

Session 801

Due Diligence Tips for Acquiring and Disposing of IP Assets

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1999 ANNUAL MEETING

**DUE DILIGENCE TIPS FOR
ACQUIRING AND DISPOSING OF IP ASSETS –
*WHEN TECHNOLOGY IS PROTECTED BY TRADE SECRETS***

FRIDAY, NOVEMBER 5, 1999

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I. Introduction

Virtually any useful information can qualify as a trade secret. A “discovery” is enough, even if it is only a relatively minor improvement on a process already known in the trade. Also, the law extends beyond technology to cover business information, such as customer lists, financial projections and marketing plans. The key to understanding the expansive nature of trade secret law is that it can protect any process or information that is both private and useful.

The difficulty with defining “trade secrets” in the abstract is that there are so many ways to go about it. In a large part, this is a reflection of the fact that the law of trade secrets, unlike the law of patents, trademarks, or copyrights, is a nature of the common law rather than of statute. The reality of trade secret law is that the primary source of the law -- the opinion of judges in particular cases --- is grounded in very specific fact situations that sometimes do not easily or accurately suggest universal principals.

We are going to do a brief review of the definition of a “trade secret,” what material is protectable as a trade secret; typical situations where trade secret protection may be lost; and finally, what steps should be taken when buying/selling a company where technology is protected by trade secrets. However, before moving to the definition, let’s take a quick look at the development of the trade secret law.

II. Development of Trade Secret Law

The first trade secret case in U.S. jurisprudence is *Vickery v. Welsh*¹. This dispute involved a secret process for making chocolate. The defendant agreed to sell his chocolate factory to the plaintiff, together with his exclusive right and art or secret manner of making chocolate. But when the time came for transfer of the property, he refused to give any assurance that he would not later divulge the secret to others. The court held that the obligation of secrecy was implied.

*Peabody v. Norfolk*² is perhaps the best known of the early U.S. trade secret opinions. It involved a process for manufacture of gunny cloth. A machinist employed at the plaintiff's factory resigned to work for a competitor, and in violation of his non-disclosure agreement, revealed information regarding the operations of plaintiff's secret machines. An injunction was granted to the plaintiff to prevent the employee from disclosing the secret.

*Pressed Steel Car Company v. Standard Steel Car Company*³. The steel car case dealt with railroad car blueprints that had been sent to vendors without express non-disclosure contracts. This case reflects the notions that secrecy does not have to be absolute and that an express contract is not a prerequisite for relief. While there were no express restrictions placed on the ownership of the prints, or any express limitation as to the use to which they were to be put, it is clear, as observed by the trial court, that the purpose for which they were delivered by the plaintiff was understood by all parties. The subsequent use by the defendant was a clear violation not only of the property rights of the plaintiff in the prints, but also of the trust and confidence for which the prints were received. This unauthorized act and breach of confidence resulted in a great advantage to the defendant and a great loss to the plaintiff.

¹ *Vickery v. Welsh*, 36 Mass. 523 (1837).

² *Peabody v. Norfolk*, 98 Mass. 452 (1868).

³ *Pressed Steel Car Company v. Standard Steel Car Company*, 210 Pa. 464; 60 A. 4 (1904).

III. How have trade secrets been defined?

There are basically three definitions that stand out as most often cited and recognized by the courts.

A. The first is the Restatement of Torts § 757, comment b (1939):

“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.”

This formulation is widely cited in the case law, even though it has been dropped from the Restatement of Torts (in favor of the Restatement “Third”) of Unfair Competition. The section continues to be used as a reference even in states that have adopted the Uniform Trade Secret Act (UTSA).

B. The UTSA provides the second major definition of a trade secret:

“Information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (I) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertained by proper means by other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”

The UTSA has been adopted, with some modification, by our fifty states.

III. How have trade secrets been defined? (cont.)

C. The third definition comes from the Restatement (Third) of Unfair Competition § 39 (1995);

“A trade secret is any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.”

D. The Commonwealth of Pennsylvania:

Pennsylvania has neither a state nor civil statute of general application defining trade secrets. Instead Pennsylvania relies entirely on the Restatement of Torts for the purpose of determining whether a particular form of information constitutes a trade secret.

E. Is there a state criminal statute defining trade secrets?

Yes, there is in Pennsylvania. Theft of a trade secret may be found at 18 Pa.Com.State.Ann. § 3930 which provides:

- 1) Felony of the second degree. A person is guilty of a felony of the second degree if he: (1) by force or violence or by putting in fear takes from the person of another any article representing a trade secret; or (2) willfully and maliciously enters any building or other structure with intent to obtain unlawful possession of or access to an article representing a trade secret.
- 2) Felony of the second degree. A person is guilty of a felony of the second degree if he, with intent to wrongfully deprive of, or withhold from the owner, control of a trade secret, or with intent to wrongfully appropriate a trade secret for his use, or for the use of another: (1) unlawfully obtains possession of, or access to

III. How have trade secrets been defined? (cont.)

an article representing a trade secret; or (2) having lawfully obtained possession of an article representing a trade secret, or access thereto, converts such article to his own use or that of another person, while having possession thereof or access thereto makes, or causes to be made, a copy of such article to another.

Under the criminal statute, knowledge is a key element. However, “memorizing” is not “stolen” property; it must be in “tangible/physical” form. Under the criminal statutes in the state court of Pennsylvania, there is a very strict burden on the owners of trade secrets to prove that the matter, in fact, was a secret.

IV. What specific instances have the courts granted trade secret protection?

Even in the absence of a non-disclosure covenant, courts have found trade secrets protectable.

A. Scientific data such as chemical processes, manufacturing methods, machines and devices

Technical data regarding efficiency factors, if kept secret, may be awarded trade secret protection. *SI Handling Systems, Inc. v. Heisley*, 753 F. 2d 1244 (Third circuit 1985).

Product testing methods are protectable (*Spearyran Corporation v. Rideout*, 311 F. Super. 910, 923 (E.D. Pa. 1970)).

B. Business information such as strategic and/or marketing plans, financial information, and credit and pricing policies

Business information that is not generally known in the industry is protectable as a trade secret. Business knowledge that could enable a competitor to thwart the

IV. What specific instances have the courts granted trade secret protection? (cont.)

plaintiff's plans to compete without the burden of testing and market analysis born by the plaintiff is protectable as a trade secret. *Air Product v. Johnson*, 296 Pa. Super. 405, 419, 442 A.2d 1114, 1121-22 (1982).

C. Customer/account/client lists and/or related information such as customer/account/clients' needs, preferences, or contacts

Customer lists represent a material investment of an employer's time and money. This information is highly confidential and constitutes a valuable asset. Such data has been held to be property in the nature of a trade secret. *Morgans Home Equipment Corporation v. Martucci*, 390 Pa. Super. 618, 623, 136 A.2d 838, 842 (1957).

The courts will not grant protection to customer lists that are readily and easily generated from trade journals, telephone book listings, or other sources of information generally available. *Bell Fuel Corporation v. Cattolico*, 375 Pa. Super. 238, 544 A.2d 450, 461 (1988).

D. Computer programs and/or data compilations

The idea of putting together computer programs to achieve a specific result and the expertise necessary to develop the programs are not subject to trade secret protection, but the specific program developed to accomplish the purpose is protected. *Computer Print Systems Inc. v. Louis*, 281 Pa. Super. 240, 422 A.2d 148 (1980).

E. Employee know-how, including specialized and general skills and knowledge

An employee, upon terminating his employment relationship with his employer, is entitled to take with him the experience, knowledge, memory and skill, which he gained while there employed. The concept of a trade secret does not include a man's aptitude, his skill, his dexterity, his manual and mental ability, and such other subjective

IV. What specific instances have the courts granted trade secret protection? (cont.)

knowledge as he obtains while in the course of his employment. Pittsburgh Cutwire Company V. Sufrin, 350 Pa. Super. 31, 38 A.2d 33 (1944). However, an injunction may be issued by a court of equity to protect an employer of the unlicensed use of its trade secret by an ex-employee provided the employee entered into a restricted covenant, or was bound to secrecy by virtue of a confidential relationship existing between the employer and the employee. Felmlee v. Lockett, 466 Pa. Super. 1, 351 A.2d 273, 276 (1976).

Trade secret protection has also been granted to ideas; combination of elements; and this idea of “negative information.” In other words, information that is known to not work also raises to the level of trade secret and is protectable under the law.

V. What are typical situations where trade secret protection may be lost?

Given that trade secret coverage extends so far beyond other forms of intellectual property protection and that it will be lost without vigilance on the part of the owner, it is critical to have the support and participation of the highest levels of management before implementation of any trade secret protection program.

A. Employment relations and employee departures

To avoid trade secret problems related to the hiring of employees, two goals predominate. One is to avoid the appearance of having “targeted” a competitor --- in this regard, it is advisable to recruit as broadly and openly as possible. The other objective is to employ only those who are likely to understand and respect the company’s trade secret policies.

V. What are typical situations where trade secret protection may be lost? (cont.)

The first step is the pre-employment interview: discuss the company's policy regarding proprietary information --- both the company's information as well as others' information. Also discuss and provide copies of the company's employment agreement, emphasize its importance, point out and discuss invention assignment provisions, note any lists of previous inventions, and evaluate whether or not there are any restrictive covenants involved in the prior employment. It is also a good idea to inquire about the circumstances as to why the employee left his prior employment. Furthermore, when available, get copies of any prior employee agreements, any termination agreements, any warning letters, any prior litigation in which the employee may have been involved, and note the employee's attitude toward proprietary rights of his previous employer.

Exit interviews should be a part of the employee relations programs when trade secret policies are at issue. Discuss with all employees in an exit interview the following matters: 1) the reason for leaving; 2) provide a termination agreement and be sure to get the employee's signature; 3) the new employment; 4) be sure to obtain the return of company materials; 5) be sure to find out what projects are currently pending and make specific arrangements for any debriefing that is necessary; 6) the continuing obligation that the employee has under his/her current employee agreement; and finally, 7) advise the ex-employee that he/she may call with questions of confidentiality or other obligations.

B. Customer and vendor relations

Visitors to the company, especially to facilities where trade secret information is available, must be escorted at all times. Visitors must sign in and out at a front entrance and must be escorted by a company employee while they are on the premises. Take care not to allow access to areas which are off-limits to visitors.

V. What are typical situations where trade secret protection may be lost? (cont.)

C. Patent applications

It is imperative that patent applications, publications, speeches and the like are reviewed by all necessary parties to ensure that the company's trade secrets are maintained.

D. Joint Development

Joint ventures and other forms of collaboration are increasingly common in global commerce. It is important to lay out at conception what the rights of each party in the enterprise are to be for any jointly developed information, which may or may not be outside the immediate scope of the joint venture relationship. It may be that no rights will be developed outside of the relationship, but in order to ensure the rights of who should own any of this property, be sure to ensure that the people performing these functions, be they employees, independent contractors, members of other professional organizations or any other third party that is involved, understands the process that is to be used for determining who owns trade secrets.

VI. What steps should be taken when buying/selling a company where technology is protected by trade secrets?

Having been in commodity industries and businesses such as soda ash, liquid chlorine, caustic soda, polymers, textile fibers, and minerals, for most of my career, I've concluded that two things drive business acquisitions and/or sales. The two drivers are either tax benefits associated with acquiring or selling of a business, or the potential business opportunity housed in the company's technology. The success of any purchase really depends on two arm-length buyers and sellers reaching what both will agree is a reasonable price. The objective in this particular presentation is to outline the steps that should be used by either buyers or sellers when the reason for the purchase of a business is for its trade secret technology.

VI. What steps should be taken when buying/selling a company where technology is protected by trade secrets? (cont.)

The price that one pays for a business when the business purchase is driven by trade secrets should clearly be determined on an objective basis. The purpose here is to use that objectivity in establishing a score board as to how the trade secret has been maintained.

This is an in-house perspective on the kinds of things that should be looked at by the Intellectual Property Department in order to support a purchase driven by trade secrets.

Listed below are checklists useful in looking at IP assets that are protected by trade secrets:

1. Contracts
 - (a) Employee Confidentiality Agreements/Non-Compete Agreements
 - (b) Secrecy Agreements/Confidentiality Agreements with Vendors, Suppliers, Consultants, Visitors, Contractors, etc.
 - (c) Non-Disclosure/Non-Analysis Agreements
 - (d) Joint Research Agreements
 - (e) License Agreements

2. Physical Security
 - (a) Use of codes for ingredients and/or steps in recipes, formulas, procedures, processes.
 - (b) Cleaning of blackboards and charts/removal of same from view of windows.
 - (c) Use and enforcement of "Authorized Personnel Only" signs.
 - (d) Use of signs designating restricted areas.

VI. What steps should be taken when buying/selling a company where technology is protected by trade secrets? (cont.)

- (e) Entrance designated specifically for visitors.
- (f) Restricted access entrance (employees only).
- (g) Locked fences.
- (h) Security guards at facility entrance.
- (i) Locked building entrances.
- (j) Sign-in/Sign-out log book.
- (k) Visitor credentials verified before entrance, visitor badges, visitor escorts.
- (l) Use of computerized key-access to maintain facility access log.

3. Reasonable Information Security

- (a) Restrictions against removal of paper containing proprietary information.
- (b) Shredding or other destruction of proprietary/trade secret documents.
- (c) Storage of documents in locked cabinets.
- (d) Stamping of documents “Confidential – Do Not Copy or Distribute.”
- (e) Restrictive photocopying policies regarding trade secret documents.
- (f) System/restriction in place regarding trade secret documents.
- (g) Copies of Corporate Policy/Procedure manuals.

IP DUE DILIGENCE CHECK LIST

ACCA's 1999 Annual Meeting

Due Diligence Tips for Acquiring & Disposing of IP Assets

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I. PATENTS

- A. Identify all foreign and domestic patents and patent applications and all active invention disclosures owned, used or intended for use in the Business.
 - 1. Divide the patents and patent applications into separate lists for North America and the rest of the world.
 - 2. Verify ownership of patents and patent applications and confirm that no security interests have been recorded against the patents.
 - 3. Identify those patents and patent applications, if any, which will be licensed and not transferred and for each, identify;
 - a. any territorial restrictions;
 - b. any field of use restrictions;
 - c. whether the license is exclusive or non-exclusive;
 - d. any maintenance issues; and
 - e. any restrictions on transferability.
 - 4. Identify the status of pending applications.
 - 5. Identify any statutory bars to filing patent applications on active invention records.
- B. Identify all current and anticipated patent litigation or potential conflicts within the last ten (10) years, including notice letters, complaints, settlements, validity or infringement searches and opinions.
 - 1. Identify all patents known to be owned by third parties which relate to the Business.
 - a. Identify those patents that have caused Company to modify a product or process to avoid infringement or which may

- require the purchaser of the Business to modify a product or process to avoid infringement.
2. Describe all action taken by the Company to enforce its patent rights.
 - a. Describe the Company's enforcement policy regarding its patents.
 3. Identify all known or suspected infringements of the Company's patents and any action taken or any action proposed, in writing, to be taken.
 4. Identify all pending patent applications of others known to the Company which, if issued, may prompt modifications of a current product or process of Company which relates to the Business.
 5. Identify all pending patent applications of the Company which relate to the Business and which, if issued, would be or which the Company has reason to believe would be, infringed by others.
- C. Describe how the Company stays current with respect to the payment of maintenance fees and annuities.
1. What system does the Company use.
- D. Identify all patent licenses (whether the Company is licensor or licensee), sublicenses and all other agreements which include a patent licensing provision whether express or implied and for each, identify:
1. Limitations on transferability of such patent licenses and, where present, describe them.
 2. Current or future royalty obligations.
 3. Cross-licensing obligations.
 4. The scope of indemnification provisions.
 5. Current or anticipated disputes relating thereto.
 6. All express or implied waivers.
- E. List all pending or potential interferences, oppositions, re-issues and re-exam proceedings and for each, identify:
1. costs;
 2. counsel;
 3. prospects for success.

- F. Identify all declaratory judgment actions anticipated to be brought by the Company against a patent of a third party or threatened, in writing, by any third party against any patent of Company.
- II. **TRADEMARKS (INCLUDING SERVICE MARKS, TRADE DRESS TRADE NAMES AND INTERNET DOMAIN NAMES)**
- A. Identify all state, federal and foreign trademarks, registrations and pending applications for registrations; and their current status and renewal dates. Divide into lists by country.
1. Identify the products to which each trademark applies.
 2. Verify ownership of registered trademarks and confirm that no security interest have been recorded against the trademarks.
 3. Identify those trademarks, if any, that will be licensed and not transferred and for each, identify:
 - a. any territorial restrictions;
 - b. any field of use restrictions;
 - c. whether the license is exclusive or non-exclusive;
 - d. any maintenance issues; and
 - e. any restrictions or transferability.
- B. Identify any pending trademark litigation or potential conflicts within the last 10 years, including demand letters, pleadings, oppositions, searches and opinions.
1. Describe any action taken by the Company to protect its trademarks within the last 10 years.
 - a. Describe the Company's enforcement policy regarding its trademarks.
 2. Identify all known or suspected infringements of the Company's trademarks and any action taken or any action proposed, in writing, to be taken.
 3. Identify all current trademark litigation and for each, identify:
 - a. costs;
 - b. counsel;
 - c. damage assessment; and
 - d. status of settlement discussions.

- C. Identify all trademark licenses (whether the Company is licensor or licensee) for each, identify:
 - 1. Limitations or transferability of such patent licenses and, where present, describe them.
 - 2. Current or future royalty obligations.
 - 3. Cross-licensing obligations.
 - 4. The scope of indemnification provisions.
 - 5. Current or anticipated disputes relating thereto.
 - 6. All express or implied waivers.
- D. Identify all trademark certification programs.

III. **COPYRIGHTS**

- A. Identify materials presently copyrighted by Company and registered with the United States Copyright Office.
- B. Describe the extent to which the Company seeks to establish and utilize copyright protection and how this has been implemented.
- C. Identify any copyright infringement claims by third parties asserted against the Company within the last 10 years (prior, pending or threatened).
- D. Identify all known or suspected infringements of the Company's copyrighted works within the last ten years and any action taken or any action proposed, in writing, to be taken.
- E. Identify all copyright licenses and for each identify:
 - 1. Limitations or transferability of such patent licenses and, whether present, describe them.
 - 2. Current or future royalty obligations.
 - 3. Cross-licensing obligations.
 - 4. The scope of indemnification provisions.
 - 5. Current or anticipated disputes relating thereto.
 - 6. All express or implied waivers.

IV. **TRADE SECRETS/KNOW-HOW/CONFIDENTIAL INFORMATION**

- A. Identify the Company's trade secrets/know-how/confidential information (collectively, "Proprietary Information") that will be transferred.

- B. Identify any formal policy or procedure the Company has in place to protect Proprietary Information.
 - 1. Describe generally how, if at all, the Company conducts employee entrance and exit interviews.
 - 2. Determine whether the Company communicates with employees regarding protection of its Proprietary Information and describe the nature and frequency of these communications.
 - 3. Describe any policies of the Company related to the handling of Proprietary information furnished by third parties.
 - 4. Describe how Proprietary Information is recorded and reported.
- C. Identify any pending litigation or potential conflicts within the last 10 years, relating to Proprietary Information including demand letters, pleadings, and opinions.
 - 1. Describe all actions taken by the Company to protect its Proprietary Information within the last 10 years.
 - a. Describe the Company's enforcement policy regarding its Proprietary Information.
 - 2. Identify all known or suspected misappropriations of the Company's Proprietary Information within the last 10 years and any action taken or any action proposed, in writing, to be taken.
- D. Identify all agreements between Company and a third party relating to the relevant technology, including joint ventures, consulting arrangements, confidentiality or secrecy, joint or contract research, joint or contract development, tolling arrangements or non-analysis and, for each, identify any restrictions on transfer, the ownership rights, if any, (including patent rights) in the resulting Proprietary Information, continuing disclosure obligations and licensing indemnification obligations.

V. GENERAL INTELLECTUAL PROPERTY

- A. Identify all persons and firms responsible for all aspects of intellectual property for the Company, including without limitation, patent and trademark prosecution; intellectual property litigation, payment of patent and trademark maintenance fees and annuities; licensing of technology (both as a licensee and as a licensor); identification of competing technology and development of new technology.

VI. EMPLOYEES AND CONSULTANTS

- A. Identify any employees or consultants that have asserted against the Company their individual rights to discoveries and inventions.
- B. Identify any agreements between the company and employees or consultants not included in IV. D., that contain the following provisions and describe such provisions if any.

1. Confidentiality.
2. Assignment of invention.
3. Employment.
4. Non-competition.
5. Ownership of Proprietary Information.

VII. **COMPUTER SYSTEMS AND DATABASES**

- A. Identify all agreements pertaining to: computer hardware, software, maintenance, processing, source code escrow, facilities management, time-sharing, disaster recovery and describe any terms relating to continuing obligations, transfer restrictions or termination costs.
- B. Describe any written procedures of Company for protecting computer programs and databases.
- C. Describe any steps taken to preserve title to software and documentation.