

Can Claims for Software Copyright Infringement and Trade Secret Theft Co-Exist? Don't Bank On It!

On June 30, 2015, the U.S. Court of Appeals for the Fifth Circuit ruled that state law claims of theft involving software are preempted by federal copyright law. *Spear Marketing, Inc. v. BancorpSouth Bank et al.*, ___ F.3d ___, 2015 WL 3972246 (5th Cir. June 30, 2015). (A copy of the opinion can be found [here](#).) The Fifth Circuit thus joins the majority of federal appeals courts which have granted copyright preemptive sway over trade secrecy, meaning that claims relating to trade secrets embedded within software may only be vindicated as copyright violations (in federal court) and not trade secret misappropriation (in state court). For software companies, this is not necessarily bad news as the remedies afforded by federal copyright—which include actual damages, statutory damages, and attorneys fees—are generally greater than those afforded by state trade secrecy law—which are usually limited to actual damages. Nevertheless, software companies should take extra caution in the manner in which they assert their rights in court, lest they arm infringers with an easy dismissal on the basis of federal preemption.

Copyright Preemption in Action

Spear Marketing Inc. (“SMI”) developed a proprietary cash management software program,

VaultWorks, designed to help banks optimize cash levels, by reducing the amount of cash—a non-earning asset—in bank branches, ATMs, and central vaults, and thereby freeing up surplus cash for earning purposes.

BancorpSouth Bank (“BCS”) was one of SMI’s largest customers. SMI never provided BCS—or any of SMI’s customers—with the source code, object code, or software for VaultWorks; rather, BCS was allowed to enter daily cash flow information into VaultWorks on customer-specific user interface screens SMI made available to its customers via the internet.

In 2011, after using VaultWorks for nearly ten years, BCS decided not to renew its contract with SMI, instead opting to license an alternate cash management software solution from ARGO Data Resource Corp. (“ARGO”), a competitor of SMI.

In August 2012, alleging that BCS colluded with ARGO throughout the preceding year to misappropriate SMI’s trade secrets related to VaultWorks, SMI filed suit in Texas state court against BCS and ARGO, asserting nine state law claims, including trade secret misappropriation, violation of the Texas Theft Liability Act (TTLA), unjust enrichment, fraud, breach of

contract, and unfair competition. Each of SMI's state law claims centered on the misappropriation of its trade secrets, which defendants supposedly stole in order to build a competing cash management solution and siphon business away from SMI.

In September 2012, the defendants removed the case to federal court, arguing that SMI's claims were preempted pursuant to the federal Copyright Act (17 U.S.C. §§ 101 *et seq.*).

Section 301(a) of the Copyright Act, which establishes the Act's exclusivity, provides:

"[A]ll legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright . . . in works of authorship that are fixed in a tangible medium of expression and come within the subject matter of copyright as specified [elsewhere in the Copyright Act], whether . . . published or unpublished, are governed exclusively by this title. Thereafter, no person is entitled to any such right or equivalent right in any such work under the common law or statutes of any State."

In May 2013, the U.S. District Court for the Northern District of Texas denied SMI's motion to remand the case back to state court, holding that federal jurisdiction was proper because at least two of SMI's claims—

including its TTLA and conversion claims—were completely preempted.

Under the "complete preemption doctrine," the pre-emptive force of a particular statute may be so extraordinary that it converts an ordinary state common-law complaint into one stating a federal claim. If a federal statute completely preempts an area of state law, any claim purportedly based on that pre-empted state law is considered, from its inception, a federal claim, and therefore arises under federal law. Accordingly, as noted by the district court, if any of SMI's state claims are preempted, the entire case may be removed to federal court.

On appeal, the Fifth Circuit applied a two-part test to determine whether a state law claim is preempted by the Copyright Act:

- First, the claim is examined to determine whether it falls "within the subject matter of copyright" as defined by Section 102 of the Copyright Act.
- Second, the cause of action is examined to determine if it protects rights that are "equivalent" to any of the exclusive rights protected by Section 106 of the Copyright Act, such as the right to reproduce the copyrighted work, to prepare derivative works based upon the copyrighted work, and to distribute copies of the

copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending.

As to the first prong of the preemption analysis, section 102(a) extends federal copyright protection to “original works of authorship fixed in any tangible medium of expression.” However, section 102(b) excludes from copyright protection “any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work.”

SMI maintained that its trade secrets—which SMI carefully defined to include only “know-how, ideas, procedures, processes, systems, methods of operation, and concepts”—fell outside the scope of the Copyright Act, by virtue of Section 102(b).

The defendants argued—and the Fifth Circuit agreed—that because the processes and systems at issue had been fixed in a tangible medium of expression, SMI’s software—and the trade secrets contained therein—qualified as copyrightable subject matter for purposes of section 301(a) preemption, even though the software also contained elements that are unprotected under section 102(b).

In finding that that the technical trade secrets contained within VaultWorks fall within the subject matter of copyright, the court noted:

“First, computer software is a tangible medium protected by the Copyright Act. Second, SMI claims as trade secrets, *inter alia*, “the selection of categories of input data used by VaultWorks . . . [and] selection of categories of output data to be generated by VaultWorks.” Although some of these may be ideas, they are “fixed,” so to speak, in the VaultWorks software user interface. As the crux of SMI’s case is that ARGO stole its trade secrets by (1) enticing SMI to perform a demo of its software to ARGO, as part of an acquisition pitch, and (2) receiving screenshots of VaultWorks from BCS during the implementation of CIO, SMI cannot dispute that these ideas have appeared in a tangible medium. And as the tangible medium falls within the subject matter of copyright as defined in § 102(a), so do the specific trade secrets contained within it.” (Citations omitted.)

As to the second prong of the preemption analysis, in analyzing SMI’s causes of action to determine if they protect rights that are “equivalent” to any of the exclusive rights of a federal copyright, the Fifth Circuit agreed that SMI’s conversion and TTLA claims were completely preempted.

While claims relating to physical property—as opposed to intellectual property fixed in a tangible medium—do not fall within the scope of

interests protected by the Copyright Act, claims for conversion of intangible property are preempted. The Fifth Circuit therefore found that SMI's conversion claim, to the extent it alleges conversion of intangible "confidential information" and "certain trade secrets," is preempted.

SMI's TTLA claim was predicated on three allegations: (i) defendants stole SMI's physical property, documents, and confidential information; (ii) defendants copied objects, materials, and writings representing SMI's confidential information; and (iii) defendants communicated and transmitted SMI's confidential information. Because copying, communicating, and transmitting are equivalent acts to reproducing and distributing, the Fifth Circuit agreed that SMI's TTLA claim is also preempted.

In holding that copying or theft of an idea or non-copyrightable work fixed in a tangible medium is preempted by federal copyright law, the Fifth Circuit aligns itself with the Second, Fourth, Sixth, Seventh and Ninth Circuits. To date, the Eleventh Circuit is the sole outlier, finding that ideas are categorically excluded from copyright protection, even if the matter is fixed in a tangible medium. How the remaining Circuits will rule is yet to be seen.

Implications

As claims involving theft or misappropriation of trade secrets

contained in software may be preempted as copyright violations subject to exclusive federal jurisdiction, software publishers now have an even greater incentive to federally register the source code underlying their software offerings with the U.S. Copyright Office. Naturally, trade secret information should be redacted from any source code deposited with the U.S. Copyright Office.

Further, while federal registration is not required to enjoy legal protection in a copyrightable work, there are significant benefits of federal registration, regardless of the jurisdiction in which the copyright holder operates its business. Most notably, a copyright holder's rights in a work generally cannot be enforced—via a copyright infringement lawsuit—unless the work is federally registered. Further, without timely registration, a copyright holder is limited to actual damages in the case of infringement, which may be nominal and/or difficult to prove. With registration, however, the copyright holder is entitled to statutory damages—up to \$150,000 per infringement—and attorneys' fees.

Given the relatively low filing fees, federal copyright registration of your software clearly gives the most bang for your buck. At least that you can bank on!

If you have any questions about this article, please contact:

Robert McHale, Esq.
R | McHale Law
9 West Broadway, Suite 422
Boston, MA 02127
Tel. 617.306.2183
Email: robert.mchale@rmchale.com



DISCLAIMER: The contents of this publication are not intended, and cannot be considered, as legal advice or opinion. The contents are intended for general informational purposes only, and you are urged to consult an attorney concerning your situation and any specific legal questions you may have.