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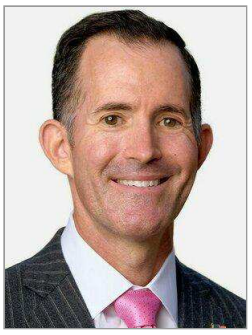
Takeaways From Holmes' Unsuccessful Trade Secret Defense

By **Bradford Newman, Sara Pitt and Kelton Basirico** (March 28, 2022, 5:27 PM EDT)



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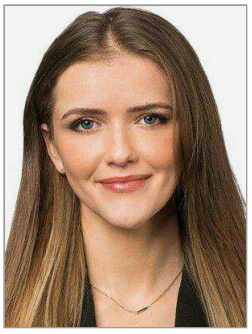

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In 2004, Elizabeth Holmes dropped out of Stanford University to start Theranos Inc., a health care technology startup once valued at $10 billion, which touted an ability to run hundreds of tests with blood drawn from a single finger prick.

On Jan. 3, 2022, a federal jury for the U.S. District Court for the Northern District of California found Holmes guilty in U.S. v. Elizabeth Holmes,[1] on four counts of fraud based on statements made to investors and business partners about Theranos' proprietary blood testing devices, their capabilities and uses in the market.

Throughout her trial, the jury heard testimony regarding Holmes' and Theranos' efforts to silo employees and limit the visibility of outside investors — all in the name of protecting the company's valuable trade secrets.

But, while Theranos claimed that its privacy measures were in line with some of the most revered startups to come out of Silicon Valley, Holmes' trial revealed that much of this secrecy was simply a measure of deceit designed to cover up failed — and phantom — technology and deteriorating business strategy.

In the hypercompetitive world of technology-driven startups, and for more mature companies in other industries, Holmes' attempt to immunize herself from the consequences of her fraud by invoking the purported need to protect the company's trade secrets provides valuable lessons about the contours of what is — and is not — entitled to legitimate trade secret protection.

What Is Not Entitled to Trade Secret Protection

The Holmes trial uncovered a number of secrets — but not trade secrets — Holmes withheld from the investing and consuming public, as well as the stories she told to cover them up. Among them, was Holmes' boast that Theranos' proprietary technology could allegedly conduct more than 1,000 tests with a just few drops of blood — and that these tests generated the highest quality results.

Evidence presented at trial, however, revealed that Theranos' devices could run only 12 tests — and in the face of repeated concerns regarding accuracy of their results, Holmes instructed lab employees to toss purported outliers from result sets. What's more, jurors learned that the vast majority of commercial tests run by the company were being performed on existing third-party commercial analyzers, not the Theranos-developed machines.

Holmes' lies did not stop at the efficacy of her allegedly innovative technologies, but expanded to the business itself. Despite internal revenue estimates of less than $150 million, Theranos publicly disclosed estimates over $1 billion. And to get investors to buy in on the vastly inflated projections, Holmes bolstered her lies with more lies.

Theranos claimed to have entered into agreements with the U.S. military to use its proprietary devices on helicopters in Afghanistan, and fabricated the endorsements of big-name pharmaceutical companies on internally generated reports validating the devices and results.

In her defense, Holmes claimed a need for secrecy to protect the company's valuable intellectual property, including because Theranos had not finished filing patents for its allegedly innovative technology. But Holmes' secrets extended well beyond the need to protect her allegedly proprietary innovations.

Instead, they centered on efforts to hide significant shortcomings. As the jury's verdict reflects, they perceived Holmes' statements not merely as omissions regarding the effectiveness of emerging technology, but as affirmative misstatements about the capabilities and present use of the startup's core technology. Simply stated, the statutory protections afforded to legitimate trade secrets do not serve as permission to lie to investors, partners and patients about what the alleged technology can — and in this case, cannot — accomplish.

When Secrecy Is Appropriate

Secrecy — as compared to blatant lies — is appropriate, and in fact required, when reasonably necessary to protect legitimate trade secrets. The Uniform Trade Secrets Act, now adopted by 49 States, defines a trade secret as:

- Information, including a formula, pattern, compilation, program, device, method, technique, or process that:
    - Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
    - Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Not only does a trade secret need to provide a competitive advantage to its owners over competitors that disclosure would undercut, but it in order to protect a trade secret, it must be just that — a secret.

Holmes' failure to actually develop the innovative technology she pitched to investors certainly met the secrecy requirement. But the reasonableness of Holmes' secrecy measures is of no consequence where the secrets she was guarding were nothing more than material falsehoods intended to cover up over a decade of failures in her business and its technology.

The vaporware nature of what was supposed to be game-changing technology derives no independent economic value from not being generally known, and in fact, Holmes' concealment of these shortcomings as part of fundraising constituted garden variety fraud.

In this context, it is important to stress that certain development failures can potentially warrant trade secret protection. In fact, courts have found certain instances of negative knowledge — such as failed experiments — to be protectable trade secrets when its disclosure could provide a leg up to competitors, for example by allowing a competitor to save time or money by skipping a step in the development process.

Take, for example, Waymo LLC v. California Department of Motor Vehicles,[2] in which the Superior Court of Sacramento County on Feb. 18 granted temporary injunctive relief for autonomous car company Waymo allowing the company to withhold certain proprietary information — including the company's internal analyses of collisions involving its driverless vehicles — from public disclosure.

Waymo's petition successfully claimed that such information constitutes a trade secret, and that its release

> will allow Waymo's competitors access to confidential information regarding the design, process and operational implementation of Waymo's [autonomous vehicles].

Unlike with Theranos, the court found the information Waymo sought to withhold contained

> no evidence ... that the information sought by the document request contains evidence of fraud or that its nondisclosure would otherwise work injustice which would eliminate the trade secret privilege.

In sum, the saga of Holmes offers valuable insight into the significant dangers of excessive puffery in the startup world. There is a fundamental distinction between failures that instruct how to successfully build innovative technology, and fraudulent scams designed to mask the lack of the innovation purportedly being sold to investors and the market.

Companies should take great caution in their representations to the investing and consuming public, and understand that not all information one wishes others not know is a statutorily protectable trade secret — and as Holmes has learned, that concealment of material information can constitute criminal fraud.

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[1] United States v. Elizabeth Holmes, et al., 18-CR-00258-EJD (N.D. Cal.).

[2] Waymo LLC v. California Department of Motor Vehicles, No. 34-2022-80003805 (Cal. Super. Ct. Feb. 18, 2022) (order granting preliminary injunction).
