

*Intellectual Property Valuation Insights***THE VALUE OF A TRADE SECRET***Robert P. Schweih*

An important distinction between a trade secret and other types of intellectual property is that a trade secret is never registered with a federal or state agency. This discussion describes the generally accepted trade secret valuation approaches, methods, and procedures. The most appropriate valuation method for any particular trade secret valuation analysis is usually influenced by: (1) the purpose and objective of the valuation, (2) the quantity and quality of available data, and (3) the experience and judgment of the valuation analyst.

INTRODUCTION

Any subject matter is eligible for trade secret protection as long as it:

1. gives a competitive advantage to its owner and
2. is being kept secret.

Legal protection of the other types of intellectual property—patents, copyrights, and trademarks—is available only when the attributes of that intellectual property are disclosed to the public.

Patent protection is available for new and useful machines, processes, manufacturers, and compositions of matter—as long as they meet the novelty and nonobviousness requirements. Clearly, in order to meet those requirements, the critical attributes of the invention must be made known.

Similarly, copyright protection is available for original literary, musical, and artistic expression which, of course, has been revealed.

Trademark protection extends to visually perceivable names, marks, or product features that consumers identify with particular sources.

In contrast, trade secrets are undisclosed. Therefore, trade secrets are not as well recognized as an asset class as are these other types of intellectual properties.

Any information, technical or nontechnical, can qualify as a trade secret if:

1. the information is not generally known in the trade,

2. there have been appropriate steps taken to protect the secrecy of the information, and
3. there is an actual competitive advantage derived from the secrecy of the information.

Many companies make the deliberate decision to not patent certain technological advances. This decision is made because, in order to get legal protection as a patent, the technology must be revealed in detail in the patent application.

A patent and a trade secret cannot exist in the same idea at the same time. This is because the attributes of a patent have to be made public. And, a trade secret ceases to exist when it becomes public knowledge.

A patent protects against unlicensed use of the patent even by one who, through independent research, legitimately discovers it. However, unlike a patent, novelty and nonobviousness are not requisite characteristics of a trade secret.

COEXISTENCE WITH OTHER INTELLECTUAL PROPERTY

A trade secret can coexist with other intellectual property. A trade secret can exist based on confidential information that is:

1. misappropriated before the time that the patent gets issued or
2. related to the use of a patent.

Copyright and a trade secret often coexist in computer systems when vendors of a computer software program rely on:

1. copyright protection for the object code and
2. trade secret protection for the source code.

Trademark and trade secrets coexist when a product incorporating the trade secrets is sold under a label.

If a counterfeit product is produced, the plaintiff may assert both:

1. a trade secret claim for the taking and use of the trade secrets and
2. a trademark claim for use of the label.

ILLUSTRATIVE EXAMPLES OF TRADE SECRETS

The type of business information that typically is considered a trade secret includes information about:

1. customers, such as customer order and credit characteristics, confidential customer lists, and proprietary mailing lists;
2. personnel, suppliers, or distributors, such as sources of supply;
3. the costs and pricing of goods, as well as the books and records of the business;
4. new business opportunities and current methods of doing business; and
5. know-how, such as databases and operating manuals.

Some commonly recognized commercial intangible assets may, in fact, be trade secrets. For example, under certain circumstances such common intangible assets as proprietary technology, customer relationships, formulas, chemical processes, and performance manuals may qualify as trade secrets.

The confidential information that is the basis of a trade secret generally relates to the continuous production of goods, as opposed to confidential information regarding a single event in the conduct of the business.

Examples of single-event confidential information that is not usually considered an intellectual property asset include the following:

1. the bid price of a contract
2. the bonuses of certain employees

3. the date of the announcement of a new policy
4. the price of an acquisition

Improper disclosure of these types of corporate information may be the subject of legal action. However, the claim is usually not brought as misappropriation of a trade secret intellectual property asset.

The legal interest in a trade secret arises somewhat spontaneously and perhaps broadly. The expected remaining useful life of a trade secret may not be obvious. This is because spontaneous, independent development of similar ideas by innocent third parties can shorten or end the life of the trade secret.

In many situations, trade secrets are not held precious. This is because, in our information-based economy, they are frequently created but are rapidly disseminated or become obsolete.

However, trade secrets can be extremely important and valuable. This is because the expected remaining useful life of a trade secret is potentially unlimited. A trade secret is protected as long as competitors fail to duplicate it by legitimate, independent research.

THE IDENTIFICATION OF THE SUBJECT TRADE SECRET

Having secret information is not the same as owning a trade secret. To be a trade secret, the secret has to provide an economic advantage to its owner. And, some information or knowledge must be accessible in order for the trade secret to generate an economic advantage.

When a trade secret is generally identified as an asset subject to valuation outside of a litigation context, the valuation analyst may seek some legal counsel (and other expert) advice to define the bundle of rights that are to be included as the trade secret asset. Important components of the trade secret intellectual property are that it is:

1. not known in the trade and
2. used to the owner's advantage in a business.

In many situations, those essential attributes of the trade secret intellectual property may not become known outside of the litigation.

Secrecy

Matters of public knowledge or of general knowledge cannot be appropriated as a trade secret.

Reasonable measures must be taken to protect secrecy. For example, if a company has already suffered a computer

theft of trade secrets, one would typically expect subsequent security to be at a higher level. Typically, one would expect a larger corporation to have more sophisticated trade secret protection measures than a smaller operation.

The burden of establishing reasonable security rests on the trade secret owner. The type of security measures that are in place may help the analyst to define exactly what the trade secret is. For example, if the owner did not think much about providing security to protect the information, the trade secret may have less value.

The standard of care in the industry comes into play with respect to this “security” factor. So, the measures used by competitors in the industry may be one security standard to consider when analyzing the reasonableness of the care taken to protect the secrecy of what has been identified as the trade secret asset.

Competitive Advantage

Whether a trade secret provides a competitive advantage is usually determined by analyzing the economic benefit associated with the trade secret. The economic benefit may be based on the increased revenue or profit available to the trade secret owner. Or, the economic benefit may be based on the trade secret owner’s ability to reduce competition.

The trade secret owner’s competitive position is either better as a result of the trade secret, or the competitor’s position is diminished because it lacks knowledge of the trade secret.

Competitors who lack knowledge of the trade secret would otherwise have to spend time, effort and money in trial and error to get into the position they would occupy if they had the trade secret knowledge.

Special Relationship

If the party who has allegedly misappropriated a trade secret can show that the trade secret was independently developed without access to or use of the owner’s information, then alleged infringer has the right to practice with the information embodied in the trade secret.

A trade secret is protected until it is revealed through innocent means or deliberately through reverse engineering. Reverse engineering is a process in which the competitor begins with the end product and, using only information that already exists in the trade, uncovers the secret information.

Trade secret protection is extended to owners of such secret information in order to prevent actions by employees or third parties who obtain access to the information in confidence and then breach that obligation of confidentiality. A special relationship may be formed between the owner of the secret information and employees or third parties who obtain access to the information in confidence.

Contractual agreements can provide evidence of the special relationship and help protect an owner from persons who have access to proprietary information. Employment agreements with confidentiality covenants or confidentiality agreements with subcontractors are examples.

A covenant not to compete may be different from a confidentiality covenant. This is because, for example, even after the term of a noncompete agreement expires, the obligation to protect a trade secret may survive.

COMMON REASONS FOR THE TRADE SECRET VALUATION ANALYSIS

There are numerous individual reasons for conducting a valuation or economic analysis of a trade secret. Typically, all of these individual reasons can be grouped into a few general categories of client motivations:

1. Transaction pricing and structuring for the sale, purchase, or license of the intellectual property.
2. Financing securitization and collateralization, for both cash flow-based financing and asset-based financing.
3. Financial statement reporting, taxation planning and compliance with regard to: reporting the value of assets acquired in a business combination, intangible asset amortization deductions, abandonment loss deductions, charitable contributions, and various other federal income taxation matters—as well as with regard to federal gift and estate tax compliance and estate planning.
4. Management information and strategic planning, including business value enhancement analyses, identification of licensing and other commercialization opportunities, identification of spin-off opportunities, and other long-range strategic issues.
5. Pre-bankruptcy and reorganization analysis and planning (because the bankruptcy process itself may require disclosure of the information).
6. Litigation support and dispute resolution, including infringement, misappropriation, fraud and misrepresentation, lender liability, marital dissolution, and a wide range of deprivation-related reasons (e.g., breach of contract, expropriation, etc.).

GATHERING TRADE SECRET OWNER/ OPERATOR-SPECIFIC DOCUMENTATION

Trade secret ownership interests are routinely examined from many perspectives by corporate intellectual property owner/operators. The corporate legal, sales, accounting, and tax departments may maintain information that relates to the value of the trade secret.

The corporate legal department may retain documentation about previous license/sale transactions involving the information embodied in the trade secret. When prior transactions are used in a trade secret valuation analysis, controversy may arise as to whether, for example:

1. the property/information conveyed in the transaction is comparable,
2. there were contingencies attached to the transaction or
3. the transaction took place at arm's-length.

Information regarding the commercial applicability of the trade secret may be maintained in the corporate sales department in the form of trade association publications, brochures and catalogs, customer or supplier databases and files, contractual obligations, proposals, order backlogs, and budgets and forecasts.

The accounting and tax departments may apply inter-company transfer prices when information is owned in one state or country in which the company does business and is used in another state or country in which the company does business.

TRADE SECRET VALUATION APPROACHES AND METHODS

Regardless of the reason that the trade secret value is required, the valuation analyst may consider all three generally accepted approaches to estimating the value of the trade secret. However, the purpose to which the valuation is put may affect the valuation methods used or the emphasis placed on each valuation method.

Typically, valuation analysts attempt to apply the market approach to value trade secrets. Valuation analysts typically research "the market" for both sale transactions and license transactions that may be useful in estimating the value of the subject intellectual property.

When it comes to trade secrets, it is difficult to find and to analyze pricing data related to other trade secrets that have changed hands in arm's-length transactions. It is often difficult to apply the market approach to generate a meaningful trade secret value indication. This is because of the difficulty of comparing one trade secret to another.

The cost approach is based on the total cost to create, at current prices, a hypothetical trade secret that has utility equal to the subject trade secret. The cost approach may be difficult to apply to value trade secrets. This is because of the difficulty of demonstrating the costs that would be required to replace unique information.

The valuation analyst will typically apply one or more income approach valuation methods to value the trade secret.

These income approach valuation methods include:

- Valuation methods that quantify incremental levels of economic income. That is, the subject trade secret owner will enjoy a greater level of economic income by owning the trade secret as compared to not owning the trade secret.
- Valuation methods that quantify decremental levels of economic costs. That is, the subject trade secret owner will experience a lower level of economic costs by owning the trade secret as compared to not owning the trade secret.
- Valuation methods that estimate a relief from a hypothetical license agreement royalty payment. That is, the amount of a royalty that the trade secret licensee would be willing to pay to a third-party owner in order to obtain the use of—and the rights to—the trade secret.
- Valuation methods that quantify the difference in the value of the trade secret owner's business. The differential in the owner's business value is measured as the difference in two operating scenarios.

In the first operating scenario, the trade secret is owned and used in the subject business. In the second operating scenario, the subject business does not own the trade secret and does not use it in the business.
- Valuation methods that estimate the value of the trade secret as a residual from the value of the overall business enterprise. These valuation methods may also estimate the value of the trade secret as a residual from the total intangible asset value of the business enterprise.

ESTIMATING A TRADE SECRET LOST PROFITS/ECONOMIC DAMAGES FOR LITIGATION SUPPORT PURPOSES

Trade secret infringement claims are usually brought under state laws. The exact tort under which a trade secret owner can seek relief is different from state to state.

Most states have adopted the Uniform Trade Secrets Act to protect trade secrets. Theft of a trade secret may be a federal crime under the Economic Espionage Act of 1996. This statute criminalizes receiving, buying, or possessing trade secret information that has been stolen.

When a trade secret has been misappropriated or is alleged to have been misappropriated, the owner may seek a remedy from the court. The owner of a trade secret who suspects misappropriation will first attempt to preclude its disclosure by telling the intruder to not reveal the proprietary information.

The first challenge is to determine whether or not the information qualifies as a trade secret. The evidence required to investigate this challenge requires disclosure from the owner of the secret of at least some proprietary information. This evidentiary process is intrusive and often discourages parties from pursuing claims of trade secret misappropriation.

Once in court, the first remedy the court may consider in the face of a threat of misappropriation of a trade secret is an injunction. Again, to get to this point, some proprietary information needs to be disclosed.

After the trade secret has been misappropriated, however, the cure is more likely to be a remedy of economic damages (i.e., money) than of an injunction. In the situation where the trade secret has already been misappropriated, the economic damages may be judged to be equal to the sum of the:

1. profits already lost,
2. disgorgement of the infringer's profits, and
3. future lost profits.

Claims for profits already lost (i.e., prior to the date of the trial) are analyzed beginning with historical evidence regarding the performance of the competitors and the action of customers in the relevant market. This information is considered in the lost profit analysis even if that information was not known or knowable on the date that the alleged misbehavior began.

Evidence for the existence and the amount of economic damages usually unfolds from the date of the alleged misappropriation. This is in contrast to a valuation analysis of trade secrets.

In the typical valuation assignment, the analysis usually excludes consideration of any information that was not known or knowable as of the valuation date.

The measurement of lost profits usually begins with an estimate of lost sales (either in dollars or in units). Spare parts, replacement parts, tools, and other products that have a functional relationship with and are sold in tandem with the trade secret are called "convoyed products."

In some cases, revenue from convoyed products that were sold or would have been sold along with the trade secret is included in the measurement of lost sales.

Some of the other valuation methods previously mentioned may be applicable in the process of estimating economic damages. For example, to determine the profit margin to apply to the lost sales, guideline prices, transactions, or royalty rates may be considered.

When estimating lost profits beginning with lost revenue, only incremental costs should be subtracted. An incremental cost is a cost associated with producing the additional number of units at the 'but for' volume level. In this way, incremental costs are not the same as variable costs.

If the trade secret owner would have sold its units at prices higher than the actual historical prices "but for" the infringer's competition, then the trade secret owner has suffered damages from price erosion.

In many ways, the price erosion analysis is similar to the lost profits analysis: measure the difference in the intellectual property owner's revenue (and consequential profit) that is attributable to the infringement. Adjustments should be considered for "price elasticity," that is, the effect that the different price would have on the volume of sales.

Similarly, the effect that the price and quantity of units sold would have on the incremental costs should typically be measured.

The infringer would attempt to demonstrate that, instead of the infringer's competition, it was market forces (such as customer bargaining power and noninfringing alternative products) that prevented the trade secret owner from enjoying the higher product price alleged by the plaintiff.

When measuring lost profits by applying a royalty rate to lost revenue, it may be appropriate to award a reasonable royalty greater than or at the high end of the range of rates and terms that the parties would have negotiated had they met in the normal course of business. If the rate is simply equal to what the parties would have negotiated, then the infringer would be in a "heads-I-win, tails-you-lose" position.

If the remedy is no more than the normal rate that would have been paid, parties would be motivated to infringe. This is because all it would eventually cost them is what they would have had to pay in license fees anyway if they had negotiated in good faith from the outset.

Disgorgement of an infringer's profit may be part of an appropriate remedy for trade secret misappropriation. Many of the same factors considered when measuring lost profits are encountered when measuring the infringer's profits.

For example, it may be difficult to isolate the appropriate revenues of the defendant when the infringing product is bundled and sold in combination with other products or aggregated in the defendant's financial records.

Let's assume the court finds that infringement of a trade secret has occurred and an injunction preventing future use is not a reasonable remedy. In that case, to capture future lost profits, the court will often impose a reasonable royalty on future revenue generated by the infringer.

VALUING A TRADE SECRET FOR (NON-LITIGATION) TRANSACTIONAL OR NOTATIONAL PURPOSES

There is an obvious potential contradiction in the process of valuing a trade secret outside of a litigation context.

Some kinds of information or knowledge must be disclosed in the normal course of business.

This information must be disclosed in order for the trade secret to generate an economic benefit for its owner. Disclosure of too much information would reveal the secret and eliminate the legal protections available to trade secrets.

Thus, some kind of special relationship is needed between the trade secret owner and at least certain workers. In the litigation context, a court will preserve the secrecy of an alleged trade secret by reasonable means by, for example:

1. granting protective orders in connection with discovery proceedings,
2. holding in-camera hearings,
3. sealing the records of the action, and
4. penalizing any person involved in the litigation who discloses a trade secret.

Preservation of the trade secret that is valued outside of the litigation context is more challenging. Therefore, confidentiality agreements are increasingly commonplace in order to protect information that may be judged to be trade secrets.

When a trade secret is to be valued for financing securitization and collateralization purposes, the lender is typically interested in knowing the value of the intellectual property in case of default on the loan.

In the event of a default, one of the typical lender's remedies is foreclosure on the intellectual property. And, to foreclose on a trade secret, the lender may need to be able to secure and disclose, if necessary, detailed information regarding the intellectual property.

For financial statement reporting and/or taxation planning and compliance purposes, it may not be necessary to disclose the details of the trade secret in order to report its value. However, auditors may be skeptical when the details of the trade secret cannot be disclosed.

Ordinarily, the bankruptcy and reorganization processes are intrusive and may require disclosure of the protected information. Here again, the stakeholders in the bankruptcy proceeding are inherently skeptical. Trade secrets are difficult to keep during the debtor reorganization process.

TRANSACTION PURPOSES AND MANAGEMENT INFORMATION PURPOSES

When trade secrets change hands in a transaction with a third party, the trade secrets are usually bundled with other assets. This is because they coexist with other assets that are included in the transaction.

Some intellectual property owner corporations carry out intercompany transactions among related corporate entities at intercompany transfer prices. These intercompany prices may reflect specific corporate goals and objectives that may not be consistent with arm's-length pricing.

For example, a domestic corporate entity may make trade secrets available to a foreign related party at a royalty rate that is greater than or less than what would result if the parties were negotiating on an arm's-length basis.

Valuation analysis for intercompany transfer pricing purposes may need to be presented in a format that conforms to the transfer price methods necessary for that purpose.

Transaction-based methods used in intercompany transfer pricing assignments prepared for federal income tax purposes include:

1. the comparable uncontrolled price method,
2. the comparable uncontrolled transaction method,
3. the resale price method, and
4. cost plus methods.

Income approach methods used in intercompany transfer pricing assignments include:

1. the comparable profits method, and
2. several profit split methods.

A detailed description of these transfer pricing methods is beyond the scope of this discussion.

SUMMARY AND CONCLUSION

Trade secrets enjoy special legal recognition. A trade secret is protected as long as competitors fail to duplicate it by legitimate, independent research. Confidentiality agreements to protect information that may be judged to be trade secrets are increasingly commonplace.

There are many reasons to conduct a valuation or economic analysis of a trade secret. Regardless of the reason that the trade secret value is required, the valuation analyst will typically consider all three generally accepted approaches to estimating the trade secret value.

The purpose and objective of the valuation may also affect (1) the valuation methods to be applied or (2) the emphasis placed on the each valuation method.

Robert Schweih is a managing director of the firm and is resident in the Chicago office. Bob can be reached at (773) 399-4320 or rschweih@willamette.com.