

A banner image showing a dark, modern building facade. On the left, there is a large glass window reflecting the sky. To the right of the window, the words "Cheng Cohen Alert" are written in a large, white, serif font. In the background, to the right of the text, the words "CHENG COHEN" are visible in large, dark, 3D block letters mounted on the building's exterior wall.

Cheng Cohen Alert

Adequately Protecting Your Confidential Information?

Common to most franchise agreements is the franchisee's obligation to protect the confidentiality of the franchisor's confidential information. In agreements we write for our clients, we also typically either require or reserve the franchisor's right to require that the franchisee have its employees who have access to confidential information sign individual confidentiality undertakings. While following through on that right might seem cumbersome, the importance of doing so was highlighted in a recent South Dakota federal court case. In that case, the Little Caesar franchisor sued a terminated franchisee who had changed the name of its business but continued operating under Little Caesar's system of offering "all day, every day ready-for-pick-up pizzas." The franchisor claimed that its system was "proprietary," qualified for trade secret protection under the South Dakota Trade Secrets Act, and was being misappropriated by the former franchisee. Under South Dakota's (and most other states') law in this area, to constitute a trade secret, the information must not be generally known to or readily ascertainable by proper means by other persons and must be the subject of reasonable efforts to maintain its secrecy. The court here sided with the franchisee, finding that the franchisor failed to show that the system wasn't readily ascertainable by other persons – the former franchisee testified that he knew of "hundreds" of other pizza restaurants that prepared pizza in the same way. But, for good measure, the court went on to discuss how "Little Caesar also cannot clearly establish" that it used reasonable efforts to protect

the secrecy. It's that part of the court's decision that provides the lesson here.

The court noted that, to qualify for trade secret protection, there need only be a showing of *reasonable* efforts to maintain secrecy – the efforts need not be overly extravagant, and absolute secrecy isn't required. Here, the franchisee clearly agreed to protect the confidentiality of the information when it signed the franchise agreement. However, it was the franchisee's pizza-preparing employees who had the most detailed knowledge of the system that the franchisor sought to protect, and those employees were under no obligation of confidentiality. The court noted that the employees were not required to sign confidentiality agreements, but it's unclear (and probably irrelevant) whether that requirement was missing from the franchise agreement or was there but not enforced. Interestingly, the court also noted that these employees didn't have access to the franchisor's Operations Manual which was clearly marked "confidential." [Query whether that would have changed the court's view of whether marking the Operations Manual to which the employees had access "confidential" constituted "reasonable efforts to maintain secrecy" of the system.]

This case provides two lessons for franchisors. First, although not at the heart of this particular case (but critical to an earlier case between these parties), don't let the former franchisee's declaratory judgment action seeking to have the court declare the post-term non-compete unenforceable go unopposed - not sure why Little Caesar did that here, but it did. Second, include in your franchise agreements *and enforce* the requirement to get confidentiality agreements from the franchisee's employees since they're the ones most likely to have access to the franchisor's proprietary information. At least according to this South Dakota court, failing to do so can mean the loss of trade secret protections.

Look for an expanded discussion of this issue in the upcoming edition of *Franchise Law News* (the quarterly supplement to *Franchise Update* magazine) or call us if you would like more information about this decision.

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