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Trade Secret Protection in Acquisitions & Divestitures

Trade secrets often form a portion of the intellectual property assets that are transferred in an acquisition/divestiture.[i] Trade secrets are intangible assets relating to the possession and use of confidential information.[ii] Unlike other types of intellectual property such as patents, trademarks, and copyrights, trade secrets are not publicly-known, readily identifiable, registrable, or recordable property rights. Trade secrets depend for their survival on being kept confidential and being available only to those who are entitled to know and use them.

Trade secrets are also sticky. They remain in the memories of employees, in computer systems, in paper files and records, and sometimes embodied in physical facilities, structures, or apparatuses. They also travel with employees, computer systems, paper files and records, and physical facilities, structures, or apparatuses wherever they may end up.

This stickiness problem affects both parties to a transaction. The new putative "owner"[iii] of the trade secret does not obtain exclusive access to or control over use and disclosure of the acquired trade secret if that trade secret information also remains behind with the divesting company in the memories of retained employees, in retained computer systems, etc. The divesting company loses exclusive access to and control over trade secret information about its retained products and businesses that travels to the acquiring company in the memories of departing employees, divested computer systems, etc. Thus, following an acquisition/divestiture, trade secrets often end up being known by and accessible to -- and sometimes used or disclosed to others by -- people who are not supposed to know, have access to, use, or disclose them.

These issues can be more pronounced and more complex where only a portion of business or only one of multiple business units is divested/acquired because employees, systems, records, physical facilities, etc. as well as trade secrets themselves are more likely to overlap between the divested and retained businesses.

Three common post-close scenarios illustrate the issues:

1. Trade secret information relating solely to the business that is divested is often retained by the divesting company (in the memories of employees, in computer systems, records, etc. that remain with the divesting company).
2. Trade secret information relating solely to the business that remains with the divesting company is often transferred with the divested business to the acquiring company (similarly in the memories of employees, in computer systems, records, etc. that move to the acquiring company).

3. A set of trade secrets may be relevant to both the divested and retained businesses and need to be "shared" between them going forward.

The challenges presented by these scenarios can be overcome, and reasonable steps can be taken to ensure continued confidentiality and control, provided that the issues are identified, recognized as important,[iv] and managed in the purchase agreement.[v] The following sections provide ideas on how to manage these trade secret issues in divestitures/acquisitions.

Trade secret inappropriately remaining with divesting company or moving to acquiring company (Scenarios #1 & #2).

In these scenarios, trade secrets end up in the possession of a party that is not entitled to know, have access to, use, or disclose the trade secrets.

- A first layer of protection can be provided by "cleansing" all physical and electronic materials of non-relevant trade secret information such that trade secret information is neither retained nor transferred inappropriately. This is often easier said than done, but protection of trade secret information requires the use of efforts that are reasonable under the circumstances to maintain secrecy. Determining what steps are "reasonable" typically involves a balancing of costs and benefits.[vi]
- A second layer of protection can be provided by confidentiality and non-use agreements that the departing and retained employees (should) have with the divesting company. This layer of protection is similar to that utilized in the case of any other movement of employees from one employer to another. Confirming the existence of the appropriate agreements, and putting them in to place where needed,[vii] is a useful step in preparing for the transaction. The acquiring company should make sure these agreements are in place (after close it will be too late, at least as a practical matter).
- A third layer of protection can be provided by requiring each side in the transaction to take reasonable steps to ensure confidentiality and non-use of trade secrets in its possession that relate solely to the other side's business.[viii] This layer of protection is a good practice because it ensures ongoing awareness of and attention to the issue by both sides at the corporate level, rather than merely at the level of individual employees. In addition, should a concern or problem arise each side can efficiently address the issue directly with a corporate entity rather than through various individuals employed by the other company. Care should be taken to define the trade secrets at issue with a reasonable amount of detail, but not so much detail as to disclose the trade secret itself.[ix]

  In addition, each side should ensure that the other has or will have agreements with its employees to enable it to enforce at the corporate level the confidentiality obligations it undertakes in connection with the transaction.

Shared trade secrets (Scenario #3).

In this scenario, the divested and retained products or their respective markets are closely related, such that trade secrets like customer lists, market analyses, manufacturing processes, and product software or subassemblies overlap.[x] Thus, both the divesting company and the acquiring company need to have access to and use the same set of trade secrets.

Two obvious options come to mind:

- The divesting company and the acquiring company jointly "own"[xi] the trade secrets and set forth in the purchase agreement (or an attachment or separate agreement) the terms of the joint owners' rights and obligations (*e.g.,* both must take reasonable steps to maintain secrecy, each is free to use for their own manufacturing and sales without accounting to the other joint owner, defined fields of use, no licensing in the other joint owner's fields, etc.); or
- One party "owns" and licenses the other under specific terms and conditions (*e.g.,* licensor and licensee must take reasonable steps to maintain secrecy, royalty-free license, no sublicensing without licensor's consent, etc.).

In both situations, each side should ensure that the other has or will have agreements with its employees to enable it to enforce the confidentiality obligations it undertakes at the corporate level in connection with the transaction.

The choice between the two options may depend on tax consequences, administrative burdens, or simply the parties' preferences.

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[i] As an aside, sometimes people will use the term "know-how" instead of or interchangeably with the term "trade secret." Know-how is a broader concept than trade secret because not all information utilized by a business that might be called know-how meets the technical requirements for protection as trade secrets (such that trade secrets are better thought of as a subset of know-how). *See* note ii, below.

[ii] In general, a "trade secret" is information that (i) derives economic value from not being generally known to others, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. *See, e.g.,* CAL. CIV. CODE §3426.1(d)(California's enactment of the Uniform Trade Secrets Act, defining "trade secret"). *See also* MASS. GEN. LAWS CH. 266, §30(4)("The term 'trade secret' as used in this paragraph means and includes anything tangible or intangible or electronically kept or stored, which constitutes, represents, evidences or records a secret scientific, technical, merchandising, production or management information, design, process, procedure, formula, invention or improvement"); *Ashland Management v. Janien*, 82 N.Y.2d 395, 407 (N.Y. 1993)("a trade secret must first of all be secret").

[iii] It is not clear that anyone can "own" a trade secret. Trade secret law focuses on the right of a person to prevent disclosure and use of information, rather than on ownership of or "title to" a defined scope of property. *See, e.g., DTM Research v. AT&T,* 245 F.3d 327 (4th Cir. 2001)(where issue was whether "ownership" of trade secret was necessary for standing, "the question of whether 'fee simple ownership' is an element of a claim for misappropriation of a trade secret may not be particularly relevant in this context. While trade secrets are considered property for various analyses . . . the inherent nature of a trade secret limits the usefulness of an analogy to property in determining the elements of a trade-secret misappropriation claim.

The conceptual difficulty arises from any assumption that knowledge can be owned as property. The 'proprietary aspect' of a trade secret flows, not from the knowledge itself, but from its secrecy. It is the secret aspect of the knowledge that provides value to the person having the knowledge.")

[iv] Sometimes it is assumed that because the divesting company is "getting out" of the relevant the business, a future dispute is unlikely and the trade secret issue is not that important. That is not a wise assumption to make. First, business direction can change rapidly and the divesting company might well return to that same business or might enter a closely related business. Second, the divesting company might compete with the acquiring company in other related or unrelated areas, and disputes may arise in which trade secret issues can be relevant or provide leverage. Third, both the divesting company and the acquiring company risk losing trade secret status for valuable business or technological information if they do not undertake efforts that are reasonable under the circumstances to maintain their secrecy.

[v] Note that confidentiality agreements entered into between the parties at the beginning of an acquisition/divestiture process can help protect information that is disclosed or exchanged during the negotiation and due diligence phases, but rarely do those confidentiality agreements govern the post-close world in a manner that adequately protects trade secrets. For example, those confidentiality agreements typically do not contemplate protection of trade secrets in the post-close world and are usually rendered superfluous (or at least of questionable utility) by the integration clause of the purchase agreement.

[vi] *See, e.g., Rockwell Graphic Sys., Inc. v. Dev Indus., Inc.,* 925 F.2d 174, 179 (7th Cir. 1991)(reasonable precautions to protect secrecy of trade secrets "depends on a balancing of costs and benefits that will vary from case to case and so require estimation and measurement by persons knowledgeable in the particular field of endeavor involved.").

[vii] Sometimes an objection is raised that obtaining confidentiality and non-use agreements where they have not been executed previously would necessarily "tip–off" employees that a divestiture is imminent, causing disruption in the business. Every company should have a policy regarding employee confidentiality and non-use agreements, and, to the extent any employees have not executed the current version of the agreement, the requirement to execute the agreement can be presented, truthfully, as an ongoing compliance matter.

[viii] Trade secret status can be lost by failure to clearly maintain confidentiality, in particular by not having a written confidentiality agreement. *See, e.g., Whyte v. Schlage Lock Co.,* 101 Cal.App.4th 1443, 1454-55 (Ct. App. 4th Dist. 2002)(finding "line review documents" not protectable as trade secrets because "[i]t does not appear Schlage maintained the confidentiality of the line review documents because they were disclosed to The Home Depot" and "[w]ithout a secrecy agreement, The Home Depot presumably could give the line review documents to Kwikset and other Schlage competitors."). *See also* note iv, above.

One might propose to rely on an implied obligation of confidentiality arising from the nature of the transaction (*e.g.,* the sale and assignment of trade secrets to the acquiring company). Two issues are immediately apparent: (i) an implied duty might arise as to the divesting company's retained knowledge of the divested trade secrets (*i.e.,* that which was sold), but it is not clear that the acquiring company would have an implied duty to protect knowledge of the divesting company's trade secrets that comes to it via employees, etc. that transfer to the acquiring company; and (ii) as a matter of best practices (or even "good" practices) why rely on an implication and incur a potential cost of proof when it is easy to make it explicit?

[ix] This layer of protection can present challenges in defining the trade secrets at issue. It may not be clear what universe of trade secrets is at issue and it can be difficult to define trade secrets in any detail without revealing the actual trade secret information. One approach is to define the trade secrets by category, for example "trade secrets relating solely to the manufacture of [name of a divested product]." To the extent the trade secrets can be identified with greater specificity (*e.g.,* "chromium oxide coating process for 316L stainless steel implantable devices"), it is likely useful to do so provided that the actual trade secret is not expressly or implicitly disclosed (*e.g.,* if the use of chromium in the coating in the immediately preceding example is confidential, then the trade secret should be defined as "coating process for 316L stainless steel implantable devices").

[x] It is wise to not assume that because the divested products are different than the retained products, there are no overlapping trade secrets. This an issue that should investigated to make sure the facts are clear. There may be some interesting surprises.

[xi] *See* note iii, above, regarding "ownership" of trade secrets.