To: Sun Chemical Asian Counsel
From: Outside Counsel
Date: October 13, 2009

Re: Opinion Letter on Allied – Sun Chemical Agreement

Issue and Recommendation:

This letter addresses the proposed licensing agreement between Sun Chemical (Sun) and Allied Chemical Inc. (Allied) concerning the distribution of Sun's new product, ChemFloat, throughout the United States. Due to potential liability in class action lawsuits arising from implant products produced thirty years ago, it is vital that Sun avoid consenting to U.S. jurisdiction.

Accordingly, we suggest modifying the agreement, primarily Sections 4 Testwork and Services and 8 Confidentiality, to avoid the risk of Sun's consenting to U.S. jurisdiction, while still maintaining confidentiality of ChemFloat. While we believe our recommendations provide adequate protections for the confidentiality of ChemFloat, confidentiality should not come at the expense of risking consent to U.S. jurisdiction because: (1) a class action lawsuit could bankrupt the entire company, (2) Allied's potential profits create a strong enough incentive for it to ensure the secrecy of ChemFloat, and (3) competitors are already developing similar products that could make confidentiality irrelevant in a matter of years.

I. General vs. Specific Jurisdiction

For Sun to be named as a defendant in any lawsuit involving the implant products, the plaintiffs would need to prove that Sun or its agent consented to general jurisdiction within the U.S. For Sun to consent to general jurisdiction, it or its agent's contacts within the U.S. involving ChemFloat must be so systematic and continuous as to make it consistent with traditional notions of fair play and substantial justice to subject Sun to the jurisdiction of the forum, even where the cause of action is unrelated to the contacts. Virtualmagic Asia, Inc. v. Fil-Cartoons, Inc., 99 Cal. App. 4th 228, 238 (2002).

If Sun consents to specific jurisdiction within the U.S., it will not be at risk of being included in claims involving implant products, but it will be subject to claims arising from Sun's contacts within the U.S. involving ChemFloat. Specific jurisdiction exists if: (1) the defendant has purposefully availed itself of forum benefits with respect to the matter in controversy; (2) the controversy is related to or arises out of the defendant's contacts with the forum; and (3) the assertion of jurisdiction would comport with fair play and substantial justice. Sonora Diamond Corp. v. Superior Court, 83 Cal. App. 4th 523, 536 (5th Dist. 2000).

II. Theories of Consent to U.S. Jurisdiction by a Foreign Corporation

A. Agent/Principal Relationship

Neither ownership nor control over a subsidiary corporation by a parent corporation automatically subjects the parent to general jurisdiction in the state that the subsidiary conducts its business. Sonora, 83 Cal. App. 4th at 540. However, control is the key characteristic of the agent/principal relationship. As a practical matter, the parent must be shown to have taken over

Comment [G1]: Very good—identify key problems. You then effectively stay focused on them throughout the memo and there's a clear takeaway—we need to decide what to do about testwork/services and relationships with sub-licensees with respect to confidentiality if we take this licensing approach.

Comment [G2]: I think this was a smart way to decide and focus on the key issue of agency and to address confidentiality only as it relates to that. This also allows you to paint a clear picture for the client of what is at stake.

Comment [G3]: great

Comment [G4]: Excellent concise, client-relevant statement of the law.

Comment [G5]: Is this relevant to them at this point? Seems like this is in here more to meet a completeness criterion than an advise-the-client criterion.

Comment [G6]: Given that Sun has asked for your opinion on a proposed licensing arrangement, why are you talking about subsidiaries?

performance of the subsidiary's day-to-day operations. Id. at 542. Actions a principal can take without establishing an agent/principal relationship with its subsidiary include: consolidating financial reporting, sharing professional services (such as an accountant), monitoring performance, supervising budget decisions, and setting general policies and procedures to be followed. Id. at 541, 551.

A principal must also be cautious of establishing ostensible agency. Ostensible agency arises when the ~~principle~~ principal intentionally, or by want of ordinary care, causes a third party to believe another to be his agent who is not really employed by him. CAL CIV. CODE § 2300 (West 2009). If the principal's conduct causes a third party to reasonably believe that an agent possesses authority to act on the principal's behalf, an ostensible agency may be established and personal jurisdiction is enforced on the principal. Tomerlin v. Canadian Indem. Co., 39 Cal. Rptr. 731 (1964).

B. Representative Services Doctrine

The Representative Services Doctrine describes a specific type of principal/agent relationship when a local subsidiary performs a function that is compatible with, and assists the parent in the pursuit of, the parent's own business. Jurisdiction will be enforced if there is no basis for distinguishing between the business of the parent and the subsidiary, Bellomo v. Penns. Life Co., 488 F. Supp. 744, 746 (S.D.N.Y.1980), and if the sole purpose of the subsidiary is to seek customers and market for a business that the principal operates. Chan v. Society Expeditions, Inc., 39 F. 3d 1398, 1405 (9th Cir.1994).

III. Changes to the Proposed Agreement

Analysis of the legal issues above are relevant to our analysis of which contract clauses could increase the likelihood that a court would infer Sun's consent to U.S. jurisdiction.

A. Suggested Modifications to Section 4, Testwork and Services: Require Allied employees approved by Sun to conduct all testwork and services

Section 4 of the contract raises several red flags. Section 4.1.2 will presumably lead to Sun employees conducting plant testwork within the U.S. If Sun needs to complete testwork, it should be conducted outside the U.S to prevent any unnecessary risk. If Sun sends employees within the U.S., plaintiffs of potential implant suits could argue that Sun consented to jurisdiction because its employees continuously and systematically acted within the U.S. or on Sun's behalf. Testwork by Sun employees will likely need to be done for every plant built in the U.S. and over time this has a high probability of being considered tantamount to consent to jurisdiction. Furthermore, sending Sun employees to individual plants could create ostensible agency because third-party plant owners could reasonably infer that their agreement with Allied was on behalf of Sun.

To avoid these potential issues, the clause should be changed to require that all testwork by Sun be done at localities outside the U.S. There is a small risk that conducting testwork for Allied would be seen as controlling Allied's performance and constituting an agent/principal relationship. It is more likely that a court would view this as simply monitoring Allied's performance, not as consenting to U.S. jurisdiction through agency theory.

Section 4.2.2 creates many of the same issues as § 4.1.2. It requires Sun to furnish ore-separation and analysis services at plants within the U.S. Allowing Sun employees to enter

Comment [G7]: Good—other than being from a different context of control over a sub, this is what we need: specific examples of things that have and have not been deemed 'control' for purposes of 'agency' findings.

Comment [G8]: Again, I'm unclear why this is in here except to be a 'complete' presentation of the law of agency. The focus on 'deliberately' makes it sound irrelevant to the setting here—no-one is trying to mislead people about Allied being Sun's 'employee'. The risk here is not that Sun will be sued for Allied's misdeeds (not to say that wouldn't be a concern every.) There IS a real danger that no matter what is in the contract or Sun intends, if it looks like agency it will be deemed agency for purposes of finding jurisdiction.

Comment [G9]: Again, why is doctrine about subsidiaries relevant?

Comment [G10]: Now this sounds interesting—but does it apply to contracting arrangements as well, or just subs? I think Chan is not a sub case? How good is the analogy to our facts?

Comment [G11]: Good use of heading and focused advice. More importantly, this is a key potential problem with the draft.

Comment [G12]: Say more—why is it likely that this probability 'over time' becomes high? Because of what happens factually in terms of behavior of employees and management, at Sun and at Allied?

Comment [G13]: Good – is ostensible agency relevant for jurisdiction (doctrine appears above to be about responsibility in tort for misdeeds of agent)—or is the point that if they look like agents to third-party plant owners, they'll be functioning like agents for purposes of jurisdictional findings?

Comment [G14]: You want to suggest this rather than propose it so definitively. This could be a huge problem from a business perspective.

Comment [G15]: Do you mean even if its done outside the US? And if so, why? What's the reasoning? Case analogies?

plants in this capacity raises the similar concerns about systematic and continuous activity. Moreover, this section potentially crosses the agency/principal relationship line because it involves Sun performing services and controlling Allied's day-to-day operations. Since ChemFloat must be adapted specifically for every plant, any changes made at the sole discretion of a Sun employee will alter the day-to-day operations of that plant. Instead, Allied should complete these services because it contracts with the plants. Plaintiffs in an implant suit would point to this clause as evidence that Sun has authority over Allied's day-to-day operations at the plants within the U.S. Therefore, Sun would be consenting to general jurisdiction through its agent, Allied. Potential plaintiffs could also argue that Allied and Sun shared an agent/principal relationship based on the Representative Services Doctrine if a court determines that Allied sought the business of the sub-licensees but intended for Sun to perform the actual work.

Recommendation: We recommend amending §§ 4.1.2 and 4.2.2 to require Allied employees to perform all testwork and services. Section 4.5 ensures that Sun will still be able to approve the employees conducting the testwork and services; thus, confidentiality of the ChemFloat Process and Technology will still be protected. To further ensure confidentiality, a clause could be added requiring Allied employees involved with ChemFloat to follow general policies and procedures determined by Sun, because these would not create a principal agent relationship, as held in Sonora.

B. Suggested Modification to Section 8, Confidentiality: Require Allied to protect the confidentiality of ChemFloat and add a liquidated damages clause

According to the Uniform Trade Secrets Acts, in order for Sun to consider ChemFloat a trade secret: (1) the technology must have "independent economic value, actual or potential, from not being generally known" and (2) Sun must take reasonable efforts under the circumstances to keep it confidential. Morlife, Inc. v. Perry, 56 Cal. App. 4th 1514, 1520-21 (Ct. App. 1997). It is clear that the first prong of this test is satisfied. However, § 8 must be strong enough to satisfy the second prong of the test and maintain ChemFloat's trade secret status, but not so strong as to constitute an agent/principal relationship between Allied and Sun.

Section 8.7 requires certain contractual provisions be included in Allied's agreements with sub-licensees. While this helps to protect ChemFloat's confidentiality, it potentially could establish an agent/principal relationship. Plaintiffs of potential implant suits could argue that Sun's ability to control Allied's contracts makes Allied an agent of Sun. Seeking new sub-licensees is part of the day-to-day operations of Allied, and controlling such operations could be seen as exercising enough control to constitute an agent/principal relationship. Although these contract provisions could be seen as Sun setting general policies and procedures for Allied to follow, they still create a significant risk considering Sun's potential liability if it consents to U.S. jurisdiction. Thus, we suggest limiting § 8.7 to state:

> "Allied shall ensure that all sub-licensees take all adequate and necessary measures, equal to those of Allied, to protect the confidential and proprietary nature of the ChemFloat Process and Technology."

This significantly reduces the chance of an agent/principal relationship, while sufficiently protecting confidentiality.

Sun should also add a liquidated damages clause to § 8 to provide to protect itself in the event that Allied's current or new management does not continue to protect ChemFloat

Comment [G16]: Interesting. Can you say more about how this can develop into day-to-day control? How it relates to the type of control courts have seen as 'agency'? A distinction here in the caselaw would have been helpful—courts generally don't see control directed to protecting legitimate interests, in a trademark for example, as agency control.

Comment [G17]: Tread carefully on the business elements here. It's a major change to the business model to say 'Allied should do this.' You should be raising this as a set of considerations for their business analysis but they'll need to decide how the costs/benefits of having Allied do this work play out.

Comment [G18]: And perhaps more importantly point to the actual behavior that this clause sets up.

Comment [G19]: There's more to be said about how this looks in practice.

Comment [G20]: I think this is a very important and interesting line of analysis—but too briefly done here. Are there cases with licensing arrangements like this? The Chan case involves a local agent chartering cruises on a ship owned by the foreign corporation—different?

Comment [G21]: I think that also raises a red flag and if you think differently you haven't explained why.

Comment [G22]: But Sonora is a sub-parent case. More importantly, how 'general' is 'general'? If Sun has to approve employees who do this work, probably trains them, provides an operations manual for them to follow, and monitors their performance with the capacity (as with approval at first) to require that they be removed from the team....sounds like day-to-day operational control? Sounds like characteristics of some of the cases (see franchising examples) of what counts as agency?

Comment [G23]: This heading reads as though you have shifted from focus on agency—although that is where you go in second paragraph.

Comment [G24]: Good—brief treatment.

Comment [G25]: Be more specific—what in this section looks like "control" over operations—and how do those controls relate to cases, and distinction between control to protect legitimate interests and agency control?

technology. It should state (don't need the "that":

> "In the event that Allied breaches this contract, thereby damaging Sun Chemical's interest in its proprietary trade secret, Allied agrees to pay [a predetermined amount of money] in liquidated damages. Allied and Sun Chemical agree that while it is impossible to estimate the exact damages that would result from such a breach, [that amount of money] is within the reasonable range of damages that both parties anticipate would flow from such a breach. These liquidated damages do not preclude Sun Chemical from seeking additional damages as provided within the contract."

Liquidated damages clauses are generally considered unreasonable and unenforceable "if [they bear] no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach." Util. Consumers' Action Network, Inc. v. AT & T Broadband of Se. Cal., Inc., 135 Cal. App. 4th 1023 (2nd Dist. 2006). Therefore, Sun's financial department must make an adequate determination of lost profits that would occur if Allied allowed ChemFloat to be exposed to competitors.

Furthermore, § 8.8 poses a significant risk of Sun's consenting to U.S. jurisdiction because it will assign any claim against a sub-licensee to Sun if Allied fails to comply with its confidentiality obligations. The fact that Sun would be seeking the protection of the U.S. court system would likely be interpreted as Sun consenting to general jurisdiction within the U.S. For that reason, this clause of § 8.8 should be removed. The liquidated damages clause should provide enough incentive for Allied to pursue infringing sub-licensees, and if they fail to do so, Sun will be compensated while avoiding the liability of being joined as a party within the U.S.

Recommendation: We suggest revising §§ 8.7 and 8.8 as previously explained and adding the specified liquidated damages clause. The liquidated damages clause will incentivize Allied to protect confidentiality, protect Sun if confidentiality is breached, and drastically reduce the risk of an agent/principal relationship. To bolster confidentiality, Sun could also specifically identify Chemfloat as a trade secret within the contract and include additional protocols, such as distribution of an employee handbook identifying the information as confidential, so long as these inclusions only constituted general policies and practices so as not to establish an agent/principal relationship.

IV. Conclusion

For the aforementioned reasons, Sun should significantly modify §§ 4 and 8 of its proposed agreement to ensure that it has minimal risk of consenting to U.S. jurisdiction because the risk of bankruptcy supersedes of the benefits of confidentiality, especially given that Allied has a strong incentive to maintain ChemFloat's secrecy and competitors are already developing similar products.

Comment [G26]: In any way?

Comment [G27]: 8.8 simply requires Allied to comply with a demand to assign a claim against a breaching sub-licensee if Sun demands it—so the impact on jurisdiction of such an assignment can be assessed at that time. Why take the option away?

Comment [G28]: This is too simplistic—there's lots of risk of breach and undercompensation, no matter what we do. The world doesn't work the way contracts say they do.

Client Comments – Sun Chemical

Our general understanding of the various recommendations made by the attorney groups is that the single biggest issue with the proposed contractual agreement between Sun Chemical Co. ("Sun") and Allied Chemical, Inc. ("Allied") is that several of the contract provisions when taken together form what appears to be a principal-agent relationship. This agency relationship is dangerous in that it could potentially subject Sun to general jurisdiction in the United States. All of the groups recommended on varying levels amendments to the contract in order to avoid agency between Sun and Allied. A number of these amendments affect confidentiality provisions that Sun believes protects its intellectual property.

Additionally, all of the groups also recommended the use of the Uniform Trade Secrets Act ("UTSA") as a form of protection for the ChemFloat process. It seems that the logic is that even without the various confidentially provisions that would be removed to prevent agency, Sun would still be protected because ChemFloat would be classified as a Trade Secret under the UTSA. We have strong concerns with this line of reasoning. First, although the attorney groups expressed belief that the second prong of the UTSA requiring that the party with the trade secret take reasonable efforts to maintain its secrecy could still be met without the various confidentiality provisions, we have some concerns. Without confidentiality protection Sun risks losing an extremely valuable economic resource. The confidentiality provisions were initially included because Sun believed they were the best manner to protect its asset. We now understand the risk of agency but we also understand the risk of not protecting our asset.

We feel that on a basic level the attorney groups did not actively seek the best possible balance between avoiding agency and maintaining confidentiality. We question whether there is not a way to better protect the trade secret while avoiding any appearance of agency. We are not completely comfortable with total reliance on the protections of the UTSA. Beyond the question of whether we would even be protected under the UTSA if the confidentiality provisions were omitted there are concerns over what would happen if the trade secret was compromised and the UTSA provided our only enforcement mechanism.

In particular, the attorney groups recommended that provisions regarding sub-licensees be omitted because they assert too much control. Removing the provisions relating to the sub-licensees concerns us for several reasons. First, not having any input in the selection of sub-licensees is extremely risky since the sub-licensees will be directly responsible for the protection of the trade secret. Second, in the event that Allied was longer financially viable, the business contracts would effectively dissipate. Sun would be in a position that it would have to start anew in the North American market at great costs. Lastly, it is concerning that Sun would have no direct recourse against a sub-licensee in violation of the trade secret. It is a leap of faith to rely entirely upon Allied to protect Sun's confidentiality interests even though they have a financial interest in the matter.

In sum, we feel the attorney groups have given us a nice overview of the various issues that may arise out of a contractual arrangement between Sun and Allied. What we would like to hear more about now is how far we can stretch the confidentiality provisions without stepping over the agency line. In our view we should push the envelope as far as possible given the immense importance of maintaining confidentiality and protection of the ChemFloat process. We simply are not comfortable with throwing out all of the confidentiality provisions without being certain that it is the only course of action.