



## **Trade Secret Audits: Protecting And Valuing Your Company's Secret Know-How**

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## **TRADE SECRET AUDITS: FOUNDATION FOR IDENTIFICATION & VALUATION**

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## **The Importance of Trade Secrets Has Accelerated in the Last 5 Years**

- 1979 – Uniform Trade Secrets Act
  - 2014 - 47 States, D.C. and all U.S. Territories had enacted a form of the UTSA
  - 1996 - Economics Espionage Act
  - 2010 - America Invents Act
  - 2012 – Congress began considering the Protecting American Trade Secrets and Innovation Act
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## **FBI Identified Economic Espionage and the Theft of Trade Secrets as its Number Two Priority**

- Terrorism is number one

## **FBI Congressional Testimony**

- **“...Economic espionage and the theft of trade secrets are increasingly linked to the insider threat and the growing threat of cyber espionage.”**

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## **Trade Secrets Are No Longer the Poor Second Cousin to Patents, Trademarks and Copyrights**

- **Wide adoption of UTSA**
- **Federal legislation**

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## **Today's Collaborator May Be Tomorrow's Competitor**

- **Joint ventures**
- **Product collaborations**
- **Failed mergers or acquisitions**
- **Non-disclosure agreements**
- **Just the beginning**

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## **How Does a Company Know it Has a Trade Secret?**

- **Not until tested in litigation**

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## Trade Secret Audits

- **Systematically identifying, categorizing and valuing the trade secrets of a company**

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## Trade Secret Audit Team

- **Lawyer: Knowledge and experience in trade secret litigation**
- **Engineers, Plant/Office Managers, CFOs, Marketing Executives, Researchers, V.P. of Sales/Sales Managers and others**

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## Identify Trade Secrets

### Basic Questions to Ask:

- What information could hurt my business if my competitors could get it?
- How much would it hurt?

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## Whom Do You Ask?

- Not just your top dogs
- Include the people who actually do the work
- Protecting trade secrets is protecting job security

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## Trade Secret Security

- What are the policies/methods in place to protect trade secrets?
- Is access to trade secrets limited?
- How?
- What additional measures can you implement?

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## Not All Trade Secrets are Equal

- Some trade secrets die a natural death
  - Marketing Plans
  - Plans to Hire a New Executive
  - Product Roll-Out
  - New Office Location
- Others live forever ...if protected
  - Engineering Designs
  - Manufacturing Know-How
  - Sources of Supply
  - Formulae

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## Trade Secret Protection Plan

- Permanent trade secrets
- Temporary trade secrets
- Absolute lock-down protection for some

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## Methods and Measures Tailored to Value and Importance

- Separate file cabinets
- Separate passwords changed frequently
- No offsite transmission or downloading
- Lock out employees about to be terminated
- No laptop use for lock-down secrets

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## Educate Employees

- **Audit team & Management**
- **Need to emphasize the importance of the audit**
- **Educate – involve – re-educate and remind**
- **Non-disclosure agreements for key employees, board members and all collaborators**
- **Employee handbooks**

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## Valuing Trade Secrets

**Keep track of:**

- **Money, time, trials, errors**
- **Number of people and amount of other resources**
- **Document competitive advantages attributable to a trade secret or combination of trade secrets**

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## Trade Secrets Enhance a Company's Value

- **Litigation has a greater chance of success or becomes unnecessary**
- **Value allows the trade secret owner to establish damages more readily**
- **A well documented and well protected trade secret portfolio is worth money in a merger or acquisition**

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The purpose of this article is to assist the reader in understanding the importance of a company's trade secrets in today's business climate, the threat to those secrets through a variety of deliberate misappropriations and inadvertent disclosures, and how a trade secret audit is the first line of defense to protecting the company's valuable trade secrets.

### Background

In 1979, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Trade Secrets Act (UTSA)<sup>1</sup> for the purpose of bringing uniformity to the patchwork of trade secret laws of the various states. This Uniform Act has been adopted by every state, United States territory and the District of Columbia, except New York, North Carolina and Massachusetts, where adoption is pending. In 2012 Congress began considering the Protecting American Trade Secrets and Innovation Act. If passed, this legislation would provide for a federal cause of action when the trade secret complaint involves a substantial need for national service of process, or the trade secrets are taken from the United States to another country. Although the Justice Department has prosecuted several criminal cases under the Economic Espionage Act of 1996 (EEA), the pending legislation would allow

companies to protect their trade secrets immediately upon discovering misappropriation.

The recognition of the commercial advantages of trade secrets has been accelerating since the adoption of the America Invents Act (AIA) in 2010<sup>2</sup>. The AIA provides a safe harbor for those parties who have been utilizing trade secrets that would otherwise infringe an issued patent, so long as those trade secrets were utilized prior to the patent's filing date. Therefore, not only does a "prior user" have an ironclad defense to patent infringement, but it may also continue to use its trade secret without a license from the patent owner. Consequently, many companies have begun to evaluate carefully whether to seek patent protection or maintain trade secret protection for their inventions.

Recently, trade secrets have been newsworthy. In May of this year the United States Justice Department brought cyber-espionage charges against five Chinese military officials accusing them of hacking into computer systems belonging to several U.S. companies in order to steal their trade secrets. The Federal Bureau of Investigation's website identifies economic espionage as the FBI's number two priority—second only to terrorism. And even though cyber-espionage may garner the headlines, FBI congressional testimony points out, "...

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1 Uniform Trade Secrets Act (amended 1985), 14 U.L.A. 529 (2005).

2 35 U. S. C. § 273.

economic espionage and the theft of trade secrets are increasingly linked to the insider threat and the growing threat of cyber espionage.” The FBI enumerates seven methods for economic protection:

1. Recognize the threat.
2. Identify and value trade secrets.
3. Implement a definable plan for safeguarding trade secrets.
4. Secure physical trade secrets and limit access to trade secrets.
5. Provide ongoing security training to employees.
6. Development insider threat program.
7. Proactively report suspicious incidents to the FBI before your proprietary information is irreversibly compromised.<sup>3</sup>

Even for those who have regarded trade secrets as a poor second cousin to other intellectual property such as patents, trademarks and copyrights, the federal legislation has made obvious the need to identify, protect and value a company’s trade secret portfolio. If that is not enough, there are many cases involving potential joint ventures, contemplated acquisitions and other business transactions that fail where one party accuses the other of misappropriating its trade secrets.<sup>4</sup> Even in cases where companies exchange nondisclosure agreements there are disputes, that in some cases, cost millions of dollars. *Id.* The reality is that today’s collaborator may be tomorrow’s competitor. Thus carefully documenting and protecting your trade secrets is paramount in today’s business world.

One of the difficulties is that you cannot be sure you have a trade secret, until it is tested by litigation. Thus, the same criteria used in trade secret litigation, should be used as a guide for identifying and protecting a company’s trade secret portfolio. In short, a trade secret owner must identify the trade secrets that give it an economic advantage over its competitors, and show that it has taken reasonable measures to keep them secret by limiting access to those who need to know.

## Trade Secret Audit

A trade secret audit is a systematic method of identifying, categorizing and valuing the trade secrets of company. Before commencing this process, however, identifying and empowering the audit team is essential. Although a lawyer who has a thorough knowledge of trade secret law is essential, the most important members of

the team are going to be, depending on the business, engineers, plant/office managers, controllers, CFOs, marketing executives, research and development representatives and the vice presidents of sales/sales managers. The audit team does not need to include all of these aspects of the company’s business. Indeed, a small company that only makes a few products would be best served by having a one or two person team. Of course, a large complex business will require a larger more diverse team.

The first step in the process is to identify the trade secrets. The scope is broad because a trade secret may be almost anything that has economic value and provides an advantage over competitors. Certain team members may not realize that public information collected and utilized in a unique way, may be a trade secret. Likewise, there is no need for novelty or originality as would be required for a valid patent. Manufacturing/ business know-how, computer programs, sources of supply, customer lists, specifications, bills of materials, machinery, pricing employee information, and marketing plans have all been found to be subject to trade secret protection.

There are number of basic questions that may act as a guide to identifying a company’s trade secrets. For example:

What information would hurt my business if my competitors could get it?

How much would it hurt?

As these questions are answered you will identify what information key people in the company consider to be trade secrets, and how valuable they are.

The next step is to determine what security measures are in place to protect the company’s trade secrets from disclosure. This is the point that is most hotly contested in trade secret litigation. Thus, any company would be well served by giving special attention to this aspect of the audit.

Questions to ask: What are the policies and/or methods in place to protect trade secrets?

Is access to the trade secrets limited, and by what means?

Can the company implement any additional measures to protect its trade secrets?

<sup>3</sup> See [www.FBI.gov/hq/ci/economic.htm](http://www.FBI.gov/hq/ci/economic.htm). Last visited, May 29, 2014.

<sup>4</sup> *The Recorder*, “After Deal Talks Falter, Companies Clash on Secrets” (October 18, 2013)

As trade secrets are identified, some will be more important than others. In addition, it will become clear that trade secrets usually fall into three categories: process/ method; product; or format. The more critical to the company's product or service, will determine a trade secret's value and dictate the degree of security required for its protection.

What will also become obvious to the audit team is that there are some trade secrets that die a natural death. For example, a product may be a secret until it is released. A marketing plan, a plan to open a new office, a product rollout strategy or the identity of a new manager or executive are trade secrets that will no longer be secret once publicly disclosed. These temporary trade secrets should not be categorized and treated the same as those secrets which never die, as long as they are reasonably protected from disclosure. Thus, for example, engineering designs, manufacturing, business know-how, detailed customer lists, sources of supply and formulae should be treated separately.

Once the audit team has constructed the list of trade secrets, separated the permanent trade secrets from the temporary trade secrets, and determined the most valuable secrets it needs to develop a Trade Secret Protection Plan.

This plan is essentially where and how the secrets are maintained, and who has access to them. Documents and other physical items that contain trade secrets should be stored in locked cabinets or vaults. In any company today most information is accessible by computer. Thus, separate passwords for the most critical secrets are essential. These passwords should be changed periodically, without fail. If it is necessary that the trade secret be accessible through a laptop in order to conduct the company's business downloading to thumb drive or any other device should be blocked. A record of each time the information is accessed remotely should be maintained meticulously, and downloading the information should be prohibited, if possible. E-mailing trade secret information from the company's computer to any other computer should be electronically barred, or only allowed with special permission through the IT department, if possible. The IT department, or some other appropriate person(s) should be required to keep a record of any electronic distribution or download of secret information. It is best if downloading trade secret information to a thumb drive or any other external drive should be electronically prohibited.

Some of these methods of protection may not be practical, at least for some employees, especially salespeople and executives. Nevertheless, documenting every time a trade secret is moved off-site and by whom, is essential for the most critical trade secrets. These methods are not required for all trade secrets, indeed by requiring extreme measures for trade secrets that the company does not consider to be the most critical to its competitive advantage, can actually work to its detriment. First of all, employees will not take overly restrictive rules seriously, and neither will management. Once it is established that the restrictions do not apply to some secrets, courts may interpret the failure to comply as a lax trade secret protection scheme that has no value.

A cookie-cutter plan that the key employees will not follow is useless, and indeed will serve as the basis to prove the company does not protect its alleged secrets. Some employees may interpret many of these measures to imply that the company does not trust them. One of the most important functions of the audit team is to educate the employees regarding the importance of trade secrets to the company's competitive position, and job security. This type of education begins as part of the audit process itself. Employees in different areas of the company should be asked what they consider to be the trade secrets that give their company its competitive advantage. Involving the people who actually work with valuable information every day will deepen the audit team's understanding, and provide the workers with a vested interest in the process and the results. In this way, when the employees are asked to sign nondisclosure agreements, or they see more detailed information in their employee handbooks, they will, hopefully, have a better understanding of how these measures help them protect their jobs. In any event, employee education, reeducation and reminders, are key elements to managing a company's trade secret portfolio.

## **Valuing Trade Secrets**

There are a couple of methods for valuing trade secrets. One is to use a discounted cash flow model if the company can ascertain the amount of revenue attributable to a trade secret.<sup>5</sup> That is not always possible. Another widely accepted method is to value the amount of money, time and effort invested in the development of the trade secret. For existing trade secrets, this effort of accounting can be

5 Halligan and Weyand, "The Economic Valuation of Trade Secret Assets" Trade Secret Office, [www.thetso.com](http://www.thetso.com). Last visited May 13, 2014.

accomplished by review of requisitions, reports, review of minutes, expense reimbursements and interviews. A calculation of return on investment after trade secret implementation may also be possible, by evaluating increased sales, increased efficiencies, reduced costs or any other tangible benefit that could be tied to trade secret or group of trade secrets.

On a prospective basis, someone in the accounting department should be charged with the responsibility of collecting the information related to the development of any new undertaking. Managers should be required to maintain this information and provide quarterly reports to the accounting department, as well as to the executives to whom the managers report. Although this reporting may be deemed another unnecessary administrative burden initially, financially rewarding the participants for the successful development and implementation of a trade secret will most likely lighten the burden. Perhaps more importantly, should the company become involved trade secret litigation, it will not only have an excellent record of its trade secrets

and how well they are protected, but also the value of the secrets for purposes of determining damages and/or royalties. As an added bonus, in an effort to value the company for purposes of an acquisition or merger, a well-developed and carefully implemented trade secret audit will add to the company's value.

## **Conclusion**

In the hustle and bustle of developing newer and better products and services, securing funding, joint ventures and other collaborations, protecting the trade secrets created along the way is essential to capturing and exploiting their value. It is understandable that many companies see this task as time-consuming and potentially unnecessary. It is only when something bad happens whether through ill will or misunderstanding; that the severity of pain and the cost becomes manifest. A little extra effort in developing and using a trade secret audit to identify, manage and protect the company's trade secrets can pay big rewards, and avoid genuine heartache.

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David L. Harris is first and foremost a trial lawyer with the unique capacity to quickly synthesize complex issues and present them to a jury in a clear, precise and convincing manner. He is at his finest when the factual issues are technically obtuse, the legal issues are complex and the stakes are high. David has been lauded as one of the top ten litigators in New Jersey, and he is known for his trial, appellate and arbitration skills in complex business litigation spanning multiple jurisdictions, including intellectual property, antitrust and trade secrets litigation.

David's success lies in the strong relationships that he builds with his clients. His first priority is to understand their business inside and out, as the matter at issue is part of their business and the outcome will shape its course. Closely intertwined is his approach when taking a case to trial. His keen understanding of his clients' business objectives drives his litigation strategy, always with the end goal in mind.

Giving back to the community and establishing a level playing field between the powerful and powerless have always defined David, and he is active in the firm's substantial pro bono efforts. He is currently working on a high-profile matter brought on behalf of children with disabilities in New Jersey against the Department of Education for failing to provide adequate educational opportunities in general education classes.

David has a deep interest in theology and is currently studying at the Newark School of Theology, where he is a member of the board.

**Practice Areas**

- Antitrust & Trade Regulation
- Class Action & Derivative Litigation
- Commercial & Business Litigation
- Employment
- Intellectual Property Litigation
- Litigation
- Trademark Prosecution and Enforcement

**Other Distinctions**

- Chambers USA: America's Leading Lawyers for Business (2003–2014) – Consistently recognized by clients and peers in complex commercial and intellectual property litigation, noting that "David Harris is championed as a 'smart, wily litigator with good trial sensibilities' [and] particular expertise in IP-related disputes."
- The Best Lawyers in America (2003–2014) – Recognized for commercial, antitrust and intellectual property litigation as "tough, smart and knowledgeable."
- Super Lawyers (2005–2014) – Recognized for business litigation and intellectual property

**Education**

- Rutgers University School of Law - Newark (J.D., 1979); National Appellate Moot Court Team (1978-1979); Chair, Moot Court Board (1978-1979); Best Oralist, Moot Court Competition (1978)
- Pennsylvania State University (M.Ed., 1972)
- Pennsylvania State University (B.A., 1970); Lion's Paw; Skull and Bones; President, Student Government, Shenango Campus (1968)