Some Key Elements of a Trade Secret License

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A trade secret license can help extract value from a trade secret, a valuable form of intellectual property asset. However, omitting a key ingredient from a trade secret license can result in the ultimate loss of the value of the asset, disagreements between the licensor and licensee and lost opportunities. Some key ingredients are summarized here in three broad categories — license terms, payment terms and general terms.

License Terms

The license terms should describe the trade secret that is the source of the license. Unlike other intellectual property licenses this should be done without disclosing the entire trade secret itself. The nature of the trade secret license is the right for the licensee to receive the trade secret rather than the ongoing use of the asset which is the right granted in other intellectual property licenses.

There may be more to the license than just the trade secret in the case of a hybrid license. That is, a hybrid license may be comprised of know how (the trade secret) that accompanies a patent license. A hybrid license may also include an existing trade secret combined with future improvements to the trade secret that are discovered by the licensor (or that are discovered by the licensee depending on the agreement).

The license may also be qualified and include restrictions — it may be an exclusive, sole or non-exclusive license, it may be limited to a field of use and it may have geographical or product constraints, much like patent licenses.

The license terms need to be accompanied with appropriate obligations for the licensee to maintain the secrecy of the trade secret. In some cases there may even be specific confidentiality obligations imposed on the licensor to maintain the secrecy. For example, if the trade secret license is exclusive and the licensee gets value from knowing the trade secret and from the licensee's competitors not getting access to the trade secret then the licensee may want to be sure that the licensor is taking appropriate steps.

Payment Terms

A trade secret license needs to be supported by some form of consideration – typically a royalty, payment stream or lump sum payment (or some combination of these). Each

form of fee is suitable for different circumstances to address a party's risk and return profile. There are an almost infinite variety of payment methods, so as is the case with negotiating any contract, it is best if each party has a solid understanding of what it expects to get out of the deal.

Some examples of how payment terms can help a party achieve its goals:

1. A royalty payment that is tied to the licensee's actual cost savings or incremental revenue as a result of using a trade secret to manufacture a product can help ensure that a licensee's payment obligations are proportionate to its success (i.e. revenue and expense matching). By contrast, a licensee may be upside-down on fees if it makes a lump-sum payment based on incorrectly speculating the value of incorporating the trade secret into its operations.
2. If a trade secret will only confer a short-term first mover advantage on a licensee or if there is significant risk that the trade secret will be independently developed then a licensor may be best served by requiring a lump sum payment (i.e. take the money and run). This will not necessarily be to the detriment of a licensee who may prefer the certainty of a fixed payment, the non-recurring nature of the payment and potentially favourable accounting treatment when making this type of payment.
3. A stream of equal payments (based on a fixed amount rather than a calculation as in the case of a royalty) can help alleviate the complications in arriving at a suitable royalty calculation and it eliminates the need to monitor royalty calculations through audits. This can help a licensee spread its payments out over time which is helpful if it has shallow pockets, or if it has cleverly negotiated some conditions when the payment stream will end to try to reduce its overall license fee exposure.
4. Some combination of these (such as a lump sum payment coupled with an ongoing royalty) can help fine-tune each party's relative interests and balance risks and returns.

If the parties use a royalty payment structure that is calculated based on a licensee variable (such as product revenue or cost, overall revenue (gross or net), units sold, etc.) then the agreement should include audit rights and royalty reporting obligations. This will give the licensor the peace of mind that the licensee is incented to carefully calculate and accurately report its royalty payments. Audit rights also allow the licensor to investigate suspected abuse or careless calculation by the licensee. Audit terms have some usual characteristics (such as covering the cost of the licensor's audit if it reveals material underpayment by the licensee) and restrictions (such as only permitting a reasonable number of audits per year to avoid disrupting the licensee's operations).

The term of the license agreement should be considered in conjunction with the payment terms. If the royalties or the payment stream are tied to the length of the agreement then a lengthy or perpetual license may not best serve a licensee's interests as it may require the licensee to make payments well beyond the usefulness of the trade secret to the licensee. However, such an arrangement may ultimately be fair if the licensee will continue to realize an advantage for as long as the licensee is making products that can only be produced with the knowledge of the trade secret. The parties should carefully consider termination rights and remedies and how these affect the term and, by implication, how such rights and remedies affect the license payments.

If the license is hybrid or if it bundles the trade secret license with knowledge transfer services then the payment allocation for each component of the license should be clear, and licenses and services should be separated to avoid disputes if a component of the agreement expires or is terminated.

General Terms

Aside from getting the license and payment terms right there are some general provisions in a trade secret license agreement worth addressing. As these are sometimes treated as boilerplate terms the necessary adjustments to make them more suitable for a trade secret license can sometimes be overlooked:

1. An arbitration provision that includes an obligation to keep the arbitration confidential can help keep the trade secret confidential. While the same effect may be attained through litigation it can require the parties to take extra steps and the outcome may not be as certain.
2. Both parties benefit from having a single clear governing law in the license to provide certainty on the interpretation of the contract terms and on enforceability. In many cases a licensor will insist upon setting the governing law since it is providing the trade secret and arguably has the most to lose if there is a need to enforce the license agreement.
3. If the parties signed a non-disclosure agreement initially to allow the licensor to share some details of the trade secret then it is helpful if the entire agreement clause does not unintentionally extinguish the non-disclosure agreement.
4. The survival clause should contemplate that even after termination of the license agreement and any payments the licensee is still not at liberty to disclose the trade secret if it is still a secret.
5. The notice provisions can be appropriately tailored to ensure that critical notices to the licensor match the licensee's early warning notification obligations (in the event of an unintended disclosure of the trade secret) in a way that gets the licensor's counsel's attention to try to help preserve the confidentiality of the trade secret if there is a chance.
6. The assignment clause can ensure that the licensor can appropriately manage the number of future parties that receive access to the trade secret. This can also be addressed by properly defining the licensee parties to determine if the licensee's affiliates can or cannot obtain access to the trade secret from the licensee.

While this coverage of key terms for a trade secret license is not exhaustive (a discussion on liability is missing, for example) it reveals opportunities to thoughtfully approach some key terms in a trade secret license to avoid disputes and to help the parties construct a contractual vehicle that serves each party's interests.

This article has been peer reviewed by Eric Boehm.

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