A Legal Update from Shipman & Goodwin LLP

Ventures and Intellectual Property Group Letter

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INTERNATIONAL TRADE COMMISSION

AN ALTERNATIVE TO ENFORCE INTELLECTUAL PROPERTY RIGHTS

Protecting intellectual property rights remains one of the most important goals of a successful and thriving business. Policing, licensing and enforcement activities all are important tools in reaching this goal, and litigation over IP rights often is a crucial component of an enforcement scheme. When infringement of IP impacts international trade, federal law provides a comprehensive enforcement scheme separate from traditional litigation. Assuming certain statutory prerequisites are satisfied, an aggrieved party can bring a complaint before the ***International Trade Commission*** (***"ITC"*** or ***"Commission").*** If successful, this proceeding will prevent the importation and sale of infringing articles.

ITC AND SECTION 337 BACKGROUND

The ITC is an independent federal agency with jurisdiction over matters relating to international trade. To assist in the Commission's administration of numerous United States trade laws, the ITC has five major operations: ***Import Injury Investigations; Intellectual Property-Based Import Investigations; Industry and Economic Analysis; Trade Information Services;*** and ***Trade Policy Support.*** With regard to its **Intellectual Property-Based Import Investigations,** the ITC is empowered to prohibit unfair trade practices, which extends to preventing patent, copyright and trademark infringement.

The statute governing the ITC's determinations and investigations in unfair competition and intellectual property trade matters is **Section 337 of the Tariff Act, 19 U.S.C. § 1337.** This statute declares unlawful the importation of items that infringe registered United States patents, trademarks and copyrights. If a

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violation is found, the Commission may prohibit the importation of the infringing items. The statute also applies to other *"unfair methods of competition and unfair acts in the importation of articles,"* such as false advertising, trade libel, misappropriation of trade secrets, false designation of origin or source, tortious interference with business relations and violations of the antitrust laws.

Although the ITC has authority to investigate and decide complaints involving unfair competition and infringement through the importation of goods, its jurisdiction over such cases is statutorily limited to situations in which an *"industry in the United States"* is affected by the unlawful importation. This requirement is satisfied by demonstrating that a domestic industry either currently exists or is in the process of being created that will exploit the intellectual property rights at issue. For cases involving the alleged infringement of registered patents, trademarks and copyrights, the statute provides that the *"industry in the United States"* requirement is met by demonstrating that, with respect to the articles protected by the IP, there is a:

(1) ***"significant investment in plant and equipment;"***

(2) ***"significant employment of labor or capital;"*** or

(3) ***"substantial investment in [the article's] exploitation, including engineering, research and development, or licensing."***

WHICH FORUM IS RIGHT FOR YOU? ITC VS. FEDERAL COURT

In many respects, **Section 337** investigations are similar to traditional litigation. A complaint is prepared and submitted to the ITC and, if an investigation is commenced, the parties engage in discovery and, with certain exceptions, present their claims and defenses to the trier of fact for resolution. A jury is not available; an administrative law judge presides over the trial and prepares a recommendation for disposition by the ITC itself, which disposition can be appealed to the United States Court of Appeals for the Federal Circuit.

While the process itself is generally similar to that experienced in court, there are several notable differences between a **Section 337** proceeding and a federal court case.

Available Remedy

The most striking difference is the relief that may be afforded to a successful claimant: whereas in federal court a plaintiff may seek to recover money damages as a component of its relief, money damages are not available in a **Section 337** investigation. Instead, the ITC is only empowered to issue exclusion orders or cease-and-desist orders prohibiting the articles at issue from entering the country, or, if the articles have already been imported, prohibiting their sale within the United States.

Damages for past infringement need not be surrendered, however. As discussed below, the aggrieved party is free to commence a lawsuit geared toward obtaining this more traditional form of relief even while the **Section 337** investigation is ongoing. In the meantime, obtaining an exclusion order puts an end to the harmful effects of infringement on the aggrieved party's place in the market.

Exclusion Orders

The power to issue exclusion orders aimed at particular goods, as opposed to the activities of an alleged infringer, is unique to the ITC. **Exclusion orders may take one of two forms: limited exclusion orders or general exclusion orders.** Limited exclusion orders are directed to the specific respondents in the action to prevent those persons from importing the unlawful items. General exclusion orders are much broader in scope and prohibit the importation of the unlawful articles from any person, even if they are not identified as a respondent in the proceeding. However, because of the far-reaching effect of such an order, the statute provides that the ITC may issue a general exclusion order only if it finds that it ***"is necessary to prevent circumvention of [a limited exclusion order]; or there is a pattern of violation of [Section 337] and it is difficult to identify the source of the infringing products."***

Speed of Proceedings

While a typical infringement action in federal court may take anywhere from three to five years to reach a trial verdict, the ITC is required by statute to complete its investigations ***"at the earliest practicable time."*** In practice, the Commission has reported that it tries to complete most investigations within 12 to 15 months after the institution of the investigation. The accelerated schedule at the ITC means that discovery, while similar procedurally to discovery in federal court, proceeds much more rapidly. For example, responses to discovery requests are often due within two weeks, in contrast to the thirty days a party usually has to respond in federal court. Moreover, the entire discovery process in **Section 337** proceedings is often completed within a matter of months.

Parallel Federal Court and ITC Proceedings

If personal jurisdiction exists over an ITC respondent in the United States, the ITC complainant may bring a parallel action in the appropriate federal court seeking damages and/or bringing causes of action not available before the ITC. Additionally, while an ITC respondent is permitted to bring a counterclaim in a **Section 337** proceeding, regulations require that the counterclaim be removed to a federal court. In either of these situations, the parties may agree, with the court's approval, to stay the federal court action pending the Commission's resolution or they may decide that the federal court action should proceed in the ordinary course.

Although many cases in federal court that parallel **Section 337** proceedings are settled relatively quickly once the ITC renders its decision, in those cases that are not resolved, the Commission's decision may or may not be binding (i.e., given preclusive effect) by the federal court. In patent cases, the ITC's findings regarding patent issues are not binding on the federal court. While the federal court cannot give preclusive effect to the Commission's decisions on patent issues, the court is permitted to decide whether, and to what extent, the ITC's findings regarding patent issues may be persuasive. On the other hand, several courts of appeal have concluded that the ITC's decisions in non-patent cases (for example, trademark infringement and unfair competition cases) are binding on federal courts in parallel proceedings.

The Investigative Attorney

A **Section 337** investigation is commenced by the ITC itself upon its acceptance of a complaint. Once the investigation is commenced, the ITC appoints an ***investigative attorney*** from its ***Office of Unfair Import Investigations.*** The investigative attorney is charged with representing the public's interest in the proceeding by investigating the charges of the complaint and presenting evidence at any proceedings. Thus, the investigative attorney is a full party to the proceeding in addition to the complaining party and the party accused of infringement.

In traditional litigation, the parties are left to litigate their dispute before a neutral tribunal. In contrast, **Section 337** proceedings entail the involvement of the government, through the investigative attorney, in the proceeding itself. Because the role of the investigative attorney is to champion the public interest – and not the interests of the complainant or the respondent – the investigative attorney may at times take positions that are contrary to those espoused by the parties.

CONCLUSION

Section 337 investigations are unique, quasi-judicial proceedings that provide an alternative means for an aggrieved party to enforce its intellectual property rights when those rights are impacted by international trade. While in many respects these proceedings mirror the procedure entailed in traditional litigation, including the expense of litigation, their relative speed and effective enforcement schemes can provide an enormous tactical advantage to a party aggrieved by infringement of its intellectual property rights.

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VENTURE BRIEFS

IS YOUR BUSINESS POWER HUNGRY?

The Washington Post recently reported a story about power hungry corporations searching rural America for places to expand their operations. These corporations are not power hungry in the traditional sense – ***they are electric power hungry, and they feed on cheap electricity*** – a commodity that is becoming increasingly difficult to find. The reported solution – locate your business in the boondocks where electricity is cheap and hope the low cost of electricity in your new-found paradise is not discovered by the masses of equally power hungry business that will join you and drive demand, and consequently your rates, ever higher. While expanding corporate giants often have the luxury to carefully select the location for their newest power hungry facility, businesses that are grounded and unable to move from their well-established base of operations must continue to strain against the pressures of increasing grid-based energy costs.

Energy prices in the Northeast have risen dramatically in the last year, and they are almost certainly expected to maintain that trend as demand continues to outpace supply. If this trend is exerting tremendous pressure on your bottom line and moving your business to cheap power is not an option, why not consider bringing the cheap power to your facility? Examples of low-cost, on-site electricity generation include: **fuel cells, microturbines,** and **photovoltaic cells.**

Each of these technologies can be suited to the specific needs and conditions of most facilities, and the initial capital investment cost of each of these technologies can be defrayed by low interest loans, government subsidies, grants and tax incentives. In many cases, projects involving the installation of these technologies can be cash-flow positive almost immediately. We have actively pursued these technologies for our clients and assisted them with permitting, contracting and financing issues related to project implementation. If your energy costs are hurting your bottom line, let our energy lawyers help you identify options for on-site energy generation that will cut your energy costs and provide you with energy independence.

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WRITE WHAT YOU MEAN OR LOSE $10 MILLION

Shareholders in a merger lost out on receiving an earn-out when the United States District Court for the District of Maryland, applying Delaware law, recently held that factual mistakes in a contract provision do not necessarily rise to the level of ambiguity for purposes of contract interpretation. In ***Martek Biosciences Corp. v. Zuccaro***, the district court granted Martek's motion for summary judgment, finding that the payment trigger in an earn-out provision was not met. The dispute in ***Martek*** arose from the merger of Martek Biosciences Corporation and OmegaTech, Inc., two companies that develop the omega-3 fatty acid commonly known as DHA. The merger agreement contained an earn-out provision which stated that, "[i]f the National Academy of Sciences ("NAS"), at any time during the [e]arn-out period, makes an authoritative statement recommending a Dietary Reference Intake . . . citing a specific milligram level for . . . DHA . . . that permits the application to the U.S. Food and Drug Administration . . . for a nutrient content claim on food labels" (the "Nutritional Milestone"), then Martek was to deliver $10 million in shares of Martek common stock to the former shareholders of OmegaTech as additional merger consideration. During the earn-out period, the Institute of Medicine ("IOM"), a division of NAS, issued a report entitled "Dietary Reference Intake: Energy, Carbohydrate, Fiber, Fat, Fatty Acids, Cholesterol, Protein and Amino Acids." The IOM's report recommended certain dietary nutrients but did not cite a specific milligram level of DHA that a person should take. Zuccaro, as representative of the former shareholders of OmegaTech, argued that the IOM report met the Nutritional Milestone. Martek countered by stating that the report did not meet the Nutritional Milestone and refused to deliver the common stock. Zuccaro asked the court to consider parol evidence (such as discussions between the parties as to what they really intended the Nutritional Milestone to mean) in determining the true meaning of the Nutritional Milestone, stating that several factual inaccuracies about how they described the Nutritional Milestone rendered the provision ambiguous. The district court noted that "[u]nder Delaware law, contracts are to be construed objectively and, '. . . when a writing is clear, the writing itself is the sole source for gaining an understanding of intent'" (quoting ***Haft v. Haft***). Further, the court stated that "a court is permitted to examine parol evidence if the fact of the contract is unclear . . . ." The district court rejected Zuccaro's argument that the provision was ambiguous, finding that the inaccuracies were such that they did not rise to the level of ambiguity. The court went on to hold that the Nutritional Milestone was not met because, among other things, IOM's report did not cite a specific milligram level of DHA that a person should take but only reported an upper limit of how much DHA a person could take. Therefore, Martek was not required to deliver the common stock to the former shareholders of OmegaTech.

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BUSINESS BUYER'S NON-COMPETE UPHELD

While a business seller's covenant not to compete with the buyer of a business is often an essential part of the transaction, a buyer agreeing not to compete with the seller is somewhat unusual. Nevertheless, a Florida District Court of Appeal recently overruled its precedent that the seller of a business could not enforce a non-compete against the buyer of the business. In ***Henao v. Professional Shoe Repair, Inc.***, the court held that, in this *"somewhat atypical . . . situation,"* a seller could enforce a non-compete against *"the buyer of a business . . . [who] agree[d] not to engage in any business with one of the clients of the business, whom the parties agreed the seller could retain for himself."* In reaching this conclusion, the court overruled its prior decision, ***Flatley v. Forces***, which held that *"a covenant prohibiting the buyer . . . from competing with the seller is unenforceable."* The court noted that the ***Flatley*** decision was based on a statute that, with respect to restrictive covenants, was repealed in 1996 and replaced with a statute governing valid restraints of trade or commerce. In overruling ***Flatley,*** the court noted that the 1996 statute was intended to be expansive in scope, in contrast to the prior statute that deemed, with two exceptions, all restraints of trade illegal and unenforceable.

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AMENDMENTS TO SEC COMPENSATION DISCLOSURE REQUIREMENTS AND RELATED MATTERS

On August 11, 2006, the SEC issued final amendments to its regulations governing disclosure of compensation of executive officers and directors, and certain related matters. The amendments, originally proposed in January 2006 and analyzed in the **First Quarter edition of the VIP Letter**, were the subject of considerable debate. SEC Chairman Christopher Cox noted that *"[w]ith more than 20,000 comments, and counting, it is now official that no issue in the 72 years of the Commission's history has generated such interest."*

In 1992, the SEC adopted amendments to its executive compensation disclosure requirements that mandated the use of certain formatted tables to present executive compensation disclosure. Under the final amendments, the tabular disclosure will be substantially revised and reformatted, and supplemented with a plain English narrative description of compensation policies. The SEC believes that these changes will facilitate compliance with its requirement that all elements of compensation be disclosed in a clear and meaningful way.

Among the other important changes made by the final amendments are: expanded disclosure of change-in-control benefits; the addition of a director compensation table; the modification of Form 8-K reporting requirements to combine all employment arrangement disclosure under a single item number and to eliminate certain filing requirements where no executive officer or director is involved; and expanded disclosure of financial relationships between reporting companies and their directors, executive officers, significant stockholders and certain other related persons.

The final rules contain a few changes from the original proposal, the most notable of which are:

- As proposed, the new narrative overview of compensation policies – an overview that will be filed with the SEC and subject to certification by a reporting company's principal executive officer and principal financial officer – would have replaced the old compensation committee report. Under the final rules, the compensation committee report will be retained, but will be amended so that it functions in a manner similar to that of the audit committee report, requiring the compensation committee to state whether it has reviewed the narrative overview of compensation policies and discussed it with management, and, if so, whether it has recommended that it be included in the company's annual report or proxy statement. The compensation committee report will be considered "furnished" to the SEC, not filed.

- In response to the recent stock option timing scandals, the SEC will now require that the narrative description of compensation policies include specific disclosure of a reporting company's policies and practices with respect to the timing of option grants and the establishment of exercise prices.
- The performance graph, which would have been eliminated, will be retained. The graph will no longer be coupled with executive compensation disclosure, however, but will appear with other required disclosures regarding the reporting company's equity securities.
- The proposal that would have required disclosure of total compensation and a job description for up to three additional employees who are not executive officers or directors, but who earn more than any named executive officer, has been re-proposed with an exclusion for employees who have no responsibility for significant policy decisions (as would be the case for many professional athletes and entertainers).

The amendments to the Form 8-K reporting requirements on executive compensation will go into effect for triggering events that occur 60 days or more following publication of the final amendments in the Federal Register. Most of the other amendments will go into effect on December 15, 2006. The effective dates mean that companies must, if they have not done so already, immediately implement disclosure controls and procedures that address the new disclosure requirements.

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SEC REGULATION OF HEDGE FUND ADVISERS STRUCK DOWN

In ***Phillip Goldstein, et al. v. SEC,*** the Court of Appeals for the District of Columbia Circuit recently struck down the SEC's attempt to regulate hedge funds. While no definition of "hedge funds" exists in the securities laws, they are generally private equity funds that are professionally managed and employ hedging strategies such as taking long and short positions in securities to reduce risk. Such funds (like other private equity funds) have been largely unregulated since the funds themselves are usually exempt from registration under the **Investment Company Act** (pursuant to which mutual funds are registered) based on having not more than 100 investors, and their professional managers are usually exempt from registration under the **Investment Advisers Act** based on having fewer than fifteen clients (funds) to which they provide investment advice. Because of concerns about failures of large hedge funds yet an increase in investment in hedge funds (some estimate $600 billion to $900 billion invested in hedge funds), the "retailization" of hedge funds and the increased number of fraud actions against hedge funds, the SEC sought to regulate the industry by requiring the registration of hedge fund managers as investment advisers. The ***"Hedge Fund Rule"*** required a manager to not just count the hedge fund as its client, but to also "look through" the fund and count the individual investors in the fund. If that counting resulted in more than fourteen "clients," the manager was required to register. The court struck down the rule as arbitrary, being ***"beyond the bounds of reasonableness"*** and coming ***"close to violating the plain language of the statute."*** It observed that hedge fund managers have no direct relationship with the fund investors as distinct from the fund itself and that the managers are concerned with the fund's financial performance and not the individuals' financial condition and that if the investors were also deemed clients, managers would often be in a conflict of interest position. Managers owe fiduciary duties to the fund not the investors. Thus, the court concluded that investors in a hedge fund should not be considered clients of the hedge fund manager based on a mechanical "look through" counting rule.

The SEC has indicated that it will not appeal the decision but will focus instead on other rule making. Specifically, it is considering a new antifraud rule under the Investment Advisers Act that will have "look through" provisions to provide protection to investors of hedge funds. In addition, to combat the "retailization" concern, it is considering requiring investors in hedge funds that charge a performance fee to have a net worth of $1.5 million, an increase from the current requirement of $1 million.

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The **Ventures and Intellectual Property (VIP) Group** at Shipman & Goodwin has a long-standing practice of assisting high-technology and other emerging growth companies, as well as venture capital and other financing sources and financial intermediaries. We represent public and private companies in all stages of their development in various industries, including engineered materials, semiconductors, photonics, computer hardware and software, internet services, telecommunications, e-business and health care, in both domestic and international transactions. We regularly provide advice on venture capital finance and fund formation, securities offerings, equity compensation, intellectual property protection, technology development and commercialization, joint ventures and strategic relationships, and internet and e-business matters.

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