, the act of loaning funds to the market manipulator would clearly fall within that category and would expose the bank to liability for aiding and abetting. Imposition of such liability on banks would virtually make them insurers regarding the conduct of insiders to whom they loan money. If it is assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. Knowledge of wrongful purpose thus becomes a crucial element in aiding and abetting or conspiracy cases.

The United States Supreme Court, in *Dirks v. SEC*, in discussing the derivative liability of an outsider who is alleged to have passed on insider information to others who thereafter trade on that information, noted that:

... a tippee [outsider] assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

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42. 463 U.S. 646 (1983).

43. *Dirks*, 463 U.S. at 660. Further, the Court made specific reference to the knowledge requirement as follows:

Professor Loss has linked tippee liability to the concept in the law of restitution that 'where a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.' 3 L. Loss, *Securities Regulation* 1451 (2d ed. 1961) (quoting *Restatement of Restitution* § 201(2) (1937)). Other authorities likewise have expressed the view that tippee liability exists only where there has been a breach of trust by an insider of which the tippee had knowledge. *See, e.g., Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); A. Jacobs, *The Impact of Rule 10b-5, § 167, at 7-4 (1975)* ("[T]he better view is that a tipper must know or have reason to know the information is nonpublic and was improperly obtained."); Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 818, n. 76 (1973)* ("The extension of Rule 10b-5 restrictions to tippees of corporate insiders can best be justified on the theory that they are participating in the insider's breach of his fiduciary duty.") *Cf. Restatement (Second) of Agency § 312 comment c (1958)* ("A person who, with notice that an agent is thereby violating his duty..."
In denying an *in pari delicto* defense in a 10b-5 action, the United States Supreme Court, in *Batement Eichler, Hill Richards, Inc. v. Berner*,\(^{44}\) reviewed a tippee's derivative liability and noted that "[t]he tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty" toward corporate shareholders.\(^{45}\)

Although the Ninth Circuit Court of Appeals has expressed some doubt about aiding and abetting and other "add-on" theories of liability under the Securities Act,\(^{46}\) the securities law cases stand for the proposition that to find secondary liability on an aiding and abetting theory, there must be actual knowledge and that knowledge must be knowledge not only of the underlying facts, but of the unlawful purpose.\(^{47}\) Those requirements stem from the common law element of aiding and abetting a fraud as expressed in section 876(b) of the Restatement (Second) of Torts.\(^{48}\)

As noted in *Monsen v. Consolidated Dressed Beef Co., Inc.*, to satisfy the knowledge requirement:

\[
\ldots \text{the proof offered must establish conscious involvement in impropriety or constructive notice of intended impropriety} \ldots .
\]

Such involvement may be demonstrated by proof that the alleged aider-abettor was generally aware that his role was part of an overall activity that was improper.\(^{49}\)

Finally, section 297 of the Restatement (Second) of Trusts provides a multi-factor test for determining whether a party should have known of another's breach of trust:

Among the circumstances which are or may be of importance are the following: (1) whether he knows that the person with whom he is dealing is in fact a trustee; (2) the extent to which he has reason to believe that the person with whom he is dealing is or may be a trustee; (3) the character of the property dealt with, whether it is land or a chattel or a chose in action, negotiable or non-negotiable; (4) whether the transaction is one in the ordinary

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47. We are not here concerned with situations in which there is a fiduciary duty owed by the alleged aider and abettor to the injured party, or in which a confidential relationship exists between them.
course of the business of the trustee; (5) whether the trustee is disposing of the property for much less than its real value; (6) whether the third person knows or has reason to believe that the trustee is dealing with the property for his own benefit; (7) whether the third person is purchasing the property or engaging in some other transaction with the trustee.

VI. DUE DILIGENCE: THE TWO-EDGED SWORD

Thus, almost invariably, the question of the venture firm's liability will turn on the issue of notice. Although the plaintiff has the burden of proof, the venture firm, as a practical matter, must persuade the factfinder that it did not have notice of the underlying breach of fiduciary duty, and must do so by an affirmative showing that it did not and could not reasonably have known of the unlawful conduct. By engaging in the customary due diligence, the venture firm educates itself on those facts which are at the core of the factual inquiry attendant to and presented at the trial. By the very act of engaging in due diligence, the venture firm creates the opportunity for plaintiff's counsel to assert that the venture firm, in spite of protestations to the contrary, knew or certainly should have known of the underlying breach of fiduciary duty.51

In effect, the due diligence becomes a two-edged sword. On one side, it will be used to attack the venture firm on the basis that the firm had the requisite notice, and indeed was specifically aware of and anticipated the likely assertion of the plaintiff's claims. On the other side, however, the venture firm will use due diligence as the basis for its argument that, in spite of its extensive efforts, it did not become aware of facts sufficient to put it on actual notice that there had been a breach of fiduciary duty. It may be difficult, however, for the firm to establish, whether by testimony or argument, the fact that its due diligence was both thorough and accurate, and yet that it did not go so far as to discover the underlying breach of fiduciary duty.

VII. THE POSSIBLE ARGUMENTS IN OUR PROTOTYPICAL CASE

What, then, might be the arguments of the parties in our proto-

50. See, e.g., Nickelson v. General Motors Corp., 361 F.2d 196, 198 (7th Cir. 1966). See generally JAGER, supra note 1, at § 5.02 and cases cited therein.
51. Whether the venture firm had such knowledge need not be determined based on direct evidence or the lack thereof, but may be inferred from other facts. See Rohm & Haas Co. v. Adco Chemical Co., 689 F.2d 424, 430-31 (3d. Cir. 1982).
typical case? Alphabetics will adopt some or all of the following themes and present, and accentuate, testimony or documents regarding them.

A. The Tortious Conduct of the Former Employees

Alphabetics will assert that the individual defendants, Bob, Carol and Dan, have acted in bad faith. Any preparatory steps taken by them will be probed in an effort to show that they were disloyal. In fact, the trade secret claim is accompanied by a claim for the breach of a duty of loyalty and misappropriation of a corporate opportunity. Moreover, Alphabetics will argue that its former employees developed their expertise and had access to the underlying technology and market analysis exclusively as a result of their employment with Alphabetics, that their access to the technology and market analysis was given to them on a need-to-know basis, and that their duty to Alphabetics was commensurate with their high-level positions, and with their compensation while employed by Alphabetics. Finally, Alphabetics will assert that Elfspeak is a mere continuation of the individual defendants' unlawful activity commenced while they were employed by Alphabetics.

Alphabetics' strategy will be to create an atmosphere in which the factfinder will conclude that it would be fundamentally unfair, if not morally wrong, to allow Fantastic Ventures to profit in any way from its involvement with the remaining defendants. In effect, Alphabetics will seek a finding of liability against Fantastic Ventures in the wake of such a finding against the remaining defendants.

B. Product and Market Information

Alphabetics will assert that it is a pioneer in its field and that the subject product information and market analysis is not publicly known. The lack of documentation associated with Elfspeak's

52. We will focus only on those arguments which implicate Fantastic Ventures. For a statement of the elements of a trade secret claim against the primary defendants, see JAGER, supra note 1, at § 5.04. See also MILGRIM, supra note 1, at § 7.07(1).


54. For the classical statement of the corporate opportunity rule, see Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 303, 511 (1939). Here, Alphabetics will claim that the Elfspeak product is one which Alphabetics has under consideration, and one that it will likely develop when market conditions are right. Success of this argument will probably hinge on determinations of witness credibility.

55. The comments to RESTATEMENT OF TORTS § 757 (1939) discuss both the definition of trade secrets and the secrecy requirement. Here, we have assumed that the subject product and market information is susceptible to trade secret protection.
product and the fact that Elfspeak's product is not the result of reverse engineering will draw sharp cross-examination and argument. Alphabetics will assert that "but for" the disclosure and use of trade secret and confidential information, Elfspeak's "head start" or "short lead time" would not have been achieved. Alphabetics will accentuate the fact that the misappropriated information has allowed and will continue to allow Elfspeak to avoid costly and time consuming "dead ends." Alphabetics will assert that Fantastic Ventures knew or should have known that Elfspeak's efforts and ability to develop a product within the schedule set forth in the term sheet and before the market window of opportunity closed was based upon a misappropriation of Alphabetics' propriety information. Alphabetics efforts again are intended to create a climate for a finding of liability against all the defendants lumped together.

C. The Status of the Venture Capital Firm

Fantastic Ventures will be cast as a sophisticated investor, experienced in the area and willing to take risks. In other words, the company will not be cast as an innocent third party, but as an integral part of a collective and unlawful effort. Alphabetics will assert that Fantastic Ventures effectively has control of Elfspeak by virtue of its domination of the board of directors and dominant shareholders position. Also, Alphabetics will assert that the time provisions of the term sheet show that Fantastic Ventures acted positively to force Elfspeak to rely on Alphabetics information in order to meet the time deadlines and capture the market opportunity.

56. "Reverse engineering" is simply the independent discovery of trade secret or confidential information achieved through the dissection and inspection of a product lawfully acquired and not subject to an express or implied obligation to maintain confidence. See UNIF. TRADE SECRETS ACT § 1, 14 U.L.A. 541 commissioner's comment (1979).

57. RESTATEMENT OF TORTS § 759 (1939) provides:

One who, for the purpose of advancing a rival business interest, procures by improper means information about another's business is liable to the other for the harm caused by his possession, disclosure or use of the information.

Comment (b) to section 759 states that the principles thereof apply to information about one's business whether or not that information constitutes a trade secret.

58. See Winston Research Corp. v. Minnesota Mining & Mfg. Co., 350 F.2d 134, 144 (9th Cir. 1965); Aerosonic Corp. v. Trudyne Corp., 402 F.2d 223, 228 (5th Cir. 1968).

59. See Telex Corp. v. IBM Corp., 510 F.2d 894 (9th Cir. 1978) per curiam, cert. dismissed, 423 U.S. 802 (1975) (liability imposed for development cost savings with respect to product not marketed).
D. Using Due Diligence Offensively

Alphabetics will assert that "but for" the disclosure and intended use of the trade secret and confidential information, Fantastic Ventures would not have invested in Elfspeak, and Bob, Carol and Dan, through Elfspeak, would not have been able to compete with it. Alphabetics need not prove the causal link between the disclosure or use and the investment, however, because as against Fantastic Ventures, Alphabetics is only required to show that Fantastic Ventures had notice that such disclosure or use constituted a breach of fiduciary duty. 60

Focusing specifically on Fantastic Ventures' due diligence, Alphabetics will argue that Fantastic should not be permitted to hide behind the advice of its counsel. 61 The due diligence was conducted, if not directly under the guidance and assistance of Fantastic Ventures' counsel, then certainly with its counsel's knowledge and approval. 62 The focus of the due diligence was on the very subject of the litigation, namely, any possible breaches of confidence. Alphabetics will support its assertions by presenting its own expert on the purpose, nature and extent of due diligence in the industry.

Alphabetics will also point out that the overwhelming industry practice is to make software packages available only upon the execution of an appropriate license agreement or other pledges of confi-

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60. **Query:** Is the investment by Fantastic Ventures (i) "use" of the trade secrets within the meaning of the RESTATEMENT OF TORTS § 757; and (ii) "substantial assistance" within the meaning of the RESTATEMENT (SECOND) OF TORTS § 876? Alternatively, is disclosure of information to Fantastic Ventures sufficient "use" by Bob, Carol and Dan to support relief, if the court ultimately finds that Fantastic Ventures' investment was based not on that disclosure, but on information independently developed in Fantastic Ventures' due diligence?

61. It is beyond the scope of this article to analyze the potential liability of professionals such as lawyers, accountants and other consultants who work with the venture capital firm as part of its due diligence effort. In Kochler v. Pulvers, 606 F. Supp. 164, 171 (S.D. Cal. 1985), however, the court determined that an attorney who helped draft a prospectus may be liable as an aider and abetter if he knew that those for whom he worked were committing a fraud and he substantially aided the overall enterprise, citing Admiralty Fund v. Jones, 677 F.2d 1289, 1296 (9th Cir. 1982).

62. Fantastic Ventures may face a difficult tactical decision if a situation arises at trial which permits it to invoke the attorney-client privilege. Fantastic Ventures may not want to disclose confidential communications with its counsel, yet because this is a civil action, the factfinder may be allowed to draw an adverse inference from Fantastic Ventures' assertion of the privilege. The law in this area is inconsistent. See McCORMICK, ON EVIDENCE § 76 (1954); 8 WIGMORE, ON EVIDENCE § 2322 (1940). Proposed Federal Rule of Evidence § 513 would have prohibited any comment by opposing counsel on any inference from the invocation of the attorney-client privilege. See 2 WEINSTEIN'S EVIDENCE § 513[2] (1985). For discussion of the analogous Fifth Amendment issue, see Heidt, The Conjurer's Circle — The Fifth Amendment Privilege in Civil Cases, 91 YALE L. J. 1062 (1982); Note, Use of the Privilege Against Self-Incrimination in Civil Litigation, 52 VA. L. REV. 322 (1966).
dentivity. Here, Alphabetics will highlight Fantastic Ventures’ understanding of industry practices, both as a consequence of its prior experience in the industry and as a result of the work of its consultant. Accordingly, Alphabetics will argue, Fantastic Ventures knew or should have known that virtually all information concerning the Alphabetics’ product and its market was considered proprietary.

E. The Venture Capital Firm’s Response

Obviously, Fantastic Ventures wants Elfspeak and its principals to prevail, because there can be no liability against Fantastic Ventures without a finding of liability against Bob, Carol, Dan or Elfspeak. At the same time, Fantastic Ventures will be seriously concerned with its legal exposure, which may exceed the amount of money already, invested in Elfspeak. Accordingly, Fantastic Ventures must strike a balance between supporting the primary defendants, Bob, Carol, Dan and Elfspeak, and yet not appearing to stand too close to them and thereby creating a risk that Fantastic Ventures will be lumped together with the primary defendants in the case of a finding of liability against them. The appropriate balance is difficult to strike. At a minimum, Fantastic Ventures should have separate counsel. Its counsel will be faced with several tactical decisions in trying to achieve the appropriate balance. For example, should Fantastic Ventures’ counsel cross-examine Alphabetics’ witnesses who testify only on issues implicating the primary defendants? In addition, should Fantastic Ventures’ counsel introduce or comment on, in his or her opening statement and closing argument, evidence not directed toward the secondary liability of Fantastic Ventures?

Fantastic Ventures will assert that it relied on the express representations of Bob, Carol and Dan that their intended venture would not place them in violation of any employment or confidentiality agreement, or of any other agreements with Alphabetics. Fantastic Ventures will also assert that its investments in the new enterprise were based, in part, on its assessment of the business plan of the principals of Elfspeak. If Elfspeak’s business plan does not contain any trade secret or confidential information, Fantastic will

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64. This point may also cut both ways; Alphabetics will argue that the representation was sought precisely because Fantastic Ventures was on notice of the likelihood of wrongdoing by the principals. Press reports concerning recent litigation between two major oil companies suggest that a similar argument was highly persuasive to the jury.
accentuate that fact. Of course, if Elfspeak's business plan does contain such information, then Fantastic Ventures must show, in a real sense, that it did not understand, or have notice of the fact, that the information was of a trade secret or confidential nature. It may be difficult for Fantastic Ventures to prevail on such an assertion while simultaneously defending the quality of its due diligence.

Fantastic Ventures will accentuate the fact that Bob, Carol and Dan took no documents with them and necessarily delivered no documents reflecting trade secrets or confidential information to it. It makes no difference, however, as a matter of law, whether the information was taken in the form of documentation or merely taken in the heads of the former employees and thereafter disclosed or used, particularly where, as here, the founders did not need documentation in order to carry away the trade secret and confidential information.

Fantastic Ventures will attempt to show that its investment in the new company was based in substantial part on its determination that the principals were extremely competent and that their general knowledge, experience and skill in the relevant market would ensure the success of the enterprise. The argument will be difficult, however, because Elfspeak intends to market a specific product in a specific market. The information regarding the product and the market is precisely the information which Alphabetics will assert is trade secret and/or confidential.

Fantastic Ventures will further claim that its decision to invest in Elfspeak was the result of its due diligence, which yielded no incriminating facts, and not, as Alphabetics contends, as the result of Fantastic Ventures' calculated gamble to take advantage of trade secret and confidential information which it knew or should have known was misappropriated.65 Fantastic Ventures may present evidence regarding its duty to its investors, which requires that the principals of Fantastic Ventures not unnecessarily and unreasonably expose its investors' capital to legal risk. Alphabetics will rejoin by asserting that venture capital firms and their investors are primarily engaged in high risk ventures. In addition, the enormous

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65. Fantastic Ventures' use of an independent consultant in its due diligence will provide an opportunity for Fantastic Ventures to show that its consultant did not uncover information which led him or her to conclude that the proposed product development must be based on misappropriated information. Alphabetics, however, can rejoin by arguing that the independent consultant's superior knowledge of industry standards and existing and potential market conditions should be imputed to Fantastic Ventures so as to put it on notice of a breach of fiduciary duty. If the factfinder concludes that there was in fact a misappropriation, it is difficult to see how Fantastic Ventures' argument can prevail.
potential return from Elfspeak's venture justifies any risk, financial
or legal, attendant to Fantastic Ventures' investment.

Fantastic Ventures may also rely on industry standards regarding
due diligence. It can show what other venture capital firms do
and how its due diligence was consistent with the industry standard.
The difficulty with this argument is that the industry standard in-
cludes important elements of due diligence which are specifically
directed at possible adverse legal consequences resulting from the
intended investment. These adverse legal consequences are focused
primarily on the potential liability of the new company and its prin-
cipals for misappropriation of trade secrets or confidential
information.

Fantastic Ventures' prospects of avoiding liability may depend
in large measure on its ability to rebut Alphabetics' allegations that
it was a joint or contributing tortfeasor or liable as an aider and
abetter because Fantastic Ventures knew or should have known of
the breach of the underlying fiduciary duty. The factfinder's deter-
mination in this regard, however, may depend on the factfinder's
assessment of the credibility of the witnesses. For example, Gopher
will testify on behalf of Fantastic Ventures that he did not know
that Bob, Carol and Dan may have violated their fiduciary duty to
Alphabetics. In spite of Gopher's direct testimony, however, the
factfinder may determine that Gopher, and therefore Fantastic Ven-
tures, knew or should have known of the breach as the result of
Fantastic Ventures' due diligence. Unfortunately, there may not
have been any alternative way in which Fantastic Ventures could
have structured the transaction or conducted its due diligence so as
to avoid this dilemma.

66. Gopher can testify to his knowledge, intent and state of mind as the general partner
of Fantastic Ventures. See 2 WIGMORE, ON EVIDENCE § 581 (1940) (practically universal
disapproval of the view that a person, especially a party, should be disqualified from testifying
as to his own intent or motive even where that intent or motive is material to the investiga-
tion). Of course, Gopher's testimony may not be believed by the factfinder.

67. Query: Can Fantastic Ventures claim that although it may have had knowledge of
the facts which ultimately are determined to be sufficient to afford trade secret protection to
Alphabetics' information, it did not know that use or disclosure of such information by Bob,
Carol and Dan would constitute a breach of fiduciary duty? In short, is Fantastic Ventures
required at its peril to anticipate the factfinder's ultimate conclusion? Although this question
may seem to provide a convenient solution to the problem, resolution in favor of Fantastic
Ventures would appear inconsistent with basic principles applied to litigants in other situa-
tions. For example, the inability to predict a factfinder's determination in a "business judg-
ment" case has not been thought to relieve a director of his/her potential liability.

68. Had Fantastic Ventures sought and received agreements from Bob, Carol and Dan
requiring indemnification of Fantastic Ventures in the event of litigation, those agreements
might be used as evidence that Fantastic Ventures knew that the Elfspeak venture involved
VIII. **Recommended Legal Standard**

The most appropriate legal standard to be applied in these situations is one that requires either knowing participation by the venture capital firm in the breach of the underlying fiduciary duty sufficient to find liability as a joint or contributing tortfeasor, or, on an aiding and abetting theory, *actual* knowledge on the part of the venture capital firm that such a duty is being violated. Investments by venture capital firms may be essential to either the growth or continued vitality of regional economies. To the extent that courts use a less than knowing participation or actual knowledge standard, there necessarily will be a substantial chilling effect on investments by venture capital firms in situations like these.

Despite the requirements of Rule 11 of the Federal Rules of Civil Procedure and comparable state court rules, there appears to be increasing resort to so-called "tactical law suits" in which a company sues its former employee in order to stifle, in large measure, any further investment in the new venture and thereby inhibit competition. On a lesser standard than that recommended here,

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69. Rule 11 of the Federal Rules of Civil Procedure provides:

> "The signature of an attorney or party constitutes a certificate by him that he has read the pleading, motion, or other paper; that to the best of his knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation."

Rule 11 also provides for sanctions against the attorney, his client or both where the rule is violated.

70. Defined broadly, "tactical law suits" include both those actions in which proprietary rights violations are asserted in bad faith, and those actions where serious questions of the advisability and appropriateness of litigation have been resolved in favor of proceeding with litigation because of the impact of the mere pendency of the action. For example, the pendency of the litigation might inhibit any further investment in the new venture by venture capitalists; might have a chilling effect on the willingness of vendors and other third parties to enter into business relationships with the new venture; and might seriously impair the ability of the new venture to make the customary warranties and representations in the marketplace regarding its ownership and right to use the underlying technology. In addition, the pendency of an action may have an *in terrorem* effect on existing employees of the plaintiff who might be entertaining thoughts of leaving and founding competitive enterprises. Finally, in cases where the departure of key employees from the plaintiff has been highly publicized, the filing of litigation might stabilize the stock price and otherwise afford the plaintiff's stockholders some comfort in knowing that the plaintiff is vigorously pursuing its legal rights.

71. Although a defendant may assert counterclaims in response to a tactical law suit in appropriate circumstances, such counterclaims are difficult to prove because the means used to inhibit competition is the litigation itself, and the plaintiff has a First Amendment interest
venture capital firms would have greater exposure to such suits. In addition, venture firms might decline to pursue investment opportunities because the cost of due diligence may become prohibitive in light of the potential legal exposure.

Moreover, a possessor of trade secrets or confidential information is in most instances, protected against misappropriation of such information. Where a misappropriation of trade secrets is proved, the plaintiff can show that it is entitled to appropriate monetary and/or injunctive relief against the former employees and the new venture.\(^\text{72}\) By using the recommended legal standard, plaintiffs, in some situations, may prove liability against the primary defendants, but may be unable to prove liability against a venture capital firm and thereby will be deprived of an opportunity to collect on a monetary judgment against a defendant able to satisfy the judgment. Otherwise, the plaintiff is protected. We suggest that the availability of an additional “deep pocket” recovery is not necessary to give adequate protection to trade secret plaintiffs, and that the arguments in favor of broadening such recoveries are outweighed by the potential inhibiting effect on venture capital financings.

In addition, to the extent that the former employer wants to limit competition by its former employees, it can enter into covenants not to compete with its employees. Covenants not to compete, if they are reasonable in time, territory and activity enjoined, are generally enforceable.\(^\text{73}\)

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\(^{72}\) In a trade secrets case, a successful plaintiff can be awarded damages in the nature of lost profits, an accounting of the defendant’s profits or the imposition of a reasonable royalty. See generally MILGRIM, supra note 1, at § 7.08[3]; JAGER, supra note 1, at § 7.01. In addition, courts often use their creative equitable power in fashioning appropriate injunctive relief. See, e.g., Analogic Corp. v. Data Translation, Inc., 371 Mass. 643, 649, 359 N.E.2d 804, 806 (1976). Courts can also specifically enforce express covenants not to disclose trade secrets or confidential information. See Cherne Industries, Inc. v. Grounds & Associates, Inc., 278 N.W.2d 81, 92 (Minn. S. Ct. 1979).

\(^{73}\) See MILGRIM, supra note 1, at § 2.09[7][ii]; RESTATEMENT (SECOND) OF CONTRACTS § 188 (1973); see also Fleming Sales Co., Inc. v. Bailey, supra note 71 (an employer worried that the skills and knowledge acquired by an employee during the course of employment will give him or her an undue competitive advantage may guard its interests by use of a restrictive covenant).
The policy rationale reflected in the securities law cases applies with equal force in these situations. To impose secondary aiding and abetting liability without actual knowledge of wrongful purpose may unreasonably expose venture firms to liability and, as pointed out in the *Woodward* case, may make the venture capital firm an insurer regarding the conduct of companies in which they invest. Arguably, the former employer would merely be required to prove a breach of fiduciary duty by its former employees and assistance by the venture firm in the form of its investment.

The actual knowledge standard also reflects the reality of financing high technology start-up companies. In most situations, the founders of a new venture have taken permissible preparatory steps while still in their prior employment. Once they terminate their employment, they must move quickly to capitalize on their product concept and market opportunity. The venture firm conducts its due diligence speedily, discreetly and in a manner which minimizes the chance that the founders' business plans will be disclosed to third parties, including the founders' former employer. The venture firm should not be forced, in effect, to contact the former employer as part of its due diligence to determine whether the new venture's business will result in a breach of the former employee's fiduciary duty and thereby precipitate litigation. The former employer would want to know the nature of the new venture's product and its anticipated marketing methods in order to respond to the venture firm's inquiry. Any disclosure along those lines certainly diminishes the new venture's actual or potential competitive advantage. The former employer simply may take business measures to forestall or block effective competition. At a minimum, the former employer could withhold its approval or, if the situation so warrants, hold out the threat of litigation until it has more information which it can verify. Even the most forthcoming former employer would be reluctant to waive claims it may have in light of what necessarily will be a minimal disclosure. Certainly counsel for the former employer would almost always recommend against any statement in the nature of a waiver, however qualified.

For the foregoing reasons, courts faced with claims against venture capital firms which have funded start-up companies should apply the generally recognized standards associated with joint

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74. *See supra* notes 39-47 and accompanying text.
75. *Woodward*, 522 F.2d at 96.
76. *See Restatement (Second) of Agency § 393 (1957).*
tortfeasor or contributing tortfeasor liability, and, with respect to secondary liability as an aider and abettor, the actual knowledge standard that has found favor in the securities law cases.