

The waiting game

The US is still waiting for its first major IP-based shareholder suit; the one that will change the way company boards view IP rights forever. And with Sarbanes-Oxley now fully up and running and the SEC beginning to take an interest, many predict the wait may soon be over

By **Victoria Slind-Flor**

Plaintiffs securities lawyers in the United States have yet to take on a company for mismanagement of IP assets. But the day may well be coming soon, particularly in the wake of a 2002 law that mandates stricter control of corporate assets. Perhaps the first hint of things to come reached corporate officials' awareness in September, when speaker Mark Halligan read a letter aloud at the annual meeting of the Intellectual Property Owners organisation in Chicago. Halligan, a partner in the windy city's Welsh & Katz law firm, sent a ripple of apprehension through his listeners.

The letter he read was from the US Securities and Exchange Commission and focused on the acquisition activities of a company Halligan did not identify. In the letter, the SEC demanded an independent appraisal report for the fair value of the intellectual assets involved in the transaction. There was an additional ominous-sounding sentence: "Please tell us why you have not included a fair value."

SarBox bites

The letter was a harbinger of the troubles in which publicly-listed companies in the United States could find themselves ever since the so-called Sarbanes-Oxley legislation mandating better corporate financial control became law back in 2002. "The fact of the matter is that the SEC understands the value and power of Sarbanes-Oxley," says Halligan. And, as a result, directors and officers who are careless about the valuation and handling of their intellectual property are taking significant risks. In fact, Halligan continues, should there

be a feeling that a company has failed to look after its IP rights, the chances are shareholder-instigated litigation will follow – it always comes quick on the heels of SEC enforcement actions. Companies that do not act to get a good grip on their IP will be targets of a rash of shareholder suits, he says.

Alexander Poltorak and Paul Lerner, of General Patent Corporation of Suffern, New York – an affiliate of GPC International (GPCI), one of the US's leading contingency patent enforcement firms – issued a paper in January 2004 in which they gave a stark warning to corporate officials. Poltorak is chairman and CEO of GPCI and Lerner is its senior vice-president and general counsel and the company has worked successfully on behalf of a number of independent inventors and small businesses to enforce their patent rights against larger corporations. In their paper, the two men wrote that companies can no longer afford to "ignore intellectual property, leaving it to a clerical staff that filed and forgot it". Poltorak and Lerner said the fiduciary "duty of care" is one point of potential D&O liability, while "wasting of assets" by not designing a "sensible IP management program" is another.

But that was two years ago. "Nothing dramatic has happened yet, but there are lots of rumblings about this," says Stuart P Meyer, a partner in Palo Alto, California's Fenwick & West. "We're really at a stage where people are trying to sort out what the likely required approach will be. A lot of it will come from the earliest enforcement actions in this area."

The wolf's still there

In late 1999, Kevin Rivette's and David Kline's groundbreaking *Rembrandts in the*

Attic: Unlocking the Hidden Value of Patents was published. The book suggested ways in which corporations could improve their bottom lines by focusing on their intellectual property. Shortly thereafter, a number of accounting and law firms started warning their clients that failure to maximise the return on IP assets risked both wrath and litigation from dissident shareholders.

After he read *Rembrandts*, Stanton Lovenworth of New York's Dewey Ballantine tried hard to sell his clients on the need for IP audits. It was a hard task. "I realised I was wasting my time and looking a bit silly," he says. "I was trying to sell a product people weren't interested in. I wrote articles, sent out client memos and had no takers." Kenneth Godlewski of the Washington DC office of Atlanta's Kilpatrick Stockton found himself in a similar situation back in those early post-*Rembrandt* days, "I cried wolf," he says. "But I think the wolf is still there."

In 2003, Godlewski co-authored a paper outlining Sarbanes-Oxley IP compliance strategies, warning that in the post-Enron atmosphere, the penalties for non-compliance can be severe, including individual statutory fines of up to US\$5 million and 20 years in prison. And he pointed out that under the SEC's rules of professional responsibility for attorneys doing Sarbanes-Oxley work, some of those wolves could even be companies' IP counsel-turned-whistleblowers, required to report breaches of fiduciary duty and material violations they discover.

Litigation is happening

Chicago's Ocean Tomo offers its clients a wide range of IP-management services. Chief Executive James E Malackowski has been on the stump, warning of the dangers of IP-related shareholder litigation and emphasising that companies these days need IP experts on their boards. Not only is there a risk of shareholder litigation for IP mismanagement, but there is also always the possibility of infringement suits from competitors or fraud suits from customers.

In his PowerPoint presentation on the subject, Malackowski points out that the proportion of tangible assets to intangibles has changed dramatically in the past 30 years, with the intangibles now as much as 80% of a company's value. He has also searched shareholder class actions, looking for IP-related terms such as "patent", "trademark", "copyright", "false advertising", and "trade secret". And, so far, 26 reported decisions have turned up, affecting a wide

range of industries including pharmaceuticals, consumer electronics, industrial controls, toys, medical devices, dental products and veterinary procedures.

Malackowski has assembled a frightening-looking laundry list of allegations that have arisen in these cases. They include failure to disclose adverse facts regarding patent enforcement efforts, failure to disclose inadvertent lapse of key patent maintenance fees, false claims regarding licensing agreements, false claims regarding exclusivity of company licences, promotion of known invalid patents, false press releases regarding licences to use famous brands and wasting of corporate resources in patent infringement suits without merit.

He notes that almost all cases involved sale of securities, and there were many that were carry-overs from the kinds of accounting-fraud litigation that Sarbanes-Oxley was intended to wipe out. As a result, Malackowski makes a number of recommendations to help keep corporate boards out of this kind of trouble, including updating corporate guidelines on IP-based public relations, education of corporate officers on IP value and risk factors, and seeking out directors' and officers liability insurance with IP-related coverage.

Waiting for a suit

Many IP experts have been expecting the first full-bore shareholder suit of this kind would be launched against Research In Motion in the wake of the disastrous US\$612 million paid to NTP Inc in the first half of 2006 to settle the BlackBerry patent infringement case. Prior to this settlement, RIM could have made the case go away for US\$450 million or – if some reports are to be believed – for substantially less than US\$100 million before the dispute got near the courts. But RIM's management refused to deal. "You have to wonder what the RIM board was thinking because they could have settled the case for so much less," says Robert Sterne of Washington DC's Sterne Kessler Goldstein Fox.

So far, RIM shareholders have not filed a suit against the directors and officers. Perhaps that's because of RIM's immediate rearguard action, blaming their plight on the US Patent Office. Shortly after the settlement with NTP was announced, RIM took full-page advertisements in leading US newspapers decrying what it termed "a bizarre set of circumstances" allowed by the patent system and called for the patent system to "close loopholes", and "become



Rob Sterne

Surprised RIM shareholders have not expressed concerns over BlackBerry case

Class actions and IP

Although there has yet to be a shareholder suit in the US in which IP mismanagement has formed the central plank of the case, there have been a number of class actions in which IP issues have been prominent. Here are a few:

***Barrus v Sylvania*, 55 F3d 468, 470 (9th Cir 1995)**

In this case, the plaintiffs charged Sylvania with Lanham Act false-advertising violations and argued they were injured by the company's misrepresentations made about energy-saver light bulbs. The claim was dismissed by the 9th Circuit.

***Aetna US Healthcare v Hoechst AG*, 48 F Supp 2d 37 (DDC 1999)**

Healthcare company filed a consumer fraud class action, charging that Hoechst prevented introduction of the generic version of Cardizen, an anti-hypertension drug.

***Valley Drug v Geneva Pharmaceuticals*, 344 F3d 1294 (11th Cir 2003)**

This case involved charges that a drugs company made settlement agreements with two competitors to keep their less-expensive generic versions of the anti-hypertension drug terazosin hydrochloride off the market.

***Tilley v TJX Cos*, 212 FRD 43, 50 (D Mass. 2003)**

This copyright case involved a design for wallpaper the designer charged was copied and sold to more than 500 retailers.

***MGM Studios Inc v Grokster Ltd* (04-0480), 545 US , 125 S Ct 2764 (2005)**

Plaintiffs from the music and movie industry sued founder of peer-to-peer file-sharing software company, charging copyright violation.

***Perez v Wyeth Laboratories Inc*, 161 NJ 1 (1999).**

The plaintiffs successfully charged that the maker of the contraceptive drug Norplant engaged in deceptive advertising to its consumers.

***In re Buspirone Patent Litigation*, 185 F Supp 2d 340 (SD NY 2002).**

The plaintiffs, who were users of an anti-depressant drug, sued the manufacturer, charging the company initiated frivolous patent infringement action against competitors in attempt to keep a generic version of the drug off the market.

***In re Tamoxifen Citrate Antitrust Litigation*, 429 F3d 370 (2d Cir 2005)**

Users of the antibiotic Cipro sued the drug manufacturer, charging collusion with several generics manufacturers kept a generic version of the drug off the market.

***In re Tamoxifen Citrate Antitrust Litigation*, MDL No 1408, 2003 WL 21196817, at *9 (EDNY May 13, 2003)**

Users of this anti-cancer drug charged that the manufacturer entered into agreements with makers of generics to keep generic form of the drug off the market.

***Nichols v SmithKline Beecham Corp*, (2005) WL 950616**

In this case, the plaintiffs charged that the company filed baseless patent infringement cases to block US Food and Drug Administration approval of generic forms of the drug.

***In re Cardizem CD Antitrust Litigation*, 105 F Supp 2d 618 (ED Mich. 2000)**

The plaintiffs charged the manufacturer of the anti-hypertension drug Cardizem violated antitrust law by making US\$10 million quarterly payments to makers of generic drugs to keep a generic version of the drug off the market.

Information provided by Ocean Tomo

more balanced.

Sterne suggests that RIM's animosity to and bashing of the US patent system "comes from a need by the company's senior staff to justify their decision-making". But the final RIM onslaught was merely a continuation of what had been happening for the previous two

years, during which time the media debate on the case had been focused squarely on the threat posed by alleged troll NTP's threat to close down the BlackBerry line, so depriving three million Americans, as well as the US military, of the right to use the product. Scrutiny of this kind not only deflected attention from RIM's failure to settle the case previously but also masked the fact that the company had been found to be concocting evidence at the trial. In addition, no-one asked questions about whether RIM had ever done any patent searches before BlackBerry production had begun and what the results had been; and why if in 2005 RIM was suddenly able to find invent-around technology that avoided infringing NTP's patents this had not been done before.

Still, RIM's PR campaign notwithstanding, it is possible that somewhere either in the US or Canada, plaintiffs lawyers are quietly drafting a shareholder complaint against the company. After all, explains Sterne that US\$612 million settlement came from the shareholders. "I'm surprised the shareholders haven't held senior management to task for that," he says.

A plaintiff's view

From the other side of the equation, it would probably take a case of RIM's magnitude to mobilise plaintiff's lawyers. Darren Robbins' firm Lerach Coughlin Stoya Geller Rudman & Robbins LLP is well-known for its representation of unhappy shareholders, but so far Robbins and his colleagues have not taken a close look at IP mismanagement. Such cases will happen though, he says. "It'll be the day when somebody irresponsibly says 'I'm gonna stick my head in the sand instead of paying US\$50 grand to settle the case', but instead gets whacked by a US\$500 million judgment."

Which, in effect, is what the management at RIM did. However, on the day its US\$612 million settlement was announced, the company's share price actually jumped 17% and stood significantly higher than it had done on the day RIM lost its court case. Normally, however, a judgment or settlement of that size would be expected to trigger a dive in the stock price, and that's when the wave of shareholder suits will be launched. "Institutional investors are awakening to the value of patents," says Robbins, although he adds that so far his firm has no plans to launch this kind of IP-related suit.

Neither has one of the other likely

candidates, Minneapolis's Robins, Kaplan, Miller & Ciresi. Ronald Schutz, who chairs the firm's IP litigation group, says so far, IP-related shareholder litigation is on the backburner. "It is something that's been talked about, more than acted on. Although people have been talking for a long time about directors' and officers' liability, those cases haven't come to bear."

But there is one glaring exception: an old patent case involving a now-defunct biotech company, Cellpro Inc of Bothell, Washington, and Baxter Healthcare. After Cellpro was found to have infringed patents licensed to Baxter, and US District Judge Roderick McKelvie issued a blistering opinion excoriating Cellpro officials and their IP lawyers from Los Angeles firm Lyon & Lyon, stock prices plunged from US\$20 to US\$3.50 per share. The Seattle office of Washington DC's Cohen, Milstein, Hausfeld & Toll and five other plaintiffs firms then filed a shareholder class action, charging that Cellpro had made false and misleading statements about its intellectual property. That case settled in 1999 with US\$4.25 million and various stock shares going from Cellpro and its IP firm to the shareholders. Then Lyon & Lyon went under in 2002, a death many IP lawyers say was initially triggered by the backwash from the Cellpro judgment.

Schutz says so far his firm is too busy to get involved in IP-related shareholder litigation. "We haven't seen it as a way to make money," he explains. "We think the better way to make money is on the underlying idea itself. We have so much contingent-fee patent litigation opportunities. I get a call about three times a month where somebody's wanting us to take a look at a patent [with an eye to litigation]."

In any case, he continues, making a case for IP mismanagement may be difficult. "You'd have to see conduct on the part of management that's so egregious that they should be held liable. Such conduct would be rare and while you can sue people for fraud, you can't necessarily sue them for being plain stupid," Schutz concludes.

Looking for an angle

Mergers and acquisitions may well be the place where shareholder IP concerns rise high enough to trigger a lawsuit. Robbins points out recent litigation minority shareholders brought against Lexar Media Inc, of Fremont, California, a maker of flash memory devices. These shareholders were trying to halt the company's acquisition by Micron Technology Inc, of Boise, Idaho, a

large semiconductor maker.

Shareholders included corporate raider Carl Icahn and hedge funds Elliott Associates LP and Elliott International LP. Robbins says they challenged the acquisition on the grounds that there were "a series of patents and claims that were not properly disclosed". They filed suit in a California state court, but the request for an injunction barring the merger was dismissed at the end of May (Micron was represented by Fenwick & West in this action).

The two companies' boards then approved the merger in early June and, following an increase in the offer of Micron shares for Lexar shares, the Lexar shareholders finally approved the merger on 19th June. This time, Lexar dodged the bullet, but, many observers say, it is likely that the case points the way to what may happen in other M&As in which IP is one of the assets involved.

The recent firing of Bristol-Myers Squibb CEO Peter Dolan also has at least some of its roots in alleged IP mismanagement. On Dolan's watch, Bristol-Myers Squibb used an exclusionary payment to settle HatchWaxman patent litigation with Apotex Inc, a Canadian generics pharmaceutical manufacturer. The agreement, which was made in March 2006, would have delayed Apotex's entry into the market with a generic version of Bristol-Myers' best selling blood-thinning drug Plavix. Plavix was a big-ticket drug, earning Bristol-Myers nearly US\$4 billion per year. But the exclusionary payment, terms of which were secret, did not sit well with federal and state prosecutors.

A number of different states' attorneys general did not approve the agreement and, as a result, Apotex began shipping its generic version in early August. Later that month US District Judge Sidney Stein issued an injunction halting further generic sales, but Apotex has asked the US Court of Appeals for the Federal Circuit to review his ruling. In any case, Bristol-Myers lost its hegemony and enough of the generic version was shipped before Judge Stein's order to have a negative impact on demand for Plavix for months.

Smaller companies under threat

While this case involved a company classified as big pharma, more often it is the smaller companies that have IP-management problems. Rob Sterne believes that sometimes trouble flows from companies founded by individuals who were philosophically opposed to the notion of patents as a protected class of assets.



Darren Robbins

IP mismanagement cases will happen





Mark Halligan

Important to capture, classify and manage trade secrets

Ron Schutz (Left)

IP-related shareholder litigation on the backburner

"They categorically refused to embrace them. Those people could have been negligent of their shareholders," he says.

The likes of Microsoft Corp and Apple Computers got religion later on and now file significant numbers of patent applications every year. But in the late 1980s and through much of the 1990s, the copyright dispute between Apple and Microsoft over graphical user interfaces bounced back and forth from one court to another, with Apple ultimately failing to prevail. "Had the *Apple v Microsoft* case been predicated on patent liability rather than copyright, it might have been a whole other ballgame," says Sterne. "But Apple took the position that patent protection was irrelevant to their product line. You wouldn't see that today. Look how Bill Gates went from being anti-patent to pro-patent."

Sterne thinks that companies at greatest risk for IP-related shareholder litigation fall into a certain category: they are young and they have grown quickly. "The smaller the company, the higher the risk is that they don't have their act together," he says.

But regardless of the size or age of potential defendant companies, the good news for them is that it is not going to be as easy for their unhappy shareholders to sue them as it once was. The bar for securities class actions in general has been raised in recent years. "They've increased the pleading requirements and the consequences for bringing frivolous suits," says John Neeleman, a litigation partner in the Seattle office of Portland's Lane Powell. He predicts that only cases in which company officials have been grossly negligent in their IP management will ever be targeted.

Finding value

Another barrier would-be plaintiffs might face is determining an appropriate metric for IP value. "Unless the IP changes hands somehow in a transaction, you don't ever really know what the value of the IP is," says John Hutchins, an IP litigation partner at Atlanta's Troutman Sanders. And if there's been no underlying infringement litigation, determining that value will be even more difficult. Without a Markman hearing in federal court to determine the scope of patent claims "it becomes more problematic to drill down to a particular piece of IP", says Sterne. "This is not like a piece of real estate where you can do a title search, much less take it to the bank."

Fenwick's Meyer says new definitions of IP value are emerging, but there's still not much clarity. That's why Mark Halligan has

just put in six years developing a system through which intangible assets such as trade secrets can be given a value. Halligan, with co-author Richard F Weyand, has just published *Trade Secret Asset Management*, outlining strategies for inventorying, classifying and managing trade secrets. The book, Halligan says, is aimed at so-called "C-level management" – chief executive officers, chief financial officers, chief technology officers, chief intellectual-property strategists and the like. He suggests a trade-secret management system can be set up through interviewing employees to find out just what the trade secrets are. This information then needs to be reviewed by experts who can "generate an accurate and useful inventory: which must be kept updated".

Trade secrets are among a company's assets, Halligan says, and his book points to the 1837 US Supreme Court Case of *Vickery v Welsh*, which definitively established this fact. Many corporations, however, have not wanted to start enumerating trade secrets and listing them as assets because they are afraid of tax consequences. "But that's a very short-sighted view," Halligan says. "If the assets are properly identified and managed, the cash flow will outweigh the tax consequences." In his presentations to clients, Malackowski has also recommended that companies conduct trade secret inventories.

One strategy Halligan's book suggests is that companies set up trade-secret holding companies to manage the portfolio. Such companies can be set up as a profit centre, with revenue flowing from royalties and would be effective tools for Sarbanes-Oxley compliance. Trade secrets can be licensed and collateralised. However, this side of the Coca Cola company, with its locked-in-a-safe recipe for the famous soft drink, many corporate officials are clueless about what their companies' most important trade secrets might be.

The jury's out

The Chicago-based consulting firm of Willamette Management Associates does a lot of IP valuation work and, so far, managing director Robert Reilly has not heard of dissident stockholders suing a company for IP mismanagement. And as far as SEC demands for IP audits are concerned, Reilly considers that the jury is out. "It is still a strange new thing for the SEC under Sarbanes-Oxley. It's not easy [for the SEC] to find. IP doesn't show up on recorder financial statements."

Reilly predicts that it will be almost

impossible for a shareholder to point to an individual item in an IP portfolio and say it is being under-exploited. The company's immediate response can be the one Reilly already sees employed in patent infringement cases. "There the defendant will say, 'whether I admit infringement or not, I don't see you guys using that [patented technology]'. The plaintiff's immediate response, which is the right response, is that 'we use it defensively. We have that patent or trademark or copyright to make sure that you don't use it'."

He says common sense is the appropriate response to shareholder charges that IP assets are undervalued in an acquisition. "When the minority stockholder says you sold it too cheaply, the response is 'why would I do that to myself?' It's the easiest defence in the world. Why would I as a 60% stockholder sell the company for US\$60 million when I could have gotten US\$100 million?"

In recent years Reilly has testified in at least four cases in which a class of minority shareholders claimed that a company sold for too low a price or they were disadvantaged because the company mismanaged corporate assets. None of the cases ever even went to trial, he says. "The shareholder/plaintiffs could not prove they were damaged by the D&O actions. In all cases, the D&O defence was 'we did our best to maximise the total company value'."

A minority shareholder would have to prove not only that it has been damaged, but that the majority stockholders has been unjustly enriched. Reilly says he has not ever seen a minority stockholder prevail in allegations that the company failed to fulfill the value of its IP. If stockholders are not happy with how a company's IP assets are managed, the solution is simple. "They should just sell their stock and invest in some other companies."

Change on the way

The day a set of directors and officers loses a suit based on the mismanagement of IP assets is the day the whole IP world changes. Because it will be the day that IP forever becomes a central concern for all senior executives in every publicly quoted company in the US and, most likely, beyond. When they see one of their contemporaries fired, fined heavily, paying out damages or even jailed because of an IP-related disaster, executives will realise that the IP for which they are ultimately responsible can have a direct consequence for them, and they will

do whatever is necessary to avoid potential trouble. For that reason, it is a day that many long to see. But, it seems, they may have to wait a while yet.

The plaintiffs bar has yet to decide that this kind of litigation can be interesting or, much more important, profitable. That said, given the growing importance of IP to the corporate bottom line, and heightened scrutiny brought about by Sarbanes-Oxley, it is surely time for the boards of companies both large and small to get serious about inventorying IP assets and to place a stronger emphasis on their management. The sky may not be on the verge of falling this week, or even this year, but in time a significant metric for assessing directors' and officers' effectiveness will be their stewardship of companies' precious IP assets. And none of them, surely, would want to find that out after it had become too late. ■



Robert Reilly

Almost impossible to point to an individual item in an IP portfolio and say it is being under-exploited

vsindflor@iam-magazine.com