The Guide to Monetisation - Edition 1

Trade secret insurance and why it is a crucial step forward for the market

The Guide to Monetisation - Edition 1

The first edition of the *IP Guide to Monetisation* provides global coverage and a nuanced exploration of valuing and monetising patents, trademarks, copyright and trade secrets, to answer the big questions of where to find untapped intangible assets, how to put a price on them and why they could be the engine to an entirely new revenue stream for businesses.

Generated: October 7, 2024

The information contained in this report is indicative only. Law Business Research is not responsible for any actions (or lack thereof) taken as a result of relying on or in any way using information contained in this report and in no event shall be liable for any damages resulting from reliance on or use of this information. Copyright 2006 - 2024 Law Business Research

Explore on **IAM**

Trade secret insurance and why it is a crucial step forward for the market

Mary Guzman
Crown Jewel Insurance

Summary

WHAT IS A TRADE SECRET?
BACKGROUND IN INSURANCE FOR THE VALUE OF IP ASSETS
THE INSURANCE INDUSTRY CREATES SOLUTIONS
REGULATORY, LEGAL AND ENVIRONMENTAL DEVELOPMENTS AFFECTING TRADE SECRETS

WHAT IS A TRADE SECRET?

A trade secret is a type of intellectual property (IP) that can be either technical or non-technical know-how or innovation such as formulas, drawings, designs, techniques, business processes and algorithms that provide a company with competitive advantage. Trade secrets must be managed differently from other types of IP, including patents, copyrights and trademarks, because these other three types of IP are approved via registration with a federal government entity, upon which they become public. In contrast, trade secrets are never filed or approved, because their value to their owner is directly tied to their secrecy. They are fragile assets that maintain their integrity and value as an IP asset only as long as certain attributes exist.

Many US state laws provide for enforcement under the Uniform Trade Secrets Act, and the federal statute providing legal protection for trade secrets under US law is the Defend Trade Secrets Act (DTSA). The DTSA was passed in 2016 and considers an innovation asset to be a trade secret if it is independently developed and owned by the company and derives independent economic value, actual or potential, from not being generally known to and not ascertainable through 'proper means' by another person, and whose secrecy is protected using 'reasonable measures'. Unlike patents, trade secrets are often created outside of research and development (R&D) or engineering and can include things that will either generate money for the company or save money by creating an efficiency via a process that generates results that are better, faster or stronger than those of its competition.

Trade secrets are the most valuable assets many modern, innovative companies have, often referred to as the 'crown jewels'. Almost everything in the more mature stages of a company's R&D pipeline could qualify as a trade secret, because those inventions have not yet been patented (and may never be) and otherwise meet the criteria outlined by the DTSA. For companies that spend over 10 per cent of their revenue on R&D, this fact alone is significant. In addition, the velocity of innovative change and difficulty in ascribing a 'person' as the inventor of some of today's assets, such as the output of generative artificial intelligence (gen AI), makes trade secret protection the best IP strategy for things such as financial algorithms, supply chain processes, strategic plans for mergers and acquisitions, new product launches and emerging technology of almost any type that would be very difficult for a third party to develop or reverse-engineer without insider knowledge.

BACKGROUND IN INSURANCE FOR THE VALUE OF IP ASSETS

TRADITIONAL IP INSURANCE

Today's IP insurance products provide either liability coverage (defence and settlement for third-party assertions that a company infringed on someone else's IP) or enforcement or abatement coverage that funds legal recourse following a theft or infringement of IP. There has generally been no insurance solution covering the significant value of IP assets, though they make up the majority of the value for most companies today (e.g., Google, Amazon, Meta and UPS) – until now.

CYBER AND CRIME INSURANCE

Cyber policies generally cover corporate confidential information, but cover only the cost to replace data, as opposed to the value of what resides therein. Fidelity, or crime, insurance covers the theft of money and securities but not intangible IP assets.

WHY ARE TRADE SECRETS INSURABLE WHEN OTHER IP (THE VALUE OF PATENTS, TRADEMARKS AND COPYRIGHTS, ETC.) STILL IS NOT?

It is because all of those types of IP are knowable by the public via the use of simple search tools. Trade secrets, as the only unregistrable IP asset, can be covered as an asset because of its confidential nature, allowing for the 'trigger' of a loss to be similar to cybercrime, which is the theft or disclosure of that asset. Once a trade secret is compromised, the value as an IP asset is decimated, as it no longer provides the owner with exclusive rights to its use. It is that simple.

Neither IP insurance nor cyber or crime insurance covers the value of trade secrets themselves. This value can include the costs associated with the time, money and resources it took to develop the idea and bring it to its current state, as well as the potential or expected future value of the asset over its useful life as a provider of critical competitive advantage.

There have been many challenges in developing insurance capacity for this fragile asset class.

First, companies need to have a formal process in place for identifying the in-house-created innovation assets that provide a competitive advantage because they are secret. Those are the assets that qualify as trade secrets, as long as reasonable measures are used to maintain their secrecy. Many companies today do not have a formal process of identifying and documenting their assets that should be protectable trade secrets and therefore will fall short on the other steps necessary to maintain the integrity of the IP.

Second, a robust risk management programme needs to be present. That means that a company must identify, value or quantify, and protect the insurable asset or assets from risk of loss. Although seemingly simple, this is more challenging in the trade secrets area, because these assets are both intangible and not static, and they can come from anywhere in the company (unlike patents, which tend to come from engineering or R&D alone). Generally speaking, the determination as to whether or not something is, in fact, a trade secret is made only at the time of litigation, unless that asset is insured as a trade secret. Having insurance in place signals that proper protections were in place and will help establish that a company used reasonable measures. A huge advantage of having the insurance is this 'guaranteed' trade secret status.

Third, the value of a trade secret can increase (as more investment goes in or the future value increases) or decrease (if the trade secret becomes known or readily ascertainable, becomes obsolete or is patented, in which case the value goes to zero as a trade secret because patents are public). In addition, the one and only 'hazard' peril that can destroy a trade secret is theft (or accidental disclosure), which means that protection against that single peril is critical. The markets have expressed concern about the fluid nature of the asset's value, which could make claims adjustment difficult as well.

THE INSURANCE INDUSTRY CREATES SOLUTIONS

Despite these challenges, the insurance industry is offering the first insurance that actually covers the value of scheduled trade secrets The policy triggers from theft leading to misappropriation of a covered asset and pays for crisis management efforts to preserve the integrity of the asset as a trade secret and, if not successful, pays the pre-agreed value of the asset. The reason this is critical is that once the secret is out, the ability to protect that asset and use it exclusively ceases to exist. If that secrecy is breached using 'improper means',

then there is a legal case for misappropriation, which means that the creator or company is entitled to either injunctive relief or monetary damages, or both. If that secrecy is lost by 'proper means', there is no misappropriation. So although the value of the asset as a trade secret goes to zero, there is no insurable or recoverable loss.

The policy wording and underwriting process address the above concerns by (1) requiring robust risk management that is validated or improved via the due diligence process, (2) including crisis management expertise in the event of a suspected theft of a covered trade secret and (3) freezing the value at an agreed amount (limit) at the beginning of the policy period. The coverage will evolve as claims emerge and as other entrants into the market put their stamps on this new area of insurance.

Insurers must continue to develop solutions that cover these most valued crown jewels as 'property'. They now are estimated to bring over US$15 trillion in value to the US economy alone, representing the largest class of IP assets as a subcategory of intangible assets. Intangible assets represent 90 per cent of the value of the S&P 500 and perhaps an even bigger percentage of the small and midsize business segments, with the top 10 Nasdaq companies spending, on average, 20 per cent or more of revenue on R&D.

HOW DOES THE INSURANCE HELP COMPANIES KNOW WHAT ASSETS MIGHT QUALIFY AS CROWN JEWEL TRADE SECRETS?

There is a standard 'litmus test' from the restatement of torts that can be used to determine whether or not an asset is a trade secret. A key factor for insurability is that there must be reasonable measures around the secrecy of that asset. For insurance purposes, we look at legal, physical, technical and processes (such as training) to ascertain the adequacy of these protections. Sample lists of assets that would qualify, questionnaires about the inner workings of the company, workshops and even AI scanning tools can be used to inform and create a registry (which should be updated regularly) of trade secret assets capturing only the metadata of the assets as opposed to the 'secret sauce' itself. In addition, documenting the existence of a trade secret using blockchain creates immutable evidence that may become critical for enforcement purposes.

VALUATION OF TRADE SECRETS

A large portion of the value of a trade secret is in the resources (time, money and opportunity cost) a company has spent on the development of the unique know-how from its inception forward. Sometimes, that know-how comes after years of trial and error (the 'error' part, which teaches a company what does not work, is called 'negative know-how'); other times, the value is created in just weeks or months of concerted, focused effort. Until this insurance was introduced, no other insurance covered the cost of R&D of a trade secret, including cyber (which almost always excludes the value of IP).

The second major component is the expected future value generated by the asset or know-how once it is in use. This is a much harder number to calculate but can be done using 'standard' accounting methodologies such as the cash flow method, relief from royalty, or the with and without method. A fair amount of competitive research goes into this subjective valuation; therefore, the insurance markets today are relying on IP valuation experts to validate and vet each asset by trying to estimate the expected life of the asset (until it becomes known in the industry, is reverse-engineered or becomes obsolete). The newer and more quickly changing the asset is (such as the output from gen AI), the more uncertainty

there is and therefore the harder it is to value. That simply means that the agreed value of the asset will be more conservative for insurance purposes.

WHAT IS THE CURRENT THINKING ON REASONABLE MEASURES THAT A COMPANY CAN UNDERTAKE TO PROTECT A TRADE SECRET?

As with the protection of personally identifiable data, the main thrust of protections come from people, process and technology. Underwriters will be looking for physical security around areas that house trade secret assets, such as warning signs, badges or other access-controlled entry, cameras and recording devices, and fences, etc. However, the vast majority of trade secrets today are stored and processed electronically, making technology access controls and security much more relevant. There are emerging standards around things such as AI coming from the National Institute of Standards and Technology and others to inform and guide security controls, which will become increasingly important over time.

Although the fate of many cases turns on whether or not reasonable measures were deployed, to date, there is little to no evidence that information or cybersecurity experts are being brought in as witnesses to ascertain what is reasonable. That is likely to change because, already, many standards are being applied to different types of assets or outages for things such as personally identifiable information and personal health information. Trade secrets are simply different types of assets that require protection. Additionally, following standard enterprise risk management policies and procedures, the higher the value of the asset (value at risk), the more rigorous the protective countermeasures should be.

WHAT DOES TRADE SECRET INSURANCE COVER?

The coverage available today does two things. First, it provides crisis management services immediately upon the trigger of the insurance (suspected theft), the goal of which is to prevent actual damage. The insurance provides the funding and expertise necessary to determine the source and scope of a theft or disclosure and to pursue immediate mitigation remedies, including injunctive relief, expedited due diligence or an ***ex parte*** seizure order, etc.

Second, if achieving proper injunctive measures is not successful during the crisis management phase, the insurance provides reimbursement to the insured for either the cost expended during R&D or the expected or agreed future value of the asset, or both. It is a first-party insurance policy that actually values IP assets as though they are tangible assets.

THE IMPORTANCE OF SUBROGATION

Unlike in most other types of insurance, the opportunity for the underwriters to successfully subrogate and make themselves whole is fairly likely. This is because in misappropriation there is almost always a 'bad guy' doing the taking. Whether or not that bad guy is reachable legally or jurisdictionally and whether or not there are deep enough pockets to pursue them are determining factors in whether or not to pursue subrogation. This point is critical because to build a new industry vertical, the market needs to see that the likelihood of profitability is high.

REGULATORY, LEGAL AND ENVIRONMENTAL DEVELOPMENTS AFFECTING TRADE SECRETS

Several factors are driving the recent surge in interest around trade secret risk management and insurance.

-

Patents are expensive and time-consuming to get approved, and there is a 75 per cent or better chance that they will get overturned if they are challenged at the Patent Trial and Appeal Board. That is not a good exchange for the effort. And even if the patent remains valid, the only way to enforce rights is to spend time and money on expensive litigation.

- Patents are public. A company is unlikely to want to spend 10 years and tens of millions of dollars developing something only to tell its competitors all over the world exactly what it is doing. That said, some assets, such as those that are tangible and easily reverse-engineered once in the public domain, must be patented to maintain exclusivity for the inventor. A combined strategy is critical.
- Patents provide a 'guarantee' of exclusive use for up to 20 years, but the majority of today's secrets will be obsolete in five years anyway.

Harvesting and assigning an agreed value to individual trade secrets provides instant lift in the value of any company (often in the tens or even hundreds of millions of dollars). The process dramatically improves a company's profile and negotiating position with lenders and investors.

If the company takes the further step of insuring the value of these assets against theft and misappropriation, the only hazard peril that impacts them is covered. The insurance provides a financial backstop previously unavailable and allows the assets to be monetised. It also smooths earnings and provides board members, senior leadership and investors with 'sleep insurance'.

Public companies (and their boards) now have a US Securities and Exchange Commission (SEC) obligation to (1) disclose what is being done to mitigate exposure to these 'material' assets and (2) notify the SEC and shareholders within four days (via an 8-K filing) the details of what happened, the potential impact and what is being done to rectify or recover when one of these assets is stolen. This is a massive attempt to keep companies from ignoring these events, as the impact of these losses can result in 'bet the company' litigation that is much more severe than a privacy breach or outage.

The Federal Trade Commission (FTC) passed a total ban on non-compete contracts for departing employees, which was supposed to come into effect in September 2024. It has been delayed on the basis that the FTC did not have legal authority to implement this ban, but it is being appealed. Whether or not there is a federal ban, this issue is significant because much of today's enforcement around theft of IP assets comes in the form of breach of contract claims where a non-compete contract was in force. Other steps must be taken to protect IP assets.

The fact that insurance now exists to reimburse a company for the value of these assets is a huge step for the market. The ability to provide such coverage remained elusive for many years. The value of these assets is the underlying reason for most investment today; therefore, many stakeholders stand to lose when trade secrets are stolen. Not only is insurance the best final step in protection; it can also help to monetise these assets for lenders and investors in companies that have little to no value in their tangible assets. The industry will provide more supply of capacity as there is an increase in demand. It will be exciting to watch this sector grow.

ENDNOTES

[1] Mary Guzman is chief executive offer at Crown Jewel Insurance.

Mary Guzman mguzman@crownjewelinsurance.com

Tel: (833) 999-9981

https://www.crownjewelinsurance.com/

Read more from this firm on IAM