

Trade Secrets: Fair Market Value Considerations

Healthcare enterprises are increasingly relying on intangible assets to enhance their ability to provide timely, quality professional medical services to patients. Trade secrets are one such class of intangible asset that may be owned by a healthcare enterprise. A trade secret is any information that has economic value and is not generally known by the public.¹ Technical and specialty research may be considered the “*work-in-progress*” of patents, copyrights, trademarks, or other intangible assets, and this research usually entails the use of *trade secrets*, i.e., special “*know how*” that is often protected (or *padlocked*), in contrast to being *patented*.

The *Uniform Trade Secrets Act* defines trade secret as:

*“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 ascertainable 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.”*²

Additionally, the definition of a *trade secret*, as set forth in The Merriam Webster Dictionary, is:

*“something (such as a formula) which has economic value to a business because it is not generally known or easily discoverable by observation and for which efforts have been made to maintain secrecy.”*³

For information to be called a trade secret, it should meet the following requirements:

- (1) The information should not be generally known in the trade;
- (2) The information should provide competitive advantage to the owner; and,
- (3) Steps are taken to protect the secrecy of the information.⁴

Information that is typically considered to be a trade secret includes, but is not limited to:

- (1) Formulas, recipes, ingredients, and methods of combination;
- (2) Accounting procedures, personnel practices, marketing strategies, and sales techniques;
- (3) Research and development information, experimental designs; and,
- (4) Formations and plays of a sports team, or its training regimen.⁵

The benefits to the owners of the trade secret are similar to that of the grantor of a trademark or trade name.⁶ The owners of the trade secret have the right to control access to their trade secret, and whether to sell or license it (in full or in part) to another party. Licensing enables the owner of the trade secret to expand their geographic footprint and increase market penetration by allowing the licensor to utilize the licensee’s local resources in markets to which the licensor may not have access.⁷

The competitive advantage associated with a trade secret creates economic value for the trade secret by way of:

- (1) Increased sales;
- (2) The ability to charge a price premium;
- (3) Reduced costs; and,
- (4) Increased market share.

Trade secrets can be valued within the framework of the following general valuation methods:

- (1) Asset or Cost-based approach;
- (2) Market-based approach; and,
- (3) Income-based approach.

Asset/Cost-based approach methods seek an indication of value by determining the cost of reproducing or replacing an asset. It is difficult to use a cost-based approach to value trade secrets as an analyst might not be able to determine the exact costs to create or replace a trade secret.⁸

A hybrid market and income-based approach *relief from royalty method* can be used to value trade secrets. This method applies a market or income derived royalty rate to the future cash flows of a business entity or business segment and then discounts those projected cash flows to their present value equivalent at an appropriate risk adjusted required rate of return to arrive at an indication of value for a specified date. In some situations, using this method would be challenging given the absence of

disclosed information regarding the licensing of comparable trade secrets.

A valuation analyst may also utilize an income-based approach to calculate an indication of value for a trade secret. The following are income-based methods for valuing a trade secret:

- (1) *Incremental Earnings Method* – This income-based valuation method seeks to quantify the difference between the: (i) earnings of the business segment or business enterprise *with* the use of the trade secret; and, (ii) earnings of the business segment *without* the use of the trade secret; and,
- (2) *Excess Earnings Method* – This income-based valuation method seeks an indication of value by subtracting the required return on all the other assets of the business enterprise (excluding the trade secret) from the total earnings of the business enterprise to arrive at an indication of the value of the residual earnings attributable to the trade secret.

Trade secret infringement or misappropriation occurs when someone improperly acquires a trade secret or improperly discloses or uses a trade secret without

consent or with knowledge that the trade secret was acquired through a mistake or accident.⁹ Economic damages in the case of a misappropriation are calculated as a sum of the following elements:

- (1) Lost profits;
- (2) Disgorgement of the infringer's profits; and,
- (3) Future loss in profits.¹⁰

Examples of trade secrets in the healthcare industry include, but are not limited to:

- (1) Patient lists;
- (2) Payor and vendor contract rates and contract terms;
- (3) Patient care procedures and protocols;
- (4) Manufacturing processes, formulas, and development research (especially for pharmaceutical companies); and,
- (5) Marketing tactics.

Trade secrets are gaining importance in the healthcare industry as organizations have come to realize the importance of trade secrets and the competitive edge offered by them. Many healthcare companies possess valuable information, which should be protected under strong internal confidentiality policies.

1 "Guide to Intangible Asset Valuation" by Robert F. Reilly and Robert P. Schweihs, New York, NY: American Institute of Certified Public Accountants, Inc. (2013), p. 37.

2 "Uniform Trade Secrets Act with 1985 Amendments" National Conference of Commissioners on Uniform State Laws, August, 1985, p. 5, http://www.uniformlaws.org/shared/docs/trade%20secrets/utsa_final_85.pdf (Accessed 5/9/2018).

3 "Trade Secret" Merriam Webster, 2018, <https://www.merriam-webster.com/dictionary/trade%20secret> (Accessed 5/9/2018).

4 Reilly and Schweihs, 2014, p. 20.

5 "Intellectual Property: Valuation, Exploitation, and Infringement Damages" by Gordon V. Smith and Russell L. Parr, Hoboken, NJ: John Wiley & Sons, 2005), p. 29.

6 For more information, see: "What's Your Brand Worth? The Benefits of a Brand to the Grantor" Health Capital Topics, Vol.

11, Issue 4 (April 2018), https://www.healthcapital.com/hcc/newsletter/04_18/PDF/BRAND.pdf (Accessed 5/9/18).

7 "Licensing Patents and Trade Secrets" Presented at the American Conference Institute's Licensing Intellectual Property Conference, Chicago, Illinois, June, 2000, <http://www.oblon.com/publications/licensing-patents-and-trade-secrets/> (Accessed 5/9/2018).

8 "The Value of a Trade Secret" Willamette Management Association, Robert P. Schweihs, http://www.willamette.com/insights_journal/09/autumn_2009_5.pdf (6/17/2018).

9 "Trade Secret Infringement" Justia, <https://www.justia.com/intellectual-property/trade-secrets/infringement/> (Accessed 6/17/2018).

10 Schweihs, 6/17/2018.



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