The economic valuation of trade secret assets

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The economic valuation of trade secret assets has perplexed the intellectual property bar for years. This perplexity emanates from the economic and legal aspects of a trade secret that must be validated in litigation.

Today, trade secret valuations are necessary for strategic planning, accounting and commercial transactions. But most companies do not have an internal accounting system designed to identify, classify, protect and value trade secrets. This article addresses the valuation of trade secrets.

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Several accepted methods exist for the valuation of a property asset: depreciated cost, replacement cost, fair market value and net present value of future cash flows. All can be acceptable valuation measures under specific circumstances.

Depreciated cost is the cost of an asset that can be depreciated. It is equal to the acquisition cost of the asset minus its estimated salvage value at the end of its useful life. Depreciation represents how much of an asset's value has been used. It allows a company to earn revenue from the assets it owns by paying for them over time. For intangible assets, including trade secrets, the depreciated cost accounting method is not acceptable. Depreciation requires physicality.

Replacement cost is the cost to replace the asset. But how does one replace a flash of genius? By what means can one calculate the amount an entity would have to pay to replace a trade secret? For patents, copyrights and trademarks, injunctive relief can be a true replacement — the restoration of the exclusive use of the intellectual property. But trade secrets, once lost, are lost forever. The bell cannot be unrung. Under these circumstances, the replacement cost cannot even be conceptualized, much less determined.

Fair market value is the price that an asset would sell for in an open market. There are typically no ''market-comps'' for trade secrets

which are, by nature, secret. The trade secret holder protects against disclosure of the trade secret assets to derive an economic advantage from the secrecy of the trade secret information. Thus, a fair market valuation is often impossible for trade secret assets.

The valuation method that works best for trade secret assets is the *net present value of future cash flows*. This is a method of valuing a trade secret asset using the concept of the time value of money. The estimate of future cash flows is discounted to a present dollar value by a present value discount rate.

Net present value of a future cash flow requires an evaluation of three factors:

(1)   The total amount of future cash flow;

(2)   The discounted basis of that future cash flow as a present value;

(3)   The probability that the future cash flow will occur.

If accurate values can be assigned to these three factors, then the economic value of a trade secret can be calculated by multiplying these three factors together.

The first factor in the trade secret valuation model is the total amount of income over time to be derived from keeping the information secret, as compared to the expected income over time if the information were in the public domain. This is analogous to the valuation of patents, where the economic value of the patent is the value of the exclusive right to prevent others from making, using, offering for sale, or selling the patented invention.

The second factor in the trade secret valuation model is a valuation method used to estimate the value of an investment based on expected future cash flows. The discounted cash flow (DCF) analysis seeks to determine the value of an investment today, based on projections of how much money that investment will generate in the future.

The third factor in the trade secret valuation model is the assessment of the probability of future cash flows derived from the trade secret asset, which can be calculated by evaluating the probability of the trade secret holder prevailing in a civil lawsuit to protect the trade secret asset.

The third factor has been the stumbling block and barrier to calculating the economic value of a trade secret asset because it has been widely assumed (erroneously) that it is too risky to

calculate the probability of validating the existence of a trade secret in a trade secret misappropriation lawsuit. These risks include the failure of the trade secret holder to take reasonable measures to protect the trade secret asset; the risk that the trade secret will be misappropriated by a former employee or competitor; and the risk there will be public disclosure of the trade secret.

There is a powerful tool for validating the existence of a trade secret and predicting the likelihood that the alleged trade secret will qualify as a statutory trade secret. It is the six-factor test identified by the American Law Institute in 1939 after a review of over 100 years of case law in the 19th century.

Everything has risks. Probability means possibility. How likely is something to happen? In trade secret law, secrecy defines the probability of the existence of a trade secret. There is a low probability of trade secret misappropriation for a well-protected trade secret. There is a high probability of loss for a poorly protected trade secret.

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The six factors are:

Factor 1: The extent to which information is known outside the company (the more extensively the information is known outside the company, the less likely that it is a protectable trade secret).

Factor 2: The extent to which the information is known by employees and others involved in the company (the greater the number of employees who know the information, the less likely that it is a protectable trade secret).

Factor 3: The extent of measures taken by the company to guard the secrecy of the information (the greater the security measures, the more likely that it is a protectable trade secret).

Factor 4: The value of the information to the company and competitors (the greater the value of the information to the company and its competitors, the more likely that it is a protectable trade secret).

Factor 5: The amount of time, effort and money expended by the company in developing the information (the more time, effort and money expended in developing the information, the more likely that it is a protectable trade secret).

Factor 6: The ease of difficulty with which the information could be properly acquired or duplicated by others (the easier it is to duplicate the information, the less likely that it is a protectable trade secret).

The six-factor test is miraculous in its predictive capabilities. The six-factor test evaluates the "strength" of the alleged trade secret ranging from a strong trade secret to a weak trade secret, to no trade secret.

Evaluation of the economic value of a trade secret asset, using the six-factor test, provides the factual basis for the trade secret holder to identify the economic value of a trade secret asset including the calculation of the probability of future cash flows resulting from the six-factor analysis.

The economic valuation of trade secret assets is not too risky. It is a necessary requirement for trade secret accounting. Well established valuation methods and the six-factor test provide trade secret holders with the tools necessary to determine the economic valuation of trade secret assets.

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