

Toll Manufacturing Transactions: Trade Secret and IP Protection

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A Practice Note outlining measures companies can use in toll manufacturing arrangements to protect their trade secrets and other valuable intellectual property (IP). This Note includes a discussion of the risks and benefits of toll manufacturing, due diligence considerations, and practical and contractual methods of protecting trade secrets and technological assets.

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In today's corporate environment, many companies consider toll manufacturing arrangements in emerging market countries to reduce costs while maintaining access to a highly educated and technologically advanced work force. Toll manufacturing in countries such as Brazil, Russia, India and China (BRIC countries) can allow a company to realize cost savings by outsourcing functions to highly specialized service providers in lower cost jurisdictions.

While toll manufacturing can provide companies with valuable bottom-line drivers in their production pipelines, it presents unique risks for the potential loss of trade secrets and the enablement of a new competitor.

This Note outlines a combination of structural, contractual, practical and institutional measures companies should use in toll manufacturing arrangements and agreements to protect their trade secrets and other valuable intellectual property (IP). Specifically, it focuses on:

- The general benefits and risks of a toll manufacturing arrangement.
- Due diligence measures to carry out before entering into any toll manufacturing transaction.
- How a company can strategically structure a toll manufacturing arrangement.
- Practical and contractual protective measures and controls to secure trade secrets and technological assets.
- An overview of other key contractual provisions to include in a toll manufacturing agreement.

For a checklist addressing these issues, see *Toll Manufacturing: Protecting Trade Secrets and IP Checklist*.

BENEFITS AND RISKS OF TOLL MANUFACTURING

In a toll manufacturing arrangement, a company provides its raw materials or semi-finished goods to a third-party service provider. The service provider, who often has specialized equipment or infrastructure, provides a subset of manufacturing processes on behalf of the company using those materials or goods for a fee.

To effectively leverage a toll manufacturing relationship, a rights holder must license a combination of proprietary trade secrets, know-how, processes, data and materials to the toll manufacturer. However, this introduces risks of teaching a third party to replicate proprietary processes and allowing the third party to access valuable know-how that it may either:

- Use for its own independent benefit.
- Sell to a third party.
- Inadvertently allow others to access through the absence of effective controls.

The lack of protective laws or effective remedies for misappropriation in BRIC countries and other emerging market countries may heighten these risks.

Trade secret protection is a particularly sensitive issue in toll manufacturing relationships because the manufacturers with the requisite expertise are typically already engaged in the relevant business or field. Accordingly, they may be well-positioned to compete with the company during or after the term of the toll manufacturing agreement.

Importance of Internal Controls

A company's internal controls may help to ensure proper:

- Vetting and selection of the prospective manufacturer during the due diligence process.
- Negotiation of the toll manufacturing relationship.
- Management of the toll manufacturing transaction and relationship with the manufacturer.

Delegating signing authority and supervisory responsibility to one member or a core team of company management can:

- Improve risk-benefit assessments.
- Help achieve uniform application of the company's toll manufacturing protocols.

Centralized oversight may also facilitate:

- Knowledge and data management concerning past and current toll manufacturing transactions.
- Institutional learning to implement and refine protocols for future transactions.

DUE DILIGENCE OF THE TOLL MANUFACTURER

Selecting a trustworthy partner is an essential first step to a successful toll manufacturing transaction. A company should only enter into a definitive transaction with a prospective toll manufacturer after ensuring it will be an acceptable partner. This requires the company to conduct rigorous due diligence, which may include:

- Background checks of the manufacturer's principal officers and directors.
- Audits of the manufacturer's financial statements.
- Inspections of the manufacturer's facilities.
- Investigations of the manufacturer's supply chain and trading partners.

In addition, a company should require the prospective manufacturer to submit:

- Business references from past and current clients.
- References and credentials for key employees.
- An overview of its complete organizational structure, as well as beneficial ownership documentation.
- A list of all current clients.

As part of the diligence process, a company should assess to what extent the prospective manufacturer or any of its affiliates is or in the future may become a competitor in the commercial areas that will be the subject matter of the agreement. This may also impact the assessment of the potential practical risks raised by the particular toll manufacturing relationship.

While a company should avoid disclosing any trade secrets or related information until it enters into a definitive agreement with the prospective manufacturer, it should enter into a non-disclosure agreement with the prospective manufacturer before beginning its due diligence process. This is to:

- Protect the company if any trade secrets or other business information are shared.
- If appropriate, prevent disclosure of the potential manufacturing arrangement itself.

TRANSACTION STRUCTURE

Once the company selects a potential manufacturing partner, it should design a transaction structure that reinforces its commercial expectations and the manufacturer's contractual obligations. Specifically, the company should structure the toll manufacturing transaction in a manner best suited to protect the company's key IP. Transaction structure considerations include both:

- The particular corporate and contractual form of the relationship.
- How the company will delegate the manufacturing process to the toll manufacturer.

Joint Venture or Arm's-Length Contract

The first structural decision is the corporate and contractual form of the relationship itself. The parties can enter into a:

- Joint venture with the proposed manufacturer.
- Simpler contract manufacturing relationship.

Forming a contractual joint venture with the proposed manufacturer or a legal-entity joint venture, by moving certain manufacturing assets and personnel of the counterparty into a new entity in which the company will have an ownership interest, offers certain benefits. For more on establishing joint ventures, see *Practice Note, Joint Ventures: Overview* and *PLC Commercial, Practice Note, Cross-border Contractual JVs in the Manufacturing Sector*.

The benefits of a joint venture may include:

- Greater operational control over the manufacturer.
- Increased transparency on the use and protection of key manufacturing assets and related know-how.
- An enhanced ability to influence the manufacturer's practices and policies on a go-forward basis.

However, a relationship where the company takes an ownership stake or the parties otherwise document a collaborative joint venture relationship involves a:

- Higher level of complexity with respect to diligence and documentation.
- Greater commitment of time and resources.
- Potentially more difficult exit.

Joint ventures also require additional considerations relating to the transfer, licensing and ownership of trade secrets and other IP required for and developed by the joint venture.

Together, these factors may undercut the cost-cutting rationale for seeking a toll-manufacturing solution.

Companies may therefore prefer a more straightforward contract manufacturing relationship in most contexts and this relationship is assumed for this Note.



Segmenting the Manufacturing Process

After deciding on the basic corporate or contractual structure, the company should decide how best to strategically divide up the manufacturing process. In the toll manufacturing context, the best process involves not only efficient manufacture, but also most effective process to mitigate potential trade secret risks.

To protect its assets, the company must first identify which IP has the greatest value and therefore needs the most structural and contractual protection.

Because of the inherent difficulties in enforcing breach of contract actions alleging misuse of confidential information, practical and structural protection measures are also critical. These measures should be built directly into the toll manufacturing relationship. Where practicable, the company should divide crucial know-how in a manner that prevents the manufacturer from having access to all of the trade secrets necessary to complete the manufacturing process.

Limiting Access and Use

The strictest form of control over the company's trade secret and technological assets is to ensure that any manufacturer personnel do not access these assets, by either:

- Having the company handle key aspects of the process internally at facilities outside of those of the manufacturer.
- Where internal treatment cannot be used, having company personnel themselves work in the manufacturer's facility.

If possible, it can be beneficial to allocate different phases of the process to different manufacturers. For example, in car manufacturing, a company may produce the engine or technology-intensive parts internally or through multiple service providers. The division of know-how between different entities can reduce the ability of, and potential harm caused by, a manufacturer that attempts to misappropriate valuable information.

Where the use of different manufacturers is not possible, the company may benefit from separating the process into different phases within a single manufacturer's organization. The company can require that separate teams of employees and management personnel work on each phase, and that internal firewalls prevent the spread of information between the teams.

To the extent practicable, confidential information should be either or both:

- Provided on a just-in-time and as-needed basis.
- Expunged from the manufacturer's systems immediately after use.

Establishing and Maintaining Oversight

Requiring the manufacturer to maintain a designated facility for all work involving the transaction can reduce the risk of violations and simplify the monitoring and protection of the company's IP. In

all cases, the company should reserve the right to frequently audit the manufacturer's facilities. If possible, the scope of these audit rights should extend enterprise-wide to ensure protection and containment of critical information.

The company should also consider appointing one or more company delegates to oversee key steps of the toll manufacturing process within the manufacturer's facilities. This is the case even where the manufacturer's employees, and not the company's delegates, are responsible for the manufacturing activities. The company's delegates also can serve in a quality-control capacity.

Control over the Final Product

Finally, if the company can control the distribution and sale of the products following manufacture, it may be in a position to:

- Better control the continuity of its business.
- Limit the impact of the manufacturer attempting to compete in the future if the company transitions from the manufacturer to another service provider or to its own facilities.

CONTRACTUAL TRADE SECRET PROTECTION MEASURES

In addition to using structural and practical protections (see *Segmenting the Manufacturing Process*), the company should include specific measures for protecting its confidential information in the toll manufacturing agreement. These should address:

- The identification of the company's trade secrets (see *Identifying the Company's Trade Secrets*).
- The manufacturer's obligations concerning its employees and contractors (see *Obligations Concerning the Manufacturer's Employees and Contractors*).
- The manufacturer's commitment to establish and enforce:
 - physical barriers and electronic firewalls (see *Physical Barriers and Electronic Firewalls*);
 - special information technology protocols (see *Information Technology*); and
 - procedures for the use of confidential information (see *Protocols for Confidential Information*).
- A narrowly tailored license of the company's trade secrets and other IP (see *Licensing of Trade Secrets and IP*).

In negotiating the toll manufacturing agreements, the company's internal controls play an important role in protecting the company's interests and continuity of company practices (see *Importance of Internal Controls*).

Identifying the Company's Trade Secrets

The agreement should first identify the type and nature of the trade secrets and confidential information the company intends to protect. To maximize protection, the agreement should describe the information:

- With sufficient detail for the information that the company wants to protect to be identified.
- Without being overbroad, because:
 - the information might be perceived as being defined too generally; and
 - the obligation might be found unenforceable.

The company should consider reviewing and updating the description periodically or as necessary to ensure that the agreement continues to accurately and completely reflect the information it has shared with the manufacturer.

The agreement should include an acknowledgment by the manufacturer of this information's great value and that this value derives in large part from its secrecy.

Obligations Concerning Manufacturer's Employees and Contractors

Access Limitations

The toll manufacturing agreement should require procedures that limit access to the company's confidential information to specific, identified manufacturer personnel and solely to the extent they need to know the information for performing the services.

Employee Contracts

The company should require the manufacturer to amend its employment contracts with individuals having access to the company's confidential information to provide for confidentiality and non-compete obligations concerning this information. The toll manufacturing agreement should make the manufacturer directly liable to the company for any breach of these obligations.

The company should also consider requiring that key employees with access to company trade secrets execute a confidentiality agreement directly with the company. As a result, the company will be in direct privity with the individuals and may not have to rely on the manufacturer to enforce employee contracts or on potentially limited third-party beneficiary rights.

These employment contracts should provide for the assignment to the company of all IP derived from and improvements made to the company's trade secrets and other IP. Alternatively, the agreements can require assignment to the manufacturer, who should in turn be contractually obligated to assign these rights to the company. This may be particularly important in certain BRIC countries, such as China, where applicable laws would allow the manufacturer's employees to make these improvements despite any contractual provisions to the contrary.

Employee Training and Education

The company should require that employees be educated on best practices for protecting confidential information and preventing disclosure. The toll manufacturing relationship should include ongoing education and information for employees and managers covering:

- The importance of protecting commercially sensitive information.
- The commercial benefits from this protection.
- The economic and legal consequences of failing to properly safeguard sensitive information.

The toll manufacturing agreement should provide for disclosure to and consent from the company for any new or substitute employees that the manufacturer proposes to use in connection with sensitive employee functions.

Employee Termination

The company should require the manufacturer to adopt protocols to govern termination of the manufacturer's employees in a manner that minimizes the risk of the employees taking confidential information with them when they leave the manufacturer. These may include:

- Giving employees short notice before termination.
- Automatically disabling access by these employees to secure areas or systems before giving notice.
- Informing employees of, and requiring them to agree to, the withholding of their final salary or severance payments, or both, pending the company's review of their information access and transmission records.

Use of Independent Contractors and Consultants

The company should take into account the risks of permitting the manufacturer to use third-party independent contractors or consultants. To limit the disclosure and use of its confidential information, the company should consider expressly prohibiting the manufacturer from using any independent contractors or consultants.

However, where the company is willing to allow the use of these individuals, it should ensure that the toll manufacturer:

- Is directly responsible for their actions and obligations.
- Has agreed to confidentiality obligations and practices for these individuals at least as protective as those used with the manufacturer's employees, including the company's:
 - approval of any individuals before any permitted disclosures; and
 - review and, if necessary, revision of relevant agreements.

Security Procedures for Access, Storage and Transmission

Physical Barriers and Electronic Firewalls

The company should contractually require the manufacturer to set up physical barriers and electronic firewalls to protect confidential information, including:

- Implementation of e-mail filters.
- Download limitations to prevent the transmission of large data files.

The company should ideally require confidential information in electronic format to be isolated from the manufacturer's main computer network and from any computer or network with internet access.

The manufacturer also should maintain physical security for its facilities, including:

- Building security guards.
- Internal access restrictions based on clearance levels.
- Surveillance devices.

Information Technology

Because of vulnerabilities in cybersecurity and efforts by corporate, state and criminal actors, particularly those based in certain BRIC countries, to access and siphon off economically and competitively valuable information, the company should specify special information technology protocols for the manufacturer. These protocols can include:

- Keeping certain highly sensitive information entirely off of the manufacturer's, and perhaps even the company's, network.
- Performing periodic information technology audits to assess the networks' security.

Protocols for Confidential Information

The toll manufacturing agreement should cover generally applicable measures for the use and transmission of confidential information. These should include requiring:

- All documents containing trade secrets and similar know-how to be marked as confidential.
- Encryption for electronic files.

Transmission of confidential information should also only occur through secure channels.

Local Law Considerations

The laws of each particular jurisdiction define what constitutes a trade secret in that country and the protective measures that owners must take to be eligible for legal remedies for misappropriation. Local counsel should therefore be consulted in each relevant jurisdiction to review the proposed agreement and to help determine the most effective means under local law to protect the applicable IP.

Licensing of Trade Secrets and IP

The licensing of the company's trade secrets and other IP should be consistent with the company's identification of its trade secrets and other IP and appropriately limited in scope. Among other considerations, the license should be:

- Narrowly tailored to cover only the manufacturer's required use of the licensed information and IP.

- Revocable and subject to immediate termination when appropriate.
- Sublicensable and assignable only to the extent necessary under the arrangement.

TOLL MANUFACTURING AGREEMENT PROVISIONS

In addition to practical and contractual protections specific to trade secrets, the company should address the following considerations in its toll manufacturing agreement to help reinforce the manufacturer's confidentiality obligations and protect the company:

- Providing for a limited initial term (see *Term and Termination*).
- Making renewal terms at the company's discretion (see *Term and Termination*).
- Seeking a right to terminate for convenience (see *Term and Termination*).
- Addressing transition services after the agreement (see *Transition Services*).
- Including adequate trademark protection (see *Trademark Protection*).
- Requiring non-compete covenants (see *Non-Compete Covenants*).
- Including assignment and change-of-control restrictions (see *Assignment and Change-of-Control Restrictions*).
- Specifying means for dispute resolution (see *Dispute Resolution Procedures*).

Term and Termination

The company should keep the initial term of the agreement relatively short. In addition, the company should consider including either or both of the following:

- Renewal terms at the company's discretion.
- A termination for convenience provision.

Due to the overhead required for the manufacturer to start the services, the manufacturer may not agree to short terms with unilateral renewal rights or the right for the company to terminate for any or no reason. If so, the company may wish to focus on more readily exercisable breach and termination triggers with relatively short cure periods. These features should create strong incentives for the manufacturer to comply with the agreement's confidentiality provisions. For example, the company could include:

- A termination trigger if the company establishes its own facilities.
- An option for the company to acquire the manufacturer's designated facilities.

Transition Services

After termination or expiration, the company should require the manufacturer to provide extensive transition services to the company. In addition to customary provisions, the agreement could provide for the transfer to the company of key:

- Equipment.
- Materials.
- Facilities.

The agreement can further require the manufacturer to offer severance to crucial employees and encourage them to accept future employment with the company directly.

Trademark Protection

The company should require that the products manufactured by the toll manufacturer:

- Prominently bear the company's trademarks.
- Are not offered in association with the name or mark of the manufacturer or any other third party.

The agreement should also include appropriate quality control obligations and oversight relating to the use of the marks. This should help the company create and maintain equity in the marketplace concerning company-authorized products.

Non-Compete Covenants

The company should consider requiring certain non-compete covenants from the manufacturer so that the manufacturer has less incentive to misuse company trade secrets. These can also be included in modified employment agreements with the manufacturer's employees. These provisions may be limited to a specific industry or sector, or in connection with specific company competitors.

Assignment and Change-of-Control Restrictions

Change-of-control and anti-assignment restrictions are important protections in any toll manufacturing agreement. They can provide the company with assurances that:

- The identity of the manufacturer will not change during the term of the agreement.
- A competitor will not obtain access to the company's sensitive information through corporate affiliation with the service provider.

For more on assignment and change-of-control provisions, see *Practice Note, Restrictions on Assignment and Change of Control*.

Dispute Resolution Procedures

The dispute resolution procedures of the agreement should account for difficulties that the company may encounter in enforcing contracts and other legal rights in the manufacturer's jurisdiction. For example, China does not give reciprocity to judgments by US courts, but Chinese courts do enforce decisions by arbitral tribunals. The company should consider an arbitral forum that offers established procedures and a large number of potential arbitrators who are fluent in English and have experience with toll manufacturing transactions, such as:

- New York or Miami for a Brazil agreement.
- London or Geneva for a Russia agreement.
- London or Singapore for an India agreement.
- Hong Kong or Singapore for a China agreement.

The agreement should be subject to a neutral governing law with well-established principles and well-developed precedent for trade secrets, such as Delaware or New York in the US or English law.

As a general matter, parties based in different countries generally will seek to resolve disputes through arbitral institutions that principally focus on international disputes. For example, the International Chamber of Commerce (ICC) has a long history of providing an arbitral forum for international commercial disputes, and parties frequently agree on the ICC the appropriate tribunal for arbitration. In addition, depending on the region in which the manufacturing is to occur, there may be international arbitration tribunals with substantial experience in handling international commercial disputes in that region. For example, for disputes involving a China agreement, the Singapore International Arbitration Center or Hong Kong International Arbitration Center may be preferable among available arbitral institutions on the basis of:

- Available remedies.
- Predictability.
- Enforceability of award.

Accordingly, the company in each instance should consider the appropriate arbitral forum based on its own prior experience and the reputation of the forum in the applicable region.

For more on arbitration in the US, UK, Switzerland, Singapore and Hong Kong, see PLC Arbitration, Articles:

- *Arbitration procedures and practice in United States: overview.*
- *Arbitration procedures and practice in UK (England and Wales): overview.*
- *Arbitration procedures and practice in Switzerland: overview.*
- *Arbitration procedures and practice in Singapore: overview.*
- *Arbitration procedures and practice in Hong Kong: overview.*

For the links to the documents referenced in this note, please visit our online version at <http://us.practicallaw.com/8-525-5209>.



Additional Deterrents to Prevent Breach

To help safeguard against the worst case scenario of the manufacturer's breach, the company may consider including additional contractual deterrents. These may include requiring the manufacturer to:

- Post a bond in escrow.
- Purchase insurance.
- Maintain a letter of credit.
- Grant the company a lien on certain assets.

The company's rights under these safeguards should be triggered by either or both of the following:

- The manufacturer's material or intentional breach of the agreement.
- Specific provisions concerning trade secrets.

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- Supply of Goods and Services
(<http://us.practicallaw.com/topic0-103-1128>)
- Trade Secrets
(<http://us.practicallaw.com/topic3-506-0474>)

Practice Note: Overview

- Joint Ventures: Overview
(<http://us.practicallaw.com/1-107-3580>)

Standard Document

- Confidentiality Agreement: International Joint Ventures
(<http://us.practicallaw.com/2-500-4898>)

Checklists

- Confidentiality and Nondisclosure Agreements Checklist
(<http://us.practicallaw.com/6-501-7380>)
- Protecting Trade Secrets and IP in Toll Manufacturing Agreements Checklist
(<http://us.practicallaw.com/8-520-6049>)

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