

TRADE SECRET LICENSING

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## **I. Understanding Trade Secrets.**

### **A. Legal Framework for Trade Secrets.**

The system of trade secret law is defined principally by the Uniform Trade Secret Act, adopted in most states and Washington DC and by common law principles in non-UTSA jurisdictions. Trade secret rights also arise under federal law, most notably the Federal Economic Espionage Act.

The following states have not adopted the UTSA, and rely on common law:

- New York\*
- Texas
- New Jersey\*

The following state has a trade secret statute not modeled on the UTSA:

- Massachusetts\*

\* Bills introduced in 2006 to adopt UTSA.

The UTSA and allied common law principles protect trade secrets by providing a set of remedies for *improper* access, use or disclosure those secrets. The crux of any trade secret lawsuit is this notion of the *propriety* of the use, access or disclosure, not just the *proprietary* nature of the subject matter. In that sense, trade secret law is more akin to tort law than property law.

## **B. Trade Secrets Defined.**

In California, which has adopted the UTSA, a trade secret is defined as:

Information, including a formula, pattern, compilation, program device, method, technique, or process that: (1) derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. Cal. Civ. Code § 3426.1(d).

The restatement of torts offers a similar definition:

A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. Restatement of Torts § 757.

Under both the statutory and common law formulations, the scope of trade secret protection is very broad in terms of subject matter. A whole range of business and technical information is potentially eligible for protection.

The following are examples of subject matter that has been protected under trade secret law:

- Computer software and hardware
- Formulas, designs, production processes and product strategies
- Customer lists

- Customer product use and preferences, and other customer information
- Internal cost information and profit margins
- Know-how
- Articles written by employees describing company business processes
- Marketing materials

Note that trade secrets are not necessarily exclusive, which distinguishes them from other types of intellectual property such as patents. Suppose, for example, that there are twenty competitors in a market and two of the twenty independently develop and protect, as secret and proprietary, a formula. Is that formula trade secret even though held by two companies? Potentially, yes. Neither the statute nor the common law definitions require that the putative trade secret holder be the only party in the world that possesses the secret knowledge. Rather, the requirement is that the information not be “generally known to the public or to other persons who can obtain economic value from its disclosure or use” and be subject to reasonable efforts to safeguard its secrecy.

### **C. Rights of Trade Secret Owners.**

Trade secret law protects the owner of a trade secret from misappropriation. Misappropriation can take several forms under the UTSA:

- (i) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or

- (ii) disclosure or use of a trade secret of another without express or implied consent by a person who
  - (A) used improper means to acquire knowledge of the trade secret; or
  - (B) at the time of disclosure or use, knew or had reason to know that his knowledge of the trade secret was
    - (I) derived from or through a person who had utilized improper means to acquire it;
    - (II) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or
    - (III) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
  - (C) before a material change of his or her position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

Several points should be noted with regard to this definition. First, it effectively provides the owner of a trade secret with three rights:

- the right to prevent access through improper means
- the right to control disclosure
- the right to control use

Second, in each instance, misappropriation requires an element of impropriety. Information that is acquired,

disclosed or used through proper means is not the subject of trade secret misappropriation.

For example, the following have been held proper means for acquiring a putative trade secret:

- Discovery by independent invention
- Discovery by reverse engineering of a known product (provided that the known product is acquired by fair and honest means such as purchase on the open market)
- Discovery under a license from the owner of the trade secret (provided that any subsequent disclosure or use is permitted under the license)
- Observation of the item in public use or on public display
- Study of published literature

Third, information acquired by mistake or accident (notwithstanding reasonable efforts to safeguard secrecy) can still be protected from misappropriation if the acquiring party “before a material change of his or her position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.”

#### **D. Comparing Trade Secrets to Other Types of IP.**

To more fully understand trade secret protection, it is helpful to compare it to other types of intellectual property.

## **1. Patents.**

A patent under 35 USC § 100 is an exclusive right in an invention granted by the government upon application by the inventor. Perhaps the antithesis of trade secrets, a patent grant effectively bestows a property right in an invention for a limited time in exchange for the public disclosure of that invention in the form of a published patent. Once that limited time expires (typically 20 years from the date an application for patent is initially filed), the invention enters the public domain.

Patents protect inventions from unauthorized use, manufacture or sale, without regard to whether the invention was acquired by the infringer through “improper means.” For example, subsequent independent invention is not a defense to a claim of patent infringement.

A trade secret could, but does not necessarily have to be, patentable subject matter. Many times companies must make a strategic decision whether to protect a subject technology as a trade secret or a patented invention.

## **2. Trademarks.**

A trademark under 15 USC § 1051 is a word, name, symbol, or device used by a person to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods. In other words, trademarks are brands.

The trademark law protects against use of the same or similar brands on the same or related goods in a manner that is likely to cause confusion among purchasers as to the origin of the goods.

Prior to its use in commerce, a proposed trademark or series of trademarks could conceivably be protected as a trade secret.

But generally speaking, trademarks, like patents are the antithesis of trade secrets. One notable commonality between trademark infringement and trade secret misappropriation is that they are both a form of unfair competition.

### **3. Copyrights.**

Copyrights under 17 USC § 101 are rights in original works of authorship. These rights protect against reproduction, modification, distribution, public performance or public display of copyrighted works.

Copyrighted works are often published (and therefore not secret). However, it is possible that a trade secret would be documented or memorialized in an unpublished copyrighted work, and that the distribution, reproduction or modification of that work would constitute both copyright infringement and trade secret misappropriation.

#### **E. Acquiring and Maintaining Trade Secret Rights.**

Trade secret protection applies automatically to information that is secret and provides the owner with economic value and is subject to of reasonable effort to safeguard its secrecy. No expensive application process is required as in the case of patents. This makes trade secret law a cost-effective alternative to patent protection if the invention can be maintained in secrecy.

- **Secrecy.** The information must not be generally known within the industry; absolute secrecy is not required,

but those with knowledge must be under a duty of confidentiality.

- **Economic Value.** The information must provide the owner with an advantage over its competitors; considerations include the time and money spent on developing the trade secret, the willingness of others to pay for access to the information, and the benefits derived from its use.
- **Reasonable Efforts.** The owner must make reasonable efforts to maintain secrecy and by restricting disclosure to persons subject to an obligation of confidentiality.

Disclosure of a trade secret is made in “confidence” when (1) the person to whom the secret is disclosed expressly promises to keep it secret, or (2) it is disclosed in the context of a relationship in which the law will imply an obligation of confidentiality.

The efforts required to maintain secrecy need only be reasonable. Courts do not require extreme security measures to safeguard against industrial espionage. Reasonable efforts can include the following:

- Restrict access to persons with a “need to know”
- Destroy unnecessary copies of proprietary documents
- Password protection
- Use encryption
- Identify and mark proprietary materials
- Employ physical security measures (lock up documents)
- Employee exit interviews
- Physical dispersion (no individual has full knowledge of entire processes)

- Access controls
- Restrict visitors

#### **F. Remedies for Misappropriation.**

The UTSA provides a range of remedies for misappropriation:

- **Injunctions.** Misappropriation may be enjoined permanently for a limited period of time.
- **Damages.** Damages can include both the trade secret owners' actual losses and the defendant's unjust benefit caused by misappropriation. Alternatively, damages may be based on a reasonable royalty.
- **Exemplary Damages.** If willful and malicious misappropriation exists, the court may award exemplary damages not exceeding twice actual damages.
- **Attorneys Fees.** In cases where a claim of misappropriation is made in bad faith or where misappropriation is willful and malicious, the court may also award attorneys fees to the prevailing party.

Courts may provide broad relief for trade secret misappropriation, including injunctions and damages. Misappropriation may also constitute criminal conduct.

#### **G. Doctrine of Inevitable Disclosure.**

In many states, courts recognize the doctrine of inevitable disclosure, which holds that an employee (even absent proof of bad intentions) can be enjoined from taking employment with a competitor if the nature of the new jobs means the

employee will “inevitably” disclose trade secret information of the previous employer.

The leading case applying the doctrine of inevitable disclosure is *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995), in which the court held that a plaintiff may prove a claim of trade secret misappropriation by demonstrating that defendant’s new employment will inevitably lead him to rely on the plaintiff’s trade secrets. The rationale behind *Pepsi* is that if the defendant is imbued with the previous employer’s trade secrets, that it would be impossible for him to perform a similar function at a competitor without necessarily taking advantage of those secrets.

California courts have squarely rejected the doctrine of inevitable disclosure. In California, employees are free to work for competitors without restriction, so long as they do not in fact misappropriate their former employer’s trade secrets. *Whyte v. Schlage Lock Co.*, 101 Cal.App.4th 1443, 1446 (2002) (holding that “Lest there be any doubt, our rejection of the inevitable disclosure doctrine is complete”).

## **II. Drafting Considerations.**

### **A. Defining the Subject Matter.**

A principal drafting challenge in preparing a trade secret license is to define the trade secret that is the subject matter of the license.

Trade secrets may be defined either expressly – that is where the secret itself is specified in the contract or an exhibit -- or by reference to one or more past or prospective extrinsic communications. For example:

“Secret Sauce” means...

- the formulae generally described on Exhibit A.
- the formulae specified on Exhibit A.
- the steak sauce formulae set forth in Documentation delivered by Licensor pursuant to Section 2.2.
- any and all technical information relating to hamburger sauces disclosed or otherwise made available orally, visually, electronically, or in writing by Licensor to Licensee.

In some cases, the licensed subject matter will be very specific and therefore amenable to precise definition. In other cases, the licensed subject matter will include amorphous know-how that may be conveyed orally or visually. In the latter circumstance, the licensor will require a definition that makes reference to extrinsic communications where this know-how is imparted to the licensee.

In any case, the licensor will typically require the licensee to expressly acknowledge the trade secret status of the licensed subject matter.

The careful drafter should be aware of several nuisances in defining and describing trade secrets.

First is the distinction between information and artifact. The trade secret or other licensed subject matter is knowledge and therefore inherently abstract. That knowledge, however, may be embodied in a physical artifact such as a prototype or documentation. One practical implication of this distinction

is that the license should expressly address the delivery of applicable artifacts and the licensor should retain physical title to these. They remain the licensor's personal property apart from the trade secret information embodied therein.

Second is the distinction between trade secrets, on the one hand, and know-how and confidential information, on the other hand. Trade secrets are pieces of information that meet the applicable common law or statutory definition of trade secrets.

Confidential Information is information that is not generally known. A person's medical records are confidential information, but they are not her trade secret.

Know-how is technical information that one party happens to have and the other party happens to want. Know-how is not necessarily a trade secret or even confidential information.

In sum, all trade secrets are necessarily confidential information, but not all confidential information constitutes a trade secret. Know-how may, or may not be, confidential or a trade secret.

The drafter should bear in mind this critical fact: when one prepares a contract, one can define rights and responsibilities with respect to *all* of this information above and beyond the rights and remedies afforded to trade secrets.

In other words, a licensor can require a licensee to keep medical records confidential, even though they are not trade secrets. Likewise, a licensor can require payment for the transfer of know-how, even if the information is publicly available.

## **B. Complications in Defining Trade Secrets.**

### **1. Oral or Visual Disclosure.**

One of the principal difficulties in defining knowledge transfer occurs when the information is not memorialized and is likely to be delivered orally or visually. The lack of documentation presents risks to both parties: the licensor's concern is in proving that it in fact was the source of particular information; the licensee's concern is the over-zealous licensor who alleges transfers of information that did not in fact take place.

The first – and licensee favorable – tactic for addressing this problem is to simply exclude from the definition of licensor's intellectual property any information that is not disclosed in writing.

In transactions involving ongoing collaboration and meetings, this restriction will be objectionable to the licensor, who is likely to divulge information orally or visually. To address this concern, the definition of licensor's intellectual property can provide an opportunity for oral or visual disclosures to be summarized in a writing with a set time period (typically thirty days) to preserve confidentiality of those materials.

A licensor with sufficient bargaining power will reject both of these tactics and simply insist that any secret information imparted to the licensee remain confidential regardless of its mode of transmission.

### **2. Improvements.**

Another problematic area is the ownership of improvements. A licensee will often improve upon a trade secret, raising the question of which party owns the resulting improvement. From a licensor's perspective, the answer is clear: the licensor should own any improvement that utilizes the underlying trade secret.

From a licensee's perspective, however, this arrangement potentially ensnares the licensee in ongoing obligations to the licensor even when the original underlying trade secret is no longer a trade secret. Ultimately, the issue is resolved by the parties' relative bargaining power.

### **3. Exceptions.**

Because trade secrets are perishable, a licensee will seek to include exclusions to the licensor's protected information in cases where the information is not in fact secret. Typical exclusions include:

- Already in Licensee's possession, free of any obligation of confidence, as shown by Licensee's written records in existence at the time of disclosure.
- Generally known to the public at the time Licensor communicates such information to Licensee.
- Becomes known to the public through no fault of Licensee
- Acquired from a third party without restriction
- Independently developed by Licensee's personnel without the benefit of access, directly or indirectly, to the trade secrets

#### **4. Residuals.**

A challenge to the licensee in accepting trade secrets or other confidential information is the risk that the information will be inadvertently used or disclosed by the licensee's employees once they have been exposed to it simply because the information is in the employees' unaided memories.

To address this risk, licensees may insist on a so-called residuals clause such as the following:

Either party shall be free to use for any purpose the residuals resulting from access to or work with such Confidential Information, provided that such party shall maintain the confidentiality of the Confidential Information as provided herein. The term "residuals" means information in non-tangible form, which may be retained by persons who have had access to the Confidential Information, including ideas, concepts, know-how or techniques contained therein. Neither party shall have any obligation to limit or restrict the assignment of any such persons or to pay royalties for any work resulting from the use of residuals. However, the foregoing shall not be deemed to grant to either party a license under the other party's copyrights or patents.

In effect, the residuals clause acts as an exception to the requirement of confidentiality by excluding information in the memories of persons exposed to the trade secret.

The strategic impact of a residuals clause will depend on the nature of the information that is disclosed. If the information is a list of 10,000 customers, the residuals clause might have limited effect on the protection of the licensor's information.

If, however, the information is a new type of semiconductor gate that, once explained to a qualified engineer, is forever understood, then the residuals clause effectively eviscerates the licensor's rights in that information.

### **C. License Grants and Prohibitions.**

Our next drafting consideration is license grants and prohibitions. These provisions define what the licensee is authorized to do with the trade secret and the artifacts that embody it.

It is helpful to recall that a license is permission to do something that is otherwise legally prohibited. In the case of trade secrets, what is legally prohibited? The answer of course it is *misappropriation*, which in licensing terms translates into rights (and prohibitions on) the access, use and disclosure of the trade secret information.

For example:

Licensee may use the Trade Secret to design, test, manufacture and maintain Licensed Products.

Licensee may disclose the Trade Secret to those of its employees who have a need to know the Trade Secret in order for Licensee to exercise its rights hereunder; provided, however, that each employee receiving the Trade Secret has first entered into an enforceable written agreement with Licensee in the form of Exhibit A.

Licensee may reproduce one (1) back-up copy of the Documentation so long as such copy bears (without modification) the proprietary rights legend set forth on the Documentation as provided by Licensor.

The issue of access, while potentially the subject of the license grant, is usually addressed in a provision under which the licensor will physically deliver to the licensee artifacts (such as files, documents or prototypes) that embody the trade secret information.

A careful drafter representing a licensor will include in the license provisions a blanket prohibition against all disclosure or use of the trade secret except those disclosures and uses expressly permitted in the license.

Licensors who retain physical title to artifacts delivered to the licensee can also address – from a personal property perspective – the permissions and restrictions on use of those artifacts.

Finally, to the extent that the trade secret information is conveyed in copyrightable documentation, the license grant can include copyright-centric provisions permitting or restricting reproduction and creation of derivative works.

#### **D. Safeguards.**

In connection with the granting of license rights and the imposition of restrictions, a licensor should specify that the licensee will exercise at least reasonable safeguards to keep the trade secret secure. Failure to require a licensee to exercise these safeguards could jeopardize the trade secret status of the licensed information.

Depending on the value and sensitivity of the licensed information, a licensor might specify in considerable detail the required security measures. These can include:

- Strict Limitation of Internal Distribution
- Physical, Logical and Procedural Security

- Off-Network Storage
- Limited Serialized Reproduction
- Use Only at/in a Specific Site or Jurisdiction

To ensure compliance, a license licensor may want to have the right to audit or inspect the licensee's handling of licensed information.

#### **E. Royalty.**

Royalty schemes in a patent or copyright license are constrained by concepts of misuse. For example, a licensor cannot charge a royalty on sales of a patented article after the patent has expired.

Trade secret licensing is more flexible because in effect what the licensee is paying for is the disclosure of the secret and parties have more freedom to construct the metrics that will be used to calculate that payment.

This flexibility is reflected in several ways. First, the royalty base can be more liberally defined to include revenues that are related to exploitation of the secret but that transcend the commodities that embody the secret.

Second, payment obligations can also survive public disclosure (and thus destruction) of the trade secret.

Third, the obligation to pay royalty can be based on global sales or manufacturing activities. In contrast, patents are limited to specific jurisdictions and an astute patent licensee will object to payment of royalties on activities that fall completely outside those jurisdictions where licensed patents have been obtained.

## **F. Enforcement and Remedy.**

Because a licensee can destroy trade secret rights through mishandling of the licensed information, a licensor should insist on contractual provisions that will permit expeditious, cost-effective judicial relief if such mishandling is threatened.

This provisions include typical dispute management clauses such as choice of law, jurisdiction and venue, and service of process. Licensors should also consider a provision awarding attorneys fees to the prevailing party.

From the licensor's perspective, the agreement should specify that equitable relief is available. Rather than rely on a boilerplate clause, however, a licensor may want to enumerate specific types of relief such as destruction of inventory and return of documents, that are tailored to the specific transaction.

When dealing with foreign licensees, arbitration can be an effective dispute resolution vehicle; however the arbitration clause should contemplate that the licensor may seek equitable relief in any forum having jurisdiction over the licensee.

To deter breach, licensors can insist on immediate or automatic termination of license rights in the event of material breach.

If the licensee is permitted to disclose licensed information to third-party disclosees, those disclosees should be in privity with the licensor, such as by signing a form of nondisclosure agreement that is attached to the license as an exhibit. A licensor might also insist on indemnification by the licensee

for any misappropriation committed by third-party disclosees to whom the licensee provides the licensed information.

Finally, because it may be difficult to measure damages for misappropriation of a trade secret or other breaches (such as the failure to provide agreed-upon security measures), the parties can consider liquidated damages clauses.

### **III. Practical Tips.**

We conclude with practical tips for trade secret licensing:

- Never disclose a trade secret that you are not willing to lose.
- The contract is no substitute for trust built on the recipient's honesty, competency, longevity and solvency.
- Think of the worst case and work backward. For example, if your client is the licensor, and a misappropriation were to occur in a distant country, how would your client achieve a cost-effective and timely legal remedy?
- Keep the contract administrable and auditable.
- Try to break the secret up into pieces and avoid giving one party all the pieces.
- If you license a strategic secret outside the US, try to have as a contracting party a viable, deep-pocketed defendant that you can sue in the U.S.