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"You Acquired Trade Secret Assets. Now, Can You Enforce Them?"

When acquiring a product or business by purchase of assets, it is important to obtain all the seller's intellectual property rights necessary to continue the manufacture, sale, and service of the product or to carry on the acquired business. The recently-decided case of *Chemetall GMBH v. ZR Energy, Inc., et al.*, 320 F.3d 714 (7th Cir. 2003), suggests some of the difficulties in acquiring and enforcing these rights.

Transfer of Trade Secrets and Other Intellectual Property Assets

Typically, an asset purchase agreement will include an assignment clause and schedules identifying all or the most important assets being acquired. Patent rights and trademark rights (including domain names) are generally transferable in this manner, which suffices because these assets are formally defined in official filings and the associated rights are well understood. Registered copyrights can be handled in the same way. Unregistered copyrights may require transfer of the copyrighted works themselves; otherwise, the details necessary for use and future enforcement of the property are not clearly identifiable. Intellectual property rights under license-in agreements are also generally transferable assets (subject to contractual restrictions on transfer) by an assignment and assumption clause with specific identification of the agreements.

Trade secrets used in the acquired product or business are more difficult to transfer. They are not formalized in any official registration system. They may not be well-documented or even documented at all. Effective legal transfer requires a trade secret assignment clause and schedules that adequately identify the trade secret subject matter. However, to the extent the trade secrets are not fully identified by the schedules (almost always the case), provisions for the transfer of files and other materials embodying the trade secrets or requiring the seller to provide documenting, teaching or training services may be necessary. Sometimes, hiring knowledgeable employees of the seller is required to place the buyer in full possession of the acquired trade secrets.

To effectively own the trade secrets, the buyer also needs enforcement rights: the ability to protect the acquired rights against misappropriation. While protection against theft by strangers is difficult, protection against potential theft by employees of the seller is possible. Most employees are under a statutory duty to maintain the confidentiality of their employer's trade secrets. In addition, many employers require employees to sign written agreements that insure the employer's ownership of trade secrets and other intellectual property created by the employee and reinforce the duty to protect all trade secrets of the employer from disclosure. These are the rights that a business owner would turn to if its employees or former employees misappropriated trade secrets. How does a party acquiring trade secrets best position itself to use these same enforcement rights?

The Chemetall Decision

In the *Chemetall* decision, Chemetall acquired the assets of Morton International ("Morton") in connection with zirconium powder, a chemical product used in various pyrotechnic applications, including automobile airbags. Fraval was employed by Morton in the zirconium powder business. He signed an Employee Trade Secret Agreement with Morton. After Chemetall's acquisition of assets, Fraval left Morton and formed a competing company, ZR Energy, Inc. Chemetall sued Fraval for breach of his agreement with Morton not to use or disclose its confidential information. Fraval defended by questioning whether the duty of confidentiality he owed to Morton was transferred to Chemetall.

No doubt to the surprise and dismay of Chemetall, the district court left the question of whether Chemetall acquired the right to enforce Fraval's duty of confidentiality for the jury. The appellate court largely agreed.

Fraval's agreement with Morton was explicitly intended to "inure to the benefit of [Morton's] successors and assigns." However, Fraval relied on two provisions of the Morton/Chemetall Asset Purchase Agreement that identified assets excluded from the sale. In particular, Fraval relied on the following sentence:

> No employee of Seller shall become an employee of Purchaser as a result of this transaction and Purchaser ***shall not assume*** any liability or obligation with respect to any employee of Seller, ***including***, but not limited to, any ***employment or consulting*** agreement entered into by Seller.

(Emphasis added.) The court concluded that Chemetall, under this provision, simply declined to become Fraval's employer.

Second, Fraval pointed out that the Asset Purchase Agreement generally excluded any assets not listed in the Agreement, and Fraval's Trade Secret Agreement was not contained on the list of included assets. The court noted, however, that confidential information relating to the acquired assets was expressly included in the sale to Chemetall. Further, the obligations of Morton and its employees with respect to that information were mentioned in the following provisions:

"18(a) After the Closing, Seller shall keep secret and retain in strictest confidence, and shall not use for the benefit of itself or others any of the subject Assets or information pertaining thereto and shall not disclose such information to anyone outside of the Purchaser . . .

"(b) All of Seller's employees who have been active in the Business at any time before the Closing Date, shall be bound to a secrecy undertaking in accordance with Paragraph 18(a)."

The court viewed these terms as not establishing conclusively the seller's and buyer's intent with respect to Fraval's pre-existing confidentiality agreement, but also as not foreclosing an intent to assign the confidentiality agreement.

The jury was instructed that:

"[Chemetall] must prove that there was an intent for Plaintiff to become the Assignee or Successor to that confidentiality obligation. Intent may be proven by direct or circumstantial evidence."

Fraval challenged this instruction on several bases. One basis was that the instruction allowed the jury to find an assignment, even though Morton retained some of the rights under its agreement with Fraval, thus such a partial assignment would be invalid. The court held that an assignor may transfer some or all of its rights and, if only part of a right is transferred, that part may be enforced by the assignee as if it were a separate right. This holding permitted Morton to retain the right to enforce Fraval's duty to maintain secrecy of information relating to assets not transferred to Chemetall, while assigning to Chemetall enforcement rights for the trade secret assets sold.

Fraval also argued that the instruction permitted the jury to find an assignment even though the agreement was in the form of a personal services contract where the duty to perform may not be delegated. The court concluded that Fraval's performance of his Trade Secret Agreement was in no way affected by the identity of the party entitled to enforce.

A Recommended Approach

Although Chemetall ultimately prevailed, preventing the seller's former employee from misappropriating trade secrets that Chemetall acquired, it was forced to go through a trial and an appeal. Acquirers of significant trade secret assets who wish to avoid this fate should consider the following:

1) Include in the asset purchase agreement at least those clauses the Chemetall courts found helpful to the buyer;
2) Where possible, obtain an assignment of the seller's rights under employee trade secret agreements, identifying such agreements both by category and specific listing for key employees; if the seller will not assign all rights, take a partial assignment covering the trade secrets acquired;
3) Seek an assignment of all other rights, contractual or otherwise, necessary to protect buyer's rights in acquired intellectual property assets; and
4) As a practical matter, try to ensure that no records or other material aids to reconstruction of the acquired trade secrets are left behind with seller employees; require the seller to instruct employees to surrender such records and materials.

A buyer of trade secrets might also wish to require the seller to join as a nominal party, if necessary, and to otherwise assist and cooperate in any litigation required to protect against misappropriation of acquired trade secrets. This is needed where trade secret documentation is weak, making the buyer's identification of the rights to be enforced difficult.

It is also vital to remember when making an acquisition of trade secrets that the buyer may have to enforce the rights in a non-U.S. jurisdiction. This prospect has to be borne in mind when buying the asset and may influence the valuation of the asset.

Further, if the business being purchased has operations outside the U.S., then the trade secret protection in the jurisdiction where the secrets are used must be thoroughly researched, so the buyer understands the issues on enforcement. Many U.S. companies will find the trade secret laws in other jurisdictions surprising, both from the point of view of what can't be enforced and occasionally by what appears to be better protection for trade secrets in some foreign jurisdictions. For instance, the enforceability of employee covenants that restrict future employment of an employee who has had access to a company's trade secrets, can be effectively enforced on some occasions in European jurisdictions. Although the periods involved in such enforcement tend to be fairly short, they are important and can be a major assistance in trying to protect trade secrets. However, such protections can only be effective if there is a bona fide trade secret to protect, and it is embodied in a contract between the employee and the company that would be directly affected by any breach of the agreement, not, for instance, between the employee and the parent of the company for whom he or she works.

In dealing with any purchase of a company, or its assets, the international aspect of the business must always be taken into consideration. In the area of trade secrets, it is particularly important to bear in mind not just the jurisdiction in which the employees that have access to the secret are employed, but also the fact that people travel and may breach their duties in any country in the world. The enforceability of trade secrets in these broader circumstances must be a consideration when planning to purchase the assets of the company.

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