Assessing the Financial Impact of the Misappropriation of Trade Secrets

By Glenn C. Sheets

This article begins with the understanding that the company has reviewed and adequately protected its proprietary and confidential trade secrets by limiting their access to certain employees. These same employees have signed employment agreements written to protect the company from the unauthorized use of the protected information. However, should any of these employees violate the provisions of such agreements, the company will likely realize a significant financial impact to its business. The same is true for agreements with third parties that restrict their disclosure and the use of proprietary and confidential trade secrets.

Once confronted with the knowledge that the company's trade secrets may have been misappropriated, counsel will often need to offer assistance when assessing the magnitude of the actual or potential financial impact to the business. Once the magnitude of the impact is understood, counsel will be well-prepared to recommend the appropriate course of action to minimize and recover damages sustained from the theft of the company's trade secrets.

Potential Damage Recoveries

The Uniform Trade Secrets Act recognizes that a trade secret "…derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use…"[1] In addition to injunctive relief, federal and state case law generally allow the owner of the trade secret to recover the damage it has sustained or to receive the economic benefit realized by the party who misappropriated or inappropriately received the trade secrets.

Assessing Damages to the Owner of the Trade Secret

To assess the magnitude of damages resulting from the misappropriation of a company's trade secret, it is helpful to have an understanding of the various ways in which a company may be impacted. Once the type and magnitude of damage is identified, the company must be able to prove the fact of these damages, as well as how they are causally connected to the actions of the party inappropriately utilizing the trade secret.

On its most basic level, a company may realize lost revenue (sales) and/or increased costs (expenses) resulting from another party exploiting the company's trade secret. When combined, the net impact results in lost incremental profits, both actually sustained in the past and reasonably expected in the future. Generally the damage is measured at its net present value on a specific date, which is the result of applying a reasonable rate of return for being deprived the economic benefit of realizing those lost profits over the relevant time period.

When making inquiries of your client, it is important to consider the financial impact on an *incremental* basis. That is, for the lost sales, what specific costs would be expended to have produced the products or services ("units") that were diverted? There can be significant differences (either higher or lower) between a company's average costs to produce all units sold before the misappropriation when compared to the actual cost to produce just the units lost. Hence, a company's average profit margin on all units sold before the loss of its trade secret may be a misleading measure of the actual profit margin on those units lost once "the secret's out." As an example, certain fixed costs are allocated to all units produced regardless of the volume sold, e.g., rent, depreciation, salaried personnel, allocated general and administrative costs, etc. These costs may not be incrementally incurred to produce the units lost. Conversely, perhaps a new piece of equipment, higher material costs, or a more expensive labor classification would have been required to produce the lost units.

The following is a brief overview of the different ways a company may be impacted when another party inappropriately uses its trade secret.

- Loss sales volumes (direct)—diverted sales of either products or services.
- Loss sales volumes (indirect or collateral)—related products or services lost resulting from the loss of direct unit sales, e.g., lids sold along with a beverage container, replacement parts, extended warranty or service contracts.
- Loss of sales price or price erosion due to the company having to lower its prices to maintain or minimize the loss of units sold.
- Additional costs to maintain or minimize the loss of units sold, e.g., offering complementary products or services, marketing or advertising costs, and other costs to remediate the theft of the trade secret.
- Increased borrowing costs or cost of capital to fund the losses incurred.
- Loss of business opportunities, e.g., the trade secret allowed for ease of planned entry of ancillary or collateral product or service lines.
- Loss of goodwill or diminution in company value, e.g., loss of product or service leader status, loss of

prospective revenue and profit targets, loss of price premiums or lower cost status.

A derivative of measuring the incremental lost profits associated with the trade secret involves establishing its valuation at the time of the misappropriation. Counsel may initially wish to inquire whether the trade secret has been considered for sale by the company which may shed light on its perceived value to an outside party. Inquiries to the company's CFO, Controller, or tax personnel may be helpful if the trade secret has been considered for financial or tax reporting purposes. If the company has corporate development personnel, they may be able to give counsel an idea of the magnitude of value based upon similar transactions observed or their knowledge of the relevant market for the trade secret. Additionally, a preliminary consultation with an industry expert or valuation financial expert may give guidance as to the trade secret's expected current value.

Another measure of the financial impact to the company is the cost to develop and maintain the trade secret. Generally, this is viewed as establishing a floor for damages as it is recouping the investment in the asset, but not necessarily the current value at the time the trade secret was misappropriated. These costs may be substantiated by business records (hopefully prepared contemporaneous to the development and maintenance of the trade secret). Additionally, the trade secret may have been acquired so there are business records that establish the price paid or reasonably allocated to this asset.

Assessing the Economic Benefit Realized by the Party Who Misappropriated or Inappropriately Received the Trade Secret

Generally, federal and state case law supports that the owner of a trade secret may be awarded the economic benefit realized by the other party for its unauthorized use of the trade secret to the extent it does not duplicate the damages determined to the owner as discussed above. It has been mostly supported by case law that the owner of the trade secret need only establish the reasonable level of sales, or value derived by the other party, as the measurement of the amount to be disgorged. It is then the other party's burden to prove that the economic benefit it received was not related to the misappropriated trade secret and, not at the amount alleged by the owner of the trade secret. A typical example is that the owner of the trade secret presents proof of the likely realized sales by the other party. The other party then must demonstrate that its profits on those sales were lower than the alleged sales price and that the sales themselves were not related to the trade secret in its possession.

It is unlikely that the company's business people will have direct knowledge of the other party's specific means of exploiting the trade secret, or its actual or expected incremental profits at the time of the misappropriation. If at this point injunctive relief was not granted (or granted in part), counsel may be able to assess the magnitude of the amount to be disgorged from the other party through inquires with its business people and outside advisors. Similar to assessing the economic impact to the company, the amount determined to be disgorged from the other party should be measured at its net present value on a specific date. Below are several points of inquiry that may be pursued by counsel.

The company's sales personnel may have information and insight as to:

- Specific customers lost; cancelled or revised orders; or reduced sales volumes.
  - Loss on new business quotes and bids; no requests for proposals or quotes from known customers; loss of joint venture or collaborative partner opportunities.
  - Unexplained deviations observed from internally prepared sales forecast or projections.
  - Product or services promoted by the other party through advertising, trade show promotions, or industry publications.
  - Public information regarding product or service announcements, presentations, trade show promotion materials or contract bids.
- With the possible assistance of the company's finance, accounting, or corporate development personnel, perform a general internet search including publicly filed financial reporting disclosures made by the offending party. This information may assist with determining the other party's business expectations; sales volumes and related net income; gross margin and operating profit percentages on sales; and capital investments.
- With the assistance of the company's IT personnel or an outside computer forensic consultant, review emails and files on the company's server or acquired from the hard drives of the suspected parties' computers who misappropriated the trade secrets. Besides the value of a "smoking gun" email, many times valuable financial information may be found that will give counsel insight to the likely magnitude of the offending party's expected economic benefits to be derived from exploiting the trade secret. Below are several types of information that may be useful to counsel.
  - Customer lists; product and service pricing information; and historical sales information copied or taken.
  - Sales forecast or projections prepared by the offending party.

- Alternative cost analyses prepared to assess costs, reductions or costs avoided associated with the misappropriated trade secret. These analyses may take the form of "build v. steal" scenarios, e.g., lower cost of entry or higher market penetration expected for the business generated from the misappropriated trade secret.
- Business plans prepared by the offending party for use to determine the viability of the new venture, to support application for loans or capital funding, or used to negotiate new employment arrangements or ownership in another company.
- Valuations or financial opinions prepared to support the underlying economic value of the activities, or new venture associated with the exploitation of the misappropriated trade secret.

Obtaining this information prior to the commencement of discovery will be very useful for counsel for purposes of supporting a cease and desist letter or seeking an injunction. By demonstrating to the offending party that you have information that will likely prove the reasonable magnitude of the expected economic benefit to be disgorged, this should put the company in a position to resolve the situation in its favor without having to disclose additional information held in confidence by the company.

Reasonable Royalty as an Alternative Damage or Settlement Remedy

Counsel may be able to assess the potential magnitude of the economic impact resulting from the misappropriation of the company's trade secret by gaining an understanding of its probable value under a negotiated royalty agreement. While supported by case law as an appropriate measure of damages associated with the misappropriation of a trade secret, a reasonable royalty determination may also have value to counsel as a possible means to achieve a negotiated settlement between the parties. To assess the magnitude of the value of an anticipated royalty arrangement, expected royalties should be measured at their net present value on a specific date.

The assessment of a reasonable royalty by counsel may be dependent upon the company's history negotiating royalties for other products or services. Absent comparable royalty information within the company, counsel may need to consult with an industry or financial expert to perform a preliminary assessment of a likely royalty structure and a reasonable range of royalty rates. Although there may be a "rule of thumb" estimate for a reasonable range of royalty rates for similar products or services, experience has shown that the rate may be very sensitive to the multitude of factors associated with the parties and the products or services under consideration. Some of these factors will consider whether the sales subject to the royalty are to be made exclusively by the offending party and also inclusive of collateral products or services.

Financial experts who assess reasonable royalty rates often utilize the factors contained in the *Georgia-Pacific* case.[2] These factors are a helpful guide for counsel to make the necessary internal inquires to gather information for the assessment or to provide to a consulting expert.

Conclusion

Confronted with the possible misappropriation of a company's trade secret, counsel should work with their client and outside experts to make an early assessment of the magnitude of the economic impact to the company, as well as the estimated benefit the offending party may likely realize from exploiting the trade secret for its benefit. With a good understanding of the significance of the potential damages available to be recovered, counsel will be in a good position to recommend the appropriate course of action to pursue. Preliminary inquiries to the company's business people need not be time-consuming, nor should consulting with an outside expert be expensive, to assess the relative magnitude of damages to be recovered or the present value of a negotiated royalty agreement.

While this article postures this discussion from the position of counsel at the company owning the trade secret, the same approach should be considered by counsel for the party defending a possible action for its alleged misappropriation or inappropriate receipt of a company's trade secret. Either way, the assessment of the magnitude and likely composition of the alleged economic impact to each party is a worthwhile investment of time and resources to all parties involved.

Endnotes

1. Uniformed Trade Secrets Act with 1985 Amendments, § 1(4).
2. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970), *aff'd*, 446 F.2d 225 (1971).

Glenn C. Sheets, CPA, CFF, CIRA, CGMA, is a Managing Director in the Dispute Advisory & Forensic Services Group at Stout Risius Ross, Inc. ("SRR"). SRR is a premier global financial advisory firm that focuses on Investment Banking, Valuation & Financial Opinions, and Dispute Advisory & Forensic Services. SRR serves a range of clients from Fortune 500 corporations to privately held companies in numerous industries around the world. Mr. Sheets has extensive experience providing a broad range of business and financial advice to trial lawyers and in-house counsel throughout the dispute process. Most of Mr. Sheets' matters involve disputes in complex commercial litigation, many of which include the assessment of the economic impact to parties involving misappropriation of trade secrets, as well as breach of non-competition and non-solicitation actions. Mr. Sheets has testified numerous times as an expert in various state and federal court proceedings, including the U.S. Bankruptcy Court, CCAA proceedings, arbitrations, mediations and depositions, both domestically and abroad.