

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. The economic and legal issues are seemingly inextricably intertwined. We present here a method for valuation of trade secret assets that decouples the economic and legal issues, rendering the problem tractable.

Several accepted methods exist for the valuation of a property. Depreciated cost, replacement cost, fair market value, and net present value of future cash flows are all proper measures in specific circumstances.

For intellectual property, however, depreciated cost is not appropriate. The direct acquisition cost of intellectual property may be insignificant, as when the intellectual property results from a flash of insight. However, that same insight may result from the sudden emergence of an idea after years of study in the field and years of experimentation in the laboratory. Which, then, is the true cost, the negligible cost of a moment's insight or the sum total cost of the education and experience of a lifetime?

Similarly, replacement cost is problematic. How does one replace a flash of insight? By what means can one predict the machinery of invention? For patents, trademarks, and copyrights, injunctive relief is true replacement, that is, the restoration of the exclusive use of the intellectual property. But trade secrets, once lost in the public domain, are lost forever. The bell cannot be unring. How then can a replacement cost even be conceptualized, much less determined?

As for fair market value, there may be no marketplace for the intellectual property in question. An advance in the method of manufacturing a proprietary product, a unique corporate organizational structure or compensation plan, negative know-how, that is, knowledge about what doesn't work—none of these intellectual properties

has a marketplace from which a fair market value may be obtained.

What we are left with, then, for trade secrets is the *net present value of future cash flows*. This is a particularly appropriate measure for trade secrets because the very essence of a trade secret anticipates future cash flows. A trade secret is any information not generally known in the trade, which the owner has made appropriate efforts to keep secret and which confers a *competitive advantage* from being kept secret. The net present value of future cash flows resulting from that competitive advantage is an appropriate method for placing a dollar amount on the current value of a trade secret asset.

THE NET PRESENT VALUE OF FUTURE CASH FLOWS METHOD

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, and
3. The probability of the future cash flow occurring.

If 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 total amount of the future cash flow is the total amount of income over time that will be derived from keeping the information secret as compared to the expected income over time if the information was 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 use of the invention as compared to the situation in which the invention is available for use by all.

It may be legitimately asked whether there isn't a broader altruistic value in discovering new knowledge for the use of all, to the benefit of everyone. There is such value, but it is not economic value, that is, it is not a value on which a price can be put, such as in the sale or license of a technology. No one will pay for the use of public domain knowledge, and so the fair market value of such knowledge is zero.

Note that there may be more than one legitimate possessor of a trade secret in the marketplace. Calculation of the net present value of trade secrets is much easier if the trade secret is an invention not known at all in the trade. Since in practice it is impossible to determine whether one's competitors already have legitimate possession of the same information and are also holding it as a trade secret, the simple calculation of value comparing the situations of exclusive possession to public domain exposure is appropriate.

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