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FOREWORD

Ryan Iwahashi[†] & Britt Lovejoy^{††}

The Annual Review is a yearly publication of the *Berkeley Technology Law Journal* that provides a summary of many of the major developments at the intersection of law and technology. Our aim is to provide a valuable resource for judges, policymakers, practitioners, students, and scholars. Each Note provides a primer into a particular area of law, a development in that area of law, and commentary on that development.

The twenty-three Notes in this issue continue a tradition of covering a wide range of topics. The Notes address developments in traditional intellectual property areas—patent, copyright, trademark, and trade secret law—along with developments in cyberlaw, antitrust, and privacy. Following the Notes in each area of law, we have included a Survey of Additional IP Developments, which contains brief descriptions of important developments that were not addressed in the Notes.

I. PATENT LAW

This Annual Review covers major developments from September 2010 to August 2011. Consequently, the passage of the Leahy-Smith America Invents Act (“AIA”)¹ is not the main subject of any of the Notes. The Review addresses many significant developments in patent law, including three Supreme Court decisions and several Federal Circuit en banc decisions. In addition to these major court cases, the Review also considers other important developments affecting the patent system. Where relevant, some of these Notes discuss a recent development in light of the AIA amendment.

Our first Note² discusses whether patents belonging to “reasonable and nondiscriminatory” (“RAND”) licensing agreements can be a strategic asset

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1. Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011) (to be codified in scattered sections of 35 U.S.C.).

2. Thomas Chia, Note, *Fighting the Smartphone Patent War with RAND-Encumbered Patents*, 27 BERKELEY TECH. L.J. 209 (2012).

in the smartphone patent war. Google recently bought Motorola Mobility's patent portfolio for \$12.5 billion, however, a number of these patents are encumbered by RAND licensing agreements.³ Google subsequently announced that they intend to use these patents to avoid lawsuits with competitors.⁴ The Note analyzes whether an entity practicing this proposed cross-licensing strategy could potentially be in violation of the Sherman Antitrust Act or the Federal Trade Commission Act.

The second Note⁵ considers the Federal Circuit decision on the patentability of genes in *Ass'n for Molecular Pathology v. U.S. Patent & Trademark Office*.⁶ It points out how function and utility of products were often used interchangeably in the decision, resulting in analytical inconsistencies.⁷ The Note argues that molecular properties, like function, are a better indicator than utility of the transformation of a natural product. It proposes a sliding scale of structure and properties to determine whether a product derived from nature is patentable.

The third Note⁸ discusses the Federal Circuit en banc decision, *TiVo, Inc. v. EchoStar Corp.*,⁹ which restructured the "colorable differences" test for contempt.¹⁰ In *TiVo*, the Federal Circuit grounded the new "colorable differences" test in the actual elements of the accused products.¹¹ The Note argues that the *TiVo* decision provides guidance and increases clarity to infringers often confronted with vague injunctions.

The fourth Note¹² examines the Supreme Court's ruling in *Microsoft Corp. v. i4i Ltd.*,¹³ which upholds the traditional clear and convincing evidence standard in challenging a patent's validity.¹⁴ It examines this decision in light

3. See *Google To Acquire Motorola Mobility*, GOOGLE INVESTOR RELATIONS (Aug. 15, 2011), <http://investor.google.com/releases/2011/0815.html>.

4. Larry Page, *Supercharging Android: Google To Acquire Motorola Mobility*, OFFICIAL GOOGLE BLOG (Aug. 15, 2011, 12:52 PM), <http://googleblog.blogspot.com/2011/08/supercharging-android-google-to-acquire.html>.

5. Samantak Ghosh, Note, *Gene Patents: Balancing the Myriad Issues Concerning the Patenting of Natural Products*, 27 BERKELEY TECH. L.J. 241 (2012).

6. 653 F.3d 1329 (Fed. Cir. 2011).

7. Compare *id.* at 1365 (Moore, J., concurring) with *id.* at 1378 (Bryson, J., dissenting).

8. Conrad Gosen, Note, *Tivo, Inc. v. EchoStar Corp.: Providing Clarity to Contempt Proceedings in Patent Cases*, 27 BERKELEY TECH. L.J. 273 (2012).

9. *TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869 (Fed. Cir. 2011) (en banc).

10. *Id.* at 878.

11. *Id.*

12. Ryan R. Klimczak, Note, *i4i and the Presumption of Validity: Limited Concerns over the Insulation of Weak Patents*, 27 BERKELEY TECH. L.J. 299 (2012).

13. 131 S. Ct. 2238 (2011).

14. *Id.* at 2242.

of the AIA¹⁵ and argues that the *i4i* decision will beneficially alter the calculus of invalidity defense strategies by encouraging accused infringers to seek the invalidation of patents outside of litigation. This Note also argues that the *i4i* ruling will likely have a diminished impact because of a jury's tenuous grasp on the subtle distinction of evidentiary standards, the rarity of evidentiary standard-determinative decisions, and the ability to give jury instructions emphasizing the weight of new art.

The fifth Note¹⁶ analyzes the Supreme Court's decision in *Global-Tech Appliances, Inc. v. SEB S.A.*,¹⁷ which required an accused infringer's actual knowledge or "willful blindness" to the fact that his product would be used in an infringing manner in order to be liable for induced patent infringement.¹⁸ It examines how the willful blindness doctrine has been applied in criminal law cases and discusses how those criminal law cases could apply to future cases of induced patent infringement.

The sixth Note¹⁹ examines the Federal Circuit en banc *Therasense, Inc. v. Becton, Dickinson and Co.* decision,²⁰ which reformed the doctrine of inequitable conduct by significantly raising the standards for showing both intent and materiality and eliminating the "sliding-scale" step.²¹ The Note asserts that, although the Federal Circuit may not have perfectly reformed the inequitable conduct doctrine, the majority's decision took a significant step in the direction of efficiency and fairness and provided clarity to practitioners.

The seventh Note²² discusses the Federal Circuit decision in *Uniloc USA, Inc. v. Microsoft Corp.*,²³ which held that the twenty-five percent rule of thumb for determining a reasonable royalty was inadmissible under *Daubert*.²⁴ The Note examines how to calculate reasonable royalties for patent infringement in light of the *Uniloc* decision and proposes a workable framework for reasonable royalty calculations in the future.

15. Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011) (to be codified in scattered sections of 35 U.S.C.).

16. Yvonne Lee, Note, *Global-Tech Appliances, Inc. v. SEB, S.A.: Discovering Willfully Blind Territory in Induced Patent Infringement*, 27 BERKELEY TECH. L.J. 325 (2012).

17. 131 S. Ct. 2060 (2011).

18. *Id.* at 2068–69.

19. Priscilla G. Taylor, Note, *Bringing Equity Back to the Inequitable Conduct Doctrine?*, 27 BERKELEY TECH. L.J. 349 (2012).

20. *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276 (Fed. Cir. 2011) (en banc).

21. *Id.* at 1290–92.

22. Edward Touros, Note, *Unknotting Uniloc*, 27 BERKELEY TECH. L.J. 381 (2012).

23. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011).

24. *Id.* at 1318 (citing *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579 (1993)).

The eighth Note²⁵ discusses two recent International Trade Commission (“ITC”) opinions in which the Commission sought to clarify and refine the rules governing the non-practicing complainants.²⁶ Since the Federal Circuit determined that the *eBay* injunction test does not apply to the ITC,²⁷ non-practicing patent owners have been filing an increasing number of complaints at the ITC asserting a domestic industry based on licensing. This Note analyzes how these recent decisions will affect various types of non-practicing complainants at the ITC and proposes possible alternatives.

The final Note²⁸ in the Patent Law section discusses Supreme Court’s decision in *Board of Trustees of the Leland Stanford Junior University v. Roche Molecular Systems, Inc.*,²⁹ which held that the Bayh-Dole Act does not automatically vest patent rights in universities when the underlying research was federally funded.³⁰ It argues that the Supreme Court’s decision is good for the innovation community because it appears consistent with current practices by various actors and leaves settled expectations largely undisturbed. The Note emphasizes that there is no reason to foreclose the possibility of alternative arrangements by statutory fiat when private contracts, using settled contractual language, can achieve an equivalent function. This allows some degree of flexibility to exist.

II. COPYRIGHT LAW

The first Note³¹ in the Copyright Law section concerns the issue of copyright license enforcement in the wake of *MDY Entertainment Industries, LLC v. Blizzard Entertainment, Inc.*,³² a 2010 case wherein the Ninth Circuit held that a license violation is copyright infringement only if there is a nexus between the term at issue in the license and an exclusive right of copyright.³³ The Note argues that the Ninth Circuit’s opinion fails to address what test

25. Wei Wang, Note, *Non-practicing Complainants at the ITC: Domestic Industry or Not?*, 27 BERKELEY TECH. L.J. 409 (2012).

26. Certain Coaxial Cable Connectors & Components Thereof, USITC Inv. No. 337-TA-650, Commission Opinion (Apr. 14, 2010); Certain Multimedia Display & Navigation Devices & Sys., USITC Inv. No. 337-TA-694, Commission Opinion (Aug. 8, 2011).

27. *Spansion Inc. v. Int’l Trade Comm’n*, 629 F.3d 1331, 1359 (Fed. Cir. 2010).

28. Robert Yeh, Note, *The Public Paid for the Invention: Who Owns It?*, 27 BERKELEY TECH. L.J. 453 (2012).

29. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188 (2011).

30. *Id.* at 2192 (citing 35 U.S.C. §§ 200–212 (2006)).

31. Erik Bauman, Note, *The Nexus Analysis: License Enforcement in the Wake of MDY v. Blizzard*, 27 BERKELEY TECH. L.J. 503 (2012).

32. *MDY Entm’t Indus., LLC v. Blizzard Entm’t, Inc.*, 629 F.3d 928 (9th Cir. 2010).

33. *Id.* at 941.

should be applied to determine whether such a nexus exists and asserts that a nexus should be found only where an act would have infringed copyright if the violated term at issue were not in the license at all.

The second Note³⁴ analyzes the use of a hypothetical license fee as a measure of actual damages under the Copyright Act. It proposes borrowing aspects of the reasonable royalty inquiry used in patent law to guide courts in more accurately valuing hypothetical license fees. Specifically, the Note aims to provide a clear understanding of how the reasonable royalty award developed in patent law, clarify why copyright law's adoption of reasonable royalty principles does not run afoul of the Copyright Act, and, further, explain how the reasonable royalty concept can be tailored to apply within the context of copyright damages.

The next Note³⁵ in this section describes and analyzes a Memorandum of Understanding (“MOU”) adopted by a consortium of internet service providers in 2011.³⁶ The Note argues that the graduated response systems outlined in the MOU will benefit content owners and ISPs by reducing piracy as well as the costs and risks of litigation through efficient private copyright enforcement mechanisms. The Note further concludes that the MOU respects users' interests by providing significant procedural protections and creating flexible enforcement mechanisms that can be specifically tailored to an infringing user's activities.

The final Note³⁷ in the Copyright Law section explores the so-called “Gap Works” problem in copyright law. In creating the § 203 termination of transfers provision in the Copyright Act of 1976, Congress did not account for certain copyrightable works—so called “Gap Works.” These works were transferred prior to, but were not created until after, the Act's effective date—therefore making it unclear whether they fall within the purview of § 203, which only applies to grants “executed” on or after the Act's effective date.³⁸ The Note proposes that the “Gap Works” problem is best resolved by applying a practical analysis that accounts for the likely effects of alternate readings on relevant industries.

34. Kevin Bendix, Note, *Copyright Damages: Incorporating Reasonable Royalty from Patent Law*, 27 BERKELEY TECH. L.J. 527 (2012).

35. John M. Owen, Note, *Graduated Response Systems and the Market for Copyrighted Works*, 27 BERKELEY TECH. L.J. 559 (2012).

36. Memorandum of Understanding Between ISPs (SBC Internet Services, Inc. et al.) and Content Owners (RIAA et al.) (July 6, 2011), [http://www.copyrightinformation.org/sites/default/files/Momorandum of Understanding.pdf](http://www.copyrightinformation.org/sites/default/files/Momorandum%20of%20Understanding.pdf).

37. Kiley Wong, Note, *Beyond the Gap: A Practical Understanding of Copyright's Termination of Transfers Provisions*, 27 BERKELEY TECH. L.J. 613 (2012).

38. 17 U.S.C. § 203 (2006).

III. TRADEMARK LAW

The first Note³⁹ in the Trademark Law section explores initial interest confusion in the context of keyword advertising. The Note argues that in this particular context, initial interest confusion should be found only when consumers are *misled* rather than merely *diverted*. As the distinction between the two can be difficult to draw, the Note proposes that courts take judicial notice of third-party marketing research and surveys from related cases that may aid them in determining whether a case involves actionable confusion. The Note further argues that judicial notice may serve as a particularly useful tool at the preliminary injunction stage, when case-specific research may be insufficient due to time and resource constraints.

The second Note⁴⁰ in the Trademark Law section argues that the Trademark Dilution Revision Act⁴¹ fails to establish a clear legal standard for trademark dilution, particularly with respect to the degree of similarity required between a famous trademark and an allegedly diluting mark. The Note uses the Ninth Circuit case *Levi Strauss & Co. v. Abercrombie & Fitch Trading Co.*⁴² to illustrate three problematic effects that stem from ambiguity in the similarity requirement and recommends that either courts or Congress clarify the similarity requirement of trademark dilution, especially in the case of graphic marks.

IV. CYBERLAW

The first Note⁴³ in the Cyberlaw section discusses the role of taxation within the world of e-commerce. The Note argues that legislation created to address tax collection on internet transactions should meet four requirements: the legislation (1) should clarify the tax landscape for internet retailers and consumers; (2) it must be constitutional; (3) it should promote virtual business equally and foster e-commerce growth; and (4) it should be forward thinking, addressing developments in technology and e-commerce.

39. Winnie Hung, Note, *Limiting Initial Interest Confusion Claims in Keyword Advertising*, 27 BERKELEY TECH. L.J. 647 (2012).

40. Jane Ann Levich, Note, *Ambiguity in Federal Dilution Law Continues: Levi Strauss & Co. v. Abercrombie & Fitch Trading Co., Case in Point*, 27 BERKELEY TECH. L.J. 677 (2012).

41. Trademark Dilution Revision Act of 2006, Pub. L. No. 109-312, 120 Stat. 1730 (codified at 15 U.S.C. § 1125 (2006)).

42. *Levi Strauss & Co. v. Abercrombie & Fitch Trading Co.*, 633 F.3d 1158 (9th Cir. 2011).

43. Hannah V. Minkevitch, Note, *To Tax or Not To Tax? That's Not the Question: The Role of Tax Within the Maturing World of e-Commerce*, 27 BERKELEY TECH. L.J. 705 (2012).

The second Note⁴⁴ addresses developments relating to the Computer Fraud and Abuse Act (“CFAA”). Over the last two years, three circuit courts have held that employees who violate their employer’s computer use restrictions can be criminally liable under the CFAA for “exceed[ing] authorized access”⁴⁵ on their employer’s computers.⁴⁶ The Note discusses the problems with the circuit courts’ reading of the CFAA and argues for an alternative interpretation that ties the phrase “exceeds authorized access” to acts of computer misuse.

The last Note⁴⁷ in the Cyberlaw section explores the decision by Bay Area Rapid Transit (“BART”) to shut down wireless service in response to political demonstrations against BART police.⁴⁸ The Note addresses various First Amendment concerns related to the shutdown and analyzes possible violations of the Communications Act.

V. PRIVACY LAW

The first Note⁴⁹ in the Privacy Law section addresses the recent Sixth Circuit opinion *United States v. Warshak*.⁵⁰ In *Warshak*, the Sixth Circuit held that the Stored Communications Act is unconstitutional.⁵¹ The Note argues that in so holding, the court illustrated that the statute is outdated. The Note also asserts that the court’s reasoning provides valuable insight into the best way to revise the statute.

The second Note⁵² explores twelve recent cases⁵³ before the National Labor Relations Board (“NLRB”) involving social media in the workplace.

44. David J. Rosen, Note, *Limiting Liability Under the CFAA: A Code-Based Approach to “Exceeds Authorized Access,”* 27 BERKELEY TECH. L.J. 737 (2012).

45. 35 U.S.C. § 1030(a)(2) (2006).

46. *United States v. Nosal*, 642 F.3d 781, 783 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011); *United States v. Rodriguez*, 628 F.3d 1258, 1263 (11th Cir. 2010); *United States v. John*, 597 F.3d 263, 269 (5th Cir. 2010).

47. Jennifer Spencer, Note, *No Service: Free Speech, the Communications Act, and BART’s Cell Phone Network Shutdown*, 27 BERKELEY TECH. L.J. 767 (2012).

48. *E.g.*, Bob Franklin, BART Board of Directors President, *A Letter from BART to Our Customers* (Aug. 20, 2011), <http://www.bart.gov/news/articles/2011/news20110820.aspx>; Abdi Soltani & Alan Schlosser, *Letter to Kenton Rainey and BART, American Civil Liberties Union of Northern California* (Aug. 15, 2011), http://www.aclunc.org/issues/technology/blog/asset_upload_file335_10381.pdf.

49. Courtney M. Bowman, Note, *A Way Forward After Warshak: Fourth Amendment Protections for E-mail*, 27 BERKELEY TECH. L.J. 809 (2012).

50. *United States v. Warshak*, 631 F.3d 266 (6th Cir. 2010).

51. *Id.* at 288.

52. Ariana C. Green, Note, *Using Social Networking To Discuss Work: NLRB Protection for Derogatory Employee Speech and Concerted Activity*, 27 BERKELEY TECH. L.J. 837 (2012).

The Note argues that these cases highlight the shortcomings of the NLRB's General Counsel's approach to labor disputes involving social media. The Note asserts that applying the 1935 "concerted activity" standard without taking into account norms of online behavior has resulted in inconsistent and potentially unfair outcomes.

VI. OTHER DEVELOPMENTS IN IP

The first Note⁵⁴ in this section discusses two recent Supreme Court decisions, *Wyeth v. Levine*⁵⁵ and *PLIVA v. Mensing*,⁵⁶ in which the Court held that consumers could sue brand-name drug manufacturers under state tort laws for inadequately labeling a drug,⁵⁷ but could not sue generic drug companies under similar circumstances.⁵⁸ The Note argues that the Court's distinction between brand name and generic drugs may harm generic drug manufacturers in the long run. The Note suggests various alternatives through which the generic drug consumers and brand-name consumers can be made equal.

The second Note⁵⁹ addresses the problem of inequity in current approaches to the problem of inevitable disclosure of trade secrets. After studying international approaches to the problem, the Note proposes a system of compensated injunctions in order to ensure a balance of power between employers and employees and discusses the workability of such a system.

53. Triple Play Sports Bar & Grille, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915 (Jan. 3, 2012); Karl Knauz Motors, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452 (Sept. 28, 2011); Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011); Flagler Hosp., Adv. Mem., Case No. 12-CA-27031 (Oct. 19, 2011); Giant Eagle, Case No. 6-CA-37260, Adv. Mem. (Oct. 19, 2011); Martin House, NLRB Adv. Mem., Case No. 34-CA-12950 (Jul. 19, 2011); Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011); JT's Porch Saloon & Eatery, NLRB Adv. Mem., Case No. 13-CA-46689 (Jul. 7, 2011); Rural Metro, NLRB Adv. Mem., Case No. 25-CA-31802 (Jun. 29, 2011); Ariz. Daily Star, NLRB Adv. Mem., Case No. 28-CA-23267 (Apr. 21, 2011); Am. Med. Response of Conn., Adv. Mem., Case No. 34-CA-12576 (Oct. 5, 2010); Parks & Sons of Sun City, Inc., Case No. 28-CA-23350 (filed Jan. 28, 2011).

54. Daniel Kazhdan, Note, *Wyeth and PLIVA: The Law of Inadequate Drug Labeling*, 27 BERKELEY TECH. L.J. 893 (2012).

55. *Wyeth v. Levine*, 555 U.S. 555, (2009).

56. *PLIVA v. Mensing*, 131 S. Ct. 2567 (2011).

57. *Wyeth*, 555 U.S. at 573.

58. *PLIVA*, 131 S. Ct. at 2581.

59. Sonya P. Passi, Note, *Compensated Injunctions: A More Equitable Solution to the Problem of Inevitable Disclosure*, 27 BERKELEY TECH. L.J. 927 (2012).

The final Note⁶⁰ in this section argues that the Second Circuit's 2011 decision in *Barclays Capital, Inc. v. Theflyonthewall.com, Inc.*⁶¹ to abandon the 1997 *NBA*⁶² five-factor test does not make the tort unavailable to the one business it was intended to protect: the traditional news industry. The Note also asserts that while the tort remains alive for the traditional news industry, the *Barclays* court appears to have created a new test for misappropriation that is based on whether the plaintiff/defendant “makes” or “breaks” the news. The Note argues that without further judicial guidance on how to apply this test, future courts applying *Barclays* to non-traditional news entities will have a difficult time deciding when an industry “makes” or “breaks” the news, and will struggle with how to apply the test when an industry both “makes” *and* “breaks” news that should not be withheld from the public via a “hot news” claim.

60. Luis Zambrano, Note, *Still an Alternative Way To Protect Traditional News: Why Barclays Did Not Kill the “Hot News” Tort*, 27 BERKELEY TECH. L.J. 957 (2012).

61. *Barclays Capital, Inc. v. Theflyonthewall.com, Inc.*, 650 F.3d 876 (2d Cir. 2011).

62. *Nat'l Basketball Ass'n v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997).

FIGHTING THE SMARTPHONE PATENT WAR WITH RAND-ENCUMBERED PATENTS

Thomas H. Chia[†]

The smartphone patent war refers to the multitude of patent infringement suits currently taking place against competing companies in the increasingly competitive and litigious smartphone industry. Google's Android mobile operating system is at the heart of this patent war. In an effort to strengthen its patent arsenal and protect smartphone manufactures who implement Android, Google invested \$12.5 billion in August 2011 to acquire approximately 17,000 patents from Motorola Mobility.¹ If some patents within this portfolio are essential² to practicing a technical standard and belong to a reasonable and nondiscriminatory ("RAND")³ licensing commitment, these patents could be important strategic weapons in the smartphone patent war. Successfully using its newly acquired RAND-encumbered⁴ patents in exchange for cross-licenses to its competitors'

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1. See, e.g., *Google to Acquire Motorola Mobility*, GOOGLE INVESTOR RELATIONS (Aug. 15, 2011), <http://investor.google.com/releases/2011/0815.html>; Evelyn M. Rusli, *Google's Big Bet on the Mobile Future*, N.Y. TIMES (Aug. 15, 2011), <http://dealbook.nytimes.com/2011/08/15/googles-big-bet-on-the-mobile-future>.

2. Patents belonging to a RAND commitment made to a standard-developing organization ("SDO") are also known as "essential patents" because these patents are essential to practicing the standard. However, not all essential patents belong to a RAND commitment. For example, in defining "essential," the Institute of Electrical and Electronics Engineers ("IEEE") describes "essential patents" as necessarily infringed by "either mandatory or optional portions" of the standard. *IEEE-SA Standards Board Bylaws*, IEEE STANDARDS ASS'N § 6.2, <http://standards.ieee.org/develop/policies/bylaws/sect6-7.html#loa> (last visited Feb. 6, 2012).

3. The terms "fair, reasonable, and nondiscriminatory" ("FRAND") and "reasonable and nondiscriminatory" ("RAND") are generally interchangeable. Andy Updegrave, *Everything You Always Wanted to Know About FRAND (But didn't know who to ask)*, THE STANDARDS BLOG, <http://www.consortiuminfo.org/standardsblog/article.php?story=20120221074826486> (last visited Mar. 31, 2012).

4. Although encumbrances typically reduce the value of patents, RAND-encumbered patents have several characteristics that may increase their value. For example, RAND-encumbered patents, as with all essential patents, can be valuable because any group interested in practicing the standard must take a license to the patent. Similarly, detecting infringement of RAND-encumbered patents is relatively easy because any group practicing the standard is likely practicing the essential patent. Furthermore, no workarounds are possible since it is unfeasible to have non-infringing standards-compliant products. Finally,

patents could allow Google to obtain the right to practice technologies that would otherwise open up it to more threats of patent infringement. However, the ability to cross-license these RAND-encumbered essential patents against Google's competitors hinges, in part, on whether this tactic is permissible under the original RAND licensing terms and antitrust laws.

Part I of this Note is background on standard-developing organizations ("SDOs") and the smartphone patent war. Part II then begins by examining whether using essential patents to force cross-licensing agreements may be acceptable under a reasonable and nondiscriminatory agreement. The cross-licensing strategy is also analyzed under antitrust law—specifically, this Part considers whether such an approach is appropriate under Section 2 of the Sherman Antitrust Act and Section 5 of the Federal Trade Commission Act ("FTC Act"). Finally, Part III argues that defining "reasonable" and "nondiscriminatory" requires a multifactor analysis and shows how the proposed cross-licensing strategy can be procompetitive, especially in the case of the smartphone industry.

I. BACKGROUND

This Part of the Note addresses three topics. First, it explains the importance of SDOs in developing technical standards for the high-tech industry. Second, it covers potential problems that patents can create in establishing technical standards and reasons for RAND licensing commitments. Third, it provides a brief history of the smartphone patent war.

A. STANDARD-DEVELOPING ORGANIZATIONS AND RAND LICENSING

A SDO⁵ is primarily concerned with developing, coordinating, and promulgating common standards within a given industry.⁶ In the case of high-tech and wireless communications standards, SDOs play a vital role in allowing for the rapid adoption of new technologies, increasing the number

royalty revenues for infringing products can be estimated relatively well given the accurate forecasts for standards-compliant products. See Joff Wild, *Why Google is much better off with the Motorola patents than the Nortel ones*, INTELLECTUAL ASSET MANAGEMENT BLOG (Sept. 5, 2011), <http://www.iam-magazine.com/blog/Detail.aspx?g=b93dd179-7357-4a4d-b85e-00d0f37937f9>.

5. SDOs are also referred to as "standard-setting organizations" ("SSOs"). *Chapter 6: Forming A Successful Consortium Part II — Legal Considerations*, THE ESSENTIAL GUIDE TO STANDARDS, <http://www.consortiuminfo.org/essentialguide/forming2.php> (last visited Mar. 31, 2012).

6. EDWARD G. HINKELMAN, *DICTIONARY OF INTERNATIONAL TRADE* 572 (8th ed. 2008).

of products that can communicate with each other, and reducing costs for consumers by increasing manufacturing volume.⁷

There are dozens of SDOs within the computer-networking and telecommunications industries alone.⁸ Examples of several well-known SDOs include the World Wide Web Consortium (“W3C”), the JEDEC Solid State Technology Association, and the Institute of Electrical and Electronics Engineers Standards Association (“IEEE-SA”), which focus on developing technical standards for the World Wide Web, the semiconductor industry, and the broader electrical engineering industry, respectively.⁹

At the beginning of a technical standard development process, an SDO and its industry members must typically decide whether a new standard will be an “open,” “closed,” or a “hybrid” standard.¹⁰ Developing an open standard requires all members with intellectual property (“IP”) interests in the technical standard to give up their IP rights.¹¹ As a result, open standards allow for anyone to practice the standard without the need to pay a fee or a royalty to the patent holders whose patents are incorporated into the standard.¹² Alternatively, an SDO forming a closed standard will not require its members with IP interests in the standard to give up their IP rights and those members are free to deny anyone from practicing the standard.¹³ Entities that implement a closed standard are “locked in” to the patents that are essential to the standard.¹⁴ As a result, these “essential patent[s]” automatically confer market power onto the patent holder.¹⁵

SDOs most commonly adopt a hybrid approach that addresses the shortcomings of open and closed standards by allowing members to retain some IP rights, while at the same time taking measures to prevent an essential patent holder from abusing its market power.¹⁶ SDOs with hybrid

7. *Research in Motion Ltd. v. Motorola, Inc.*, 644 F. Supp. 2d 788, 790 (N.D. Tex. 2008).

8. Mark A. Lemley, *Intellectual Property Rights and Standard-Setting Organizations*, 90 CALIF. L. REV. 1889, 1894 (2002).

9. *About JEDEC*, JEDEC, <http://www.jedec.org/about-jedec> (last visited Feb. 16, 2012); *About Us*, IEEE STANDARDS ASSOCIATION, <http://standards.ieee.org/about/ieeesa.html> (last visited Feb. 16, 2012); *About W3C*, W3C, <http://www.w3.org/consortium> (last visited Feb. 16, 2012).

10. Lemley, *supra* note 8, at 1901.

11. *Id.* at 1902.

12. *Id.*

13. *Id.*

14. Mario Mariniello, *Fair, Reasonable, and Non-Discriminatory (FRAND) Terms: A Challenge for Competition Authorities*, 7 J. COMPETITION L. & ECON. 3, 523, 538 (2011).

15. *Id.* at 538 n.24.

16. Lemley, *supra* note 8, at 1906.

policies often require essential patent holders to commit to licensing their patents on reasonable and nondiscriminatory (“RAND”) terms.¹⁷ RAND terms are intended to prevent owners of essential patents from extorting their competitors and from erecting barriers to entry into the marketplace.¹⁸ For example, before a patent is incorporated into a standard created by the IEEE-SA, the patent owner is required to submit a Letter of Assurance (“LOA”) that agrees to the following:

[A] license for a compliant implementation of the standard will be made available to an unrestricted number of applicants on a worldwide basis without compensation or under reasonable rates, with reasonable terms and conditions that are demonstrably free of any unfair discrimination. At its sole option, the Submitter [the “Submitter” is the industry member holding the IP rights to be incorporated into the new standard] may provide with its assurance any of the following: (i) a not-to-exceed license fee or rate commitment, (ii) a sample license agreement, or (iii) one or more material licensing terms.¹⁹

The LOA essentially requires the patent’s owner to agree to license its essential patents to an unrestricted number of licensees on a reasonable basis and free of any unfair discrimination. Many agreements also require that once a patent owner commits to RAND terms, the assurance is irrevocable.²⁰ This is to prevent manipulation of the hybrid system whereby a patent holder could make RAND assurances until the SDO incorporates its patent into the standard, then immediately withdraw its commitment and attack entities locked into practicing its essential patents.²¹ Despite the intention of RAND licensing agreements, SDO member commitments have not always been a complete bulwark against unlawful monopolies.²²

17. Mariniello, *supra* note 14, at 538.

18. *Apple, Inc. v. Motorola Mobility, Inc.*, No. 11-CV-178-BBC, 2011 U.S. Dist. LEXIS 72745, at *6 (W.D. Wis. June 7, 2011).

19. *IEEE-SA Standards Board Bylaws*, IEEE STANDARDS ASS’N § 6.2, <http://standards.ieee.org/develop/policies/bylaws/sect6-7.html#loa> (last visited Feb. 6, 2012); see *License Assurance/Disclosure Form*, JEDEC, http://www.jedec.org/sites/default/files/License_Assurance-Disclosure_Form_20110119.pdf (last visited Feb. 6, 2012).

20. See, e.g., *IEEE-SA Standards Board Bylaws*, IEEE STANDARDS ASS’N § 6.2, <http://standards.ieee.org/develop/policies/bylaws/sect6-7.html#loa> (last visited Feb. 6, 2012) (“The assurance is irrevocable once submitted and accepted and shall apply, at a minimum, from the date of the standard’s approval to the date of the standard’s withdrawal.”).

21. Lemley, *supra* note 8, at 1912.

22. See *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297, 319–20 (3d Cir. 2007) (ruling that a patent holder’s intentionally false promise to license essential proprietary technology on RAND terms, coupled with a standard-setting organization’s reliance on that promise

B. THE SMARTPHONE PATENT WAR

In the past few years, the public has witnessed a smartphone patent war among major technology giants such as Microsoft, Google, Apple, Samsung, RIM, and HTC.²³ Dragging competitors into court to face patent infringement claims now appears to be a common strategy for companies seeking to obtain greater market share in the smartphone arena.²⁴ Due to the escalation in patent infringement suits in the smartphone marketplace, companies are ramping up their mobile technology patent portfolios.²⁵ In July 2011, Apple, Microsoft, RIM, Sony, Ericsson, and EMC formed an alliance to outbid Google and Intel for more than 6,000 patent assets²⁶ from Nortel Networks by placing the winning bid at \$4.5 billion.²⁷ Fearful of the competition's growth in patent strength, Google, in August 2011, acquired Motorola Mobility for \$12.5 billion. The deal, including approximately 17,000 patents, may provide greater stability for Google's Android smartphone operating system as it competes in the smartphone patent war.²⁸

Smartphone companies are amassing enormous patent portfolios in order to remain competitive against a rival's patent portfolio.²⁹ The theory is this: as long as the major smartphone companies own an approximately equal number of patents that can seriously harm their competitors, each company believes that its competitors will not launch a full-scale patent infringement

and the patent holder's subsequent breach of that promise, is actionable under Section 2 of the Sherman Act).

23. See Jacob Goldstein, *The Smartphone Patent War, In 1 Graph*, NPR: PLANET MONEY (Aug. 17, 2011), <http://www.npr.org/blogs/money/2011/08/17/139723088/the-smart-phone-patent-war-in-1-graph> (a graphic illustrating past and current smartphone patent cases); Terry Ludlow, *Trends in Patent Litigation*, INTELLECTUAL ASSET MANAGEMENT, Sept.–Oct. 2011, at 15.

24. See, e.g., *Apple Inc. v. HTC Corp. et al.*, No. 1:2011-cv-00611 (D. Del. filed July 11, 2011); *Samsung Elecs. Co. Ltd. v. Apple Inc.*, 1: No. 2011-cv-00573 (D. Del. filed June 29, 2011); *Apple Inc. v. Samsung Elecs. Co. Ltd. et al.*, 5:2011-cv-01846 (N.D. Cal. filed Apr. 15, 2011).

25. See Colleen Chien, *A Race to the Bottom*, INTELLECTUAL ASSET MANAGEMENT, Jan.–Feb. 2012, at 13–14.

26. "Patent assets" include a combination of issued patents and pending patent applications.

27. See Helen Sloan, *The US \$4.5 Billion Tipping Point*, INTELLECTUAL ASSET MANAGEMENT, Nov.–Dec. 2011, at 8–14.

28. The number of issued patents is based on the number of worldwide issued patents disclosed on Pg. 4 of its Form 10-K filing. MOTOROLA MOBILITY, ANNUAL REPORT 4 (Feb. 18, 2011), available at http://files.shareholder.com/downloads/ABEA-58XVPR/1221595050x0x442977/DABB979B-F846-4182-A153-87B36E8EBC6F/2010_Annual_Report_Form_10-K.pdf.

29. See Chien, *supra* note 25, at 10–17.

attack for fear that the retaliation will be equally destructive.³⁰ This patent strategy is analogous to the military tactic of mutually assured destruction.³¹ However, continually amassing patents under a mutually assured destruction strategy may not be financially sustainable or desirable from the perspective of technological innovation. In Part II, *infra*, this Note will propose integrating RAND licensing commitments and the smartphone patent war and will suggest that Google can strategically influence the long-term direction of the patent war by using its RAND-encumbered patents to force cross-licensing agreements with its competitors. If Google can successfully use RAND-encumbered patents to obtain licenses to patents it would otherwise infringe, this strategy may offer hope for neutralizing some of the patents each company is using offensively to threaten its competitors.

Part II of the Note identifies the major issues Google will face when asserting its cross-licensing strategy and discusses how Google will need to demonstrate that this practice is “reasonable” and “nondiscriminatory.” Furthermore, Part II identifies the antitrust issues Google may face if it leverages its RAND-encumbered patents for cross-licenses.

II. DISCUSSION

Google announced that a primary objective of its acquisition of Motorola Mobility’s patent portfolio is to protect itself and Android OS smartphone manufacturers from future litigation over patent infringement.³² Yet despite the massive portfolios that Google now possesses, it will not be fully immunized against patent infringement suits in all technology areas. The first Section of this Part is an in-depth examination of what “reasonable” and “nondiscriminatory” mean in the context of a cross-licensing arrangement. The second Section of this Part focuses on antitrust laws, specifically whether forcing cross-licensing agreements with RAND-encumbered patents is an acceptable practice under Section 2 of the Sherman Antitrust Act and under Section 5 of the FTC Act.

30. *See id.* at 13–14.

31. Mutually assured destruction is a long-standing military policy whereby adversaries on both sides possess weapons capable of complete destruction of their opponent. The theory is that as long as each side is aware of their ability to completely destroy their opponent, as well as their potential to be completely destroyed by the other, neither side will engage in a full-scale attack, resulting in a stalemate. *See*, GETTING MAD: NUCLEAR MUTUAL ASSURED DESTRUCTION, ITS ORIGINS AND PRACTICE 1–13 (Henry D. Sokolski ed., Army War College (U.S.) Strategic Studies Institute, 2004).

32. Larry Page, *Supercharging Android: Google to Acquire Motorola Mobility*, OFFICIAL GOOGLE BLOG (Aug. 15, 2011, 12:52 PM), <http://googleblog.blogspot.com/2011/08/supercharging-android-google-to-acquire.html>.

A. IS CROSS-LICENSING REASONABLE AND NONDISCRIMINATORY?

This Section explores whether Google's newly acquired RAND-encumbered patents can be used as a strategic tool for gaining cross-licensing rights to protect its vulnerable technology areas while still abiding by the requirements of a reasonable and nondiscriminatory licensing commitment. The terms "reasonable" and "nondiscriminatory" are analyzed in turn.

1. *How a Court Should Define "Reasonable"*

The goals of RAND licensing can easily be subverted if SDOs are unable to provide clear definitions to their members of what constitutes "reasonable" and "nondiscriminatory."³³ Although parties tend to disagree on the definition of "reasonable," a court should not declare Google's strategy to use RAND-encumbered patents for cross-licensing a violation of a "reasonable" term simply because of its non-traditional approach to RAND licensing. The following Sections explore several factors a court should consider when determining whether this cross-licensing agreement is reasonable.

- a) Defining "Reasonable" Requires Considering the Availability and Costs of Alternative Technologies Before the Standard Was Created

A court evaluating reasonable cross-licensing arrangements involving RAND-encumbered patents should consider the incremental value of the technology covered by the standard relative to the next best technology alternative before the creation of the standard.³⁴ In other words, if the difference in value between the technology covered by the standard and the next best alternative is significant, a hypothetical negotiation for a reasonable royalty would also likely result in significant royalty value for the patent holder.³⁵ If Google can demonstrate (1) that before their RAND-

33. Lemley, *supra* note 8, at 1964.

34. George S. Cary, Paul S. Hayes & Larry C. Work-Dembowski, *Antitrust Implications of Abuse of Standard-Setting*, 15 GEO. MASON L. REV. 1241, 1260 (2008).

35. The fifteen *Georgia-Pacific* factors are typically used for determining reasonable royalty rate when calculating patent infringement damages. *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 258 F.2d 124, 132–34 (2d Cir. 1958). However, a court calculating a reasonable royalty arising out of hypothetical negotiations may not want to apply all fifteen *Georgia-Pacific* factors:

The precise interpretation is more complex because a particular user may be locked in by the network effects surrounding others' adoption even before it has itself made any investments. This interpretation of a "fair and reasonable" royalty differs from the *Georgia-Pacific* interpretation of "reasonable royalties" in a patent infringement case in at least two ways.

encumbered patents were locked into the standard there were no competitive alternatives to its technology, (2) that the competitive alternatives that did exist were cost prohibitive, or (3) that the competitive alternatives also infringed the licensor's patents, then Google may successfully convince a court that the cross-licenses it seeks from its competitors are relatively high in value.³⁶ However, the patent demanded from one of Google's competitors seeking to practice the standard must not have a value so high as to render the adoption of the standard inefficient, such that the relevant industry would be discouraged from making the investments necessary to implement the standard and license the required technology.³⁷

b) Defining "Reasonable" Requires Considering a RAND-encumbered Patent's Contribution to the End-Product

A reasonable cross-licensing agreement may require analyzing the RAND-encumbered patent's contribution to the overall end-product. For example, if a RAND-encumbered patent covers the configuration of a smartphone's physical communication connector port, the value this patent contributes to the overall value of the smartphone is relatively small.³⁸ Therefore, it is likely unreasonable to demand a value for the RAND-encumbered patent that is incommensurate with the value the communication connector port contributes to the smartphone's overall value. In a recent case involving RAND licensing agreements, Microsoft argued that it was unreasonable for the essential patent holder, Motorola, to demand a royalty rate based on the entire product sale when the rate is

First, the *Georgia-Pacific* notion presumes that the patent is valid as well as infringed. That assumption may not hold here, so some discounting is appropriate to reflect patent strength. *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 258 F.2d 124, 132–34 (2d Cir. 1958). Second, one of the *Georgia-Pacific* factors hypothesizes a negotiation between a patent holder that is willing to license and the infringer at the time that the infringement began. In the standard-setting context, the time when infringement actually begins is too late, because it is typically after a standard is set and investments have been made.

Joseph Farrell et. al, *Standard Setting, Patents, and Hold-up*, 74 ANTITRUST L.J. 603, 637 n.134 (2007).

36. Cary, *supra* note 34, at 1260.

37. *Id.*

38. This statement rests on assumption that a smartphone's physical communication port is a feature that does not typically drive consumer demand. Instead, consumers are traditionally more concerned with smartphone features such as processor speed, screen size, camera capabilities, battery life, operating system, etc. See, e.g., *How to Buy Smartphones*, TECHCRUNCH, <http://smartphones.techcrunch.com/#buyersguide> (last visited Mar. 30, 2012).

“without reference to the proportionate contribution of the technology to the product.”³⁹ In this case, Motorola demanded a 2.25% royalty on every Microsoft Xbox 360 sold.⁴⁰ Microsoft argued this was unreasonable because Motorola could extract a royalty ranging from \$4.48 to \$10.10 depending on which bundled version of the Xbox 360 is sold, even though Motorola’s essential patents contributed the same technical capabilities⁴¹ regardless of which bundled Xbox 360 is sold.⁴²

Microsoft argued that Motorola’s “reasonable” demand of 2.25% violated the “Entire Market Value” Rule.⁴³ The Entire Market Value Rule states that a patentee is permitted to base its request for reasonable royalty on the end value of the product containing the patented technology “only where the patented feature creates the ‘basis for customer demand’ or ‘substantially create[s] the value of the component parts.’”⁴⁴ Failing this, the patent holder must separate or apportion the implementer’s profits and the patentee’s alleged damages “between the patented feature and the unpatented features.”⁴⁵ Microsoft went on to argue that the rule applies with greater force where the essential patent holder possesses the market leverage of a technical standard.⁴⁶

Therefore, if Google is infringing on a valuable non-essential patent owned by a competitor, it may be unreasonable to allow Google to cross-license that non-essential patent if Google’s essential patent offered in exchange belongs to a relatively insignificant standard. In this situation, Google’s cross-licensing demands could violate the Entire Market Value Rule because the competitor’s profits are only minimally related to Google’s essential patent. It would be unreasonable for Google to demand from its competitor a license to an infringed patent that could be worth a substantial remedy if the competitor prevailed in a patent infringement suit.

39. Motion for Partial Summary Judgment for Microsoft at 26, *Microsoft Corp. v. Motorola Inc.*, No. C10-1823-JLR, (W.D. Wash. Sept. 9, 2011).

40. *Id.* at 12.

41. *Id.* at 13 (“Each version of the Xbox 360 has the *same* built-in wireless network adapter and the *same* video decoding capabilities.” (emphasis in original)).

42. Motion for Partial Summary Judgment for Microsoft at 13, *Microsoft Corp.*, No. C10-1823-JLR.

43. *Id.* at 24.

44. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011) (citing *Lucent Technologies, Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1336 (Fed. Cir. 2009)).

45. *Id.* at 1318.

46. Motion for Partial Summary Judgment for Microsoft at 24, *Microsoft Corp.*, No. C10-1823-JLR.

c) Defining “Reasonable” Requires Understanding the Unique Relationship Between Parties

Many RAND agreements used by SDOs do not limit essential patent holders to licensing their IP rights only on a fee or royalty basis.⁴⁷ Typically there is no language on the face of most published RAND licensing agreements that would explicitly prohibit a cross-licensing arrangement.⁴⁸ For example, the International Telecommunication Union, another major SDO in the wireless communications industry, intentionally does not define reasonable because it recognizes that the arrangement between parties can differ from case to case.⁴⁹

A court should decide whether cross-licensing a RAND-encumbered patent is acceptable only after examining the unique relationship between Google and its competitors, especially taking into account business dealings between the parties. If, for example, Google attempted to use RAND-encumbered patents to gain cross-licenses to Apple’s patents, Google could request that a court take into consideration the extensive cross-licensing already in existence between the companies. Google could also request that the court consider the prolific patent litigation between Apple’s iOS and Android as another reason why cross-licensing RAND-encumbered patents should be reasonable. In this situation, a court may conclude that these companies are clearly willing to cross-license patents to each other and that Google’s cross-licensing demands are a reasonable method of reducing the excessive litigation between the parties.

In determining reasonableness, a court should also account for other business dealings between the parties, such as distribution agreements and

47. See, e.g., JEDEC MANUAL OF ORGANIZATION AND PROCEDURE § 8.2.5 (May 2010), <http://www.jedec.org/sites/default/files/JM21Q.pdf> (“A license will be offered to applicants desiring to utilize the license for the purpose of implementing the JEDEC Standard under reasonable terms and conditions that are demonstrably free of any unfair discrimination.”).

48. See, e.g., *IPR Statement*, TIA, <http://www.tiaonline.org/all-standards/procedures/ipr> (last visited Apr. 21, 2012); *ETSI Intellectual Property Rights Policy*, ETSI (Nov. 30, 2011), <http://www.etsi.org/WebSite/document/Legal/ETSI%20IPR%20Policy%20November%202011.pdf>; *IEEE-SA Standards Board Bylaws*, IEEE STANDARDS ASS’N § 6.2, <http://standards.ieee.org/develop/policies/bylaws/sect6-7.html#loa> (last visited Feb. 6, 2012); *License Assurance/Disclosure Form*, JEDEC, http://www.jedec.org/sites/default/files/License_Assurance-Disclosure_Form_20110119.pdf (last visited Feb. 6, 2012).

49. See GUIDELINES FOR IMPLEMENTATION OF THE COMMON PATENT POLICY FOR ITU-T/ITU-R/ISO/IEC, 8 INTERNATIONAL TELECOMMUNICATION UNION (Mar. 1 2007), http://www.itu.int/dms_pub/itu-t/oth/04/04/T04040000010002PDFE.pdf (“The detailed arrangements arising from patents (licensing, royalties, etc.) are left to the parties concerned, as these arrangements might differ from case to case.”).

co-branding agreements, as reasons why cross-licensing RAND-encumbered patents may be reasonable.⁵⁰ Other unique arrangements that might alter what “reasonable” means for parties transacting with each other include when a licensee is seeking a license for a limited geographic scope or for a limited term. Limitations on the scope or term likely reduce the overall value of a license when compared to an unrestricted license and may help a court assess whether the proposed cross-licensing arrangement is reasonable.

To summarize, a court weighing the relative values of a RAND-encumbered patent against a patent from Google’s competitor should consider the following factors before deciding whether the proposed cross-licensing agreement is reasonable: the availability of alternative technologies before the standard was implemented, the RAND-encumbered patent’s contribution to the overall end-product, and the unique business dealing between the parties.

2. *How a Court Should Define “Nondiscriminatory”*

As with the term “reasonable,” the term “nondiscriminatory” is also not well-defined by courts or commentators. To better understand the meaning of nondiscriminatory in the context of RAND agreements, it is helpful to divide the analysis into two paradigmatic situations. The first involves a RAND-encumbered patent with no existing licensees. In other words, Google’s competitors have no frame of reference for finding discrimination, at least with regard to the specific RAND-encumbered patent in question. The second typical situation occurs when a RAND-encumbered patent has at least one existing licensee. In this situation, a competitor might point to an existing licensee’s arrangements, fees, or royalties and demand similar “nondiscriminatory” treatment.

a) A RAND-encumbered Patent with No Existing Licensees

A competitor faced with Google’s demands to cross-license may have a less compelling discrimination case when the essential patent has not been previously licensed to any other group. In this instance, a competitor cannot point to other RAND-encumbered patent licensees and demand similar nondiscriminatory treatment based on a previously established licensing precedent.

However, a competitor claiming that a cross-licensing demand is discriminatory could identify other patents belonging to the same technical standard that are owned by other industry members and demand a similar fee

50. Defendants’ Opposition to Microsoft’s Motion for Partial Summary Judgment at 14, *Microsoft Corp. v. Motorola Inc.*, No. C10-1823-JLR, (W.D. Wash. Sept. 23, 2011).

or royalty arrangement. Google could argue that it is not discriminatory to have different licensing terms for different patents, regardless of whether the patent holder is seeking money or a cross-licensing agreement, since every patent has a unique claim set, patent term, priority date, prosecution history, etc., when compared to another patent.

Google may want to identify which of its newly acquired patents from Motorola Mobility are RAND-encumbered and have not been previously licensed to anyone. Once such patents are identified, it may behoove Google to avoid licensing these patents to parties in exchange for a fee or royalty. Instead it may try to license its RAND-encumbered patents only in exchange for cross-licensing rights, even if the cross-licensed patent it obtains is relatively insignificant to Google's practice. Doing so may provide Google with more stable footing when a competitor one day claims Google's practice is unfairly discriminating because Google can then demonstrate a precedent of only cross-licensing its RAND-encumbered patents.

However, a strategy of treating every entity seeking a RAND license the same (i.e. requiring a cross-licensing arrangement) may cause difficulty where the entity seeking a license does not own any patents. In this scenario, Google may be forced to give the license away for free or require the company to purchase a token patent only for cross-licensing purposes. Critics may also claim that this idea discriminates between patent-rich and patent-poor firms.⁵¹ Take for example a case where the company seeking a license to the RAND-encumbered patent is a small start-up with only two or three patents that each cover critical aspects of the start-up's novel technology. In this instance, a court will likely find it unreasonable for Google to demand a cross-license to one of the start-up's fundamental patents.

Ultimately, the factors for determining whether a cross-licensing arrangement is unfairly discriminating in a case where the RAND-encumbered patent has no existing licensees should not depend on whether Google is maintaining a cross-licensing precedent. Instead, regardless of whether Google is seeking pecuniary compensation or compensation in the form of a cross-license, the focus should be on whether Google is accepting similar value in return for its RAND-encumbered patents. Although patent valuation can often be more of an art than a science, some guidance on

51. Farrell, *supra* note 35, at 640.

valuing patents can be found in the literature⁵² as well as in the previous Section covering “reasonable” licensing rates, *supra*, Part II.A.1.

b) A RAND-encumbered Patent with Existing Licensees

Most RAND agreements from SDOs require that essential patent holders provide licenses that are “demonstrably free of any unfair discrimination.”⁵³ In a situation where a RAND-encumbered patent already has at least one existing licensee, Google may need to emphasize that, although it may be treating different groups differently, it is not practicing “unfair discrimination.” Justifying a difference in licensing treatment may depend on distinguishing the existing licensees’ situation from the situation of the current entity seeking a license to the RAND-encumbered patent. Instead of arguing that nondiscriminatory treatment means treating everyone the same, Google might instead focus on the rationalization of treating every entity seeking a RAND license differently because every entity is in a unique situation.

Google should be able to justify some amount of discrimination by highlighting specific reasons why the party seeking the license should be treated differently. Licensees may be distinguished from one another if licensees are requesting licenses for different fields of use, geographic scope, or duration. Other differentiating factors may include the fact that a competing company is targeting a different demographic or practicing this technical standard in a different way compared to the existing licensees. Take, for example, the case where an existing licensee is making wireless communication transmitters solely for specialized military applications. Google may be able to raise compelling public interest and policy reasons why this company should have more favorable licensing terms than a company like Apple, which sells wireless communication devices primarily for business and personal uses.

Google could also contend that it is discriminatory to require small entities and large entities to pay identical licensing rates. A start-up company, which may not even have a revenue stream, may claim that uniform licensing terms are discriminatory because it must pay the same licensing rates as a company with billions of dollars in annual revenue. A court may decide that the less discriminatory method is to scale the licensing rate depending on the

52. See, e.g., Charles Eldering and Juan Gisone, *Claims-based Patent Valuation*, INTELLECTUAL ASSET MANAGEMENT, Nov.–Dec. 2011, at 58–63.

53. See *IEEE-SA Standards Board Bylaws*, IEEE STANDARDS ASS’N § 6.3.1, <http://standards.ieee.org/develop/policies/bylaws/sect6-7.html#loa> (last visited Feb. 6, 2012); *JEDEC Manual*, *supra* note 47, at § 8.2.5.

company's revenue. In this scenario, it may be nondiscriminatory to require Apple to cross-license a valuable non-essential patent given that Apple is a company with over \$65 billion in annual revenue.⁵⁴

Google may request a court to consider that some of its existing RAND licensees should benefit from lower licensing rates because of an established long-term business relationship. In other words, Google may not be unfairly discriminating if certain companies have previously invested significant resources towards cultivating a business relationship with Google. Therefore Google may assert that some of its existing licensees are simply paying a subsidized reasonable rate because these companies have already made other significant investments in Google.

Even if a RAND-encumbered patent has existing licensees paying royalties or fees, a court should not declare Google's cross-licensing strategy unfairly discriminating simply because it deviates from a uniform licensing rate. Each company seeking a license from Google has its own unique financial, legal, and business situation. A court should focus on recognizing and accounting for important distinguishable differences between licensees when considering whether cross-licensing RAND-encumbered patents is unfairly discriminating.

B. ANTI-TRUST ISSUES IN CROSS-LICENSING RAND-ENCUMBERED PATENTS

Google may encounter antitrust issues if it employs its recently purchased RAND-encumbered patents as a tool to force competitors into cross-licensing non-essential patents. Critics of Google's cross-licensing strategy may claim that its practice is demanding excessively high value for its essential patents and that the company is violating antitrust laws by attempting to monopolize the smartphone market, chill technological innovation, and harm competition.⁵⁵ As the court found in *Research in Motion, Ltd. v. Motorola, Inc.*, a case involving Motorola's failure to uphold its RAND commitments, "[i]f Motorola licenses only at exorbitant rates, it will force its competitors [like Microsoft] to increase prices in the downstream market in

54. *Fortune 500*, CNN MONEY, http://money.cnn.com/magazines/fortune/fortune500/2011/full_list (last visited Dec. 3, 2011).

55. *See, e.g.*, Thomas Catan & Ian Sherr, *U.S. to Clear Google's Deal*, WALL ST. J., Feb. 9 2012, at B5 (stating that the U.S. Department of Justice is poised to clear the \$12.5 billion dollar patent deal between Google and Motorola Mobility, however, antitrust enforcers in the U.S. and Europe remain concerned about Google's commitment to license Motorola patents to competitors on fair terms and will closely monitor Google's use of the patents).

order to make a profit. This increase in prices for all products except Motorola's will harm competition."⁵⁶

The primary goal of antitrust law is to maximize consumer welfare by promoting competition among firms.⁵⁷ Patents incorporated into a technical standard raise antitrust concerns because the essential patent holder faces no competing technologies and may be able to appropriate the monopoly power created by the standard by demanding consideration far in excess of what it could have negotiated if its patent was non-essential.⁵⁸ Although abuses due to this standard-setting process can create significant antitrust issues, SDOs also advance antitrust goals by ensuring the interoperability of products, which enhances product utility, increases the overall consumer market, and decreases prices.⁵⁹ Industry-wide standards may also lower costs to consumers for switching between competing products and services, thereby enhancing competition among suppliers.⁶⁰

In the context of antitrust cases involving standard-setting, courts will typically focus on whether the existence and enforcement of IP rights poses a potential risk to competition.⁶¹ Google's attempt to use RAND-encumbered patents to obtain cross-licenses from competitors may be deemed anticompetitive and in violation of antitrust laws under Section 2 of the Sherman Antitrust Act (either unlawful monopolization or attempted monopolization).

1. *Unlawful Monopolization—Section 2 of the Sherman Antitrust Act*

Section 2 of the Sherman Antitrust Act makes it illegal to “monopolize or attempt to monopolize” or to “combine or conspire” with others to monopolize any relevant market.⁶² The mere possession and maintenance of a large market share, even 100% of the market, is not, in and of itself, illegal.⁶³ Rather, proving unlawful monopolization requires showing two elements: (1) that a firm has monopoly power within a properly defined relevant market and (2) that a firm was acquired, maintained, or enhanced

56. *Research in Motion, Ltd. v. Motorola, Inc.*, 644 F. Supp. 2d 788, 794 (N.D. Tex. 2008).

57. PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION* para. 100 (3rd ed. 2006).

58. Cary, *supra* note 34, at 1254.

59. *Broadcom Corp. v. Qualcomm, Inc.*, 501 F.3d 297, 308 (3d Cir. 2007).

60. *Id.* at 309.

61. Lemley, *supra* note 8, at 1938.

62. 15 U.S.C. § 2 (2006).

63. *See United States v. Microsoft Corp.*, 253 F.3d 34, 51 (D.C. Cir. 2001) (stating that “merely possessing monopoly power is not itself an antitrust violation”).

that power by the use of exclusionary or predatory conduct, “as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.”⁶⁴ Therefore, in the context of patent cross-licensing, a court would find Google in violation of Sherman Act Section 2 if it could be shown that Google has monopoly power in the relevant market and that cross-licensing RAND-encumbered patents allowed Google to acquire or maintain its monopoly position through anticompetitive tactics.

a) Possession of Monopoly Power Within a Properly Defined Relevant Market

A threshold question under the Sherman Act is whether Google possesses monopoly power in the relevant market. In theory, Google, without monopoly power in the relevant market, should not be able to do any damage if those markets are performing in a healthy, competitive way.⁶⁵

The traditional doctrinal test for market power is the market share proxy test, which first requires defining both the product market and the geographic market in which Google competes.⁶⁶ Then, given all other characteristics of the relevant market, the market share proxy test asks whether Google’s market share suggests it could raise its prices without losing business.⁶⁷

Under the first part of the market share proxy test, a court needs to identify the proper product market in which Google competes. Without a proper definition of a market, there is no way to measure an alleged monopolist’s ability to lesson or destroy competition.⁶⁸ Google’s competitors will likely attempt to define this market as narrowly as possible in an effort to inflate Google’s market share. For example, in a case where Google’s patent is essential to a technical standard covering smartphone microprocessors, competitors may argue that the relevant market is limited only to the microprocessor arena. Competitors may also argue that Google, by owning an essential patent belonging to a standard, already possesses market power in the technical standard. Google, on the other hand, will try to frame the

64. *United States v. Grinnell Corp.*, 384 U.S. 563, 571 (1966).

65. See R. Preston McAfee, *Price Discrimination*, 1 ISSUES IN COMPETITION L. & POL. 465–66 (2008); LAWRENCE A. SULLIVAN & WARREN S. GRIMES, *THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK* 58 (2000).

66. SULLIVAN, *supra* note 65, at 61.

67. See generally, *id.* at 59–67 (providing a detailed discussion on how to measure a firm’s market power).

68. See *Walker Process Equip. v. Food Mach. and Chem. Corp.*, 382 U.S. 172, 177 (1965).

relevant market as broadly as possible to dilute its market share. For example, Google, in the case of the microprocessors, may claim that the relevant market includes all smartphones that contain a microprocessor, which would include *all* smartphones available today.

It is unclear how broadly or narrowly a court would define Google's relevant market. A proper definition of the relevant market will depend on the patent's subject matter and the technical standard involved. However, if the primary goal of antitrust law is to promote consumer welfare, it may be compelling for Google to argue the relevant market from the perspective of the consumer. Given that consumers participating in the marketplace deal with Motorola Droid smartphones and Apple iPhones, not microprocessor hardware and radio transmitter components, the more appropriate relevant market may be defined in terms of the end-products—smartphones.

Products are considered to be in the same relevant market if consumers would consider them potential alternatives to each other.⁶⁹ If a consumer using a smartphone device running Google's Android OS can reasonably turn to an alternative product such as Apple's iPhone (running Apple's iOS) or a smartphone device running Windows Phone OS, a court would consider these products to be within the same relevant market. Within the smartphone market, the proper relevant market definition should include the smartphone devices manufactured by major hardware companies (e.g., Apple, HTC, RIM, Samsung) because consumers typically consider these products as potential alternatives to each other.⁷⁰

The second part of the market share proxy test is defining the geographic market in which Google competes.⁷¹ In the case of geographical area, smartphone use is well-distributed throughout the entire country. That is to say, locations where consumers could purchase Android devices are reasonably co-localized with places where consumers could also purchase iPhones, BlackBerrys, and other smartphone devices. Therefore, defining the geographic market may not be informative or pertinent to a court's inquiry into Google's U.S. market share.

Finally, under the third part of the market share proxy test, Google's market share suggests it could raise its prices without losing business. If

69. *See, e.g.*, *United States v. E. I. du Pont de Nemours and Co.*, 351 U.S. 377, 394 (1956) (reasonably interchangeable products define the relevant product market).

70. *See, e.g.*, *2012 Best Smartphone Comparisons and Reviews*, TOPTENREVIEWS, <http://cell-phones.toptenreviews.com/smartphones> (last visited Feb. 21, 2012) (comparing 21 smartphones available in 2012 with similar features such as processor speed, physical size, memory, battery life, wireless communication protocols, and camera capabilities).

71. *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 459 (1993).

Google has (1) the power to raise prices in the relevant market above competitive levels or (2) the power to exclude competition in the relevant market, then it possesses a monopoly in the relevant market.⁷²

One method for determining monopoly power is to look at a company's market share.⁷³ If the relevant market is broadly defined to be all smartphones, then Google's share in the smartphone device market may be difficult to calculate since the Android OS is open-source software and Google, by itself, does not make smartphone devices. However, as evidenced by its purchase of 17,000 patents from Motorola Mobility, Google is front and center in leading the patent war on behalf of the Android smartphone device manufacturers.⁷⁴ With its new battle chest of patents, Google, and not the Android smartphone device manufacturers acting by themselves, is the largest threat to its competitors and to fair competition.⁷⁵ Therefore, it may be fair to use the Android OS market share as a proxy for gauging Google's potential monopoly power in the device market if the relevant market is defined to include all smartphones.

A market share of 70% or more is generally considered a reasonable threshold for monopoly power.⁷⁶ A market share of less than 50% will likely be insufficient.⁷⁷ According to a recent report by Nielsen, Android currently holds the largest share of the mobile OS market with 43% of the U.S. market share.⁷⁸ A market share of 43% is likely too low for a court to find that Google has monopoly power within the smartphone market. However, the Android operating system is showing steady growth from a market share of

72. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 27 (1984); *E. I. du Pont de Nemours and Co.*, 351 U.S. at 391.

73. JONATHAN M. JACOBSON, *ANTITRUST LAW DEVELOPMENTS* 230 (6th ed. 2007).

74. See, e.g., Jack Ellis, *Google Treading the Warpath as it Puts Motorola Purchase to the Test*, INTELLECTUAL ASSET MANAGEMENT BLOG (Jan. 27, 2012), <http://www.iam-magazine.com/blog/detail.aspx?g=df971109-cfbf-4c76-9363-1816c9402175&q=google+motorola#search=%22google+motorola%22> (commenting that Motorola Mobility filed a patent infringement suit against Apple in the Southern District of Florida on Jan. 25, 2012 only after obtaining permission from Google to initiate litigation).

75. See, e.g., Florian Mueller, *These Are the Patents Google Gave to HTC to Assert Against Apple*, FOSS PATENTS (Sept. 8, 2011), <http://fosspatents.blogspot.com/2011/09/these-are-patents-google-gave-to-htc-to.html> (noting that several of the patents HTC is asserting against Apple are patents Google assigned to HTC).

76. JACOBSON, *supra* note 73, at 231.

77. *Id.* at 232.

78. Don Kellogg, *In U.S. Market, New Smartphone Buyers Increasingly Embracing Android*, NIELSEN WIRE BLOG (Sept. 26, 2011), http://blog.nielsen.com/nielsenwire/online_mobile/in-u-s-market-new-smartphone-buyers-increasingly-embracing-android.

36% in May 2011⁷⁹ to 39% in July 2011⁸⁰ to 43% in September 2011.⁸¹ Of smartphone users who purchased new smartphones from June 2011 to August 2011, 56% of users selected Android devices.⁸² This data from Nielsen suggests that Android's total U.S. market share may exceed 50% in the near future and may increase Google's risk of possessing monopoly power in the smartphone market.

A court might alternatively define the product market using the "small but significant and non-transitory increase in price" ("SSNIP") test, which seeks to identify the smallest relevant market within which a hypothetical monopolist could impose a profitable significant increase in price.⁸³ Under the SSNIP test, the candidate market is iteratively expanded by the product-in-question's closest substitute.⁸⁴ A court finds the relevant market properly defined when substitution to products outside the set is sufficiently weak to allow a collectively profitable price increase for all of the included products.⁸⁵ However, the appropriateness of the SSNIP test for defining the smartphone device product market may be questionable given the limited number of smartphone substitutes available. If the products-in-question are all Android smartphone devices, then the variety of different Android-based smartphones may far outnumber the different types of substitute smartphones available to consumers (e.g., iPhones, BlackBerrys, Windows Phones).⁸⁶ As a result, the SSNIP test may not be informative for defining

79. *Android Leads in U.S. Smartphone Market Share and Data Usage*, NIELSEN WIRE BLOG (Jul. 28, 2011), <http://blog.nielsen.com/nielsenwire/consumer/android-leads-u-s-in-smart-phone-market-share-and-data-usage>.

80. Kellogg, *supra* note 78.

81. *Id.*

82. *Id.*

83. See DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES § 4.1 (2010) (stating that the Department of Justice and Federal Trade Commission employ the SSNIP hypothetical monopolist test to evaluate whether groups of products in candidate markets are sufficiently broad to constitute relevant antitrust markets).

84. Øystein Daljord, Lars Sorgard & Øyvind Thomassen, *The SSNIP Test and Market Definition with the Aggregated Diversion Ratio: A Reply to Katz and Shapiro*, 4 J. COMPETITION L. & ECON. 263, 263 (2007).

85. *Id.*

86. For example, the AT&T online store offers 25 different types of Android smartphones for purchase, compared to 3 types of iPhone/iOS smartphones, 5 types of RIM/BlackBerry OS smartphones, and 5 types of Windows Phone OS smartphones, *AT&T PDAs & Smartphones*, AT&T, <http://www.wireless.att.com/cell-phone-service/cell-phones/pda-phones-smartphones.jsp> (last visited Feb. 21, 2012). The Sprint online store sells approximately 20 different types of Android OS smartphones, compared to 2 types of iPhone/iOS smartphones, 7 types of RIM/BlackBerry OS smartphones, and 2 types of Windows Phone OS smartphones. *Sprint Shop*, SPRINT, <http://shop.sprint.com> (last visited Feb. 21, 2012).

the product market given the limited ability to iteratively expand the substitute market.

b) Exclusionary or Predatory Conduct

Exclusionary or predatory conduct is the second required element for proving unlawful monopolization.⁸⁷ Exclusionary conduct is conduct other than competition on the merits that reasonably appears capable of making a significant contribution to creating or maintaining monopoly power.⁸⁸ Specific categories of potentially exclusionary conduct include: (1) predatory pricing; (2) refusing access to competitors; (3) vertical arrangements that foreclose competitors from suppliers or customers; (4) abuse of product designs or introductions; (5) abuse of governmental process; (6) abuse of standards setting; (7) tortious conduct; and (8) coordination with competitors to gain monopoly.⁸⁹ A court will likely be concerned with whether Google's conduct is abusing the standard-setting organizations by capturing the economic power of an industry-wide standard and turning the SDO into a source of exclusionary power.⁹⁰

A court might also apply the “No Economic Sense” test of exclusionary conduct developed by the Supreme Court in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*⁹¹ Under this test, economically irrational behavior in dealings with the competition may be indicative of an exclusionary goal.⁹² Google's competitors may argue that by sacrificing the collection of fee or royalty streams from their RAND-encumbered patents and instead seeking only patent cross-licenses, Google's conduct is exclusionary under the No Economic Sense test. In response, Google could assert a procompetitive rationale for its behavior by showing a court that its competitors' non-essential patents have economic value for the company and its products. However, this is a difficult line to tread—Google will want to show that the non-essential patents have economic value, but at the same time the value of the non-essential patents must also have comparable value relative to its

87. JACOBSON, *supra* note 73, at 240.

88. PHILLIP E. AREEDA & DONALD F. TURNER, ANTITRUST LAW para. 626b, at 78 (1978) (“Thus, ‘exclusionary’ comprehends at the most behavior that not only (1) tends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way.”).

89. *See generally*, JACOBSON, *supra* note 73, at 240–300 (describing various categories of potentially exclusionary conduct).

90. *See* Am. Soc. of Mech. Engineers, Inc. v. Hydrolevel Corp., 456 U.S. 556, 571–72 (1982).

91. *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 608 (1985).

92. *Id.*

RAND-encumbered patents in order to avoid violating its RAND commitments.

Finally, conduct that merely harms competitors, while not harming the competitive process itself, is not anticompetitive.⁹³ As the Supreme Court observed in *Aspen Skiing*, “[t]he question whether [the defendant’s] conduct may properly be characterized as exclusionary cannot be answered by simply considering its effect on the plaintiff but must also consider its effects on competition.”⁹⁴ Therefore, any antitrust claims against Google must not center only on the harm done to specific competitors, such as Apple or Microsoft, but on the entire ecosystem of smartphone competition.

2. *Attempted Monopolization—Section 2 of the Sherman Act*

In addition to bringing an unlawful monopolization claim, a plaintiff may also bring a cause of action under attempted monopolization.⁹⁵ A court may view Google’s attempt to use RAND-encumbered patents to force the competition to grant it cross-licenses as an unlawful attempt to monopolize the relevant market. An attempted monopolization claim has the same elements as unlawful monopolization (exclusionary conduct in a properly defined relevant market), but a Google competitor must additionally demonstrate (1) that Google specifically intended to acquire monopoly power and (2) that Google has a dangerous probability of successful monopolization.⁹⁶

a) Specific Intent to Monopolize

Attempted monopolization would require a plaintiff to prove that Google, in implementing its strategy of cross-licensing recently obtained RAND-encumbered patents, had the specific intent to acquire a monopoly. While a plaintiff would need to show evidence of specific intent, it is unclear what types of evidence would suffice. In *Aspen Skiing*, the Supreme Court noted that evidence of business conduct “not related to any apparent efficiency” may constitute proof of specific intent to monopolize.⁹⁷ The Supreme Court has also stated that specific intent must be “something more than an intent to compete vigorously.”⁹⁸

93. *United States v. Microsoft*, 253 F.3d 34, 58 (D.C. Cir. 2001).

94. *Aspen Skiing Co.*, 472 U.S. at 605.

95. 15 U.S.C. § 2 (2006).

96. *Spectrum Sports v. McQuillan*, 506 U.S. 447, 456 (1993).

97. *Aspen Skiing Co.*, 472 U.S. at 608.

98. *Spectrum Sports*, 506 U.S. at 459.

Direct evidence of intent would likely satisfy this element of attempted monopolization.⁹⁹ However, a court may infer specific intent in cases involving actual exclusion¹⁰⁰ or substantial and grossly anticompetitive predatory or exclusionary conduct.¹⁰¹ Therefore, a court may ask whether Google's method of gaining cross-licenses to a competitor's non-essential patents is related to any apparent efficiency and intent to compete vigorously. If not, a court may engage in a similar predatory or exclusionary conduct inquiry as outlined above in Section II.B.1, *supra*. Courts generally agree that the mere "intent" to harm one's rivals by producing a better product at a lower, but profitable, price should never violate the antitrust laws.¹⁰²

b) Dangerous Probability of Successful Monopolization

To prove a "dangerous probability of successful monopolization," an antitrust plaintiff must define a market and show that the defendant possesses a certain amount of market power.¹⁰³ In the absence of such a showing, even fairly egregious conduct is not an antitrust violation.¹⁰⁴ If a court defines the relevant market as all smartphone operating systems, then the Android OS currently holds approximately 43% of the U.S. market share for mobile operating systems.¹⁰⁵ Market share requirements vary widely in attempted monopolization cases, but the case law suggests that 43% is too

99. *Id.*

100. *See* Confederated Tribes of Siletz Indians v. Weyerhaeuser Co., 411 F.3d 1030, 1042 (9th Cir. 2005) (holding that the jury could reasonably find specific intent based upon anticompetitive conduct alone), *vacated on other grounds sub nom.*, Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc., 549 U.S. 312 (2007); Nobody in Particular Presents, Inc. v. Clear Channel Communs., 311 F. Supp. 2d 1048, 1105–08 (D. Colo. 2004) (holding that "[i]mproper exclusion is always deliberately intended" where exclusion was against defendant's financial interests accompanied by coercive threats).

101. *Spectrum Sports*, 506 U.S. at 459 (holding that a showing of predatory or anticompetitive conduct "may be sufficient to prove the necessary intent to monopolize").

102. *Conoco Inc. v. Inman Oil Co.*, 774 F.2d 895, 905 (8th Cir. 1985) (finding that an executive's statements that he intended to drive competitor "out of business" and that he wanted "100% of the lubricant business in the region" were insufficient to establish intent to monopolize in the absence of anticompetitive conduct); *William Inglis & Sons Baking Co. v. ITT Cont'l Baking Co.*, 668 F.2d 1014, 1028 (9th Cir. 1981) ("[i]ntent alone can be ambiguous . . . intent to vanquish a rival in an honest competitive struggle cannot help to establish an antitrust violation" (citations omitted)).

103. *Spectrum Sports*, 506 U.S. at 455.

104. *See, e.g.*, *United States v. Empire Gas Corp.*, 537 F.2d 296 (8th Cir. 1976), *cert. denied*, 429 U.S. 1122 (1977) (dismissing the complaint despite defendant's clear intent to monopolize using price cuts and threats of price cuts because of the low barriers to entry in the LP gas industry).

105. Kellogg, *supra* note 78 (showing that Apple iOS and RIM BlackBerry OS hold 28% and 18% of the smartphone share, respectively).

low to find a dangerous probability of successful monopolization.¹⁰⁶ However, given that the standard for attempted monopolization is “a dangerous *probability* of successful monopolization,”¹⁰⁷ and that the Android platform is demonstrating steady market share growth, a court may consider other factors for satisfying the “dangerous probability” element. Courts typically look to other factors for determining monopoly power if a company holds a 50% to 70% market share.¹⁰⁸ Some of these other factors for determining monopoly power may include the barriers to entry or expansion,¹⁰⁹ the size and strength of the competitors,¹¹⁰ the speed of technological change,¹¹¹ and pricing trends.¹¹²

3. *Google’s Procompetitive and Legitimate Business Justifications*

Courts also recognize procompetitive justifications as a defense to attempted monopolization.¹¹³ Courts typically ask whether the conduct was “more restrictive than reasonably necessary” to achieve “competition on the merits.”¹¹⁴ Google should be able to successfully advance several arguments for why its cross-licensing strategy helps increase competition in the smartphone ecosystem.

The smartphone and mobile computing device industry is still nascent and rapidly growing.¹¹⁵ Although Android possesses the largest mobile OS

106. *See, e.g.*, *Ford v. Stroup*, 113 F.3d 1234 (6th Cir. 1997) (finding a radiologist group’s 50–55% share insufficient where entry barriers were not shown to be high; showing an absence of historical entry insufficient when market appeared to be competitive; although a new entrant required an expensive linear accelerator, at least three local facilities have such equipment would have been available to a new entrant); *Springfield Terminal Rwy. Co. v. Canadian Pacific Limited*, 133 F.3d 103 (1st Cir. 1997) (finding 10% insufficient); *United States v. Empire Gas Corp.*, 537 F.2d 296 (8th Cir. 1976), *cert. denied*, 429 U.S. 1122 (1977) (finding 47–50% insufficient). *But see* *Twin City Sportservice, Inc. v. Charles O. Finley & Co.*, 676 F.2d 1291 (9th Cir. 1982) (finding 24% sufficient).

107. JACOBSON, *supra* note 73, at 311.

108. *Id.* at 313.

109. *Id.* at 232–36.

110. *Id.* at 236–38.

111. *See* Robert Pitofsky, *Challenges of the New Economy: Issues at the Intersection of Antitrust and Intellectual Property*, 68 ANTITRUST L.J. 913, 915–16 (2001) (addressing the relationship between established antitrust principles and the growing high-tech sector of the economy).

112. JACOBSON, *supra* note 73, at 237.

113. *See* *United States v. Grinnell Corp.*, 384 U.S. 563, 571 (1966) (stating “that such countervailing benefits as are said to flow from that anticompetitive conduct are either pretextual or outweighed by their anticompetitive harms”).

114. *Multistate Legal Studies v. Harcourt Brace Jovanovich*, 63 F.3d 1540, 1550 (10th Cir. 1995).

115. Joseph Palenchar, *Smartphone Users Up 60%: ComScore, as Android Overtakes Apple*, THIS WEEK IN CONSUMER ELECTRONICS (Feb. 8, 2011), <http://www.twice.com/article/463>

market share, its position in the market is still relatively fragile given that its market share is composed of multiple smartphone manufacturers that must compete with the entire smartphone industry.¹¹⁶ This is in contrast to Apple, which is the largest smartphone device manufacturer and controls the second largest mobile OS.¹¹⁷ If Google is not given the opportunity to use RAND-encumbered patents for cross-licensing, it may be severely damaged in the ongoing war against its partners such as HTC, Motorola, and Samsung. Damaging these companies through litigation such that they are unable to successfully compete against Apple and RIM may be anticompetitive to the smartphone industry and could harm consumers by increasing prices, decreasing innovation, diminishing quality, and threatening the only open-source mobile platform.¹¹⁸

Google may also convince a court that holding dominant smartphone companies to non-traditional or more aggressive RAND licensing terms has procompetitive benefits. Research conducted by independent organizations indicates that Apple's products and patents already dominate the electronics industry. A report by Nielsen in July 2011 shows that Apple is the largest smartphone manufacturer, with a substantial lead that is twice that of the leading Android smartphone manufacturer, HTC.¹¹⁹ Apple's patent portfolio also reigns over the electronics industry. The 2011 IEEE Patent Power Scorecard ranked Apple's patent portfolio the most powerful in the electronics category.¹²⁰ Courts should be aware that Apple might exploit a licensor's RAND commitments in an attempt to gain unfairly favorable licensing rates. Allowing Apple to easily obtain inexpensive licensing rates to critical technical standards may transform Apple from an already powerful opponent to an unstoppable competitor, which will ultimately harm consumer welfare in the smartphone market.

650-Smartphone_Users_Up_60_ComScore.php (stating "[t]he number of smartphone users grew 60% from the end of 2009 to the end of 2010").

116. Kellogg, *supra* note 78.

117. *Id.*

118. Submission of Google Inc. in Response to the Commission's September 21, 2011 Request for Written Submissions on the Issues of Remedy, the Public Interest and Bonding in Investigation, *In the Matter of Certain Personal Data and Mobile Communication Devices and Related Software*, Inv. No. 337-TA-710, (USITC Oct. 6, 2011).

119. Kellogg, *supra* note 78 (showing that Apple holds 28% of the smartphone manufacturing market share; HTC holds 14% of the smartphone manufacturing market share).

120. Patrick Thomas & Anthony Breitzman, *Apple Has the Most Powerful Patent Portfolio in Consumer Electronics*, IEEE SPECTRUM (Nov. 2011), <http://spectrum.ieee.org/at-work/innovation/apple-has-the-most-powerful-patent-portfolio-in-consumer-electronics/0>.

Google should be able to make a strong case that it intends to neutralize patent infringement, reduce litigation costs, and conserve resources that could otherwise be used to drive technical innovations when it cross-licenses RAND-encumbered patents. Furthermore, courts should be open to Google's cross-licensing strategy as an appropriate means to balance RAND licensing commitments with healthy competition on the merits.

4. *Section 5 of the Federal Trade Commission Act*

The Federal Trade Commission ("FTC"), created in 1914, is charged with promoting consumer protection and eliminating and preventing what regulators perceive to be harmful and anticompetitive business practices.¹²¹ The FTC enforces antitrust laws through Section 5 of the FTC Act. Section 5 prohibits "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce."¹²² The appropriate reach of the "unfair methods of competition" language in Section 5 is the subject of much debate.¹²³

The Supreme Court held in *FTC v. Sperry & Hutchinson Co.* that Section 5 "empower[s] the Commission to define and proscribe an unfair competitive practice, even though the practice does not infringe either the letter or the spirit of the antitrust laws."¹²⁴ In 1986, the Court more specifically and directly referenced the "spirit" of Section 5, stating that Section 5 "encompass[es] not only practices that violate the Sherman Antitrust Act and other antitrust laws, . . . but also practices that the Commission determines are against public policy for other reasons."¹²⁵ Included among the practices that are against public policy is conduct that is "unjust, inequitable or dishonest," conduct that is "contrary to good morals," and conduct that involves "deception, bad faith, fraud or oppression."¹²⁶ Therefore even if courts do not find Google's cross-licensing strategy in violation of Section 2 of the Sherman Antitrust Act, Google may still face antitrust liability under Section 5 of the FTC Act.

121. *About the Federal Trade Commission*, FED. TRADE COMM'N, <http://www.ftc.gov/ftc/about.shtm> (last visited Dec. 18, 2011).

122. 15 U.S.C. § 45(a)(1) (2006).

123. Thomas B. Leary, *A Suggestion for the Revival of Section 5*, ANTITRUST SOURCE, Feb. 2009, at 1.

124. *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 239 (1972).

125. *FTC v. Ind. Fed'n of Dentists*, 476 U.S. 447, 454 (1986).

126. Statement of the Commission at 2, *In the Matter of Negotiated Data Solutions, LLC*, (F.T.C. 2008) (No. 051-0094) (quoting *FTC v. Ind. Fed'n of Dentists*, 467 U.S. 447, 454 (1986)).

The FTC Act's ability to prevent Google from implementing a RAND-encumbered patent cross-licensing strategy could be justified under what is often referred to as the "gap-filling" rationale. "Gap-filling" refers to situations that satisfy the economic requirements of antitrust, but fail one of the legal elements of Section 1 (e.g. the "agreement" requirement) or Section 2 (e.g., the "monopoly power" element).¹²⁷ Both case law and legislative history support the FTC's ability to stop anticompetitive behavior under a "gap-filling" framework.¹²⁸ However, some commentators warn that the FTC should proceed with caution when enforcing Section 5 using a "gap-filling" theory.¹²⁹

Since 1995, the Commission has initiated complaints alleging market-wide anticompetitive effects in four standard-setting cases.¹³⁰ Of these four, commentators generally agree that the FTC employed a "gap-filling" theory for halting anticompetitive behavior in only one instance.¹³¹ *In the Matter of Negotiated Data Solutions LLC (N-Data)* highlights important issues and

127. Susan A. Creighton, *Appropriate Role(s) of Section 5*, ANTITRUST SOURCE, Feb. 2009, at 3.

128. *See Nat'l Petroleum Refiners Ass'n v. FTC*, 482 F.2d 672, 684–85 (D.C. Cir. 1973) ("The FTC's charter to prevent unfair methods of competition is tantamount to a power to scrutinize and to control, subject of course to judicial review, the variety of contracting devices and other means of business policy that may contradict the letter or the spirit of the antitrust law. . . . And while the boundaries of the Commission's power to proscribe conduct it deems harmful to the consumer or to competition are not clearly defined, they are indeed expansive." (citations omitted)); *see also* *Am. Fin. Servs. Ass'n v. FTC*, 767 F.2d 957, 965 (D.C. Cir. 1985) (citing Federal Trade Commission Act, ch. 311, § 5, 38 Stat. 717, 719 (1914) (codified as amended at 15 U.S.C. § 45(a)(1) (2006))). At the time of this original delegation, Congress expressly declined to enact a statutory definition of the term "unfair methods of competition." *See* S. REP. NO. 63-597, at 13 (1914) ("The committee gave careful consideration to . . . whether it would attempt to define the many and variable unfair practices which prevail in commerce . . . or whether it would . . . leave it to the commission to determine what practices were unfair. It concluded that the latter course would be better."). The House Conference Report outlines Congress's rationale: It is impossible to frame definitions that embrace all unfair practices. There is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again. If Congress were to adopt the method of definition, it would undertake an endless task. It is also practically impossible to define unfair practices so that the definition will fit business of every sort in every part of this country. Whether competition is unfair or not generally depends upon the surrounding circumstances of the particular case. What is harmful under certain circumstances may be beneficial under different circumstances. H.R. REP. 63-1142, at 19 (1914) (Conf. Rep.).

129. *See* Creighton, *supra* note 127; Richard Dagen, *Rambus, Innovation Efficiency, and Section 5 of the FTC Act*, 90 B.U. L. Rev. 1479, 1541 (2010).

130. *Rambus Inc. v. FTC*, 522 F.3d 456 (D.C. Cir. 2008); *In the Matter of Dell Computer Corp.*, 121 F.T.C. 616 (1996); *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094); *Union Oil Co. of Cal.* (F.T.C. 2003) (No. 011-0214).

131. Creighton, *supra* note 127.

considerations that may be helpful in determining whether modifying RAND agreements by Google falls within the scope of Section 5.¹³²

Fifteen years before the FTC's complaint in *N-Data*, the IEEE authorized an 802.3 Working Group to develop a new, faster Ethernet standard commonly referred to as "Fast Ethernet."¹³³ In 1994, National Semiconductor Corporation ("National"), a member company actively involved in the 802.3 Working Group, proposed that its "autonegotiation" technology (known as "NWay") be incorporated into the Fast Ethernet standard.¹³⁴ National had filed a patent application for the NWay technology in 1992.¹³⁵ National promised that if its NWay technology were chosen, National would license NWay to any requesting party for a one-time fee of \$1000 and that licenses would be made available on a nondiscriminatory basis.¹³⁶ NWay was subsequently adopted into the Fast Ethernet standard, and National successfully obtained patents on the NWay technology.¹³⁷ National assigned the NWay patent rights to Vertical Networks in 1998, and Vertical Networks was informed that the NWay patents may be encumbered by a licensing agreement promising a license for a one-time fee of \$1000 made on a nondiscriminatory basis.¹³⁸

In the spring of 2002, Vertical Networks wrote a letter to the IEEE indicating its commitment to licensing, but amended the language of the licensing agreement to read "on a non-discriminatory basis and on reasonable terms and conditions including its then current royalty rates."¹³⁹ The letter concluded by claiming that, "the assurances provided in this letter supersede any assurances provided by National Semiconductor Corporation relevant to the above-identified patents."¹⁴⁰ Around the same time the letter was sent to the IEEE, Vertical Networks sent letters to 64 target companies demanding licensing fees on a per unit basis for 802.3-compliant auto-negotiating products rather than the original \$1000 one-time fee promised in 1994.¹⁴¹ Vertical Networks rejected offers from targeted companies that attempted to accept the original \$1000 licensing offer.¹⁴² Around November 2003, Vertical

132. See *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

133. Complaint at 2, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

134. *Id.*

135. *Id.*

136. *Id.* at 3.

137. *Id.*

138. *Id.*

139. *Id.* at 5.

140. *Id.*

141. *Id.*

142. *Id.* at 6.

Networks assigned the NWay patents to N-Data.¹⁴³ From 2003 to 2008, N-Data continued demanding licensing fees for the NWay patents on a per-unit basis.¹⁴⁴ In September of 2008, the FTC issued a complaint against N-Data for engaging in acts and practices that constitute unfair methods of competition in or affecting commerce in violation of Section 5 of the FTC Act.¹⁴⁵

Following the complaint against N-Data, three out of five FTC commissioners held that N-Data had breached a prior licensing commitment to a standard-setting body.¹⁴⁶ The majority, in recognizing that standards displace competition, stated that bad faith or deceptive behavior may also undermine competition in an entire industry, raise prices to consumers, and reduce choices.¹⁴⁷ The majority considered this breach harmful to SDOs and the standard-developing process and a violation of Section 5 of the FTC Act.¹⁴⁸

The majority's conclusion is considered "gap-filling" because N-Data lacked the requisite elements needed for liability under Section 2 of the Sherman Act. Specifically, N-Data likely did not have the monopoly power within a properly defined relevant market.¹⁴⁹ Similarly, as discussed in Part II.B, *supra*, Google's Android operating system may have a market share below what is required for either an unlawful monopolization or attempted monopolization claim. However, as in the *N-Data* case, despite Google's relatively low market share, it may still be open to a potential investigation under the broad powers of the FTC Act. The *N-Data* case raises important questions about whether the FTC could intervene against Google for using its RAND-encumbered patents to gain cross-licensing rights to non-essential patents.

143. *Id.*

144. *Id.*

145. *Id.* at 8.

146. Statement of the Federal Trade Commission at 1, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

147. *Id.* at 2.

148. *Id.* at 1 (stating "[b]ut if N-Data's conduct became the accepted way of doing business, even the most diligent standard-setting organizations would not be able to rely on the good faith assurances of respected companies").

149. Dissenting Statement of Chairman Majoras at 2, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094) ("[D]espite ongoing licensing efforts by National's successors, Vertical and N-Data, only one company paid materially more than the originally-quoted \$1,000 for rights to the NWay technology. Most users evidently have preferred to infringe, running the risk of presumably minimal patent damages that they might face at the outcome of litigation.").

There are a few important differences between the *N-Data* case and Google's cross-licensing strategy. First, Google's RAND-encumbered patents purchased from Motorola Mobility are likely not bound by an explicitly defined fee or royalty rate. The essential patents Motorola sold to Google are likely only bound by an agreement that states "reasonable and nondiscriminatory" with no specific definition of what licensing terms are considered reasonable or unreasonable.¹⁵⁰ This is unlike Vertical Networks' and N-Data's situations where the previous patent owner, National, explicitly agreed to a royalty-free license with a one-time fee of \$1,000.¹⁵¹ Because Google's essential patents are likely only encumbered by a general RAND licensing commitment, Google should have a strong argument that using its patents to force cross-licensing arrangements still falls within the definition of a reasonable and nondiscriminatory licensing practice.

The second difference is that the majority in *N-Data* appeared motivated to rule against N-Data in response to behavior that the court viewed as harmful to consumers.¹⁵² In contrast, in Google's situation, consumer harm does not seem as obvious. Vertical Networks' original change to the licensing agreement in 2002 was motivated primarily by the company's financial struggles resulting from the "dot-com" bust.¹⁵³ However, Google would not be implementing its cross-licensing strategy as a means for generating a revenue stream. Instead, Google finds itself in an active field of expensive litigation and is motivated to use its patents, including its RAND-encumbered patents, to bring down the entire smartphone industry's litigation firepower and deter anti-competitive threats from competitors.¹⁵⁴ It is not immediately obvious that allowing Google to use its RAND-encumbered patents for cross-licensing is more harmful to consumer welfare

150. See, e.g., *supra* note 49 (showing that none of the RAND licensing agreements from the ITU, ETSI, IEEE-SA, and the JEDEC provide a specific definition of what licensing terms are considered reasonable or unreasonable).

151. Complaint at 3, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

152. Statement of the Federal Trade Commission at 2–3, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094) ("[W]e also have no doubt that the type of behavior engaged in by N-Data harms consumers. The process of establishing a standard displaces competition; therefore, bad faith or deceptive behavior that undermines the process may also undermine competition in an entire industry, raise prices to consumers, and reduce choices. We have previously noted that '[i]ndustry standards are widely acknowledged to be one of the engines driving the modern economy.' Conduct like N-Data's—which undermines standard-setting—threatens to stall that engine to the detriment of all consumers.").

153. Complaint at 5, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

154. See Page, *supra* note 32.

than allowing the smartphone patent litigation to continue at its current rampant pace. Google, if faced with a Section 5 complaint from the FTC, could respond with powerful arguments that their cross-licensing approach is not anticompetitive since reducing the volume of litigation will ultimately improve consumer welfare in the smartphone industry.

In her dissent, former FTC Chairman Deborah Majoras fails to find that the actions of N-Data were an “unfair method of competition” under Section 5.¹⁵⁵ Her dissent takes issue with the majority’s holding, in part, because she finds that N-Data’s renegotiation of its licensing terms could have been motivated by an independent business reason and not “coercive” and “oppressive” conduct.¹⁵⁶ In addition, Majoras states that a motivation to strike better licensing terms alone should not be considered a competition-related offense.¹⁵⁷ Chairman Majoras continues, “[I]f the majority’s theory is that the evasion of contractual price constraints triggers liability under Section 5 without a concurrent determination that the conduct violates the Sherman Act, then we are headed down a slippery slope.”¹⁵⁸ The Chairman’s comments might be a signal that some members of the FTC Commission would be unwilling to intervene under a “gap-filling” Section 5 theory if Google can demonstrate that its cross-licensing strategy has legitimate business goals and is not motivated by anticompetitive conduct.

Chairman Majoras also disagrees with treating large, sophisticated computer manufacturers as “consumers” and has difficulty in using the FTC’s authority to intervene in this type of commercial transaction.¹⁵⁹ Majoras agrees that the FTC has the authority under Section 5 to protect small businesses, but this power is judiciously applied to entities that lack the resources and, in some cases, the experience or understanding to defend themselves.¹⁶⁰ Although the majority fails to find this argument persuasive,¹⁶¹ it raises the issue of whether the FTC should involve itself in the smartphone patent war when its principal mission is focused on preventing substantial consumer injury. Companies at the front lines of the smartphone patent war,

155. Dissenting Statement of Chairman Majoras at 1, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094).

156. *Id.* at 4.

157. *Id.*

158. *Id.*

159. *Id.* at 5.

160. *Id.*

161. Statement of the Federal Trade Commission at 3, *In the Matter of Negotiated Data Solutions, LLC* (F.T.C. 2008) (No. 051-0094) (“The dissent would distinguish those cases on the ground that the businesses here are all ‘large, sophisticated computer manufacturers’ who are able to protect themselves. There is no basis for that distinction in Section 5.”).

such as Apple, Google, and Microsoft, are among the largest, most sophisticated, and well-funded entities in America.¹⁶²

In the current smartphone environment, Google may escape antitrust liability due to the fact that its market share is below the necessary critical value. However, monopoly power is apparently not relevant to whether or not intervention is justified based on a “gap-filling” theory under Section 5 of the FTC Act.¹⁶³ Google may therefore have a more difficult time avoiding an investigation by the FTC given its broad reach under the “gap-filling” rationale. However, Google can raise arguments capable of striking down the FTC’s justifications for why it should have the right to prevent Google from using its RAND-encumbered patents for cross-licensing rights to its competitor’s non-essential patents.

III. CONCLUSION

Forcing smartphone competitors to cross-license their non-essential patents in exchange for RAND-encumbered patents may be a potent strategy for attenuating the fierce litigation raging in the smartphone patent war. However, successfully deploying this cross-licensing strategy requires an understanding of the legal issues that might stand in the way of Google, which is seeking new ways to protect smartphone manufacturers implementing the Android operating system. This Note detailed reasons why this cross-licensing tactic may or may not be acceptable under a reasonable and nondiscriminatory licensing commitment. In addition, this Note discussed some major antitrust issues Google may face under Section 2 of the Sherman Act and Section 5 of the FTC Act.

SDOs promote advancements in technology and enhance consumer welfare. Courts should therefore be supportive of SDOs, especially SDOs requiring its members to abide by RAND licensing commitments. However, rigid definitions of “reasonable” and “nondiscriminatory” are unsuitable for licensing essential patents in the smartphone industry. Therefore before a court accepts Google’s strategy of cross-licensing RAND-encumbered patents, the court must consider multiple factors to determine whether the proposed licensing arrangement accords with an SDO’s reasonable and nondiscriminatory requirements.

With the smartphone market demonstrating consistent growth, it is in the interest of many consumers to have a healthy, competitive smartphone

162. *Fortune 500*, *supra* note 54 (Apple: #35, Microsoft: #38, Google: #92).

163. Dagen, *supra* note 129, at 1536.

ecosystem.¹⁶⁴ Courts should therefore encourage new approaches to avoiding retaliatory litigation so that these companies can focus on research, development, and innovation. Although some of Google's competitors may claim that its behavior is anticompetitive, a court needs to consider whether Google's cross-licensing strategy has procompetitive benefits that outweigh the anticompetitive effects of the current volume of smartphone patent litigation. A cross-licensing strategy involving RAND-encumbered patents may be an appropriate means to promote healthy industry competition while still upholding RAND licensing commitments.

164. *Generation App: 62% of Mobile Users 25–34 own Smartphones*, NIELSEN WIRE (Nov. 3, 2011), http://blog.nielsen.com/nielsenwire/online_mobile/generation-app-62-of-mobile-users-25-34-own-smartphones.

GENE PATENTS: BALANCING THE *MYRIAD* ISSUES CONCERNING THE PATENTING OF NATURAL PRODUCTS

Samantak Ghosh[†]

Thomas Jefferson wrote about “the difficulty of drawing a line between the things which are worth to the public the embarrassment of an exclusive patent, and those which are not.”¹ The controversy over gene patents is a case in point. As a widely publicized case on gene patents makes its way up the courts, it has exposed the difficulty courts are having in determining the patentability of genes.² So far, two judges have found genes to be patentable and two have found them patent-ineligible.³ This is not surprising given that the doctrine on the patentability of products of nature is far from coherent. Indeed, some have described the doctrine as “a source of confusion rather than a pillar of instruction.”⁴ However, even apart from the legal issues, gene patents are controversial because genes embody our hereditary material.

The patentability of genes cannot be resolved in isolation from the patentability of other products of nature. The Federal Circuit recently attempted to extricate the doctrine from its incoherency in *Association for Molecular Pathology v. United States Patent & Trademark Office* (“AMP”), but without much success.⁵ The divided court found genes patentable with the judges diverging significantly on the patentability standards for natural

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1. *Letter from Thomas Jefferson to Isaac McPherson (Aug. 13, 1813)*, in 6 WRITINGS OF THOMAS JEFFERSON 181 (H. Washington ed. 1854), available at http://press-pubs.uchicago.edu/founders/documents/a1_8_8s12.html.

2. *Ass’n for Molecular Pathology v. U.S. Patent and Trademark Office (AMP)*, 653 F.3d 1329 (Fed. Cir. 2011).

3. Judge Sweet of the Southern District of New York and Judge Bryson of the Federal Circuit are opposed to the idea of patenting genes while the *AMP* majority, Judge Lourie and Judge Moore support gene patents.

4. Richard Gipstein, *The Isolation and Purification Exception to the General Unpatentability of Products of Nature*, 4 COLUM. SCI. & TECH. L. REV. 2 (2003) (quoting Matthew Erramouspe, *Staking Patent Claims on the Human Blueprint: Rewards and Rent-Dissipation Races*, 43 UCLA L. REV. 961, 985 (1996)).

5. *See AMP*, 653 F.3d 1329.

products.⁶ Writing for the majority, Judge Lourie emphasized the structural difference, while Judge Moore (concurring), and Judge Bryson (dissenting), required a claimed product to have a different structure and new utility compared to its native form to be patent-eligible.⁷ This Note agrees that mere structural difference, regardless of its triviality, is not sufficient to establish patentability. But, even the dissent's and concurrence's articulation of the test fails to capture the essence of transformation in a product because it confuses the function of a molecule with its utility. The distinction between function and utility is important and might explain some of the analytical inconsistencies plaguing this doctrine. It also explains why despite adopting the same test, Judge Moore and Judge Bryson come to different conclusions.⁸

While function and properties are inherent characteristics of a molecule, utility is the exploitation of these characteristics by man to serve his purpose. Man may find a new use of an old article. However, the new utility need not reflect a change in the product. On the other hand, at the molecular level, there is, in general, a stronger correlation between the structure and function of a molecule. Rather than utility, molecular properties (including function) are a better indicator of the transformation of natural products to artificial products. The relationship between structure and properties is, however, not always linear. Sometimes small structural changes can profoundly affect the properties of a product while at other times structurally different products may have similar properties. In order to accommodate this complex interrelationship, this Note proposes using a sliding scale of structure and properties to discern the patentability of a product derived from nature.⁹ Applying this test to genes, leads to the conclusion that genes should not be patented.

Part I explains the relevant science and technology behind gene patents, and Part II reviews the case law on the patentability of products of nature. Part III discusses the Federal Circuit's opinion in *AMP* and demonstrates the shortcomings of the standard adopted by the court.¹⁰ Finally, this Note argues that although product patents should not be granted on genes,

6. *Id.* It was a two-one decision in favor of patent-eligibility of genes. *Id.* at 1333.

7. *Id.* at 1351; *id.* at 1367 (Moore J., concurring); *id.* at 1378 (Bryson J., dissenting).

8. *Id.* at 1366 (Moore J., concurring); *id.* at 1371 (Bryson J., dissenting).

9. Because this test prevents a patentee from getting patents by making insignificant changes to the natural product, it aligns well with the principles outlined by the recent Supreme Court ruling in *Mayo Collaborative Services v. Prometheus Laboratories*. In *Mayo*, the Court required some inventive contribution from the patentee claiming an application of a natural phenomenon. *See Mayo Collaborative Servs. v. Prometheus Labs.*, 132 S. Ct. 1289, 1289 (2012).

10. *AMP*, 653 F.3d at 1329.

method patents covering the new utility of isolated gene sequences could serve the goal of promoting the innovation and commercialization of these inventions.

I. CHEMISTRY AND BIOLOGY OF DNA

Confronted with the complicated issue of patentability of purified adrenaline in *Parke-Davis & Co. v. H.K. Mulford Co.*, Judge Learned Hand made the following observation: “I cannot stop without calling attention to the extraordinary condition of the law which makes it possible for a man without a knowledge of even the rudiments of chemistry to pass upon such questions as these.”¹¹ Just as Judge Hand had to learn the chemistry of adrenaline to determine the patentability of purified adrenaline, an understanding of the basic molecular biology of DNA is crucial to appreciating the issues presented in the debate over gene patents. Hence, a discussion of the relevant science, however “rudimentary” it may be, precedes the legal analysis.

DNA, or deoxyribonucleic acid, is the hereditary material in most organisms.¹² Proteins wrap around the DNA to form a compact structure called chromosomes.¹³ The building blocks of the polymeric DNA are four molecules, called nucleotides, which are made of nucleobases: adenine(A), thymine(T), guanine(G), and cytosine(C).¹⁴ These nucleotides are strung together using covalent bonds called phosphodiester bonds to form the polymer (polynucleotide) DNA.¹⁵ There are two strands of these DNA polymers intertwined in a helical manner in each chromosome.¹⁶ This is achieved by the nucleotides of each strand pairing with a complementary nucleotide of the other strand through weak hydrogen bonds, which are non-covalent forces of attraction.¹⁷ In the DNA, adenine(A) always pairs with thymine(T), and guanine(G) pairs with cytosine(C).¹⁸

11. *Parke-Davis & Co. v. H.K. Mulford Co.*, 189 F. 95, 115 (S.D.N.Y. 1911).

12. *What is DNA?*, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/handbook/basics/dna> (last visited Feb. 7, 2012).

13. *What is a Chromosome?*, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/handbook/basics/chromosome> (last visited Feb. 7, 2012).

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *A Brief Guide to Genomics*, NAT'L HUMAN GENOME RES. INST., <http://www.genome.gov/18016863> (last updated Oct. 19, 2011).

A gene is a sequence of these nucleotides, which directs the synthesis of proteins.¹⁹ This involves a number of steps. First, the DNA sequence is replicated into the form of another polymeric molecule called RNA (also called pre-mRNA).²⁰ This is done by unwinding the DNA strands, followed by pairing of the DNA nucleobases with complementary RNA nucleotides.²¹ The RNA nucleotides have some variation in structure. For instance, while the sugar sub-unit of the nucleotides in DNA consists of deoxy-ribose, those in the RNA contain ribose sugars.²² Also, instead of the thymine(T) nucleobases, RNAs contain uracil(U), which pairs with adenine(A).²³ These monomeric units called ribonucleosides polymerize to form the RNA.²⁴ Once this RNA is formed, enzymes chop off certain portions (introns) of this molecule and combine the remaining portions (exons) into a molecule called messenger RNA (“mRNA”).²⁵ Because of this process, called splicing, the mRNA no longer contains the entire nucleotide sequence of the gene.²⁶ This mRNA then directs the synthesis of proteins with each sequence of three nucleotides (triplet code) coding for one amino acid.²⁷ The amino acids are strung together into the polymeric structure called proteins.²⁸

The nucleotide sequence in a gene—the genetic sequence—is important for a number of reasons. Sometimes, due to alterations in these sequences (mutations), there is a change in the corresponding mRNA and hence, a change in the protein produced by the cell. This change may manifest itself in many ways including diseases such as cancer.²⁹ As a result, finding a correlation between mutations and diseases could have significant diagnostic and therapeutic value. One of the ways scientists achieve this correlation is through association studies, which identify the sequence of DNA in genes of

19. *How Do Genes Direct the Production of Proteins?*, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/handbook/basics/howgeneswork/makingprotein> (last visited Feb. 20, 2012).

20. *Id.*

21. *Id.*

22. RNA, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/glossary=rna> (last visited Feb. 20, 2012).

23. *Id.*

24. *Id.*

25. *Splicing*, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/glossary=splicing> (last visited Feb. 20, 2012).

26. *Id.*

27. *How Do Genes Direct the Production of Proteins?*, *supra* note 19.

28. Suzanne Clancy & William Brown, *Translation: DNA to mRNA to Protein*, SCITABLE, <http://www.nature.com/scitable/topicpage/translation-dna-to-mrna-to-protein-393> (last visited Feb. 7, 2012).

29. *See A Brief Guide to Genomics*, *supra* note 18.

a healthy person and compare it to those of diseased patients.³⁰ Scientists can also try to determine the sequence of the mRNA and identify the mutations in it. This can be done by artificially copying the mRNA into complementary DNA sequences called cDNA.³¹ These cDNA sequences can then be potentially used to screen mRNAs or DNAs in other patients for potential mutations.³² They may also be inserted into the chromosomes of bacteria to drive the synthesis of proteins in these organisms, a process called molecular cloning.³³

Gene patents typically claim the original DNA sequence that initiates the production of pre-mRNA. These patents prevent someone from extracting that particular DNA sequence from the cell.³⁴ Thus, gene patents effectively exclude others from further investigating the gene, whether it is for detecting more disease-correlating mutations or for developing therapeutics. In fact, any application that involves isolating the genes from the cells would be preempted.

II. THE PATENTABILITY REQUIREMENTS AND THE “PRODUCT OF NATURE” DOCTRINE

The Constitution authorizes Congress “[t]o Promote the progress of Science and useful Arts by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.”³⁵ In authoring the first Patent Act, Thomas Jefferson defined the subject matter for patents as “any new and useful art, machine, manufacture, or composition of matter, or any new or useful improvement [thereof].”³⁶ Subsequent patent statutes passed in 1836, 1870, and 1874, maintained this

30. See *Genome-wide Association Studies*, NAT’L HUMAN GENOME RES. INST., <http://www.genome.gov/20019523> (last updated Sept. 16, 2011).

31. See *Complementary DNA*, GENETICS HOME REFERENCE, <http://ghr.nlm.nih.gov/glossary=complementarydna> (last visited Feb. 6, 2012).

32. See Joseph DeRisi et al., *Use of a cDNA Microarray to Analyse Gene Expression Patterns in Human Cancer*, 14 NATURE GENETICS 457 (1996).

33. See S.B. PRIMROSE & R.M. TWYMAN, PRINCIPLES OF GENETIC MANIPULATION AND GENOMICS 1 (7th ed. 2006).

34. Gene patents, however, do not protect the underlying sequence information in the sense that they do not prevent someone from analyzing the sequence of the isolated DNA (i.e., the biological information that the DNA represents) as it is represented on a piece of paper or a computer screen. U.S. PATENT & TRADEMARK OFFICE, DEP’T OF COMMERCE, UTILITY EXAMINATION GUIDELINES 1093 (2001).

35. U.S. CONST. art. I, § 8, cl. 8.

36. See *Diamond v. Chakrabarty*, 447 U.S. 303, 308–09 (1980) (quoting Patent Act of Feb. 21, 1793, § 1, 1 Stat. 319).

language.³⁷ In 1952, when Congress recodified the Patent Act, it chose to retain this language in § 101 and added §§ 102 and 103, which essentially codified the existing common law requirements of novelty and nonobviousness.³⁸

Section 101 of the 1952 Patent Act states: “Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter . . . may obtain a patent therefor.”³⁹ Thus, the statute explicitly requires the patented invention be “new” and “useful.” However, it is unclear, what limitations, if any, are imposed on the phrase “invents or discovers” or on the categories of patentable subject matter—“process, machine, manufacture, or composition.”⁴⁰ Courts have nevertheless placed certain limitations on patentable subject matter, which have evolved in common law over the last 150 years.⁴¹ Courts have declared “laws of nature, physical phenomena, and abstract ideas” unpatentable.⁴²

The “product of nature” doctrine evolved from the early common law rule against patenting natural phenomena.⁴³ According to this doctrine, a naturally occurring product cannot be patented.⁴⁴ As with any common law doctrine, establishing the doctrine is only a first step. The difficulty is in working out the details of the doctrine and its scope, without legislative guidance. Unfortunately, as the following line of cases demonstrates, the application of the judicial doctrine has been inconsistent and unclear. As a result, the main debate surrounding gene patents is whether they are excluded from patent-eligibility based on this doctrine.

One of the earliest cases restricting the patentability of natural products was *Ex parte Latimer*.⁴⁵ In this case, the patent applicant had developed a method for extracting long fibers from the needles of Australian pine and claimed a patent for both the product and the process of obtaining it.⁴⁶ Commissioner Hall pointed out that plant fiber was a well-known material and whether obtained from leaves, stalks, or wood, was “essentially the same

37. *See id.*

38. *See id.*; John M. Webb, *The Changing Standard of Patentable Invention: Confusion Compounded*, 55 MICH. L. REV. 985, 990–91 (1957).

39. 35 U.S.C. § 101 (2006).

40. *Id.*

41. *See, e.g., Chakrabarty*, 447 U.S. at 309.

42. *Id.*

43. *See id.* at 308–10.

44. *See id.*

45. *Ex parte Latimer*, 1889 Dec. Comm’r Pat. 123.

46. *Id.* at 125.

thing, and possesse[d] the same construction.”⁴⁷ The difference in length, strength, and fineness of the fiber was not due to the removal process but due to the processes of nature.⁴⁸ Thus, Commissioner Hall found that the fiber was “a natural product and can no more be the subject of a patent in its natural state when freed from its surroundings than wheat which has been cut by a reaper.”⁴⁹

Although Commissioner Hall’s opinion in *Ex parte Latimer* had some effect on the practices of the patent office, it took some time before any higher court explicitly adopted the “product of nature” doctrine.⁵⁰ In fact, Judge Learned Hand dealt a serious blow to the doctrine when he held purified adrenaline patentable in *Parke-Davis & Co. v. H.K. Mulford Co.*⁵¹ In doing so, he asserted that even if the claimed products were “merely an extracted product without change, there is no rule that such products were not patentable.”⁵² He found the applicant’s adrenaline “a new thing commercially and therapeutically.”⁵³ Referring to the commercial and therapeutic success of the product, Judge Hand said, “[t]he line between different substances and degrees of the same substance is to be drawn from the common usages of men [rather] than from nice considerations of dialectic.”⁵⁴ In this case, Judge Hand found that there “was a distinction not in degree, but in kind.”⁵⁵

However, Judge Hand’s “purification” doctrine did not survive unscathed for too long. In 1928, the Third Circuit in *General Electric Co. v. De Forest Radio Co.*, deemed purified tungsten unpatentable.⁵⁶ The court noted that pure tungsten was chemically and physically different from native

47. *Id.*

48. *Id.*

49. *Id.* at 127.

50. See K.P. McElroy, *Notes and Correspondence: Elements in Patent Law*, 21 J. INDUS. & ENGINEERING CHEMISTRY 6, 608–09 (1929). Although *Ex parte Latimer* had an impact on the USPTO’s practices, none of the major late nineteenth century and early twentieth century cases that dealt with the issue of natural products mentioned it. *Diamond v. Chakrabarty*, decided in 1980, was one of the first major cases that cited *Ex parte Latimer*.

51. See *Parke-Davis & Co. v. H.K. Mulford Co.*, 189 F. 95, 115 (S.D.N.Y. 1911).

52. *Id.* Interestingly, the cases that Judge Hand cited to, in holding that purification of the product was valid ground for granting the patent, both involved purification of synthetic substance not natural products. Judge Hand cited *Kuehnmsted v. Farbenfabriken of Elberfeld Co.*, 179 F. 701 (7th Cir. 1910), and *Union Carbide Co. v. American Carbide Co.*, 181 F. 106 (2d Cir. 1910). While the former involved a patent on purified aspirin, the latter validated the patent for crystalline calcium carbide over the amorphous form mentioned in the prior art.

53. *Parke-Davis*, 189 F. at 115.

54. *Id.*

55. *Id.* at 103.

56. See *General Electric Co. v. De Forest Radio Co.*, 28 F.2d 641, 648 (3d Cir. 1928).

tungsten ore.⁵⁷ Tungsten existed in nature as brittle tungsten oxide while pure tungsten derived from the oxide was ductile and had enhanced utility.⁵⁸ However, the court asserted that the patentee merely discovered “the natural qualities of pure tungsten”; he neither created pure tungsten nor did he create its characteristics.⁵⁹

Similarly, in *In re Merz*, the Court of Customs and Patent Appeals denied patents for ultramarine and went on to outline the contours of the purification doctrine as follows:

We are in agreement with the tribunals below in their holdings that while appellant may be entitled to a patent on a method for purifying an ultramarine either artificial or natural, he is not entitled to a patent on the article which after being produced has a greater degree of purity than the product produced by former methods. This general rule is a well-settled one, but like all other rules it has an exception. The exception is that if the process produces an article of such purity that it differs not only in degree but in kind it may be patentable.⁶⁰

As subsequent cases have revealed, it is not always easy to determine whether the purification is a matter of degree or kind. In the years following *Merz*, courts have upheld the patentability of Vitamin K₁⁶¹ but denied patents on extracts containing chlorophyll,⁶² extracts from muskrat glands,⁶³ Vitamin C,⁶⁴ and glucoside isolated from red quill.⁶⁵

The Supreme Court revisited the issue in *Funk Brothers Seed Co. v. Kalo Inoculant Co.* and found a combination of naturally occurring non-inhibitive bacteria to be patent-ineligible.⁶⁶ The Court pointed out that the patentee did not “create a state of inhibition or of non-inhibition in the bacteria.”⁶⁷ These qualities were natural.⁶⁸ The Court accepted that there were advantages to the

57. *See id.* at 642–43.

58. *See id.*

59. *Id.* at 643.

60. *In re Merz*, 97 F.2d 599, 600–01 (C.C.P.A. 1938).

61. Ruloff F. Kip, Jr., *The Patentability of Natural Phenomena*, 20 GEO. WASH. L. REV. 371, 378 n.24 (1951) (citing *Ex parte* Thayer, file wrapper of U.S. Patent No. 2,348,037 (filed Sept. 11, 1939)).

62. *Ex parte* Berkman & Berkman, 90 U.S.P.Q. 398 (1951).

63. *Ex parte* Sparhawk, 64 U.S.P.Q. 339 (1945).

64. *See In re King*, 107 F.2d 618, 619–20 (C.C.P.A. 1939).

65. *Berkman*, 90 U.S.P.Q. at 400 (citing *Ex parte* Stoll, file wrapper of U.S. Patent No. 2,294,811 (filed July 17, 1939)).

66. *See Funk Bros. Seed Co. v. Kalo Inoculant Co.*, 333 U.S. 127, 130 (1948).

67. *Id.*

68. *Id.*

new combination and that it might “well have been an important commercial advance.”⁶⁹ But “[t]he qualities of these bacteria, like the heat of the sun, electricity, or the qualities of metals, are part of the storehouse of knowledge of all men . . . free to all men.”⁷⁰ Hence, the aggregation of these bacteria fell short of patentable invention.

However, in one of the first major cases dealing with natural products after the enactment of the 1952 Patent Act, *Merck & Co. v. Olin Mathieson Chemical Corp.*, the Fourth Circuit rejected a categorical exception to the products of nature doctrine.⁷¹ It held that “[t]here is nothing in the language of the Act which precludes the issuance of a patent upon a ‘product of nature’ when it is a ‘new and useful composition of matter’ and there is compliance with the specified conditions for patentability.”⁷² The Fourth Circuit upheld the patent on a purified form of Vitamin B₁₂ obtained from the fermentation of fungi.⁷³ The court clarified that this was not merely an advance in the degree of purification.⁷⁴ Until the patentee had produced it, Vitamin B₁₂ was “unidentified and unknown.”⁷⁵ “From the natural fermentates, which . . . were not known to contain the desired activity in even the slightest degree, products of great therapeutic and commercial worth have been developed.”⁷⁶ Thus, the court held that “[t]he new products [were] not the same as the old, but new and useful compositions.”⁷⁷

In 1980, *Diamond v. Chakrabarty* provided the Supreme Court an opportunity to weigh in on this issue under the 1952 Act.⁷⁸ In *Chakrabarty*, the patentee was claiming “a genetically engineered bacterium capable of breaking down multiple components of crude oil.”⁷⁹ While reaffirming the limitations on patenting natural phenomenon, the Court held that a live, human-made microorganism was patentable as a “manufacture” or “composition of matter.”⁸⁰ The Court observed that the patentee’s claim was “not to a hitherto unknown natural phenomenon, but to a nonnaturally occurring manufacture or composition of matter—a product of human

69. *Id.* at 131–32.

70. *Id.* at 130.

71. *See Merck & Co. v. Olin Mathieson Chem. Corp.*, 253 F.2d 156 (4th Cir. 1958).

72. *Id.* at 161.

73. *See id.* at 160.

74. *Id.* at 164.

75. *Id.* at 163.

76. *Id.* at 164.

77. *Id.*

78. *Diamond v. Chakrabarty*, 447 U.S. 303, 303 (1980).

79. *Id.* at 305.

80. *Id.* at 309–10.

ingenuity ‘having a distinctive name, character [and] use.’”⁸¹ Distinguishing *Funk Brothers*, the Court noted, “the patentee has produced a new bacterium with *markedly different* characteristics from any found in nature and one having the potential for significant utility. His discovery is not nature’s handiwork, but his own.”⁸² It is this “markedly different” language that was later adopted as a standard by the Federal Circuit for assessing patent-eligibility of genes in *AMP*.⁸³

Chakrabarty opened the door for biotechnology patents. Not long after the Supreme Court decided *Chakrabarty*, the U.S. Patent and Trademark Office (“USPTO”) started granting gene patents.⁸⁴ “Isolated and purified” naturally occurring substances like DNA and protein biomolecules were patented on the premise that they were substantially separated from other cellular components, which accompanied the native products. In 1991, the validity of a claim for “purified and isolated DNA sequence encoding EPO” was upheld in *Amgen, Inc. v. Chugai Pharmaceuticals Co.*⁸⁵ The district court in *Amgen* explained that unlike the erythropoietin (“EPO”) gene found in nature, which would not have been patentable because it was a natural product, the “purified and isolated” DNA sequence encoding EPO was patentable.⁸⁶

It has been estimated that the USPTO has issued more than 2,000 patents on “isolated DNA” and more than 40,000 related patents.⁸⁷ In fact, one study indicates that one-fifth of human genes have been covered by patents.⁸⁸ However, the patenting of DNA has not been without controversy. In the 1990s, an attempt by the National Institute of Health (“NIH”) to patent Expressed Sequence Tags (“ESTs”), which are DNA sequences useful for screening cells for complementary RNA sequences, faced stiff

81. *Id.*

82. *Id.* at 310 (emphasis added).

83. See discussion *infra* Section III.A & III.B.

84. See *AMP*, 653 F.3d 1329, 1355 (Fed. Cir. 2011) (citing Eric J. Rogers, *Can You Patent Genes? Yes and No*, 93 J. PATENT & TRADEMARK OFFICE SOC’Y 19, 40 (2010)).

85. *Amgen, Inc. v. Chugai Pharm. Co.*, 927 F.2d 1200, 1219 (Fed. Cir. 1991).

86. See *Amgen, Inc. v. Chugai Pharm. Co.*, 808 F. Supp. 894, 896–97 (D. Mass. 1992), *aff’d*, 927 F.2d 1200, 1219 (Fed. Cir. 1991).

87. See *AMP*, 653 F.3d at 1355 (citing Eric J. Rogers, *Can You Patent Genes? Yes and No*, 93 J. PATENT & TRADEMARK OFFICE SOC’Y 19, 40 (2010)).

88. Kyle Jensen & Fiona Murray, *Intellectual Property Landscape of the Human Genome*, 310 SCI. 239, 239 (2005); cf. David E. Adelman & Kathryn L. DeAngelis, *Patent Metrics: The Mismeasure of Innovation in the Biotech Patent Debate*, 85 TEX. L. REV. 1677, 1694 n.80 (2007) (urging a more careful interpretation of this figure because nearly all the patents cited in the study were directed to diagnostic applications and a vast majority were narrow patents covering short sections of the genome).

opposition.⁸⁹ It eventually resulted in raising the utility bar for such products.⁹⁰ However, the USPTO continued granting gene patents and in 2001, issued the *Utility Examination Guideline*, which maintained the agency's position that isolated DNA molecules are patent-eligible.⁹¹

III. ISOLATED GENES: PRODUCTS OF NATURE OR MAN-MADE PRODUCTS?

A. *AMP V. MYRLAD*: THE LATEST BATTLE OVER GENE PATENTS

Given the importance of DNA as a fundamental molecule in human beings, the intense public attention and the passionate debate surrounding DNA patents are unsurprising. This debate finally made its way to the courtroom in 2009, when a lawsuit, *Association for Molecular Pathology v. U.S. Patent & Trademark Office* (“AMP”), was filed against Myriad Genetics, seeking to invalidate their claims on isolated DNA on grounds that the claims covered unpatentable subject matter.⁹² The challenged composition claims covered two “isolated” human genes, *BRCA1* and *BRCA2*.⁹³ Alterations or mutations in these genes were found to be associated with a predisposition for breast and ovarian cancers.⁹⁴ The plaintiffs argued that isolated DNA retaining the same nucleotide sequence as native DNA was unpatentable because it was a product of nature.⁹⁵ Also challenged were process claims covering methods of “analyzing” or “comparing” a patient's *BRCA* sequence with the normal, or wild-type sequence, to identify the presence of cancer-predisposing mutations.⁹⁶ The plaintiffs further sought to invalidate some method claims directed at a method of screening potential cancer therapeutics by comparing the growth rates of cells transformed with mutated *BRCA* genes in the presence of potential therapeutics.⁹⁷ They

89. See Linda J. Demaine & Aaron Xavier Fellmeth, *Reinventing the Double Helix: A Novel and Nonobvious Reconceptualization of the Biotechnology Patent*, 55 STAN. L. REV. 303, 323–25 (2002).

90. See *id.*

91. See Utility Examination Guidelines, 66 Fed. Reg. 1092, 1093 (Jan. 5, 2001) (“Thus, an inventor's discovery of a gene can be the basis for a patent on the genetic composition isolated from its natural state and processed through purifying steps that separate the gene from other molecules naturally associated with it.”).

92. *Ass'n for Molecular Pathology v. U.S. Patent & Trademark Office* (“AMP II”), 702 F. Supp. 2d 181 (S.D.N.Y. 2010), *aff'd in part, rev'd in part*, 653 F.3d 1334 (Fed. Cir. 2011).

93. See *id.* at 184.

94. See *id.* at 181.

95. See *id.* at 221.

96. See *id.* at 233–37.

97. *Id.*

contended that these claims were directed to patent-ineligible, abstract mental processes.⁹⁸

Judge Robert Sweet of the U.S. District Court of the Southern District of New York ruled that the *BRC A* genes were not patentable because they were “not markedly different from native DNA.”⁹⁹ This conclusion was “driven by the overriding importance of DNA’s sequence to both its natural biological function as well as the utility associated with DNA in its isolated form.”¹⁰⁰ Purification alone, he held, did not change the essential characteristic of DNA—its nucleotide sequence.¹⁰¹ Indeed, the ability to reliably detect mutations depended on this essential characteristic remaining unchanged.¹⁰² Because its coding arrangement was “the result of the natural phenomena of RNA splicing,” even cDNA was found unpatentable.¹⁰³ Judge Sweet interpreted the claim language of the method claims to include comparing not only DNA molecules, but DNA sequence information as well.¹⁰⁴ As a result, he also invalidated Myriad’s method claims because they were directed at “abstract mental processes.”¹⁰⁵

On appeal, the Federal Circuit reversed the holding regarding the patentability of isolated DNA and the method claims covering the screening of cancer therapeutics.¹⁰⁶ However, all three judges agreed with the district court that method claims directed to “comparing” or “analyzing” sequences of gene for diagnostic purposes were invalid.¹⁰⁷ They “fail[ed] to satisfy the machine-or-transformation test and [were] instead directed to the abstract mental process of comparing two nucleotide sequences.”¹⁰⁸ The court stated that gene sequences could be compared by “mere inspection alone.”¹⁰⁹ In order to make the claims eligible, the court suggested including some limitations like extraction of metabolites from bodily samples.¹¹⁰ In contrast to the diagnostic claims, the court upheld the method claims directed at the screening of potential cancer therapeutics by comparing the growth rates of cells transformed with mutated *BRC A* genes. The court found that the steps

98. *Id.* at 233–34.

99. *Id.* at 232.

100. *Id.* at 229.

101. *Id.* at 231.

102. *See id.* at 231–32.

103. *Id.* at 230.

104. *Id.*

105. *Id.* at 234.

106. *AMP*, 653 F.3d 1329, 1334 (Fed. Cir. 2011).

107. *Id.*

108. *Id.* at 1356–57.

109. *Id.*

110. *Id.*

involving “growing” host cells and “determining” their growth rate were transformative steps involving manipulation of cells.¹¹¹

On the issue of patenting DNA sequences, the judges disagreed. Judge Lourie found that isolated DNA was patentable subject matter regardless of whether it was claimed as cDNA, or DNA claiming the entire gene or gene fragments.¹¹² He reasoned that isolated DNA is “markedly different” because it is not covalently bonded to other genetic material found in native DNA.¹¹³ He noted that isolated DNA has been chemically “cleaved” from native DNA or “synthesized to consist of just a small fraction of a naturally occurring DNA molecule.”¹¹⁴ Besides, isolated DNA is free from proteins, unlike the native DNA molecule, which is “packaged around histone proteins into a structure called chromatin.”¹¹⁵ Distinguishing this case from *Parke-Davis*, Judge Lourie clarified that “isolated DNA is not purified DNA” because purification makes pure what was the same material.¹¹⁶ He explained that “[i]n this case, the claimed isolated DNA molecules do not exist as in nature within a physical mixture to be purified.”¹¹⁷

In her concurring opinion, Judge Moore agreed that isolated cDNA sequences were “markedly different” from native DNA.¹¹⁸ Based on *Funk Brothers*, she posited that “an invention which ‘serve[s] the ends nature originally provided’ is likely unpatentable subject matter, but an invention that is an ‘enlargement of the range of . . . utility’” may be patentable.¹¹⁹ Since cDNA sequences did not exist in nature and had the additional utility of acting as tools for mutation detection, she found them falling squarely on the side of patent-eligible subject matter.¹²⁰

Judge Moore admitted that DNA sequences claiming either whole genes or gene fragments presented “a more difficult case.”¹²¹ She was not convinced that the “different chemical structure” alone was sufficient to make “isolated DNA ‘markedly different.’”¹²² However, given the differences, she felt that precedent required investigating whether the

111. *Id.* at 1357–58.

112. *See id.* at 1350–51.

113. *See id.* at 1351–52.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.* at 1350–51.

118. *Id.* at 1358 (Moore, J., concurring).

119. *Id.* at 1359–60 (Moore, J., concurring).

120. *Id.* at 1363–64 (Moore, J., concurring).

121. *Id.* at 1364 (Moore, J., concurring).

122. *Id.*

differences “impart[ed] a new utility.”¹²³ She found the shorter gene fragments patentable because their application as probes and primers was “clearly an ‘enlargement of the range of . . . utility.’”¹²⁴ On the other hand, “[d]espite the literal chemical difference, the isolated full length gene does not clearly have a new utility and appears to simply serve the same ends devised by nature, namely to act as a gene encoding a protein sequence.”¹²⁵ However, she felt that in light of settled expectation of the industry and the USPTO’s policy to grant gene patents, any “recalibration of the standard of patentability” should come from Congress.¹²⁶

In his dissent, Judge Bryson agreed that cDNA was patentable but differed with the majority on the issue of claims to genes and gene fragments.¹²⁷ In his view, *Chakrabarty* required an analysis of the difference in both structure and utility between what is claimed and what is found in nature.¹²⁸ He asserted that in the case of isolated genes, the structural changes were merely “incidental to the extraction of the genes” from nature.¹²⁹ He considered it similar to the extraction of new minerals from the earth.¹³⁰ Furthermore, unlike cDNA, which “can be attached to a promoter and inserted into a non-human cell to drive protein expression,” the isolated *BRCA* genes and gene fragments had no other use than their native counterpart.¹³¹ He concluded that the use of genetic sequences in a clinical setting “is not a new use; it is only a consequence of possession.”¹³² Hence, he found that isolated *BRCA* genes and gene fragments were patent-ineligible.¹³³

B. APPLYING THE STANDARD IN A “MARKEDLY DIFFERENT” MANNER

If there is one thing that all three judges in the *AMP* panel agreed upon, it is that a product “markedly different” from its natural form is patentable. Where they diverged was on the application of this standard to gene patents. Judge Lourie focused on the “distinctive chemical identity” of isolated DNA compared to the naturally occurring chromosome.¹³⁴ Judge Moore, on the

123. *Id.*

124. *Id.*

125. *Id.* at 1367 (Moore, J., concurring).

126. *Id.* at 1371–72 (Moore, J., concurring).

127. *Id.* at 1373 (Bryson, J., dissenting).

128. *Id.* at 1350–51.

129. *Id.* at 1375 (Bryson, J., dissenting).

130. *Id.*

131. *Id.* at 1379 (Bryson, J., dissenting).

132. *Id.* at 1378 (Bryson, J., dissenting).

133. *Id.*

134. *Id.* at 1351.

other hand, required a new utility compared to the natural molecule and not just “literal chemical difference.”¹³⁵ In his dissent, Judge Bryson agreed that the test required comparing the structure and utility of the claimed product to what is found in nature.¹³⁶ But in the case of isolated DNA, he found that the structural changes were superficial and “irrelevant” to “the functioning of the gene, and to their utility in their isolated form.”¹³⁷

This Note illustrates that a better way to determine whether a product is “markedly different” from another product is by comparing their structures *and* molecular properties. As Judge Moore and Judge Bryson stated, although structural difference is important, it is not dispositive. However, the Federal Circuit’s analysis was muddled by the court’s conflation of the utility of a product with its function. While a new utility of a natural product may be the basis for a claim to that utility, it does not necessarily make the product different enough to be patent-eligible. Utility is the exploitation of a product’s property by man towards a particular end, while function is the way the product behaves naturally. The following Sections explain why molecular properties (including function) are a better marker of patentable difference, rather than utility. Section III.F then offers a test for patent eligibility, which compares the structure and properties of the claimed products compared with their native form.

C. STRUCTURAL DIFFERENCE CANNOT BE THE SOLE BASIS OF PATENTABILITY

The *AMP* majority attempted to distinguish isolated DNA from the inconsistent line of cases on purified natural products by focusing on the cleavage of covalent bonds involved in isolating DNA. Judge Lourie explained that isolated DNA is more than just a purified form of the natural product.¹³⁸ It is a structurally distinct chemical identity, which was obtained by cleaving covalent bonds in natural DNA.¹³⁹ However, this emphasis on the structural difference is not supported by case law. Structural difference has neither been the necessary nor sufficient criteria for patentability of a product derived from nature. If it were a sufficient characteristic, then elements like lithium, which exist as distinct molecular species in nature, would have been patentable.¹⁴⁰ On the other hand, if structural dissimilarity

135. *Id.* at 1367 (Moore, J., concurring).

136. *Id.* at 1378 (Bryson, J., dissenting).

137. *Id.*

138. *Id.* at 1351.

139. *Id.*

140. *Id.* at 1354. Both the dissent and the majority agree that lithium is unpatentable. *Id.* at 1376 (Bryson, J., dissenting).

was essential, then purified natural proteins and vitamins could not have been patented in chemically unaltered form. Indeed, proteins like human Blood Clotting Factors VIII and IX, insulin, human growth hormone, erythropoietin, tissue plasminogen activator, and all monoclonal antibodies were found patentable in a form structurally unaltered from their natural sources.¹⁴¹

While structural differences may be an important consideration, making them the sole basis of patentability risks elevating form over substance. It is true that technically the isolated genes are different molecules than genes in the chromosome. But, as Judge Bryson correctly noted, the structural differences are irrelevant to their function in the isolated form.¹⁴² The majority emphasized the cleavage of the phosphodiester bond into terminal hydroxyl and phosphate groups in these isolated genes.¹⁴³ However, even if the terminal hydroxyl and phosphate groups were modified, the DNA sequences would still be useful for hybridizing with complementary sequences.¹⁴⁴ In fact, these modifications, called 3' and 5'-modifications, are very common and well-known molecular biology techniques.¹⁴⁵ Thus, these structural changes are not necessary to the functioning of the isolated DNA sequences but rather attendant to the process of isolation.

Besides, it is unclear from the majority's analysis what kind of structural changes merit a patent grant. For instance, instead of cleaving a bond as the majority suggests happened here, would adding a bond be sufficient? Even

141. See Brief of Intellectual Property Owners Ass'n in Support of Neither Party, *AMP*, 653 F.3d 1329 (No. 2010-1406), 2010 WL 4853326, at *22-23; see also, Robert Cook-Degan, *Gene Patents*, THE HASTINGS CENTER, <http://www.thehastingscenter.org/Publications/BriefingBook/Detail.aspx?id=2174> (last visited March 10, 2012) ("Well before the Supreme Court decision, in 1977, the University of California had applied for patents on genes for insulin and growth hormone; the patent for insulin was granted in 1982 and the one for growth hormone in 1987.").

142. *AMP*, 653 F.3d at 1378 (Bryson, J., dissenting).

143. *Id.* at 1352.

144. Sandeep Verma & Fritz Eckstein, *Modified Oligonucleotides: Synthesis and Strategy for Uses*, 67 ANN. REV. BIOCHEMISTRY 99, 104 (1998) ("The modification of either the 3'- or the 5'-terminus is a convenient method for equipping an oligonucleotide with a reactive aminoalkyl or a mercaptoalkyl group. . . . Such oligonucleotide conjugates have been used extensively for a number of applications, which include cellular delivery of antisense oligonucleotides, synthesis of artificial nucleases, and hybridization probes for biological detection.").

145. *Modifications*, INTEGRATED DNA TECHS., <http://www.idtdna.com/catalog/Modifications/ModificationHome.aspx> (last visited Feb. 25, 2012) ("A wide variety of modifications can be incorporated into an oligonucleotide at the time of synthesis. When possible, this is done using a modified solid support (CPG) for 3'-modifications or a specialized phosphoramidite reagent for internal and 5'-modifications.").

adding a hydrogen atom to the molecule would technically make it a new molecule. Would that be adequate to procure a patent? Granting patents based on any structural difference regardless of the triviality of such changes may lead to patentability hinging on inconsequential structural changes. Thus, mere structural difference should not be the sole criteria in determining the patentability of natural products. As discussed later, it could be one of the factors that tilts the scale in favor of patentability and would become a particularly strong factor if the structural change is significant or adds some value to the natural product.¹⁴⁶

D. CONFLATING UTILITY WITH FUNCTION

Aside from examining structural changes, the concurrence and dissent in *AMP* also seemed attracted to a doctrine that requires the claimed product to have a “new utility” compared to the natural product.¹⁴⁷ Relying on *Funk Brothers*, Judge Moore explained that “new utility” involves an “enlargement of the range of utility’ as compared to nature.”¹⁴⁸ Thus, she found that small gene fragments, which could be used as probes and primers, had a new utility, but the full-length sequence did not.¹⁴⁹ This is because the full-length DNA “serve[s] the same ends devised by nature, namely to act as a gene encoding a protein sequence.”¹⁵⁰ Judge Bryson, on the other hand, found that both full-length genes and gene fragments lacked new utility. In his opinion, the use of gene fragments as probes in determining genetic sequence in a clinical setting was not a new use but merely “a consequence of possession.”¹⁵¹ He explained that “each gene must function in the same manner in the laboratory as it does in the human body.”¹⁵²

In other words, despite articulating the same standard, the dissent and the concurrence in *AMP* reached different conclusions on the patent eligibility of gene fragments.¹⁵³ Judges disagreeing over the application of a test is nothing unusual, particularly in cases like these, which involve some degree of value judgment. However, in this case, one of the main reasons for the disagreement is the court’s conflation of the utility of a molecule with its function. In fact, both the concurrence and the dissent repeatedly

146. For a discussion on using the sliding scale of molecular structure and property to distinguish artificial products from products of nature, see Section III.F, *infra*.

147. *AMP*, 653 F.3d at 1361 (Moore, J., concurring); *id.* at 1378 (Bryson, J., dissenting).

148. *Id.* at 1361 (Moore, J., concurring).

149. *Id.* at 1366 (Moore, J., concurring).

150. *Id.* at 1367 (Moore, J., concurring).

151. *Id.* at 1378 (Bryson, J., dissenting).

152. *Id.* at 1329; *id.* at 1378 (Bryson, J., dissenting).

153. *Id.* at 1366 (Moore, J., concurring); *id.* at 1371 (Bryson, J., dissenting).

interchanged utility and function in the opinion. But utility is not the same as function. Utility is defined as “fitness for some purpose or worth to some end,” while function is “any of a group of related actions contributing to a larger action.”¹⁵⁴ In the context of molecules, function is often the “characteristic behavior of a chemical compound due to a particular reactive unit.”¹⁵⁵ Utility is an exploitation of the function and properties of a molecule by man. In other words, a molecule is useful for particular purposes because it has particular properties. Also, a molecule may have multiple uses based on the same function or property. For example, the use of gene fragments as primers and as probes involves the same basic mechanism or function of hybridization between complementary nucleobases.¹⁵⁶ In this case, the utility is man’s application of a gene’s natural properties to serve diagnostic or therapeutic purposes.

Some examples explain the difference between utility and function better. A piece of wood chopped from a tree could have many uses. It may be used for making fire or as a weapon or floatation device. In all these different instances of utility, the wood remains the same; the function of the wood is still determined by its inherent properties or structure. On the other hand, no one would claim that a wooden boat is the same as a block of wood just because both can keep us afloat. By starting with pieces of wood, man has made something that has both a new utility *and* a new function. It is useful because people can use it to traverse water. Its function is also new because by constructing the boat in a particular shape, man has increased its stability, buoyancy, and load-carrying capacity far beyond that of a wooden block. No doubt, some of the natural properties of wood make it particularly suitable for making a boat but the function of a piece of wood is not the same as that of a wooden boat.

Similarly, adrenaline (found patentable in *Parke-Davis*), is released in the body in response to threat or excitement, and it increases heart rate.¹⁵⁷ But, the same adrenaline can be used therapeutically to treat cardiac arrest by

154. *Definition of Utility*, MERRIAM-WEBSTER ONLINE DICTIONARY, <http://www.merriam-webster.com/dictionary/utility> (last visited Apr. 4, 2012); *Definition of Function*, MERRIAM-WEBSTER ONLINE DICTIONARY, <http://www.merriam-webster.com/dictionary/function> (last visited Apr. 4, 2012).

155. *Definition of Function*, *supra* note 154.

156. *See AMP*, 653 F.3d at 1378 (Bryson, J., dissenting) (“In order to sequence an isolated gene, each gene must function in the same manner in the laboratory as it does in the human body.”).

157. *Parke-Davis & Co. v. H.K. Mulford Co.*, 189 F. 95, 115 (S.D.N.Y. 1911).

exploiting its capacity to increase the cardiac output.¹⁵⁸ Here, treating cardiac arrest is the utility of adrenaline but the function of purified adrenaline is the same as that of adrenaline in human body, i.e., increasing the heart rate. The only difference is the human control in harnessing the function of adrenaline.

Thus, when Judge Moore discussed the utility of gene fragments as “primers in diagnostic screening,” she was indeed discussing how the gene fragments could be *used* in a different manner when they are isolated.¹⁵⁹ By contrast, Judge Bryson’s argument that the genes “must *function* in the same manner in the laboratory as [they do] in the human body” is actually an argument about the lack of their functional difference.¹⁶⁰ Both are correct. Isolated gene fragments (and even full-length genes) do have a new utility, but they behave in the same way as in their natural form.¹⁶¹ Thus, the key difference between the concurrence and the dissent is that one is looking for new utility while the other is looking for new function. So, the question becomes, which is the more appropriate inquiry: utility or function?

E. DIFFERENCE IN FUNCTION AND PROPERTY ARE BETTER MARKERS OF ARTIFICIAL PRODUCTS

It is important to understand the role that the requirement of “new utility” is playing here before deciding whether the dissent’s or the concurrence’s approach is correct. This requirement of “new utility” is distinct from the § 101 utility doctrine.¹⁶² Utility and subject matter-eligibility are two different inquiries of patentability. The § 101 utility requirement does not need the utility to be new. As long as a claimed invention has specific, substantial, and credible utility, it satisfies the § 101 utility requirement.¹⁶³ A

158. See T.H. Rainer & C. E. Robertson, *Adrenaline, Cardiac Arrest, and Evidence Based Medicine*, 13 J. ACCIDENT & EMERGENCY MED. 234 (1996).

159. *AMP*, 653 F.3d at 1365 (Moore, J., concurring).

160. *Id.* at 1378 (Bryson, J., dissenting) (emphasis added).

161. Judge Moore’s conclusion of inadequate utility of full-length gene sequences fails to capture the full range of application of DNA sequences. DNA sequences are not only useful in diagnostic screening but can also be inserted into bacteria and model animals. “The ability to introduce DNA into the germline of mice is one of the greatest achievements of the twentieth century and has paved the way for the transformation of other mammals.” PRIMROSE & TWYMAN, *supra* note 33, at 251. Apart from aiding in basic scientific research on gene function and regulation, these transgenic animals have been used as models for human diseases and in producing valuable recombinant proteins. In fact, it has been established that full-length genes are better suited for this purpose than cDNA. They also have potential medical use in gene therapy. See *id.* at 251, 259, 261.

162. 35 U.S.C. § 101 (2006).

163. *Revised Interim Utility Guidelines Training Materials*, U.S. PATENT & TRADEMARK OFFICE 3 (1999), <http://www.uspto.gov/web/menu/utility.pdf>.

new invention with an *old use* may still be patentable.¹⁶⁴ No one doubts that the claimed gene sequences have a specific utility that would satisfy the § 101 utility requirement.

Likewise, it does not appear that the “new utility” requirement is driven by a policy goal of encouraging socially beneficial inventions that have a new use over prior art. That goal can be served by granting process patents on the new utility. Newly discovered utility of an old or natural product may be the basis for patenting *that utility* but not the product.¹⁶⁵ For instance, in *Funk Brothers*, the Supreme Court had found the mixture of bacteria patent-ineligible despite recognizing that “there was ‘an advantage in the combination,’ and it was ‘new and useful.’”¹⁶⁶ Similarly, a wide range of plant extracts have been found to have therapeutic effects.¹⁶⁷ Their medicinal use is indeed a “new utility” compared to their utility in nature. However, this new utility cannot be sufficient ground for granting patent on the *product* unless they are structurally and functionally different. Instead, such discoveries should be incentivized by allowing *process* patents claiming the newly discovered utility.¹⁶⁸

Rather, the underlying goal of this inquiry is to determine whether the natural product has been sufficiently changed so that it would be considered a man-made product. Both the dissent and the concurrence agreed with Judge Lourie that cDNAs were structurally different enough from natural DNA to be considered artificial products.¹⁶⁹ cDNAs “differ from the natural gene sequence in that the introns are removed, and are the opposite (complementary) sequence of the naturally occurring RNA.”¹⁷⁰ However, for full-length genes and gene fragments, they found that the structural difference was not substantial enough to weigh in favor of patentability. According to Judge Moore, “although the different chemical structure does suggest that claimed DNA is not a product of nature,” this difference alone

164. *See id.* (“In determining credibility the examiner should consider whether or not there currently are similar or equivalent materials and/or procedures available for achieving that utility. If there are, the utility is credible and no rejection under 35 U.S.C. § 101 should be made.”).

165. Paul G. Alloway, *Inherently Difficult Analysis for Inherent and Accidental Biotechnology Inventions*, 38 SUFFOLK U. L. REV. 73, 79 (2004) (“[S]ection 101 precludes the patenting of a known product based on the discovery of a new use of the product.”).

166. *Funk Bros. Seed Co. v. Kalo Inoculant Co.*, 333 U.S. 127, 131 (1948).

167. *See* Liz Hanellin, *Protecting Plant-Derived Drugs: Patents And Beyond*, 10 CARDOZO ARTS & ENT. L.J. 169 (1991).

168. *See* discussion *infra* Section III.G.

169. *AMP*, 653 F.3d 1329, 1358 (Fed. Cir. 2011) (Moore, J., concurring); *id.* at 1373 (Bryson, J., dissenting).

170. *Id.* at 1364 (Moore, J., concurring).

did not make isolated DNA “markedly different from chromosomal DNA to be per se patentable subject matter.”¹⁷¹ In other words, they are different from the natural products but not different enough to be considered “markedly different.”

If the aim is to distinguish artificial products from natural products, function rather than utility, is a better marker of the transformation of a product. For instance, both Judge Moore and Judge Bryson agreed that a baseball bat is a man-made manufacture rather than a product of nature because it is “a product with a *function* that is entirely different from that of the raw material from which it was obtained.”¹⁷² A baseball bat may also be *used* as a weapon but it still remains a baseball bat. In other words, a new and different utility may be discovered in an old and known product, but that does not necessarily indicate a transformation of the product. Compared to utility, there is a closer correlation between function and structure.¹⁷³ In fact, properties of a product are a more comprehensive marker of transformation. At the molecular level, different physicochemical or biological properties are generally associated with different molecules. Broadly speaking, properties of a product also include its functions.¹⁷⁴ “[P]roperty is . . . to the passive coordination of the internal physical relations, as the function is to the operative co-action of these same internal physical relations.”¹⁷⁵ Hence, an inquiry into a product’s properties necessarily includes looking into its function as well. In other words, probing the properties of the product, rather than utility, can help in determining whether it has sufficiently changed to be considered “markedly different” from the natural product.

The emphasis on property and function of the claimed invention also explains the outcome of some of the Supreme Court cases on products of nature. In *Funk Brothers*, the Court found the inoculant mixture of non-

171. *Id.* at 1365.

172. *Id.* at 1366, 1377 (emphasis added).

173. See Torgeir R. Hvidsten et al., *A Comprehensive Analysis of the Structure-Function Relationship in Proteins Based on Local Structure Similarity*, PLOS ONE, (2009), available at <http://www.plosone.org/article/info:doi/10.1371/journal.pone.0006266>.

174. This Note is not claiming that function and property are exactly the same aspect of a product. Purists may quibble over such characterizations. This Note is merely defining molecular property broadly to encompass its function such that an investigation of the properties of a molecule includes investigating its function as well. See Bernard Testa & Lemont B. Kier, *The Concept of Molecular Structure in Structure-Activity Relationship Studies And Drug Design*, 11 MED. CARE RES. REV. 35, 36 (1991) (discussing the correlation between structure and property). According to Testa and Kier, “a general definition of structure must begin with the differentiation between *the form (i.e., the structure, or substructural elements) and the functions (i.e., the properties)* of the entities recognized as molecules.” *Id.* (emphasis added).

175. Kip, *supra* note 61, at 399.

inhibiting bacteria unpatentable because “[t]he combination of species produce[d] no new bacteria, no change in the six species of bacteria, and . . . each species ha[d] the same *effect* it [has] always had.”¹⁷⁶ The Court accepted that the mixture had some use and there was “an advantage in the combination.”¹⁷⁷ However, the Court did not find a patentable difference over the natural bacteria because the “use in combination” of the bacteria did “not improve in any way their natural *functioning*.”¹⁷⁸ Similarly, the *Chakrabarty* Court showed an understanding of the difference between function and use of the invention when it noted that Chakrabarty’s bacterium was “*capable of breaking down multiple components of crude oil*.”¹⁷⁹ “*Because of this property*, which [was] possessed by no naturally occurring bacteria, Chakrabarty’s invention [was] believed to have significant value for the treatment of oil spills.”¹⁸⁰ In other words, the “markedly different characteristics” of the claimed bacterium over naturally occurring bacteria was its capacity to down oil. Cleaning up an oil spill was merely an application of that property.

F. THE SLIDING SCALE OF MOLECULAR STRUCTURE AND PROPERTY

Since a molecule’s structure and properties give us a good measure of any change in the molecule, courts should analyze the molecular structure and properties to assess whether a product is “markedly different” from its natural counterpart. At the molecular level, the structure describes both the arrangements of atoms within a molecule as well as the overall shape of the molecule. Properties include all physicochemical and biological properties including function.

Although it is generally recognized that structure influences property, this correlation is not always very linear.¹⁸¹ Sometimes, small structural changes can significantly impact the properties, while at other times significant structural changes have little effect. For instance, it is well-known that the replacement of a critical amino acid in a protein can drastically affect its function, while removing an entire sub-section containing multiple amino acids may have little effect.¹⁸² On the other hand, two molecules with very

176. *Funk Bros. Seed Co. v. Kalo Inoculant Co.*, 333 U.S. 127, 131 (1948) (emphasis added).

177. *Id.*

178. *Id.* (emphasis added).

179. *Diamond v. Chakrabarty*, 447 U.S. 303, 305 (1980) (emphasis added).

180. *Id.* (emphasis added).

181. See Hedi Hegyi & Mark Gerstein, *The Relationship Between Protein Structure and Function: A Comprehensive Survey with Application to the Yeast Genome*, 288 J. MOLECULAR BIOLOGY 147, 147 (1999).

182. See H. Eldon Sutton & Robert P. Wagner, *Mutation and Enzyme Functions in Humans*, 9 ANN. REV. GENETICS 187 (1975).

different chemical formulae may behave in a similar manner.¹⁸³ In fact, investigating the structure-function relationship of macromolecules is an intensely pursued field of study in biology and chemistry.¹⁸⁴

In order to accommodate this complex interrelationship, a sliding scale of structure and properties would be an appropriate way to distinguish a natural product from a synthetic one. Although the *AMP* court did not explicitly describe it, Judge Moore likely envisioned a similar test when she stated, “Whether an isolated gene is patentable subject matter depends on how much weight is allocated to the different structure as compared to the similarity of the function to nature.”¹⁸⁵

Let us see how such a test would work. The easy case would be a product that is both structurally different from the native form and has different properties. Such a product is more likely to be artificial. A product, whose structure is substantially different from the natural product, but functions in a similar manner, may still be considered artificial. For instance, different drugs treating a particular disease often function in the same way, such as by inhibiting a particular protein. The fact that two structurally different molecules have similar or even the same function does not make them the same. At the other end of the scale are molecules with slight structural difference but profoundly different properties. Such products should also be patentable over their natural form. As discussed already, some subtle variations in molecules can have very significant effect on their function. For instance, some molecules, called stereoisomers, have the same molecular formulae and sequence of bonded atoms and differ only in the three-dimensional orientations of their atoms in space.¹⁸⁶ If these molecules have very different biological activities, they should be considered distinct from an old or natural product.

This analysis of structural and functional difference is not new to the courts. Courts have looked into structural and functional difference in distinguishing claims on chemicals from prior art for the § 103 nonobviousness analysis.¹⁸⁷ In *Application of Papesch*, the court stated that

183. Biomimetic or bio-inspired molecules, for example, are molecules synthesized by chemists that can have very different chemical composition but function like the natural molecules.

184. See P. Güntert, *Structure Calculation of Biological Macromolecules from NMR Data*, 31 Q. REV. BIOPHYSICS, 145–237 (1998).

185. *AMP*, 653 F.3d 1329, 1366 (Fed. Cir. 2011) (Moore, J., concurring).

186. See *Stereoisomers*, VIRTUAL TEXTBOOK OF ORGANIC CHEMISTRY, MICHIGAN STATE U. DEPARTMENT OF CHEMISTRY, <http://www2.chemistry.msu.edu/faculty/reusch/VirtTxtJml/sterisom.htm> (last visited Feb. 25, 2012).

187. 35 U.S.C. § 103 (2006); see also *In re Papesch*, 315 F.2d 381 (C.C.P.A. 1963).

“[p]atentability cannot be determined on the basis of obviousness of the structure alone.”¹⁸⁸ Compounds structurally similar to those in prior art could be nonobvious if they possess a new and unexpected property.¹⁸⁹ For example, structurally similar isomers and homologues of prior art molecules have been found nonobvious based on their unexpected therapeutic properties.¹⁹⁰ It is not surprising that the nature of inquiry in nonobviousness determinations for chemical patents is similar to the approach adopted in distinguishing natural products and artificial products. Natural products are, after all, chemical entities. Besides, both the nonobviousness bar and the proposed test aim to prevent trivial improvements from being patented. But there is a difference between the analysis under § 103 and the one undertaken here. Nonobviousness is based on the knowledge of a person of ordinary skill in the art; previously unknown products or phenomena of nature cannot be part of that knowledge.¹⁹¹ While the nonobviousness inquiry compares the claimed invention with the prior art, this test compares the claimed invention with the natural product.

This nonobviousness-type inquiry is also consistent with the Supreme Court’s latest pronouncements on the patent eligibility of natural phenomena in *Mayo Collaborative Services v. Prometheus Laboratories*.¹⁹² The Court insisted that a claim based on a natural phenomenon should contain an “‘inventive concept,’ sufficient to ensure that the patent in practice amount[ed] to significantly more than a patent on the natural [phenomenon] itself.”¹⁹³ Although *Mayo* concerned a natural process, the same considerations of preempting a natural phenomenon are at issue when patenting natural products and hence the same principles should apply.¹⁹⁴

Courts also undertake a similar analysis under § 271(g), which prohibits importation of products made by using patented processes abroad.¹⁹⁵ Products “materially changed” by subsequent processes are exempted from infringement liability.¹⁹⁶ Courts utilize a “two-phased test” to determine whether a product has been “materially changed.”¹⁹⁷ Expositing one part of

188. *Papesch*, 315 F.2d at 391.

189. *Id.* at 389–90.

190. *Id.* at 388–89.

191. *See* 35 U.S.C. §§ 102, 103.

192. *Mayo Collaborative Servs. v. Prometheus Labs.*, 132 S. Ct. 1289, 1289 (2012).

193. *Id.* at 1294.

194. *See id.* at 1294–95.

195. *See* 35 U.S.C. § 271(g).

196. *Id.*

197. *See Eli Lilly & Co. v. American Cyanamid Co.*, 82 F.3d 1568, 1576–77 (1996), for an elaboration of this two-part test. The first part considers a product materially unchanged if it

that test, the Federal Circuit has observed that “[i]n the chemical context, a ‘material’ change in a compound is most naturally viewed as a significant change in the compound’s *structure and properties*.”¹⁹⁸ “[M]inor chemical conversion, (e.g., conversion to a salt, base, acid, hydrate, or addition or removal of a protecting group) would not be a ‘material’ change.”¹⁹⁹ For instance, in *Amgen Inc. v. F. Hoffmann-La Roche, Ltd.*, although the accused product was structurally different the court found no “material change” because “the *structural and functional differences*” were not “significant enough.”²⁰⁰ Similarly, courts have held that mere alkylation of the claimed product, “a common reaction well known to organic chemists,” without changing “the basic structure . . . of [the] compound” does not alter it materially.²⁰¹ However, even a minor change can sometimes be important and may change a product materially if it relates to “an important feature.”²⁰²

The nonobviousness test for chemical patents and the “materially changed” test for § 271(g) demonstrate the judicial and statutory appreciation of the importance of changes in structure and properties as indicators of transformation of chemical entities. They are very similar to the sliding-scale analysis suggested by this Note, in that they recognize fact situations where

would not have been commercially viable to produce it without using the patented process. *See id.* at 1576. The second part is guided by the Senate Judiciary Report’s explanation:

A product will be considered to have been made by a patented process if the additional processing steps which are not covered by the patent do not change the physical or chemical properties of the product in a manner which changes the basic utility of the product [produced] by the patented process. However, a change in the physical or chemical properties of a product, even though minor, may be “material” if the change relates to a physical or chemical property which is an important feature of the product produced by the patented process. Usually a change in the physical form of a product (e.g., the granules to powder, solid to liquid) or minor chemical conversion, (e.g., conversion to a salt, base, acid, hydrate, ester, or addition or removal of a protection group) would not be a “material” change.

Id. at 1577 (quoting S. REP. NO. 100-83, at 49 (1987)).

It is to be noted that the Report requires changes to “basic utility of the product.” This appears to be different from *any new utility* and is more akin to requiring a change in the basic use or function of the molecule. However, courts have not elaborated on this distinction, and this Note is not undertaking the effort of interpreting § 271(g). At least for the purpose of distinguishing products of nature from artificial products, the author maintains that function and properties of a molecule are more useful indicators than utility.

198. *Id.* at 1573 (emphasis added).

199. *See id.* at 1577.

200. *See Amgen Inc. v. F. Hoffmann-La Roche, Ltd.*, 580 F.3d 1340, 1378–79 (2009) (emphasis added).

201. *Pfizer Inc. v. F & S Minerals Corp.*, 856 F. Supp. 808, 816 (S.D.N.Y. 1994).

202. *See Eli Lilly*, 82 F.3d at 1577.

significant variations in one aspect of a product may outweigh minor variations in other aspects. They provide a rich source of case law which could guide courts in their assessment of patent-worthy changes to natural products. Of course, as always, the distinctions would be fact-specific and a matter of degree. It is neither wise, nor possible, to draw a bright-line rule.

Applying the sliding-scale test to isolated gene sequences leads to the inescapable conclusion that they are *not* “markedly different” from their natural counterparts. The structural difference mainly involves the cleavage of two phosphodiester bonds into terminal hydroxyl and phosphate bonds. One could arguably compare the DNA of the entire chromosome with the isolated gene sequence and claim significant structural difference. But since the claimed product is an isolated gene sequence, rather than an isolated chromosome, such a comparison is not logical. Comparing the claimed isolated gene sequence with the gene sequence in nature, one finds insignificant structural difference because the nucleotide sequence is exactly the same. Since the same nucleotide sequence interacts with other DNA sequences using the same phenomenon of base-pairing between complementary nucleobases, an isolated gene sequence also functions in the same manner. The same reasoning is applicable to smaller gene fragments. In other words, isolated gene sequences and gene fragments are products of nature.

The cDNA sequences, on the other hand, are structurally very different from the mRNA, from which they were derived. Although the nucleotide sequence is replicated in cDNA, the ribose sugars of RNA have been replaced by the deoxyribose sugars in the entire molecule, along with the nucleobase change from thymine(T) to uracil(U). They are structurally so different from RNA that they are called DNA. Unlike mRNA, cDNAs cannot directly synthesize proteins. On the other hand, cDNAs function in a similar manner as the RNA molecules, mainly by base-pairing with complementary sequences. Comparing the structure and properties of cDNA against its closest natural counterpart, mRNA, leads to the conclusion that it is “markedly different” from mRNA. cDNA is also structurally very different from the genomic DNA because it does not contain the nucleotides in the intron regions of genomic DNA. Hence, it is distinguishable from the genomic DNA as well.

G. UNNECESSARY PRODUCT PATENTS

Several commentators have already undertaken extensive analysis of the policy ramifications of granting gene patents.²⁰³ Instead of rehashing the well-known arguments, this Note intends to dispel one policy argument traditionally forwarded in support of gene patents: they are necessary to incentivize the discovery of genes. The persistent (and often tenuous) effort by the courts to distinguish isolated genes from their natural state in order to establish their patentability is driven by this unsupported presumption. However, empirical studies indicate that we may not even need product patents to induce the discovery of genes.²⁰⁴ If that is the case, then granting exclusive rights on genes imposes a loss on society since they would have been isolated regardless of patent protection. Studies show that a significant portion of the research involved in isolating gene sequences are done in academic and non-profit research institutes. For instance, a study conducted by the National Academy of Sciences found that as of 2005, University of California was the owner of the largest number of DNA-based U.S. patents.²⁰⁵ Among the top thirty owners of DNA-based patents, almost half were public or academic research institutes.²⁰⁶ Another study found that “63% of the patents on gene sequences resulted from federally funded research.”²⁰⁷ While some may infer from this data that patents are necessary to incentivize such research, studies show that the prospect of patent protection on genetic research “does not play a significant role in motivating scientists to conduct genetic research.”²⁰⁸ “Only 7 percent [of the researchers] consider [patents] more than moderately important—but it pales in comparison to scientific importance (97 percent), personal interest (95

203. See Wesley M. Cohen & John P. Walsh, *Real Impediments to Academic Biomedical Research*, in *INNOVATION POLICY AND THE ECONOMY* 1, 13 (Adam B. Jaffe et al. eds. 2008), available at <http://www.nber.org/~marschke/mice/Papers/cohenwalsh.pdf>; NAT'L RES. COUNCIL, *REAPING THE BENEFITS OF GENOMIC AND PROTEOMIC RESEARCH: INTELLECTUAL PROPERTY RIGHTS, INNOVATION, AND PUBLIC HEALTH* 28 (2006), available at <http://www.nap.edu/catalog/11487.html>; SECRETARY'S ADVISORY COMM. ON GENETICS, HEALTH & SOC'Y, *GENE PATENTS AND LICENSING PRACTICES AND THEIR IMPACT ON PATIENT ACCESS TO GENETIC TESTS* (2010) [hereinafter SACGHS REPORT]; Rebecca S. Eisenberg, *A Technology Policy Perspective on The NIH Gene Patenting Controversy*, 55 U. PITT. L. REV. 633, 648–49 (1993); Eileen M. Kane, *Splitting the Gene: DNA Patents and the Genetic Code*, 71 TENN. L. REV. 707, 720 (2004); Tina Saladino, Note, *Seeing the Forest Through the Trees: Gene Patents and the Reality of the Commons*, 26 BERKELEY TECH. L.J. 301 (2011).

204. See SACGHS REPORT, *supra* note 203, at 1.

205. NAT'L RES. COUNCIL, *supra* note 203, at 104.

206. *Id.*

207. *AMP II*, 702 F. Supp. 2d 181, 210 (S.D.N.Y. 2010), *aff'd in part, rev'd in part*, 653 F.3d 1334 (Fed. Cir. 2011).

208. SACGHS REPORT, *supra* note 203, at 1.

percent), feasibility (88 percent), and access to funding (80 percent) as reasons to do the work.²⁰⁹ Academic researchers are generally driven by other factors such as the desire to advance scientific understanding, prestige, publication, ability to secure funding for additional research, and concerns for their own career development.²¹⁰

The fact that scientists are not motivated by patents might indicate that the number of gene-related patents secured by the academic research institutes may be an underestimation of the amount of genetic research done in academia. These statistics on gene patents do not take into account those researchers who did not seek patent rights for isolated DNA sequences. More importantly, the fact that academic researchers conduct a substantial portion of research aimed at isolating genes shows that public institutes are capable of successfully undertaking such research. For instance, it was the King laboratory at University of California, Berkeley that published the landmark paper showing that a gene related to breast cancer (*BRC1*), whose sequence was then unknown, was located in a region of chromosome 17.²¹¹ In fact, one day after Myriad filed its patent application for *BRC2* genes, the Stratton group in the United Kingdom published the sequence of the gene in an article in *Nature*.²¹² Thus, “the technical question presented by the genome project was not whether the human genome could be sequenced, but which group would finish first.”²¹³

Moreover, patenting of DNA sequences by public institutions may not effectively serve the purpose of commercializing such inventions. Public institutes are incapable of undertaking product development because of their limited resources and limited experience in the fast-paced, market-oriented development of products.²¹⁴ The only way patents may secure revenues for a university is through licensing.²¹⁵ It is thought that this revenue may then be reinvested in research, thereby spurring further innovation.²¹⁶ So far, this has been wishful thinking. Studies have shown that most technology transaction offices either break even or lose money.²¹⁷ Also, since the federal government

209. NAT'L RES. COUNCIL, *supra* note 203, at 122.

210. *Id.*; see also Cohen & Walsh, *supra* note 203, at 1, 13.

211. Ass'n for Molecular Pathology, 702 F. Supp. 2d at 201.

212. *Id.* at 202.

213. STEPHEN A. MERRILL, RICHARD C. LEVIN & MARK B. MYERS, A PATENT SYSTEM FOR THE 21ST CENTURY 91 (2004), available at <http://www.nap.edu/catalog/10976.html>.

214. SACGHS REPORT, *supra* note 203, at 23.

215. Eisenberg, *supra* note 203, at 648–49 (1993).

216. *Id.*

217. See Donald Siegel & Mike Wright, *Intellectual property: The Assessment*, 23 OXFORD REV. OF ECON. POL'Y 529, 534 (2007).

is the major funder of basic science research, it seems unfair that taxpayers—who fund the research in the first place—would also have to pay high premiums for using the subsequent products, which absorb the costs of licensing patents.²¹⁸ Then again, it is contended that securing patent rights may enable public agencies to control prices charged for subsequent products emanating from these patents.²¹⁹ However, it is doubtful whether such price-regulation is possible in a free-market system because any price control clauses in licensing agreements would make them less attractive to private firms and thereby reduce the bargaining power of the university.²²⁰

Besides, even in the absence of product patents, incentives for the discovery of genes would be maintained through process patents because patent applicants can still patent processes covering new uses of the genetic sequences. Identifying genetic sequences is the first step towards developing their potential applications. Thus, even if the academic institutes are incapable of, or uninterested in, isolating certain genes, process patents would maintain the incentive for the industry to step in and isolate the genes themselves. Moreover, contrary to industry belief, process patents would not be difficult to enforce. Traditionally, companies have preferred to obtain product patents over process patents because of the difficulty in enforcing the latter. However, the difficulty in enforcing a process patent is a greater concern when the process claims *making* a product than when it claims *using* a product. This is because inspecting a product sold in the market does not enable one to ascertain whether the product has been secretly made by the claimed process. But, in case of process patents, such as those covering genetic diagnosis, the processes cannot be accomplished without using the gene sequences. Thus, any competitor offering the same genetic screening test to the public, would necessarily have to use the same isolated genetic sequence information in standard biological assays. Since the claimed process essentially covers the consumer good or service offered, any infringement would be readily detectable. In other words, even in the absence of product patents on genes, the efforts to isolate genes would continue by virtue of the incentive provided by process patents.

The policy of granting patents on the applications of a natural phenomenon, rather than the phenomena itself, is also in accord with Supreme Court precedent. The Supreme Court has consistently recognized that applications of natural phenomena are patentable. For example, the Court in *O'Reilly v. Morse* held:

218. Eisenberg, *supra* note 203, at 648.

219. *Id.* at 649–50.

220. *Id.*

When a new and hitherto unknown product or result, beneficial to mankind, is effected by a new application of any element of nature, and by means of machines and devices, whether new or old, it cannot be denied that such invention or discovery is entitled to the denomination of a “new and useful art.”²²¹

Similarly, *Funk Brothers* held that “[h]e who discovers a hitherto unknown phenomenon of nature has no claim to a monopoly of it which the law recognizes. If there is to be invention from such a discovery, it must come from the application of the law of nature to a new and useful end.”²²²

This Note suggests that all “products of nature” can be distinguished from artificial products using the sliding-scale analysis described in Section III.F, *supra*. It recommends withholding product patents whenever it is clear that the products do not meet the prescribed threshold of artificiality, but granting process patents on any new uses discovered. Under this analysis, purified but unaltered natural products (previously found patent-eligible) would not be granted product patents.²²³ For example, “[o]ne fourth of all currently dispensed prescriptions in the United States contain at least one drug that is extracted from higher plants.”²²⁴ While the natural extracts may not be patented, the discovery of their therapeutic application should be rewarded. In order to discover the therapeutic properties of these natural extracts, firms have to invest huge amounts of resources in exploration, collection, and analysis of samples.²²⁵ Subsequent product development, FDA approval, and marketing make it possible for these substances to be finally available to the consumer.²²⁶ Without some form of patent protection, private investors would not be willing to undertake such expensive and time-consuming endeavors, and the society would not benefit from such inventions. Hence, the appeal of this policy lies in the fact that it provides enough incentive to the biotechnology companies to invest in the development of socially useful application of natural products, without giving them a complete monopoly over such products.

221. *O'Reilly v. Morse*, 56 U.S. 62, 133 (1853).

222. *Funk Bros. Seed Co. v. Kalo Inoculant Co.*, 333 U.S. 127, 130 (1948).

223. *See, e.g., Merck & Co. v. Olin Mathieson Chem. Corp.*, 253 F.2d 160 (4th Cir. 1958) (finding purified Vitamin B12 patentable); *Parke-Davis & Co. v. H.K. Mulford Co.*, 189 F. 95, 115 (S.D.N.Y. 1911), *rev'd on other grounds*, 196 F. 496 (2d Cir. 1912). (holding purified adrenaline patentable).

224. *See Liz Hanellin, Protecting Plant-Derived Drugs: Patents and Beyond*, 10 CARDOZO ARTS & ENT. L.J. 169, 170 (1991).

225. *See id.* at 169, 173 n.21.

226. *See id.* at 169 n.3.

IV. CONCLUSION

We cannot realize the aim of “promot[ing] science and useful arts”²²⁷ if we fail to properly distinguish patent-worthy inventions from unworthy ones because of a lack of nuanced understanding of the science behind the inventions. As this Note demonstrated, the distinction between function and utility of products is critical to our appreciation of their patent-worthiness. Taking that into consideration, this Note provides a comprehensive test under which claims to natural products can be analyzed. It posits that in the absence of significant structural or functional changes, isolated or purified natural products like genes should not be patented. However, process patents on novel applications of natural products should be granted. Such an approach would balance the needs of incentivizing these discoveries against the broad preclusive effects of a product patent. After all, the goals of patent law can be accomplished by neither leaving all discoveries in the public domain, nor by assigning exclusive rights to all discoveries to private entities.

227. U.S. CONST. art. I, § 1, cl. 8.

TiVo, Inc. v. EchoStar Corp.:
PROVIDING CLARITY TO CONTEMPT
PROCEEDINGS IN PATENT CASES

Conrad Gosen[†]

Marketing a redesigned product following a finding of patent infringement can result in hundreds of millions of dollars in fines for contempt of court.¹ After a finding of patent infringement, a court will often issue a broadly written injunction simply prohibiting any “further infringement of the patent.”² Infringers frequently attempt to redesign their products around the injunction and market the redesigned product, but patent holders may demand that the infringer be held in contempt of court if they believe the redesigned product violates the injunction because it continues to infringe the patent. Courts have struggled to articulate an effective test for determining whether an attempted design-around is merely a colorable change that is obviously made for the purpose of evading the decree, or whether the redesigned product is a substantially different design such that contempt proceedings would be inappropriate and potential infringement must be decided by a new trial.³

Thankfully, in *TiVo, Inc. v. EchoStar Corp.*, the Federal Circuit provided clarity and guidance for infringers who are attempting to redesign their products around vague or imprecise injunctions following a finding of patent infringement.⁴ In *TiVo*, the Federal Circuit rejected the *KSM* two-step test⁵ for determining when to hold contempt proceedings and articulated a new test for determining whether a redesigned product is sufficiently similar to the original infringing product to hold the infringer in contempt.⁶

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1. *See* *TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869, 890 (Fed. Cir. 2011) (upholding a \$90 million charge).

2. *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1526 (Fed. Cir. 1985).

3. *See infra* Part I.

4. *See TiVo*, 646 F.3d at 878 (setting out a new test for colorable differences).

5. The two-step test required district courts to first analyze if two devices were more than colorably different when deciding to hold contempt proceedings, and if they were merely colorably different, to then determine if they violated the injunction and infringed the patent. *KSM*, 776 F.2d at 1532.

6. *TiVo*, 646 F.3d at 881.

TiVo altered the “colorable differences” step of the *KSM* test by requiring courts to examine the specific infringing elements of the original product to determine if those elements had been modified in a significant way during redevelopment.⁷ This is a drastic change from the previous test in *KSM*, which focused on an evaluation of procedural aspects related to infringement.⁸ Under this new test, if the elements of the redesigned product are more than colorably different from those of the original product, then the court may not conduct contempt proceedings, and the question of infringement must be decided in a new trial.⁹ The new *TiVo* rule provides some much needed clarity for infringers in patent cases who are threatened with contempt, and it may also provide increased direction to inventors who are faced with vague and imprecise injunctions.¹⁰

In Part I, this Note will discuss the background of the colorable differences test, including the relevant procedural posture and the history of the test before *TiVo*. In Part II, this Note will explain the Federal Circuit decision in *TiVo* and illustrate how district courts have subsequently applied it. In Part III, this Note will then discuss *TiVo*'s potential ramifications, and will conclude by proposing that *TiVo*'s new test will help infringers who are confronted with vague injunctions and also bring contempt proceedings in patent cases more in line with the policy goals set forth by the Supreme Court for injunctive relief in the patent context.

I. BACKGROUND

The Patent Act of 1952 provides that courts may grant an injunction following a finding of patent infringement in order to “prevent the violation of any right secured by the patent, on such terms as the court deems reasonable.”¹¹ Following the issuance of an injunction, infringers often

7. *Id.* at 882.

8. *See id.* at 882–83; ROBERT A. MATTHEWS, 4 ANNOTATED PATENT DIGEST § 32:191.50 (2011) (“In *TiVo* the Federal Circuit transformed the ‘no[t] more than colorably different’ standard from a procedural hurdle for using summary contempt to a substantive requirement to prove contempt.”).

9. *TiVo*, 646 F.3d at 882–83.

10. *See id.* at 881 (“We conclude that *KSM*'s two-step inquiry has been unworkable and now overrule that holding We recognize now that [the *KSM*] inquiry confuses the merits of the contempt with the propriety of initiating contempt proceedings.”).

11. 35 U.S.C. § 283 (2006). Until recently, a permanent injunction was the default remedy following a finding of patent infringement. Jeremy Mulder, Note, *The Aftermath of eBay: Predicting When District Courts Will Grant Permanent Injunctions in Patent Cases*, 22 BERKELEY TECH. L.J. 67, 68 (2007). However, in *eBay*, the Supreme Court reversed this longstanding rule and instead held that courts must weigh four equitable factors before

attempt to redesign their products in order to avoid further infringement.¹² After an infringer markets a redesigned product, if the patent holder believes the redesigned product still infringes, the patent holder may move for the court to hold the infringer in contempt of court for violation of the injunction.¹³ Contempt proceedings may result in monetary or even criminal penalties.¹⁴ Courts have struggled to draw the line between redesigned products that violate the court order, on the one hand, and redesigned products that fall outside of the injunction and present a new question of infringement, on the other.¹⁵

A. INJUNCTIVE REMEDY

As with other types of cases, the Federal Rules of Civil Procedure govern injunctions in patent cases.¹⁶ Rule 65(d)(1), which covers the content of injunctive orders, requires that “[e]very order granting an injunction and every restraining order must: (A) state the reasons why it issued; (B) state its terms specifically; and (C) describe in reasonable detail—and not by referring to the complaint or other document—the act or acts restrained or required.”¹⁷

The Federal Circuit has consistently held that district courts are to be given wide leeway in crafting injunctions.¹⁸ As a result, despite Rule 65(d)’s requirements of specificity, patent injunctions are “frequently drafted or approved by the courts in general terms, broadly enjoining ‘further infringement’ of the ‘patent.’”¹⁹ The Federal Circuit has even declined to

issuing a permanent injunction in lieu of damages. *eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 391–92 (2006).

12. *See, e.g.*, *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522 (Fed. Cir. 1985); *McChullough Tool Co. v. Wells Surveys, Inc.*, 395 F.2d 230, 233 (10th Cir. 1968).

13. *KSM*, 776 F.2d at 1524–25. The Federal Circuit noted that a civil contempt proceeding for violating an injunction while primarily for the benefit of the patent owner, also serves to punish the infringer for an affront to the court for failure to obey its order. *See id.* (quoting *American Foundry & Mfg. Co. v. Josam Mfg. Co.*, 79 F.2d 116, 118 (8th Cir. 1935)).

14. 18 U.S.C. § 401 (2006).

15. *See KSM*, 776 F.2d at 1524–27.

16. FED. R. CIV. P. 65. Injunctive orders can also result from settlement agreements and stipulations of validity. *See KSM*, 776 F.2d at 1523–24.

17. FED. R. CIV. P. 65(d)(1).

18. *See KSM*, 776 F.2d at 1526–27 (“We believe it is preferable to allow the district courts wide latitude in framing injunctions.”); *see, e.g.*, *TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869, 884–89 (Fed. Cir. 2011).

19. *KSM*, 776 F.2d at 1526; *see, e.g.*, *August Tech. Corp. v. Camtek Ltd.*, No. 051396 MJD/AJB, slip op. at 7 (D. Minn. Aug. 28, 2009) (prohibiting the defendant “from practicing the method of Claim 3 or inspection methods that are colorable imitations thereof . . .”); *Nomadix, Inc. v. Second Rule LLC*, No. CV071946 DDP, slip op. at 2 (C.D.

prohibit injunctions that potentially reach non-infringing products.²⁰ Rather than regulating injunctive orders, the Federal Circuit's focus is on the infringer's redesigned product and other conduct.²¹

B. CONTEMPT FOR VIOLATION OF AN INJUNCTION

If the patent holder in a patent suit suspects that the infringer is violating the court's injunctive order, the patentee may file a motion asking the court to hold the infringer in contempt.²² Contempt authority is given to the federal courts by 18 U.S.C. § 401, which reads:

A court of the United States shall have power to punish by fine or imprisonment, at its discretion, such contempt of its authority, and none other, as—

(1) Misbehavior of any person in its presence or so near thereto as to obstruct the administration of justice; [. . .]

(3) Disobedience or resistance to its lawful writ, process, order, rule, decree, or command.²³

Contempt is a “potent weapon of judicial [. . .] power”²⁴ because parties who violate injunctions may be subject to large fines or even imprisonment (in extreme circumstances).²⁵ Given the potentially vague and broad nature of injunctions in patent cases, the Federal Circuit has been particularly cognizant of the need for clarity in contempt proceedings.²⁶ Thus, the court held in *KSM* that contempt proceedings are only appropriate “with respect to

Cal. Mar. 31, 2009) (prohibiting “directly or indirectly infringing any of [five] U.S. Patents . . . in any way”). One researcher at Stanford conducted a comprehensive analysis of injunctions issued in patent cases over the last several years and noted that in 2010, about 59% of injunctions issued in patent cases contained only language prohibiting “further infringement” or other similar broad proclamations, in an apparent violation of rule 65(d). John M. Golden, Patent Infringement-Injunctions’ Scope 11 (Feb. 1, 2011) (unpublished manuscript) (on file with author).

20. *TiVo*, 646 F.3d at 890 n.9 (“We note, however, that although we have strongly discouraged judicial restraint of noninfringing activities . . . we have never barred it outright and instead have repeatedly stated that district courts are in the best position to fashion an injunction tailored to prevent or remedy infringement.”) (internal citations omitted).

21. *KSM*, 776 F.2d at 1527 (“Whether a party is to be held in contempt [for violating an injunction], thus, becomes the matter on which uniformity is to be sought.”).

22. 18 U.S.C. § 401 (2006).

23. *Id.*

24. *KSM*, 776 F.2d at 1526.

25. 18 U.S.C. § 401 (2006); *see, e.g., TiVo*, 646 F.3d at 890 (upholding a \$90 million dollar sanction against the defendant for violation of the injunction).

26. *KSM*, 776 F.2d at 1526–27 (“We believe it is preferable to allow the district courts wide latitude in framing injunctions Whether a party is to be held in contempt [for violating an injunction], thus, becomes the matter on which uniformity is to be sought.”).

devices previously admitted or adjudged to infringe, and to those devices which are no more than ‘colorably different.’”²⁷

C. THE COLORABLE DIFFERENCES TEST BEFORE *TiVo*

For over a century, courts have wrestled with the issue of design-arounds following a finding of patent infringement and the issuance of an injunction.²⁸ Courts have uniformly agreed that not all redesigned products that infringe the patent are necessarily violations of the injunction.²⁹ However, courts have struggled to articulate an effective test for determining whether an attempted design-around is obviously made for the purpose of evading the decree, or whether the redesigned product is a substantially different design such that contempt proceedings would be inappropriate and potential infringement must be decided by a new trial.³⁰

Courts have attempted to strike a fair balance between the rights of patent holders and the rights of infringers to market legitimately redesigned products that no longer infringe.³¹ On the one hand, infringers would be unjustly hindered if a patentee could obtain summary contempt proceedings every time the infringer marketed a new redesigned product.³² On the other hand, if the patent holder were required to file a new complaint and hold a new infringement trial every time the infringer made simply small cosmetic changes to his product, then the value of the patent and the court’s order would be significantly diminished.³³ Thus, courts have tried to distinguish legitimate from illegitimate redesign attempts through the colorable differences test, which aims to strike a fair balance between the patentee’s and infringer’s rights.³⁴

27. *Id.* at 1526. The heart of the question is: how may a patentee proceed when an infringer modifies the infringing product? *McChullough Tool Co. v. Wells Surveys, Inc.*, 395 F.2d 230, 233 (10th Cir. 1968). The court must balance the right of the infringer to market new devices that are legitimately outside the scope of the patent in question with the right of the patent holder to not have to hold a new trial for each and every cosmetic change that the infringer makes to its product. *Id.*

28. *See, e.g.*, *Cal. Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609 (1885); *TiVo*, 646 F.3d at 869; *KSM*, 776 F.2d at 1522; *McChullough Tool Co. v. Wells Surveys, Inc.*, 395 F.2d 230 (10th Cir. 1968).

29. *KSM*, 776 F.2d at 1526–27 (discussing how the concept of colorable differences existed across all the circuits, but the implementation varied not only from circuit to circuit, but also from court to court).

30. *Id.* at 1526; *see also McChullough Tool Co.*, 395 F.2d at 233.

31. *McChullough Tool Co.*, 395 F.2d at 233.

32. *Id.*

33. *Id.*

34. *Id.*

Prior to the creation of the Federal Circuit, the other circuit courts employed different standards for determining when to consider contempt proceedings, what constituted contempt in this context, and at what stage they would apply the colorable differences test.³⁵ While the concept of a colorable differences test is simple, in practice it has proven to be much more difficult for courts to define what constitutes a colorable difference and to state clearly how to evaluate those differences.³⁶

1. *One of the First Appearances of the Colorable Differences Test: Molitor*

In *California Artificial Stone Paving Co. v. Molitor*, one of the earliest cases addressing the concept of colorable differences, the Supreme Court ruled that the wrongfulness of the defendant's conduct should be the deciding factor in contempt proceedings.³⁷ The lower court had found the defendant guilty of infringing a patent covering a novel method for forming blocks of cement pavement.³⁸ Following the finding of infringement, the lower court issued an injunction "restraining [the Defendant, Charles Molitor,] . . . from making, selling, or using, or in any manner disposing of, any artificial stone-block pavements embracing the invention and improvements described in the [patent]."³⁹ Molitor subsequently redesigned his product and marketed his new form of cement stone.⁴⁰ The plaintiff asked the court to hold Molitor in contempt of court for disobeying the injunction.⁴¹ The lower court held that the redesigned product was not an infringement and thus Molitor could not

35. *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1530 (Fed. Cir. 1985) ("The standard for determining a 'colorable' difference is critical, and an examination of case law indicates wide variance.>").

36. From an infringer's standpoint, knowing how to proceed following the issuing of a permanent injunction is of the utmost importance, as substantial portions of the infringer's business may be enjoined from operating until a design-around can be developed. However, without clear guidance as to what varieties of design-arounds are allowed and what types would violate the injunction, the infringer runs the risk of incurring substantial civil penalties or even criminal punishment. *See id.* at 1524; *see also id.* at 1530 ("[S]tating that the 'difference' must be 'colorable' provides little guidance to the appropriateness of contempt proceedings. The standard for determining a 'colorable' difference is critical, and an examination of case law indicates wide variance.>").

37. *Cal. Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 617-18 (1885).

38. *Id.* at 611-12.

39. *Id.* at 611-13.

40. *Id.* at 613.

41. *Id.* The most novel aspect of the plaintiff's invention was the beveling of the individual blocks to prevent them from becoming uneven relative to blocks placed next to them. *Id.* at 611. The defendant had originally used a method which included individual stones as well, but the redesigned product consisted instead of a single, very large block with small beveling traced into the surface. *Id.* at 613.

be found in contempt.⁴² The plaintiff appealed this decision to the Supreme Court.⁴³

The Supreme Court declined to rule on whether the redesigned product infringed the plaintiff's patent, holding that the mixed question of law and fact was best decided by the circuit court that had originally ruled on the construction of the claim.⁴⁴ The Court held that not all subsequent infringements that follow an injunctive order should be considered contempt of court, especially when there is a "fair ground of doubt" in the wrongfulness of the defendant's conduct.⁴⁵ The Court emphasized that contempt proceedings are only appropriate when the defendant's actions in redesigning his product were somehow "wrongful."⁴⁶ Though the Supreme Court did not use the phrase colorable differences, the Court alluded to that concept. The Court stated that the circuit court may rule on the infringing nature of the new product and may still hold Molitor in contempt, but that "[a new trial] is by far the most appropriate [option] where it is really a doubtful question whether the new process adopted is an infringement or not."⁴⁷

2. *Struggling with Colorable Differences from Molitor Through TiVo*

In the decades following *Molitor*, several circuits created colorable differences tests, with most echoing the Supreme Court's "fair ground of doubt" reasoning from *Molitor*.⁴⁸ However, the circuits each had different standards for when to consider contempt proceedings, what constituted contempt in this context, and at what stage they would apply the colorable

42. *Id.*

43. *Id.*

44. *Id.* at 617–18.

45. *Id.*

46. *Id.*

47. *Id.* at 618. The Supreme Court implied that if the continued infringement was a "doubtful question," then the defendant's conduct likely was not of the "wrongful" character required to find contempt. *Id.*

48. *See, e.g.,* *Sure Plus Mfg. Co. v. Kobrin*, 719 F.2d 1114, 1118 (11th Cir. 1983) ("Even if the [defendants'] modified mirror assembly infringes the Sure Plus patent, as long as it is more than *colorably different* the infringement should not amount to a contempt nor should it be tested in contempt proceedings.") (emphasis added); *American Foundry & Mfg. Co. v. Josam*, 79 F.2d 116, 117 (8th Cir. 1935) ("[Redesigned products] may turn out to be infringements, but if they are more than '*colorably different*, the issue of infringement must be otherwise determined than by a contempt proceeding.") (emphasis added); *Radio Corp. of America v. Cable Radio Tube Corp.*, 66 F.2d 778, 782–83 (2d Cir. 1933) ("But where infringement by the new device is not clear on the face of the matter and there are substantial issues for the determination of the court, the plaintiff may not have them determined in contempt proceedings, but must bring a supplemental bill for an injunction covering the new device, or institute a wholly new suit for such an injunction.").

differences test.⁴⁹ Several circuits drew upon the doctrine of equivalents test of patent infringement from *Graver Tank*⁵⁰ to determine the colorability of differences wherein if “two devices do the same work in substantially the same way, and accomplish substantially the same result, they are the same, even though different in name, form or shape.”⁵¹ By contrast, other circuits applied a test that considered the evidentiary elements related to the infringement of the accused device; these circuits found that two devices were more than colorably different when “infringement by the new device is not clear on the face of the matter, and [when] there are substantial issues for the determination of the court.”⁵² Thus, while the circuits agreed that only certain redesigned products should be triable in a contempt proceeding, they varied in the tests they employed to sort those eligible for contempt proceedings from those requiring a separate trial for infringement.

In 1985, the newly formed Federal Circuit established uniformity in the matter by promulgating a single test for contempt.⁵³ In *KSM*, the plaintiff, KSM Fastening Systems, brought suit against H.A. Jones Co., the alleged infringer, for manufacturing and selling hanger assemblies for securing refractory linings to furnace walls.⁵⁴ The parties settled, Jones stipulated as to the validity of KSM’s patent and infringement thereof, and Jones was also

49. *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1530 (Fed. Cir. 1985) (“The standard for determining a ‘colorable’ difference is critical, and an examination of case law indicates wide variance.”). The Federal Circuit advocated for clarity in the colorable difference test. *Id.* at 1530 (“[S]tating that the ‘difference’ must be more than ‘colorable’ provides little guidance to the appropriateness of contempt proceedings.”).

50. *Graver Tank & Mfg. Co. v. Linde Air Prods. Co.*, 339 U.S. 605 (1950).

51. *Interdynamics, Inc. v. Firma Wolf*, 653 F.2d 93, 99 (3rd Cir. 1981); *see, e.g.*, *Ransburg Electro-Coating Corp. v. Ionic Electrostatic Corp.*, 395 F.2d 294 (4th Cir. 1968); *Chemical Cleaning, Inc. v. Dow Chemical Co.*, 379 F.2d 294 (5th Cir. 1967); *Siebring v. Hansen*, 346 F.2d 474 (8th Cir. 1965). The Federal Circuit in *KSM* disfavored this substantive standard for determining colorability, and instead preferred that the measure of colorable differences be based on a consideration of procedural elements related to infringement. *See KSM*, 776 F.2d at 1532.

52. *Radio Corp. of America*, 66 F.2d at 782–83. This approach effectively considered the infringement of the redesigned product as opposed to its difference from the original product, and was also adopted by the 7th Circuit. *See, e.g.*, *Great Lakes Carbon Corp. v. Eagle Lumber Dealers Supply Co.*, 402 F.2d 106 (7th Cir. 1968); *Baltz v. The Fair*, 279 F.2d 899 (7th Cir. 1960).

53. *See KSM*, 776 F.2d at 1527 (discussing how the concept of colorable differences existed across all the circuits, but the implementation varied not only from circuit to circuit, but from court to court). The court noted that uniformity could be achieved by requiring courts to write injunctions in a particular manner, but the court decided to leave the district courts wide discretion in writing injunctions and instead insist on uniformity in contempt proceedings. *Id.*

54. *Id.* at 1523–24.

enjoined from further infringement.⁵⁵ Jones modified its hanger assembly and attempted to market the redesigned product, but KSM moved for the court to hold Jones in contempt for violating the injunction.⁵⁶ In finding Jones in contempt, the district court relied on the Third Circuit's colorable differences test, which asked whether the two devices were equivalent under the "doctrine of equivalents."⁵⁷ The district court did not consider whether the redesigned product actually infringed the claims of KSM's patent, but instead considered whether the two devices "do the same work in substantially the same way, and accomplish substantially the same result."⁵⁸ On appeal, the Federal Circuit rejected this reasoning and articulated a new, two-step test for determining whether the redesigned product was more than colorably different from the original product.⁵⁹

The two-step test attempted to separate out the colorable differences component of the test from the consideration of infringement and violation of the injunction by making colorable differences an independent step in the contempt proceedings. The first step requires a court to evaluate the differences between the original and redesigned product and to determine whether contempt proceedings are appropriate.⁶⁰ If the two products are no more than colorably different, then contempt proceedings are deemed appropriate.⁶¹ The second step requires a court to hold contempt proceedings to determine both if (a) the injunction was violated and (b) the accused device was actually an infringement.⁶² The court stressed that in the first step, the colorable differences test would be tied to a consideration of the procedural elements necessary to determine infringement.⁶³

55. *Id.* The injunction read, "[t]he Defendant . . . [is] enjoined and restrained from making, using or selling insulation hangers or refractory anchors of the type and nature identified by the Plaintiff in its Complaint against the Defendant for the remainder of the life of U.S. Patent No. 3,738,217 issued June 12, 1973." *Id.* at 1523–24 n.6.

56. *Id.* at 1523–24.

57. *Id.* at 1527 (noting that the district court applied the standard set forth in *Interdynamics, Inc. v. Firma Wolf*, 653 F.2d 93 (3rd Cir. 1981)).

58. *KSM*, 776 F.2d at 1527. The court concluded that the modified doctrine of equivalents adopted by the *Interdynamics* court does not assure a proper finding that the modified device actually infringes the claims. *Id.* at 1528. *See also* Preemption Devices, Inc. v. Minnesota Mining & Manufacturing Co., 803 F.2d 1170, 1175 (Fed. Cir. 1986) (remanding the case to the district court for similar reasoning).

59. *KSM*, 776 F.2d at 1529–30.

60. *Id.* at 1531.

61. *Id.* at 1532.

62. *Id.*

63. *Id.* at 1531. ("The question to be answered under such a standard is essentially a *procedural* one. Must substantial new issues be litigated to determine infringement?" (emphasis in original)).

The court in *KSM* held that whether or not colorable differences exist between the original infringing product and the redesigned product would depend on whether there are substantial open issues with respect to infringement that needed to be tried.⁶⁴ If the court would need to litigate complex questions of infringement—for example, if expert and other testimony subject to cross-examination would be helpful or necessary in order to determine the infringing nature of the accused product—contempt proceedings would be inappropriate, and the court would not proceed to the second step of the test.⁶⁵ Thus, under *KSM*, the colorable differences inquiry was not directed to the actual elements of the products, but rather to procedural or evidentiary considerations related to the infringing nature of the products.⁶⁶ In practice, if a court could rule on the infringing nature of a redesigned product without requiring much evidence outside of the established record, then the original and redesigned devices would not likely be more than colorably different and contempt proceedings would be appropriate. On the other hand, if the court needed to obtain substantial amounts of new evidence to determine infringement—such as several new expert reports or new witness testimony—the original and redesigned devices would likely be more than colorably different and contempt proceedings would be inappropriate.

If a court determined that contempt proceedings were appropriate, it proceeded to the second step of the *KSM* test in which it would determine whether the redesigned device actually violated the injunction and infringed the patent.⁶⁷ If the redesigned product both infringed the patent and violated the injunction, the court could then hold the defendant in contempt.⁶⁸

Unfortunately, the *KSM* decision did not enhance the clarity and uniformity of the colorable differences test. As noted by the court in *TiVo*, district courts ended up confusing the procedural infringement considerations of colorable differences in the first step with the actual infringement analysis of the second step.⁶⁹ Consequently, rather than applying the two-step process envisioned by the Federal Circuit, district

64. *Id.* at 1532.

65. *Id.* at 1531.

66. As discussed in Part III.A, *infra*, this standard ended up with courts collapsing the question of colorable differences down to one of infringement of the redesigned product. In determining what they would need to determine infringement, courts would effectively decide colorable differences of the redesigned product based the infringing nature of the redesigned product, which is exactly what the Federal Circuit wanted to avoid.

67. *KSM*, 776 F.2d at 1532.

68. *Id.* at 1532.

69. *See TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869, 881 (Fed. Cir. 2011).

courts often compressed the *KSM* test into a single question of infringement of the redesigned device.⁷⁰

II. THE *TIVO* CASE

Recognizing that the *KSM* test did not provide a clear standard for determining when to entertain contempt proceedings in patent cases, the Federal Circuit in *TiVo* discarded the test and articulated a new test for contempt and a new method for determining whether differences between two products are more than colorable.⁷¹ The Federal Circuit shifted the colorable differences analysis from a consideration of procedural and evidentiary factors, where courts consider the information needed to determine infringement, to a consideration of the substantive elements of the redesigned product, where courts analyze the changes made to the infringing elements of the original product.⁷²

A. PROCEDURAL HISTORY AND FACTS

TiVo is a producer of digital video recorders (“DVRs”), which are devices that allow users to pause and record live television.⁷³ The ability to record live TV allows TiVo users to pause or rewind a television program in the same manner they would a home movie.⁷⁴ TiVo holds several patents on its DVR, including U.S. Patent No. 6,233,389 (the “’389 patent”).⁷⁵ The claim at issue, Claim 31 of the ’389 patent, reads in its pertinent sections:

A process for the simultaneous storage and play back of multimedia data, comprising the steps of:

[1] providing a physical data source, wherein said physical data source accepts broadcast data from an input device, *parses video and audio data from said broadcast data* [the “parsing” limitation], and temporarily stores said video and audio data;

[2] providing a source object, wherein said source object extracts video and audio data from said physical data source;

70. *See, e.g., id.* at 883–84 (noting that the district court only considered whether the redesigned product infringed the patent); *Arbek Manufacturing, Inc. v. Sasan Moazzam*, 55 F.3d 1567, 1569 (Fed. Cir. 1995) (“The trial court chose, however, to undertake a substantive infringement analysis [to determine contempt].”).

71. *TiVo*, 646 F.3d at 881. Though the court did not explicitly state it in *TiVo*, one of the primary justifications for a clear test in contempt proceedings is to counter the wide discretion that district courts have in writing injunctions. *See KSM*, 776 F.2d at 1527.

72. *See TiVo*, 646 F.3d at 882–83; MATTHEWS, *supra* note 8 and accompanying text.

73. *TiVo*, 646 F.3d at 876.

74. *Id.*

75. *Id.*

[3] providing a transform object, wherein said transform object stores and retrieves data streams onto a storage device;

[4] wherein said source object obtains a buffer from said transform object, said source object converts video data into data streams and fills said buffer with said streams;

[5] wherein said source object is automatically flow controlled by said transform object.⁷⁶

In 2004, TiVo sued EchoStar for infringing several claims of the '389 patent, including Claim 31, based on EchoStar's sale of its own DVRs.⁷⁷ A jury found that the patent was valid and that EchoStar's products were infringing.⁷⁸ Specifically, the jury found that EchoStar's start code procedure met the "parsing" limitation of Claim 31.⁷⁹ The district court issued a permanent injunction against EchoStar, ordering EchoStar to (1) stop making, using, offering to sell, and selling the receivers that had been found infringing by the jury (the "infringement" provision); (2) disable the DVR functionality in existing receivers that had already been placed with EchoStar's customers and in new placements that were yet to be placed with EchoStar's customers (the "disablement" provision); and (3) not "otherwise infring[e] or induc[e] others to infringe the Infringed Claims of the '389 patent" (the "catchall" provision).⁸⁰ On the first appeal, the Federal Circuit overturned several infringement findings, but upheld the verdict of infringement of Claim 31.⁸¹

Following the first appeal, EchoStar redesigned its DVR, and TiVo subsequently filed a motion in the district court to hold EchoStar in

76. *Id.*

77. *Id.* at 877.

78. *Id.*

79. *Id.* at 878.

80. *Id.* at 877 ("The infringement provision reads: 'Each Defendant . . . [is] hereby restrained and enjoined, pursuant to 35 U.S.C. 283 and Fed.R.Civ.P. 65(d), from making, using, offering to sell, selling, or importing in the United States, the Infringing Products, either alone or in combination with any other product and all other products that are only colorably different therefrom in the context of the Infringed Claims, whether individually or in combination with other products or as a part of another product, and from otherwise infringing or inducing others to infringe the Infringed Claims of the #389 patent The disablement provision reads: 'Defendants are hereby FURTHER ORDERED to, within thirty (30) days of the issuance of this order, disable the DVR functionality . . . in all but 192,708 units of the Infringing Products that have been placed with an end user or subscriber. The DVR functionality . . . shall not be enabled in any new placements of the Infringing Products.'").

81. *TiVo, Inc. v. EchoStar Comm. Corp.*, 516 F.3d 1290, 1312 (Fed. Cir. 2008).

contempt of the court's permanent injunction.⁸² EchoStar argued that it had redesigned its products so that they no longer met the "parsing" limitation of Claim 31.⁸³ During redesign, EchoStar had replaced its infringing start code procedure with a statistical estimation element, which they argued was non-infringing.⁸⁴ Using the two-part *KSM* test, the district court held that EchoStar's redesigned product was not more than colorably different from its original infringing product.⁸⁵ The district court further held that even if the new statistical estimation feature did not infringe Claim 31, an unaltered element of EchoStar's DVR, the PID filter, still fell within the "parsing" limitation, and thus contempt was appropriate for violation of the "infringement" provision of the injunction.⁸⁶ The PID filter was present in both the original product and the redesigned product, but the jury had never ruled on whether or not the PID filter met the "parsing" limitation.⁸⁷ The district court also held that EchoStar had failed to comply with the "disablement" provision of the injunction because it had not disabled the DVR functionality in its existing receivers.⁸⁸ The court dismissed as untimely EchoStar's contentions that the injunction was overbroad, and the court awarded damages to TiVo for EchoStar's contempt.⁸⁹ EchoStar appealed to the Federal Circuit once more.

B. A NEW CONTEMPT REGIME FOR PATENT CASES

On the second appeal, the Federal Circuit rejected the *KSM* two-step contempt inquiry applied by the district court and reformulated a new one.⁹⁰ The court found the *KSM* test unworkable because many district courts, such as the district court in this case, simply analyzed whether or not the new

82. *TiVo*, 646 F.3d at 878.

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.* at 878–79.

87. *Id.*

88. *Id.* at 879. EchoStar argued that by replacing the infringing elements of its products there were no longer any "infringing" DVRs to disable. *Id.* The court rejected this contention, noting that the injunction required a disablement of the DVR functionality of EchoStar's receivers, which EchoStar could not escape by attempting changing small parts of its products. *Id.* at 886–87. The court noted that this injunction was broad, but refused to rule on the issue that it may in fact cover non-infringing activities. *Id.* at 890 n.9 ("We note, however, that, although we have strongly discouraged judicial restraint of noninfringing activities . . . we have never barred it outright and instead have repeatedly stated that district courts are in the best position to fashion an injunction tailored to prevent or remedy infringement.").

89. *Id.* at 878.

90. *Id.* at 881.

product was infringing when determining whether contempt was appropriate during the first step of the *KSM* test.⁹¹ With this confusion in mind, the Federal Circuit ruled that colorable differences in the first step of the *KSM* test would no longer be tied to any question of infringement.⁹² Furthermore, the Federal Circuit held that colorable differences would no longer be tied to the appropriateness of holding contempt proceedings.⁹³ Instead, district courts could use their discretion in deciding when to hold contempt proceedings.⁹⁴

The first step of contempt proceedings under *TiVo* is to determine whether the original and redesigned devices are merely colorably different. While this is similar to the first step of the *KSM* test, the Federal Circuit did away with the *KSM* test's required analysis of procedural and evidentiary issues related to infringement for judging colorable differences.⁹⁵ Instead, the *TiVo* court held that that when

elements previously found to infringe [have] been modified, or removed, the court must make an inquiry into whether that modification is significant, [and if they] are significant, the newly accused product as a whole shall be deemed more than colorably different from the adjudged infringing one.⁹⁶

If the district court finds that the devices are no more than colorably different, the district court may then determine whether the redesigned product violates the injunction and infringes the patent.⁹⁷

In articulating the new method for determining colorable differences, the court stressed that if there were more than colorable changes to the infringing elements of the original product, then the alleged infringement of the new product is irrelevant to the contempt proceeding, and courts must

91. *Id.*

92. *Id.* at 881–82.

93. *Id.*

94. *Id.* at 881.

95. *Id.* at 882.

96. *Id.* The court noted that “[t]he significance of the differences between the two products is much dependent on the nature of the products at issue” *Id.* To aid in determining if a change to an element is a colorable difference or not, the court stated that “[a] nonobvious modification may well result in a finding of more than a colorable difference.” *Id.* at 882–83.

97. *Id.* at 883. This varies from the *KSM* test in that rather than determining colorable differences when deciding whether or not to hold contempt proceedings, district courts now are left with broad discretion in deciding to hold contempt proceedings, and only once the court has decided to entertain contempt proceedings would it turn to the question of “colorable differences.”

order a new trial on the merits.⁹⁸ On the other hand, if the district court concludes that the infringing elements of the original device and those of the redesigned device are only colorably different, then it may proceed to hold the defendant in contempt as long as the redesigned product actually violates the injunction by infringing the patent.⁹⁹

Applying the new rule, the Federal Circuit found that the district court judge had not evaluated the changes made to the infringing start code element of EchoStar's DVRs.¹⁰⁰ Specifically, the district court failed to determine whether the new statistical estimation element was more than colorably different from the original start code element that it replaced.¹⁰¹ Rather, the district court judge had ruled that the devices were merely colorably different because a separate element, the unmodified PID filter, also met the parsing limitation, even though the infringing nature of the PID filter had not been ruled upon during the trial.¹⁰² The Federal Circuit remanded the case to the district court to determine whether, under the new test, EchoStar's replacement statistical estimation feature was merely colorably different from the previous start code procedure.¹⁰³ If the district court determines that the two are more than colorably different, then the court must order a new trial to determine infringement, even if the PID filter or the new statistical estimation feature could potentially meet the parsing limitation.¹⁰⁴

At the same time, the Federal Circuit considered and rejected EchoStar's claims that the "disablement" provision of the injunction was vague and overbroad.¹⁰⁵ First, EchoStar contended that the "disablement" provision was vague because the requirement to disable DVR functionality should not apply to machines with the redesigned software installed in place of the

98. *Id.* at 882–83. This signals a shift in colorable differences from the infringement-based analysis of the *KSM* test to a substantive comparison of the original and redesigned products devoid of any infringement considerations. *See id.* at 881 (“As to the question whether an injunction against patent infringement has been violated, courts should continue to employ a ‘more than colorable differences’ standard as [set forth] below.”).

99. *Id.* at 883.

100. *Id.* at 883–84.

101. *Id.* Interestingly, the Federal Circuit never discussed the required analysis related to the removal of the record buffer and the “flow control” limitation.

102. *Id.*

103. *Id.* at 884.

104. *Id.* The dissent argued against remanding the case to the district court on the grounds that the devices were clearly colorably different, as the element adjudicated to be infringing had been removed entirely and replaced with something else. *Id.* at 890–91.

105. *Id.* at 884–90.

original software.¹⁰⁶ The Federal Circuit dismissed this argument as untimely because EchoStar had had several opportunities to challenge the vagueness of the injunction through appeal, but had chosen not to.¹⁰⁷ The court held that EchoStar could not unilaterally decide to proceed in the face of the injunction and make an after-the-fact contention that it is unduly vague.¹⁰⁸ The Federal Circuit similarly barred as untimely EchoStar's second claim that the injunction was overbroad.¹⁰⁹

In summary, the Federal Circuit reversed the district court's holding that EchoStar violated the "infringement" provision of the injunction and remanded the case for the district court to apply its newly formulated test for contempt.¹¹⁰ However, the Federal Circuit upheld the district court's ruling that EchoStar had violated the "disablement" provision of the injunction by failing to disable any of its DVRs.¹¹¹

C. THE NEW *TiVo* RULE APPLIED: *HYDRO ENGINEERING*

In a recent district court case, *Hydro Engineering*, the court applied the new colorable differences test from *TiVo* and held that while the redesigned product may very well infringe the patent, the original product and the redesigned product were more than colorably different under *TiVo* such that contempt proceedings were inappropriate.¹¹² *Hydro Engineering* illustrates that under the *TiVo* rule, the colorable differences hurdle to contempt is entirely separate from any consideration of infringement; the question instead turns on "the differences between the features relied upon to establish infringement and the modified features of the newly accused products."¹¹³

In the initial suit, Petter Investments, Inc. ("Petter") and Hydro Engineering, Inc. ("Hydro") both sold wash fluid containment systems for cleaning large vehicles, such as bulldozers.¹¹⁴ While prior washing systems

106. *Id.* at 884–85.

107. *Id.* at 886.

108. *Id.*

109. *Id.* at 889.

110. *Id.* at 884.

111. *Id.* at 890 (holding that while the injunction was indeed very broad, EchoStar had not complied with the injunction and had failed to challenge the overbreadth or vagueness of the injunction until this time).

112. Petter Investments, Inc. v. Hydro Engineering, Inc., No. 1:07 CV 1033 *8 (W.D. Mich. July 18, 2011). The case began as a declaratory judgment action brought by Petter Investments claiming invalidity and non-infringement of Hydro Engineering's patents as well as infringement of Petter Investments' patents by Hydro Engineering, and Hydro Engineering counterclaimed for infringement. Petter Investments, Inc. v. Hydro Engineering, Inc., 664 F. Supp. 2d 816 (W.D. Mich. 2009).

113. See *TiVo*, 646 F.3d at 882.

114. *Hydro Engineering*, 664 F. Supp. 2d at 818–19.

were permanently fixed to the ground and consisted of a porous grate that the vehicle would drive onto situated over a large open tank to collect waste water, Hydro developed and patented a portable version of such a washing system (U.S. Patent No. 6,799,591) (the “’591 patent”) that could be placed on any type of surface or slope.¹¹⁵ Rather than utilizing a porous grate, Hydro’s portable system consisted of an impervious, grooved surface, where the waste water ran along the grooves and collected in a trough at the edge of the wash pad.¹¹⁶ Petter also marketed a series of portable wash pads that featured a side trough for collecting waste water.¹¹⁷

Hydro contended that Petter’s pads infringed Claim 15 of the ’591 patent, which reads:

A vehicle receiving pad comprising:

An *impervious top* comprising: (a) spaced generally transversely directed impervious ridge portions upon which vehicles, including heavy vehicles, and other items are supported in load-transferring relation for exterior cleaning using a cleaning liquid and (b) impervious generally transversely direct sloped drainage corridors disposed below the ridge portions into which used cleaning liquid and removed debris collectively flow, each drainage corridor being sloped toward at least one side of the pad;

A trough into which the cleaning liquid and debris discharged from the covering, collectively flow and are temporarily stored, so as to prevent any material debris accumulation in the drainage corridors and from which the liquid and debris can later be generally segregated and separately removed.¹¹⁸

Relying on the fact that Petter’s wash pads were “impervious” and included a “side trough,” the district court held that Petter’s wash pads infringed Claim 15.¹¹⁹ The district court entered an injunction that enjoined Petter from infringing the ’591 patent and from

making . . . any impervious ‘side trough’ wash pad, including Petter’s impervious side trough wash pads without water channels, and any other wash pads for which all of the components found in [the wash pads] determined to infringe ([1] impervious side trough

115. *Id.* at 819. Hydro also held a patent on the process of using the pad to wash a large vehicle (the ’749 patent). *Id.*

116. *Id.*

117. *Id.* at 821.

118. Petter Investments, Inc. v. Hydro Engineering, Inc., No. 1:07 CV 1033 *2 (W.D. Mich. July 18, 2011) (emphasis added).

119. *Hydro Engineering*, 664 F. Supp. 2d at 824–26.

wash pads without water channels and [2] impervious side trough wash pads with water channels) are components of any new product.¹²⁰

Following the issuance of the injunction, Petter attempted to redesign its wash pads so that the injunction would not cover the new pads.¹²¹ Petter replaced the impervious top surface of the pad with a continuous metal-plate surface that had pairs of uniformly-spaced lines of holes over drainage channels hidden beneath the wash pad surface to accommodate the water flow to the trough.¹²² Petter also relocated the trough from the side of the wash pad to the interior, near the back of the pad, such that it ran down the center.¹²³ Hydro filed a motion to hold Petter in contempt, claiming that these redesigns violated the injunction and infringed the patent.¹²⁴

Having decided that contempt proceedings were appropriate, the district court, applying the new test from *TiVo*, held that Petter was not in contempt for violation of the injunction because the differences between the original wash pads and the redesigned pads were more than colorable.¹²⁵ As required by *TiVo*, the court restricted its colorable differences analysis to the actual elements that it had previously found that Petter had infringed, which included the impervious surface and the side trough.¹²⁶ The court noted that Petter's prior infringing wash pads had an impervious top surface with ridges and grooves, but the new pads have golf ball-sized holes in the surface that allow water to drain into channels located directly beneath.¹²⁷ The court held that "[t]his difference is more than merely one of appearance; rather, it affects how the wash pad functions. Given the nature of the product and the prior art, this difference is significant."¹²⁸ The court also held that the relocation of the trough from the side to the center of the pad was more than a colorable difference.¹²⁹ Noting that the relocation of the trough may still infringe the patent, the court held that the change was more than colorable because it was unclear to what extent the relocation affected the operation

120. *Hydro Engineering*, No. 1:07 CV 1033 at *3–4. The district court also held that Petter had contributorily infringed Claims 2 and 3 of the process patent. *Id.* at *3.

121. *Id.* at *4.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* at *5 (“In the Court’s judgment, the differences between Petter’s redesigned wash pads and the accused products are significant, such that the redesigned products are more than colorably different from the adjudged infringing wash pads.”).

126. *Id.* at *4–6.

127. *Id.* at *5.

128. *Id.*

129. *Id.* at *6.

and design of the wash pad support structure.¹³⁰ Thus, the court concluded that while the new pads may still infringe the '591 patent, contempt was inappropriate and infringement should be determined through a new trial.¹³¹

III. DISCUSSION

The *TiVo* decision altered the colorable differences test and redefined it as a direct evaluation of the redesigned product, instead of a question related to infringement. This recasting of colorable differences will help to clear up the infringement-related confusion of *KSM* and force courts to independently evaluate whether the changes made during redesign were more than colorable. Even though this does shorten the potential reach of contempt proceedings, focusing the test on the products themselves helps bring the colorable differences test in line with the policy goals of *Molitor*, the early Supreme Court case on the concept of colorable differences, because it structures contempt proceedings such that contempt is only found if the defendant's conduct is somehow "wrongful." Finally, the *TiVo* test provides clear guidance to courts and to infringers attempting to redesign their products to avoid contempt.

A. COLORABLE DIFFERENCES SHIFTS FROM INFRINGEMENT TO AN EVALUATION OF THE REDESIGNED PRODUCT

The new test set forth in *TiVo* shifts the colorable differences test from a consideration of procedural and evidentiary factors related to infringement to a substantive analysis of the changes made to the infringing elements of the original product.¹³² The old *KSM* rule stressed that the colorable differences test was a question of the procedural and evidentiary issues related to the infringing nature of the redesigned product.¹³³ Under the *KSM* test, two devices were more than colorably different if substantial issues related to

130. *Id.* ("[W]hether the additional decking material is actually part of the washing surface presents a significant issue inappropriate for contempt proceeding[s].").

131. *Id.* The court went on to conclude that even if the new pads were only colorably different, they did not infringe the '591 patent because they were not "impervious." *Id.* This case illustrates the shift from considering whether or not two *products* are colorably different to whether or not the *elements* of two products are colorably different. *See id.* Here, the court found that both of the elements relied upon to establish infringement (the impervious top surface and the side trough) had been altered in more than colorable ways, but even altering one of these in more than a colorable manner would have been sufficient to avoid contempt. *Id.*

132. *See TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869, 882 (Fed. Cir. 2011).

133. *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1531 (Fed. Cir. 1985) ("The question to be answered under such a standard is essentially a *procedural* one. Must substantial new issues be litigated to determine infringement?" (emphasis in original)).

infringement would need to be litigated to determine the infringing nature of the redesigned product as compared to the original.¹³⁴ Thus, the crux of colorable differences under the *KSM* test was whether or not the original and redesigned devices were similar enough for the court to rule on the infringing nature of the redesigned product without the need for substantial further litigation.¹³⁵ Under *KSM*, if a court found that two devices were merely colorably different, then the court could entertain contempt proceedings.¹³⁶ In such a contempt proceeding, if the court determined that the redesigned product actually infringed the patent and violated the injunction then the court would find the defendant in contempt.¹³⁷

By contrast, under the new rule set forth in *TiVo*, the colorable differences step is a substantive evaluation of the changes made to the infringing elements of the original product.¹³⁸ The *TiVo* test also removes colorable differences from the “appropriateness” section of the first step of the *KSM* test and grants district courts wide discretion in deciding when contempt proceedings are appropriate.¹³⁹ Thus, under *KSM*, a court would consider colorable differences when deciding whether or not to hold contempt proceedings, but under *TiVo*, the court would not evaluate colorable differences until it has already decided to hold contempt proceedings. The *TiVo* colorable differences test is also wholly apart from any consideration of infringement, and is instead its own separate hurdle to support a finding of contempt.¹⁴⁰ Only after a district court has evaluated the changes made to the infringing elements of the original product and found the changes to be merely colorable differences may the court consider whether the redesigned product infringes the patent and violates the injunction.¹⁴¹

Unlike the *KSM* rule, the *TiVo* rule specifically sets forth what parts of the product must be analyzed to determine whether there are more than colorable differences between the original and redesigned products.¹⁴² Rather

134. *Id.*

135. *See, e.g., id.*

136. *Id.* at 1532.

137. *See id.* The presence of infringement considerations in both steps of the *KSM* test likely led to the confusion witnessed in the district courts. *See, e.g., TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869, 881 (Fed. Cir. 2011) (rejecting the *KSM* test as unworkable because many district courts simply analyzed whether or not the new product was infringing).

138. *TiVo*, 646 F.3d at 882.

139. *Id.* at 881.

140. *Id.* at 882 (“Today we reject [the] infringement-based understanding of the colorably different test.”).

141. *Id.* at 883.

142. *Id.* at 882.

than determining colorable differences based on the procedural and evidentiary ramifications of infringement proceedings of the redesigned products, district courts must now determine colorable differences by undertaking a substantive analysis of the changes made to the infringing elements of the original product.¹⁴³ Specifically, the Federal Circuit held that “[when] elements previously found to infringe [have] been modified, or removed, the court must make an inquiry into whether that modification is significant, [and if they] are significant, the newly accused product as a whole shall be deemed more than colorably different from the adjudged infringing one.”¹⁴⁴ By removing any question of infringement from the colorable differences test, the *TiVo* rule is likely to avoid the pitfalls of the *KSM* test by clearly restricting the focus of the district court. Thus, unlike *KSM*, which required courts to compare somewhat imprecisely two products based on the procedural implications of infringement, the *TiVo* rule guides courts in determining what elements of the redesigned product they should analyze when deciding whether or not changes to the infringing elements of the original product are more than colorable differences.¹⁴⁵

In summary, the *TiVo* test separates the colorable differences test from any consideration of infringement, and instead maintains it as an independent substantive consideration that courts must address before turning to the questions of infringement or violation of the injunction.¹⁴⁶

B. *TiVo* ADDS CLARITY TO COLORABLE DIFFERENCES AND CONFORMS CLOSER TO THE POLICY GOALS OF *MOLITOR*

By specifically defining the elements of a device that must be colorably different and by separating this question from infringement, the Federal Circuit has brought more clarity to contempt proceedings in the context of redesigns following patent infringement.¹⁴⁷ *TiVo* also brings the colorable

143. *Id.*

144. *Id.*

145. *Compare* *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1532 (Fed. Cir. 1985) (holding that colorable differences between two products are to be determined by evaluating if substantial open issues with respect to infringement are to be tried), *with TiVo*, 646 F.3d at 882 (holding that the changes to the actual infringing elements of the original product should be analyzed).

146. *See TiVo*, 646 F.3d at 882. In some ways this holding marks a return to the *Interdynamics* style substantive rule that was rejected by the court in *KSM* in favor of a consideration of evidentiary and procedural elements. *See KSM*, 776 F.2d at 1527–31 (rejecting the substantive doctrine-of-equivalents style test used by some circuits for determining colorable differences in favor of a more procedurally oriented test).

147. *See KSM*, 776 F.2d at 1527 (holding that a clear test for contempt was necessary to counteract the broad injunctions often seen in patent cases).

differences test in line with the Supreme Court's policy goals set forth in *Molitor*—namely that contempt should only be found when there is some “wrongfulness” in the defendant's conduct.¹⁴⁸

Infringers who are confronted with a broad injunction following a finding of patent infringement may now redesign their products with a fair understanding of how that product will be analyzed in any potential contempt proceedings. Prior to *TiVo*, courts would evaluate colorable differences in the light of an infringement analysis, as required by *KSM*.¹⁴⁹ This version of the colorable differences test provided infringers with little guidance concerning redesigned products, and infringers ran the risk that even substantial changes to infringing elements would not suffice to avoid contempt.¹⁵⁰ For example, the district court in *TiVo*, applying the *KSM* test, held that even though EchoStar had in fact removed the infringing start code procedure, the product still infringed TiVo's patent because, in the court's opinion, another element, the PID filter, met the claim limitations, and therefore the redesigned product was not more than colorably different.¹⁵¹ Thus, prior to *TiVo*, infringers who completely removed infringing elements from their redesigned product still ran the risk of contempt if the district court viewed other elements as sufficiently infringing.¹⁵² Under the new standard, however, the question of infringement is entirely removed, and the court applying the colorable differences test must focus only on the status of the elements previously held to be infringing.¹⁵³ Thus, under *TiVo*, an infringer redesigning his product can be confident in which elements of the product he should remove or substantially alter during redesign to avoid being subject to contempt proceedings. The confinement of the colorable differences analysis to the changes made to the specific modified elements which were previously found to be infringing, and not the product as a whole, provides infringers confronted with injunctions with increased

148. *Cal. Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 617–18 (1885).

149. *See, e.g., TiVo*, 646 F.3d at 883–84; *Arbek Manufacturing, Inc. v. Sasan Moazzam*, 55 F.3d 1567, 1569 (Fed. Cir. 1995).

150. *See, e.g., TiVo*, 646 F.3d at 883–84.

151. *See id.* at 878.

152. This was not the intention of the *KSM* court but rather was the result of confusion stemming from the intertwining of infringement and colorable difference questions. *See id.* at 882 (“In some cases [the infringement based colorable difference test] has misled district courts to focus solely on infringement by the newly accused devices in deciding contempt.”).

153. *Id.* (“Instead of focusing on infringement, the contempt analysis must focus initially on the differences between the elements relied upon to establish infringement and the modified elements of the newly accused products.”).

guidance and greater clarity on how to avoid contempt when redesigning their products, though they may still be subject to a new infringement suit.¹⁵⁴

The Federal Circuit's restructuring of the colorable differences test in *TiVo* also helps meet the policy goal expressed in *Molitor* that a contempt finding should be based on some "wrongful conduct" on the part of the infringer.¹⁵⁵ Courts have stressed that contempt is a severe remedy and one that is not justified if there is a "fair ground of doubt" as to the wrongfulness of the infringer's conduct.¹⁵⁶ The colorable differences test was intended as a way to differentiate between infringers who made a good faith effort to redesign their products in compliance with the court's injunctive order and those infringers who made only cosmetic changes in an attempt to shirk the order. Conversely, under the *KSM* rule, even infringers, such as EchoStar, who completely removed the infringing elements of their products, could be found in contempt of court because the judge determined that the product infringed the patent in another way.¹⁵⁷ The *KSM* rule did not effectively consider the "fair ground of doubt" as to the wrongfulness of the defendants conduct because it caused courts to focus on the potential infringement of the redesigned product instead of the changes made to the infringing elements of the original product during the redesign.¹⁵⁸ As stated by the Supreme Court in *Molitor*, not every subsequent infringement should be considered contempt of court, only those where there is something "wrongful" about the defendant's conduct.¹⁵⁹ In contrast to *KSM*, the *TiVo* rule is much better in line with the policy goals of *Molitor* because it requires courts to focus only on the changes made to the infringing elements of the original product when considering colorable differences.

Under *TiVo*, if a defendant has made a good faith effort to redesign the infringing product, the court, applying the colorable differences test, will likely find that they have made substantial changes to the infringing elements of the original product. By focusing specifically on the changes to the infringing elements of the original product, instead of the infringement of the

154. It is worth noting, however, that this conclusion applies to injunctions prohibiting further *infringement*. Infringers must still be wary of violating other provisions of any injunctions, even if they redesign their products. For example, while the Federal Circuit reversed the contempt holding for violation of the "disablement" provision of the injunction, EchoStar was still guilty for failing to comply with the "disablement" provision of the injunction (which presumably could not be avoided by redesigning the product). *See TiVo*, 646 F.3d at 890.

155. *Cal. Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 617–18 (1885).

156. *Id.*

157. *See TiVo*, 646 F.3d at 878–79.

158. *See id.* at 881.

159. *Molitor*, 113 U.S. at 617–18.

redesigned product, a court can better determine whether the defendant's conduct is wrongful and thus subject to contempt, or a good faith effort where contempt would be inappropriate.

C. *TiVo* STRIKES AN APPROPRIATE BALANCE BETWEEN PATENTEES AND INFRINGERS

The *TiVo* test will likely bring increased clarity and fairness to the colorable differences test, but this may come at a cost to patent holders as the test limits availability of contempt proceedings against redesigned products.¹⁶⁰ Requiring the patentee to institute a new infringement suit against every redesigned product diminishes the significance of the patent and the injunction.¹⁶¹ However, as noted by the court in *McChullough*, “[a]llowing the patentee to proceed by a summary contempt proceeding in all cases [involving redesigned products] would unnecessarily deter parties from marketing new devices that are legitimately outside the scope of the patent in question.”¹⁶² As discussed above in Part II, *supra*, the new *TiVo* rule necessarily means that fewer redesigned products will be eligible for contempt proceedings than under the *KSM* rule.¹⁶³ However, the *KSM* rule resulted in an untenable extension of contempt proceedings to redesigned products whose infringing nature would better have been decided by a new trial.¹⁶⁴ Thus, even though the *TiVo* rule increases the burden of patent enforcement by shortening the reach of contempt, this corrects the overbroad reach of contempt proceedings that *KSM* previously granted to patent holders.

Unfortunately, in some situations, the *TiVo* rule may prove to favor well-financed infringers over less well-off patent holders by allowing the wily infringer to continually infringe but avoid contempt. For example, an infringer may make more than colorable changes to infringing elements to avoid contempt, but purposefully not make changes substantial enough to avoid infringing the patent. In this situation, the less well-off patent holder would be forced to file a new complaint for a new infringement trial against

160. The *KSM* test as applied by many district courts potentially reached all redesigned products which infringed, whereas the *TiVo* test may only reach products that retain substantially similar infringing elements of the original products. *See TiVo*, 646 F.3d at 878–79; *KSM Fastening Sys., Inc. v. H.A. Jones Co.*, 776 F.2d 1522, 1527 (Fed. Cir. 1985).

161. *McChullough Tool Co. v. Wells Surveys, Inc.*, 395 F.2d 230, 233 (10th Cir. 1968).

162. *Id.*

163. *See infra* Section III.A.

164. *See, e.g., TiVo, Inc. v. EchoStar Corp.*, 646 F.3d 869 (Fed. Cir. 2011) (discussing that the district court based its contempt finding on the infringing nature of an element of the original product which had not been at issue during the preceding litigation).

the redesigned product, which is expensive and may not be financially feasible. In the worst case scenario, the well-financed infringer could repeat this cycle as many times as needed until the less well-off patent holder runs out of money.

However, district courts can counter this type of behavior by crafting more precise injunctions targeted at specific acts by the infringers. Instead of a broad proclamation simply prohibiting “further infringement of the patent,” which requires a colorable differences analysis, a district court could write a targeted injunction prohibiting certain actions or design elements. For example, in *TiVo*, even though the court reversed and remanded with respect to EchoStar’s violation of the “disablement” section of the injunction, the court upheld the finding that EchoStar violated the “disablement” provision of the injunction for failing to disable EchoStar’s installed DVRs.¹⁶⁵ EchoStar’s contempt for violation of the “disablement” provision of the injunction did not require a colorable differences analysis because the “disablement” provision required certain acts by EchoStar and did not involve a question of infringement. A district court could prevent the problem of a well-financed infringer by writing a careful injunction that included more than infringement provisions.

Thus, even though the *TiVo* test shortens the reach of contempt proceedings relative to the test under *KSM*, *TiVo* will help ensure that patentees cannot impermissibly prevent the creation and marketing of legitimately redesigned products. Additionally, while the *TiVo* rule may seem to reward well-financed infringers, district courts can craft more precise injunctions to prevent abuse of the new contempt regime.

IV. CONCLUSION

TiVo transformed the colorable differences test from an analysis of infringement to an analysis of the changes made to the infringing elements of the original product. This new test is a marked departure from the procedural and evidentiary considerations of the colorable differences step previously set forth in *KSM*. Not only did this change the approach to colorable differences, it also made the question of colorable differences an independent hurdle to a finding of contempt. The new test articulated in *TiVo* will provide guidance to infringers who are confronted with vague or ambiguous injunctions, because infringers will have a better idea of how courts will analyze their redesigned product. *TiVo* also helps to bring contempt proceedings in patent cases in line with the policy goals of contempt as set

165. *See id.* at 877.

forth by the Supreme Court in *Molitor*, even though it narrows the reach of contempt. Finally, the new *TiVo* rule will act as a welcome counter balance to the problems of broad injunction writing in patent cases and will encourage judges to craft more precise injunctions.

***i4i* AND THE PRESUMPTION OF VALIDITY: LIMITED CONCERNS OVER THE INSULATION OF WEAK PATENTS**

Ryan R. Klimczak[†]

In *Microsoft Corp. v. i4i Ltd.*, the Supreme Court maintained the status quo by upholding the Federal Circuit's ruling that an invalidity defense requires a heightened clear and convincing evidentiary standard.¹ The Supreme Court's ruling represented a pivotal moment for both sides of the debate over what level of validity should adhere to issued patents, as evinced by the stark divide in amicus briefs filed in the case. The technology industry, beleaguered by an onslaught of costly and vexatious infringement suits, clamored for a lower evidentiary standard to invalidate more readily weak patents asserted against them.² Across the aisle, the pharmaceutical and biotechnology industries, whose revenue drivers often reside in a few key blockbuster drugs secured by a handful of patents, argued to preserve the strong presumption of validity attached to issued patents.³ Despite these fears, the Note argues that the *i4i* decision ultimately presents little cause for alarm for either industry.⁴

The Court's ruling seeks to preserve a consistent approach towards the treatment of a patent's "presumed validity," underscoring important policy considerations of maintaining secure and reliable property rights that are

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1. *Microsoft Corp. v. i4i Ltd.*, 131 S. Ct. 2238 (2011). Clear and convincing evidence is "evidence indicating that the thing to be proved is highly probable or reasonably certain. This is a greater burden than preponderance of the evidence, the standard in most civil trials, but less than evidence beyond a reasonable doubt, the norm for criminal trials." BLACK'S LAW DICTIONARY 500 (9th ed. 2009).

2. *See, e.g.*, Brief for Apple, Inc., et al. as Amici Curiae Supporting Petitioner, *i4i*, 131 S. Ct. 2238 (No. 10-290), 2011 WL 380827; Brief for Google, Inc., et al. as Amici Curiae Supporting Petitioner, *i4i*, 131 S. Ct. 2238 (No. 10-290), 2011 WL 380826; Brief for SAP America, Inc., et al., as Amici Curiae Supporting Petitioner, *i4i*, 131 S. Ct. 2238 (No. 10-290), 2011 WL 380834.

3. *See, e.g.*, Brief for Biotechnology Indus. Org., et al. as Amici Curiae Supporting Respondent, *i4i*, 131 S. Ct. 2238 (No. 10-290), 2011 WL 1059617; Brief for The Pharm. Research and Mfrs. of America as Amici Curiae Supporting Respondent, *i4i*, 131 S. Ct. 2238 (No. 10-290), 2011 WL 994259.

4. *See infra* Part III.

congruous with inventor expectations and reliance interests.⁵ Holding otherwise would have skewed the terms of the “patent bargain”⁶ and risked eroding the constitutional underpinnings of patent law to ensure “progress in the arts and sciences”⁷ by disincentivizing innovation. This Note seeks to assess the practical consequences of the *i4i* holding. The Court’s decision will likely have only a small impact within the scope of a jury trial given the low frequency of decisions that hinge on the preponderance of the evidence standard, as well as the subtle distinction between standards themselves in the eyes of jurors.⁸ Furthermore, the application of the heightened evidentiary standard solely to factual disputes in invalidity challenges will dampen the ruling’s effect since “many claims of invalidity rest . . . upon how the law applies to facts as given.”⁹

Ultimately, the Court’s holding, combined with the effects of the America Invents Act¹⁰ (“AIA”) will beneficially alter the calculus of invalidity defense strategies by encouraging defendants to seek invalidation¹¹ outside of litigation through proceedings at the Patent and Trademark Office (“PTO”).¹² The technical sophistication of PTO examiners and administrative judges, coupled with a more streamlined process for invalidation, will alleviate the concerns that companies like Microsoft have regarding the insulation of “bad” patents by ensuring a more accurate and prompt invalidity process.¹³

This Note proceeds in three parts. Part I explores the history of the clear and convincing standard. Part II examines the *i4i* decision and the Court’s rationale for upholding the standard. Finally, Part III addresses the primary concerns voiced by the technology industry that maintaining heightened standards will unnecessarily shield weak patents. These concerns overlook

5. See Shubba Ghosh, *Patents and the Regulatory State: Rethinking the Patent Bargain Metaphor After Eldred*, 19 BERKELEY TECH. L.J. 1315, 1319–49 (2004).

6. The “patent bargain” is the general notion “that a patent represents the grant of the right of exclusivity in exchange for the disclosure of a novel invention.” *Id.* at 1315.

7. U.S. CONST. art. I, § 8, cl. 8.

8. See *infra* Part III.

9. Microsoft Corp. v. i4i Ltd., 131 S. Ct. 2238, 2253 (2011) (Breyer, J., concurring); see *infra* Section III.B.

10. President Barack Obama signed into law the Leahy-Smith American Invents Act on September 16, 2011. The Act represents a sweeping change to the U.S. Patent system, including the institution of a “first to file” system, the elimination of interference proceedings, and the creation of a post-grant and *inter partes* review system. See *infra* Part III. Leahy-Smith American Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011).

11. For purposes of this Note, invalidity is taken to encompass a finding of unpatentability in a PTO proceeding.

12. See *infra* Section III.D.

13. *Id.*

the limited consequences of *i4i* in two key respects: the small role that evidentiary standards actually play in invalidity determinations during litigation, and the availability of new and more effective avenues for patent invalidation created by the AIA.

I. THE EVOLUTION OF THE CLEAR AND CONVINCING STANDARD

In initially evaluating patent applications, examiners at the PTO must determine whether an invention falls within one of the express categories of patentable subject matter defined in § 101 and, further, analyze whether it meets the statutory requirements of novelty and non-obviousness, as defined in § 102 and § 103 under Title 35 of the U.S. Code.¹⁴ These inquiries likewise shape a potential infringer's invalidity defense.¹⁵ However, in asserting the defense, "[t]he burden of establishing invalidity . . . rest[s] on the party asserting such invalidity."¹⁶

A. AN UNCERTAIN STANDARD PRIOR TO THE CREATION OF THE FEDERAL CIRCUIT

The Supreme Court's opinion in *Radio Corp. of America v. Radio Engineering Laboratories, Inc.* (RCA), written prior to the enactment of the 1952 Patent Act, articulated the strong presumption of a patent's validity at common law.¹⁷ The RCA court held that when challenging the validity of a patent, "there is a presumption of validity, a presumption not to be overthrown except by clear and cogent evidence."¹⁸ The RCA Court underscored the force that the presumption carried in early jurisprudence by noting the "varying expression" of this presumption by previous court decisions.¹⁹ In the 1926 decision of *Austin Machine Co. v. Buckeye Traction Ditcher Co.*, the Sixth Circuit held that "the presumption of the validity of the patent is such that the defense of invention by another must be established by the clearest proof—perhaps beyond reasonable doubt."²⁰ The Supreme Court's 1873 decision in *Coffin v. Ogden* further held that the "burden of proof rests

14. 35 U.S.C. §§ 101–103 (2007).

15. 35 U.S.C. § 282 (2007).

16. *Id.*

17. *See* *Radio Corp. of America v. Radio Eng'g Lab., Inc.*, 293 U.S. 1 (1937).

18. *Id.* at 2.

19. *Id.* at 7.

20. *Id.* at 8 (citing *Austin Mach. Co. v. Buckeye Traction Ditcher Co.*, 13 F.2d 697, 700 (6th Cir. 1926)).

upon . . . [the defendant], and every reasonable doubt should be resolved against him [T]he law requires not conjecture, but certainty.”²¹

However, as Etan Chatlyne notes, prior to the creation of the Federal Circuit in 1982, regional appellate courts diverged from this approach.²² Notably, all twelve regional circuits held that a patent’s presumption of validity could be diminished or even eliminated in light of new prior art, and thus a lower preponderance of the evidence standard would suffice.²³ For instance, the Eleventh Circuit held in *Manufacturing Research Corp. v. Graybar Electric Co.* that when the Patent Office did not consider pertinent prior art in its review of patent applications, “the burden upon the challenging party is lessened, so that he need only introduce a preponderance of the evidence to invalidate a patent.”²⁴ Similarly, the Fourth Circuit held in *Heyl & Patterson, Inc. v. McDowell Co.* that “the presumption of validity can be weakened or destroyed where there has been a failure to cite prior art before the patent examiner.”²⁵ Indeed, precedent within all the circuits contained similarly strong language.²⁶ Thus, with respect to prior art not considered by the PTO, the early common law evidentiary standard appears to depart from a strong presumption of patent validity.²⁷

21. *Coffin v. Ogden*, 85 U.S. 120, 124 (1 Wall. 1873).

22. See Etan S. Chatlyne, *The Burden of Establishing Patent Invalidity: Maintaining a Heightened Evidentiary Standard Despite Increasing “Verbal Variances”*, 31 CARDOZO L. REV. 297, 305–09 (2011).

23. *Id.*

24. *Id.* at 308 n.73 (citing *Mfr. Research Corp. v. Graybar Elec. Co.*, 679 F.2d 1355, 1361 (11th Cir. 1982)).

25. *Id.* (citing *Heyl & Patterson, Inc. v. McDowell Co.*, 317 F.2d 719, 722 (4th Cir. 1963)).

26. See *id.* (“Before the Federal Circuit’s creation in 1982, the regional appellate courts . . . had either weakened or removed the presumption of validity . . . in cases where the PTO neither found nor considered pertinent prior art. The regional circuits held that in such cases they should not defer to the PTO.”); see, e.g., *Plastic Container Corp. v. Cont’l Plastics of Oklahoma, Inc.*, 708 F.2d 1554, 1558 (10th Cir. 1983); *Baumstimler v. Rankin*, 677 F.2d 1061, 1066 (5th Cir. 1982); *Futorian Mfg. Corp. v. Dual Mfg. & Eng’g, Inc.*, 528 F.2d 941, 943 (1st Cir. 1976); *Alcor Aviation, Inc. v. Radair, Inc.*, 527 F.2d 113, 115 (9th Cir. 1975); *U.S. Expansion Bolt Co. v. Jordan Indus., Inc.*, 488 F.2d 566, 569 (3d Cir. 1973); *Henry Mfg. Co. v. Commercial Filters Corp.*, 489 F.2d 1008, 1013 (7th Cir. 1972); *Ralston Purina Co. v. Gen. Foods Corp.*, 442 F.2d 389, 390 (8th Cir. 1971); *Eisele v. St. Amour*, 423 F.2d 135, 138–39 (6th Cir. 1970); *Formal Fashions, Inc. v. Braiman Bows, Inc.*, 369 F.2d 536, 539 (2d Cir. 1966); *Turzillo v. P. & Z. Mergentime*, 532 F.2d 1393, 1399 (D.C. Cir. 1976).

27. See *Microsoft Corp. v. i4i Ltd.*, 131 S. Ct. 2238, 2243 (2011).

B. THE FEDERAL CIRCUIT'S ADOPTION OF A STATIC STANDARD

The creation of the Federal Circuit with jurisdiction over the adjudication of patent claims largely supplanted this regional circuit precedent.²⁸ The Federal Circuit held that the burden of proving invalidity of a patent “is constant and never changes and is to convince the court of invalidity by clear evidence.”²⁹ Importantly, the Federal Circuit clarified that the evidentiary standard remains static, regardless of whether the PTO considered invalidating evidence during the original examination.³⁰ Although rejecting the possibility of a dual standard, the court drew a distinction between the two types of art, holding that

what the production of new prior art or other invalidating evidence not before the PTO does is to eliminate, or at least reduce, the element of deference due the PTO, thereby partially, if not wholly, discharging the attacker's burden, but neither shifting nor lightening it or changing the standard of proof.³¹

According to this distinction, new evidence lowers the hurdle for a successful invalidity defense because it avoids the deference-related issues inherent in using prior art already considered by the PTO. Using this latter type of art requires the proponent to show that expert examiners at the PTO made erroneous judgments in their assessment of the prior art.³² New art avoids this pitfall because the burden “is fully sustained merely by . . . applying the proper law.”³³

28. See, e.g., *R.R. Dynamics, Inc. v. A. Stucki Co.*, 727 F.2d 1506, 1517 (Fed. Cir. 1984); *American Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1358–60 (Fed. Cir. 1984); *Connell v. Sears, Roebuck & Co.*, 722 F.2d 1542, 1549 (Fed. Cir. 1983); *SSIH Equip. S.A. v. U.S. Int'l Trade Comm'n*, 718 F.2d 365, 375 (Fed. Cir. 1983); *Stratoflex, Inc. v. Aeroquip Corp.*, 713 F.2d 1530, 1534 (Fed. Cir. 1983); Chatlyne, *supra* note 22, at 309–10; David O. Taylor, *Clear but Unconvincing: The Federal Circuit's Invalidity Standard*, 21 *FORDHAM INTELL. PROP. MEDIA & ENT. L.J.* 293, 298–308 (2011).

29. *American Hoist*, 725 F.2d at 1360.

30. *Id.* at 1359–60 (“When an attacker, in sustaining the burden imposed by § 282, produces prior art or other evidence not considered in the PTO, there is, however, no reason to defer to the PTO so far as its effect on validity is concerned. Indeed, new prior art not before the PTO may so clearly invalidate a patent that the burden is fully sustained merely by proving its existence and applying the proper law; but that has no effect on the presumption or on who has the burden of proof. They are static and in reality different expressions of the same thing—a single hurdle to be cleared. Neither does the standard of proof change; it must be by clear and convincing evidence or its equivalent, by whatever form of words it may be expressed.” (emphasis omitted)).

31. *Id.* at 1360.

32. See *id.*

33. *Id.* at 1360.

C. UNIFYING PATENT LAW: THE SPLIT BETWEEN REGIONAL CIRCUITS
AND THE FEDERAL CIRCUIT

Congress initially created the Federal Circuit in response to the large difference in the rates at which the regional circuit courts would hold patents invalid, and in an effort to promote unity in patent law, consistency in patent rights, and discourage forum shopping.³⁴ Underscoring this concern, one study found that the variance of validity rates among circuits in the pre-Federal Circuit era was six times higher than the variance following the establishment of the Federal Circuit.³⁵ Moreover, some Federal Circuit supporters sought to “rescue patents from a judiciary often suspicious, if not overtly hostile, towards patents”³⁶—a view exemplified by the regional circuit precedent requiring a lower standard to invalidate patents in certain circumstances, as discussed in Section I.A, *supra*. Since the *American Hoist* decision in 1984, the Federal Circuit has consistently maintained its stance regarding a patent’s presumption of validity under § 282³⁷ and has furthermore upheld the validity of a greater number of patents relative to the regional circuits prior to the Federal Circuit’s creation.³⁸ Following the guidance of the Federal Circuit, which has appellate jurisdiction for claims arising under federal patent law,³⁹ district courts have employed the clear and convincing standard for invalidating patents for the past three decades.⁴⁰

34. See Fed. Judicial Ctr., *Landmark Judicial Legislation* (April 2, 1982), http://www.fjc.gov/history/home.nsf/page/landmark_22.html; Scott Atkinson et al., *The Economics of A Centralized Judiciary: Uniformity, Forum Shopping, and the Federal Circuit*, 52 J.L. & ECON 411, 421–38 (2009).

35. Atkinson, *supra* note 34, at 421 (“[T]he variation in validity rates is much larger for the pre-CAFC era . . . The variance of the circuits’ validity rates, .024, is about six times as large as .004, the variance for the [Federal Circuit] era.”).

36. Glynn S. Lunney, Jr., *Patent Law, the Federal Circuit, and the Supreme Court: A Quiet Revolution*, 11 SUP. CT. ECON. REV. 1, 2 (2004).

37. See, e.g., *ALZA Corp v. Andrx Pharm., LLC*, 603 F.3d 935, 940 (Fed. Cir. 2010); *Auto. Tech. Int’l, Inc. v. BMW of N. Am., Inc.*, 501 F.3d 1274, 1281 (Fed. Cir. 2007); *AK Steel Corp. v. Sollac & Ugine*, 344 F.3d 1234, 1238–39 (Fed. Cir. 2003); *Ultra-Tex Surfaces, Inc. v. Hill Bros. Chemical Co.*, 204 F.3d 1360, 1367 (Fed. Cir. 2000); *Greenwood v. Hattori Seiko Co.*, 900 F.2d 238, 240–41 (Fed. Cir. 1990).

38. See Lunney, *supra* note 36, at 2.

39. 28 U.S.C. § 1338(a) (2011). The Supreme Court’s decision in *Holmes Group, Inc. v. Vornado Air* underscored that regional circuits still had jurisdiction for patent-based claims asserted under a cross claim or counter claim. See *Holmes Group, Inc. v. Vornado Air*, 535 U.S. 826 (2002). Thus, disparities among circuit approaches concerning a patent’s presumption of validity remained theoretically possible prior to the Supreme Court’s *i4i* decision. However, since *Holmes* and until Congress passed the AIA, the number of cases containing patent law counterclaims where regional circuits obtained appellate jurisdiction remained exceedingly rare. See Jiwen Chen, *The Well-Pleaded Complaint Rule and Jurisdiction over Patent Law Counterclaims: An Empirical Assessment of Holmes Group and Proposals for Improvement*, 8

Nonetheless, the split between these treatments came to the fore in *KSR International Co. v. Teleflex, Inc.*—one of the Supreme Court’s seminal cases on non-obviousness.⁴¹ As a defense against infringement, KSR sought to invalidate Teleflex’s patent based on obviousness grounds, arguing that a preponderance of the evidence standard should control an invalidity challenge.⁴² Countering this notion, Teleflex cited in its brief the Supreme Court’s decision in *RCA* and the Federal Circuit’s consistent application of a clear and convincing standard as dispositive of a heightened evidentiary standard in invalidity challenges.⁴³ In its reply brief, KSR disputed the historical consistency of this standard by pointing out that “prior to the creation of the Federal Circuit, regional Circuits had held . . . that in the ‘usual’ patent case, ‘a preponderance of the evidence is sufficient to establish invalidity.’”⁴⁴ Since the preponderance of the evidence standard “is applicable in civil actions between private litigants unless ‘particularly important individual interests or rights are at stake,’” KSR claimed that if Congress had intended to apply a clear and convincing standard, it would have specified so in drafting 35 U.S.C. § 282.⁴⁵ In its holding, the Supreme Court side-stepped the issue by merely noting in dicta that “the rationale underlying the presumption” of a patent’s validity “seems much diminished” when the PTO failed to consider the relevant art.⁴⁶ Following the decision, the status of the presumption of validity became more uncertain for patents issued with relevant art not considered by the PTO in light of the vague language used in *KSR*, which likely prompted the Supreme Court to grant

NW. J. TECH. INTELL. PROP. 94, 103 (2009). In the six years following the decision, only five of these cases made it directly to regional circuit courts versus nearly three thousand patent cases at the Federal Circuit. *Id.* The America Invents Act now overrules the specific holding of *Holmes Group*, defining the Federal Circuit’s appellate jurisdiction to include an appeal from a final decision of a district court “in any civil action arising under, or in any civil action in which a party has asserted a compulsory counterclaim under, any Act of Congress relating to patents or plant variety protection.” Leahy-Smith America Invents Act, Pub. L. No. 112-29, § 19(b)(1), 112th Cong. (2011).

40. See Chatlyne, *supra* note 22, at 309.

41. See *KSR Int’l Co. v. Teleflex, Inc.*, 550 U.S. 398 (2007).

42. See Reply Brief for Petitioner at 19, *KSR*, 550 U.S. 398 (2007) (No. 04-1350), 2006 WL 3367870.

43. See Brief for Respondent at 46, *KSR*, 550 U.S. 398 (2007) (No. 04-1350), 2006 WL 2989549.

44. Reply Brief for Petitioner, *supra* note 42, at 19 (citing *Dickstein v. Seventy Corp.*, 522 F.2d 1294, 1297 (6th Cir. 1975)).

45. *Id.* at 19.

46. *KSR*, 550 U.S. at 426.

certiorari to settle the proper interpretation of the statutory presumption of validity.⁴⁷

II. THE *I4I* HOLDING AND THE SUPREME COURT'S RATIONALE

i4i brought suit against Microsoft Corp. in the Eastern District of Texas, alleging that Microsoft infringed United States Patent No. 5,787,449 (“the ’449 patent”) with its Office 2003 and 2007 products.⁴⁸ Microsoft counterclaimed and sought to invalidate the ’449 patent based upon a § 102(b) on-sale bar concerning *i4i*’s prior sale of its S4 software program.⁴⁹ However, Microsoft objected to holding this evidence, which was not considered by the PTO, to a clear and convincing evidentiary standard, arguing that a preponderance of the evidence standard should apply.⁵⁰ The district court rejected Microsoft’s proposed standard and a jury found in favor of *i4i*, awarding \$200 million in damages.⁵¹ On appeal, the Federal Circuit and the Supreme Court affirmed.⁵²

A. BACKGROUND OF THE ’449 PATENT

The ’449 patent relates to an improved method for editing computer documents involving “a system and method for the separate manipulation of the architecture and content of a document”⁵³ The technology incorporates Standard Generalized Markup Language (“SGML”) editing functionalities into regular word processing programs.⁵⁴ This involves decomposing a structured document into at least two component parts, the document structure (e.g., SGML metacodes) and the document content.⁵⁵ A user can then edit each independently and subsequently re-integrate the structure and content, allowing for greater simplicity and efficiency in the

47. *See, e.g.*, *Krippelz v. Ford Motor Co.*, 750 F. Supp. 2d 938, 959 (N.D. Ill. 2010); *Tokyo Keiso Co., Ltd. v. SMC Corp.*, 533 F. Supp. 2d 1047, 1056 (C.D. Cal. 2007).

48. *i4i Ltd. v. Microsoft Corp.*, 670 F. Supp. 2d 568, 572–74 (E.D. Tex. 2009), *aff’d*, *i4i Ltd. v. Microsoft Corp.*, 598 F. 3d 831 (Fed. Cir. 2010), *aff’d*, 131 S. Ct. 2238 (2011).

49. *i4i Ltd.*, 670 F. Supp. 2d at 583–89.

50. *Id.* at 588–89.

51. *Id.* at 573.

52. *See i4i Ltd. v. Microsoft Corp.*, 598 F. 3d 831 (Fed. Cir. 2010), *aff’d*, 131 S. Ct. 2238 (2011).

53. U.S. Patent No. 5,787,449 at col. 3-5 (filed July 28, 1998).

54. *Id.*

55. *See id.*

editing of word documents.⁵⁶ i4i filed the patent with the PTO on June 2, 1994, and the patent subsequently issued on July 28, 1998.⁵⁷

B. PROCEDURAL HISTORY

In March 2007, i4i filed a patent infringement suit alleging that Microsoft's use of Extensible Markup Language ("XML") functionality in its Office 2003 and 2007 products violated the '449 patent.⁵⁸ Microsoft counterclaimed and sought to hold the '449 patent invalid and unenforceable, claiming, in part, that i4i's prior sale of its S4 software program rendered the patent invalid under the § 102(b) on-sale bar.⁵⁹ Concurrently, Microsoft filed an *ex parte* reexamination⁶⁰ against the patent in November of 2008. However, because of the documentary prior art requirements of reexamination, Microsoft could not adopt the on-sale bar invalidity approach it used in litigation.⁶¹ Instead, it used two patent references,⁶² which were ultimately unsuccessful. The PTO denied a further reexamination request filed in August of 2010.⁶³

During litigation, the use of i4i's S4 software as a § 102(b) bar proved problematic since i4i had destroyed the software's source code prior to the suit, making it extremely difficult to assess whether the S4 software anticipated the '449 patent.⁶⁴ Thus, the factual question of whether S4 practiced the key invention disclosed in the '449 patent hinged on testimony by S4's inventors.⁶⁵ In proving its invalidity challenge of this patent, Microsoft objected to i4i's proposed jury instruction that it was subject to a clear and convincing standard in light of the fact that the S4 software had not been before the PTO during the '449 patent's examination.⁶⁶ Instead,

56. *See id.*

57. *Id.*

58. Microsoft Corp. v. i4i, Ltd., 131 S. Ct. 2238, 2243 (2011).

59. *Id.* at 2243–44. The on-sale bar under 35 U.S.C. § 102(b) is created when an invention has been on sale for over one year, barring patentability. 35 U.S.C. § 102(b) (2007).

60. Reexamination Request No. 90/010347 (filed Nov. 21, 2008). *Ex parte* reexaminations, discussed in Section III.D.1, *infra*, allow third parties to invalidate patents using prior art limited to patents and written publications.

61. 35 U.S.C. § 301 (2007) (providing "any person at any time may cite to the Office in writing prior art consisting of patents or printed publications which that person believes to have a bearing on the patentability of any claim of a particular patent.").

62. Reexamination Request No. 90/010347 (filed Nov. 21, 2008).

63. Reexamination Request No. 90/011,198 (filed Aug. 31, 2010).

64. i4i destroyed the source code, in its normal course of business, when they ceased development of the software nine years prior to the suit. *See i4i*, 131 S. Ct. at 2244.

65. *Id.*

66. *Id.* Microsoft also raised an invalidity challenge for the '449 patent based on inequitable conduct for failing to disclose the S4 software program during the prosecution of

Microsoft provided two alternative arguments. Microsoft first contended that a jury need only be persuaded by a preponderance of the evidence standard in an invalidity defense.⁶⁷ Alternatively, if a clear and convincing burden of proof applied as a general matter, Microsoft argued for a hybrid approach, requesting a burden of proof by a preponderance of the evidence “based on prior art that the examiner did not review during the prosecution of the patent-in-suit.”⁶⁸ Microsoft supported its contention by citing *KSR*, in which the court stated that the rationale underlying the presumption of validity afforded to issued patents “seems much diminished” when the relevant art had not been before the PTO.⁶⁹

The district court rejected both this standard and Microsoft’s request for a new trial based on an improper jury instruction, noting that the *KSR* decision never specifically held that a reduced standard applied when the PTO had not considered a particular piece of prior art.⁷⁰ Further, the court noted that Microsoft did not cite firm authority to support its position since, as the court noted, “the law remains overwhelmingly that patents are to be presumed valid and it is the defendant’s burden to provide invalidity by clear and convincing evidence.”⁷¹ Ultimately, the jury found in favor of i4i in May 2009, and awarded \$200 million in damages.⁷² The Federal Circuit affirmed this ruling, stating that its recent holdings “make clear that the Supreme Court’s decision in *KSR* . . . did not change the burden of proving invalidity by clear and convincing evidence.”⁷³

In a unanimous decision, the Supreme Court affirmed the Federal Circuit’s ruling by examining the statutory language, common law meaning, and legislative intent behind a patent’s presumed validity.⁷⁴ In assessing the statutory language of the invalidity defense under § 282 of the Patent Act of 1952, the Court recognized that the statute “includes no express articulation of the standard of proof”⁷⁵ The Court reasoned that the use of the common-law term “presumed valid” by Congress in describing issued patents in the Patent Act created an underlying assumption that the “term . . .

the ’449 patent. However, since the court found that the software did not establish a prima facie case of unpatentability, the prior art lacked the requisite materiality to establish a successful infringement defense. *Id.*

67. *Id.*

68. *Id.*

69. *KSR Int’l Co. v. Teleflex, Inc.*, 550 U.S. 398, 426 (2007).

70. *i4i Ltd. v. Microsoft Corp.*, 670 F. Supp. 2d 568, 588 (E.D. Tex. 2009).

71. *Id.*

72. *Id.* at 573.

73. *i4i Ltd. v. Microsoft Corp.*, 598 F.3d 831, 848 (Fed. Cir. 2010).

74. *See Microsoft Corp. v. i4i Ltd.*, 131 S. Ct. 2238, 2245–53 (2011).

75. *Id.* at 2245.

comes with a common law meaning, absent anything pointing another way.”⁷⁶ Employing basic tenants of statutory construction, the Court concluded that Congress did not intend to drop a heightened standard of proof merely because § 282 failed to reiterate it expressly.⁷⁷

The Court further rejected a hybrid evidentiary standard that would alternatively subject evidence not before the PTO during examination to a lesser, preponderance of the evidence standard.⁷⁸ Again looking to legislative intent, the Court remarked that nothing within the language of § 282 suggested that the standard of proof “would rise and fall with the facts of each case,” and had it taken the “unusual and impractical step of enacting a variable standard of proof that must itself be adjudicated in each case . . . we assume it would have said so expressly.”⁷⁹ However, the Court recognized, as the Federal Circuit had done consistently,⁸⁰ that new evidence may “carry more weight” in an invalidity defense relative to evidence previously considered by the PTO, and thus an infringer’s burden of clear and convincing evidence may be easier to sustain.⁸¹

III. THE LIMITED EFFECTS OF THE *I4I* RULING

In *i4i*, Microsoft contended that the clear and convincing standard hinders the goals of patent law by dampening innovation and shielding spurious patents from invalidity challenges.⁸² They argued that current PTO methods for invalidation fail to rectify this problem because third parties cannot assert certain grounds for invalidation, such as the § 102(b) on-sale bar, during reexamination since the process requires documentary prior art.⁸³ However, the issue of whether lowering the presumption of validity in litigation would mitigate the insulation of “bad” patents from invalidity challenges becomes less significant in light of how seldom evidentiary standards affect invalidity determinations.⁸⁴

76. *Id.* (citing *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 58 (2007)).

77. *Id.* at 2247.

78. *Id.* at 2250.

79. *Id.*

80. *See, e.g.*, cases cited *supra* note 37.

81. *i4i*, 131 S. Ct. at 2251.

82. *Id.* at 2251–52.

83. *Id.* at 2252.

84. *See* Etan S. Chatlynne, *Investigating Patent Law’s Presumption of Validity—An Empirical Analysis*, 2010 PATENTLY-O PATENT L.J. 37.

A. THE RARITY OF EVIDENTIARY-STANDARD DETERMINATIVE DECISIONS

Although empirical evidence is limited, one analysis of post-*KSR* Federal Circuit decisions found that 84% of patent challenges were evidentiary-standard independent.⁸⁵ Specifically, the study classified outcomes as “evidentiary standard independent” when the court upheld challenges by clear and convincing evidence or when the court granted motions for summary judgment or judgments as a matter of law, since the outcome would not have been affected had a preponderance of the evidence standard controlled.⁸⁶ Conversely, the study classified outcomes as “evidentiary standard dependent” when the court rejected an invalidity challenge and the lower court reached its holding following a jury or bench trial since a preponderance of the evidence standard could have swayed the outcome.⁸⁷ Importantly, these results underscore the marked rarity in which evidentiary standards affect an invalidity defense in a patent trial as evidence within patent trials may likely speak for itself.⁸⁸

85. See Chatlynne, *supra* note 84, at 39–40 (“The data set consists of post-*KSR* Federal Circuit cases from April 2008 through June 2009 involving three types of invalidity challenges: (1) lack of written description; (2) anticipation (including by prior public use); and (3) obviousness. . . . The following guidelines were further used in determining whether the evidentiary standard may have affected the determination. First, where an invalidity challenge was upheld by clear and convincing evidence, the result is evidentiary-standard independent. By definition, when a clear and convincing standard is satisfied, a preponderance of evidence standard is satisfied too. Second, grants of motion for summary judgment or judgment as a matter of law (“JMOL”) were presumed evidentiary-standard independent because the standard for summary judgment and JMOL—viewing facts in the light most favorable to a non-moving party—is more stringent than either evidentiary standard in the patent context. Third, where a patent challenge was rejected and the lower court reached its judgment following a bench or jury trial, such determination was initially assumed evidentiary-standard dependent because the opposite could not be assumed. Thirty-three cases involving forty-five invalidity challenges were analyzed to collect the empirical data.”).

86. *Id.*

87. *Id.*

88. To this extent, the S4 prior art within *i4i* highlights a unique instance in which a clear and convincing standard served a determinative role. The unavailability of *i4i*’s source code and Microsoft’s reliance on oral testimony necessarily demanded heightened assurances of accuracy given the greater unreliability of witness recollections. See *Finnigan Corp. v. Int’l Trade Comm’n*, 180 F.3d 1354, 1369 (Fed. Cir. 1999). Indeed, courts require corroboration of “any witness whose testimony alone is asserted to invalidate a patent” *Id.* In *i4i*, Microsoft corroborated the oral testimony of a former *i4i* employee with expert witness testimony. *i4i Ltd. v. Microsoft Corp.*, 598 F.3d 831, 847 (Fed. Cir. 2010).

B. SEPARATING FACTUAL AND LEGAL QUESTIONS OF LAW LIMITS THE REACH OF EVIDENTIARY STANDARDS

As Justice Breyer points out in his concurring opinion in *i4i*, “the evidentiary standard of proof applies to questions of fact and not to questions of law.”⁸⁹ Significantly, as Breyer notes, most claims of invalidity rest upon “how the law applies to facts as given,” and not upon factual disputes.⁹⁰ This further limits the frequency in which evidentiary standards affect invalidity determinations.⁹¹ Generally, a question of fact only asks whether specific acts, events, or conditions occurred, whereas a question of law, reviewable *de novo*, involves deciding which legal rule applies.⁹² Thus, the higher standard of proof lamented by Microsoft has no bearing on many aspects of an invalidity challenge. For instance, claim interpretation, as a question of law, falls outside of the purview of questions decided by the fact-finder.⁹³ Since claim interpretation represents such a critical aspect of validity, infringement, and enforceability determinations, judicial decisions in *Markman* hearings have a significant effect on the remainder of the trial, often leading to summary judgment or settlement between parties.⁹⁴

Within an invalidity challenge itself, the clear and convincing standard would only apply to certain issues, such as determining “whether a prior art reference had been published” or “when a product was first sold.”⁹⁵ However, this standard would not apply to questions of law, such as determining whether a product was previously in “public use” or whether an invention is “nonobvious.”⁹⁶ To this extent, separating out the factual matters from the legal matters in an invalidity challenge could allow a strategic litigant to avoid unnecessarily subjecting himself to a heightened evidentiary standard.⁹⁷ As suggested by Justice Breyer, to avoid the common

89. *i4i*, 131 S. Ct. at 2253 (Breyer, J., concurring).

90. *Id.*

91. *Id.*

92. BLACK’S LAW DICTIONARY 1070 (9th ed. 2009).

93. *Markman v. Westview Instrument, Inc.*, 517 U.S. 370, 372 (1996) (“[T]he construction of a patent, including terms of art within its claim, is exclusively within the province of the court.”).

94. Based upon the district court’s construction of claim terms in *i4i*, however, Microsoft was unable to evade infringement liability in moving for a judgment as a matter of law. Microsoft argued unsuccessfully that “no reasonable juror could find its accused WORD products infringed the ’449 patent literally or by the doctrine of equivalents.” *i4i Ltd. v. Microsoft Corp.*, 670 F. Supp. 2d 568, 574–76 (E.D. Tex. 2009).

95. *i4i*, 131 S. Ct. at 2253 (Breyer, J., concurring).

96. *Id.*

97. See Stephen A. Weiner, *The Civil Jury Trial and the Law-Fact Distinction*, 54 CAL. L. REV. 1867, 1868–75, 1937 n.358 (1966).

judicial pitfall of blending factual and legal issues, judges should use special verdict forms that guide specific factual inquiries.⁹⁸ This would allay some concerns over granting juries too much discretion in invalidity determinations.

This distinction may be most important when determining whether a patent is invalid under 35 U.S.C. § 103 because, under the *KSR* standard, obviousness is a question of law based on the application of facts.⁹⁹ In this context, the factual inquiries relate to determining the scope and content of the prior art, the differences between the prior art and the patented object, and the level of skill in the relevant art, as well as secondary considerations such as commercial success, unexpected results, and long felt needs.¹⁰⁰ However, the most contentious aspect of an obviousness determination occurs when the judge, using his discretion, blends these factual inquiries into a legal conclusion. Thus, high evidentiary hurdles do not necessarily factor into the ultimate outcome of § 103-based invalidations as much as they determine the outcomes in pure factual inquiries, such as anticipation.¹⁰¹

C. JURY INSTRUCTIONS AND THE HAZINESS OF THE CLEAR AND CONVINCING STANDARD

To the extent that juries, instead of judges, more often decide patent invalidity, the use of jury instructions emphasizing the weight of new art will likely further allay worries about the unnecessary protection of bad patents under *i4i*.¹⁰² Statistics demonstrate that juries typically hold 67% of patents

98. *i4i*, 131 S. Ct. at 2253.

99. *KSR Int'l Co. v. Teleflex, Inc.*, 550 U.S. 398, 399 (2007); *Graham v. John Deere Co. of Kan. City*, 383 U.S. 1, 17 (1966); *Structural Rubber Prods. Co. v. Park Rubber Co.*, 749 F.2d 707, 719–20 (Fed. Cir. 1984) (“By mandating that validity is a question of law, we understand the Supreme Court to mean that in a bench trial the decision by the trial court with respect to the application of the statute to the facts on the issue of obviousness is a legal decision fully reviewable on appeal The introduction of a jury can not change the nature of the obviousness decision. It continues to be a legal issue for the court.” (emphasis omitted)).

100. *Graham*, 383 U.S. at 17.

101. However, the defined roles of lay juries and judges in making obviousness determinations remains controversial since Federal Circuit precedent has “held that a jury may render a verdict on the ultimate issue of obviousness.” *See* *Petition for Writ of Certiorari at *i*, *Medela AG v. Kinetic Concepts, Inc.*, 130 S. Ct. 624 (2009) (No. 09-198), 2009 WL 2509227. Thus, although judges have discretion in matters of obviousness as a matter of law, it is not clear “whether a person accused of patent infringement has a *right* to independent judicial, as distinct from lay jury, determination of whether an asserted patent claim satisfies the ‘non-obvious subject matter’ condition for patentability.” *Id.* (emphasis added).

102. Indeed, only 3% of patent cases ever reach jury trial, as settlements and pre-trial court judgments have proven effective tools for litigants. *See* ADMIN. OFFICE OF THE U.S. COURTS, ANNUAL REPORT OF THE DIRECTOR 168 (2010).

valid, while judges hold 57% of patents valid in bench trials and just 28% of patents in cases decided in pre-trial motions.¹⁰³ The disparity between judge and jury invalidity rates underscores the strategic advantages for plaintiffs in seeking jury-based decisions.

In patent infringement cases, plaintiffs are able to show the jury the red ribbon and gold seal on their issued patent, conjuring up whatever reverence jurors have for government-granted patents.¹⁰⁴ Thus, a jury instruction emphasizing that a piece of prior art had not been before the PTO during the patent's prosecution may allow a juror to more readily find the patent invalid. The juror may separate the old prior art from the new, making an invalidity defense by clear and convincing evidence "easier to sustain" when the defense is based on new prior art.¹⁰⁵ Specifically, the instruction that the jury should "consider that it has heard evidence that the PTO had no opportunity to evaluate before granting the patent" may reduce the weight of a patent's presumed validity, despite strict judicial application of a clear and convincing standard.¹⁰⁶ Indeed, an analysis of past district court invalidity determinations reveals that the type of prior art relied on by challengers has a notable effect on the outcome of validity decisions, with the probability of invalidity based on cited and uncited art at 29.6% and 40.8%, respectively.¹⁰⁷

Notably, the Federal Circuit's 2007 holding in *z4 Technology v. Microsoft Corp.* highlighted this point. The Federal Circuit affirmed a district court's refusal of an instruction emphasizing the weight of new art because it "might lead the jury to believe that the burden of proof is less than clear and convincing when prior art was not considered by the PTO."¹⁰⁸ Despite this, however, the Supreme Court in *i4i* expressly recommended that district courts issue this instruction.¹⁰⁹

Furthermore, a juror's limited ability to grasp the subtle differences between evidentiary standards, along with the extensive length of jury

103. John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q.J. 185, 213 (1998).

104. See Paul F. Morgan, *Microsoft v. i4i—Is the Sky Really Falling?*, PATENTLY-O BLOG (Jan. 09, 2011), <http://www.patentlyo.com/patent/2011/01/microsoft-v-i4i-is-the-sky-really-falling.html>.

105. *Microsoft Corp. v. i4i Ltd.*, 131 S. Ct. 2238, 2251 (2011).

106. *Id.*

107. Allison, *supra* note 103, at 225.

108. *z4 Tech. v. Microsoft Corp.*, 507 F.3d 1340, 1354–55 (Fed. Cir. 2007).

109. *i4i*, 131 S. Ct. at 2252 ("In this respect, although we have no occasion to endorse any particular formulation, we note that a jury instruction on the effect of new evidence can, and when requested, most often should be given. When warranted, the jury may be instructed to consider that it has heard evidence that the PTO had no opportunity to evaluate before granting the patent.").

instructions,¹¹⁰ may together dampen the effect of the clear and convincing standard on the ultimate outcome of invalidity determinations. As one research study notes:

A general characterization of juror's cognitive performance during trials is that they are good at remembering and understanding the facts of a case but are poor at remembering, understanding and applying the relevant laws In an earlier article . . . we characterized the situations as follows: "Study after study has shown that jurors do not understand the law they are given, often performing at no better than chance level on objective tests of comprehension."¹¹¹

The use of special verdict forms, such as the Northern District of California's model patent jury instructions,¹¹² may be useful in overcoming these perceived deficiencies by guiding the jury's attention to the facts related to key patent findings. For instance, in making a determination of obviousness, the Northern District of California's model instructions pose a series of preliminary questions directed to each of the *Graham* factors,¹¹³ as well as to secondary considerations. The goal of the instructions is ultimately to guide the jury to consider whether "the Alleged Infringer has proven that it is highly probable that the claim of Patent Holder's patent would have been obvious to a person of ordinary skill in the field."¹¹⁴

For patent litigators wary of jury misunderstanding, this may represent an improvement over condensed, single-sentence instructions on obviousness.¹¹⁵ However, even with more understandable jury instructions, the more subtle distinction between the clear and convincing and the preponderance of the evidence standards may still be lost on the jury, which would ultimately dilute the effect of the *i4i* ruling. As Chief Justice Burger

110. See, e.g., MODEL PATENT JURY INSTRUCTIONS pt. III.2-13 (Am. Intellectual Prop. Law Ass'n 2008).

111. Phoebe C. Ellsworth & Alan Reifman, *Juror Comprehension and Public Policy: Perceived Problems and Proposed Solutions*, 6 PSYCH., PUB. POL'Y, & L. 788, 795 (2000) (citing Alan Reifman, S.M. Ellsworth & Phoebe C. Ellsworth, *Real Jurors' Understanding of the Law in Real Cases*, 16 LAW & HUM. BEHAV. 539, 540 (1992)).

112. MODEL PATENT JURY INSTRUCTIONS FOR THE NORTHERN DISTRICT OF CALIFORNIA (2007).

113. The scope and content of the prior art, the level of ordinary skill in the art, the differences between the claimed invention and the prior art, and objective evidence of nonobviousness—such as commercial success, long-felt but unsolved need, and failure of others. *Graham v. John Deere Co. of Kan. City*, 383 U.S. 1, 17 (1966).

114. MODEL PATENT JURY INSTRUCTIONS FOR THE NORTHERN DISTRICT OF CALIFORNIA 61 (2007).

115. See *Hynix Semiconductor Inc. v. Rambus Inc.*, No. C-00-20905 RMW, 2009 WL 112834, at *18 (N.D. Cal. Jan. 16, 2009).

acknowledged in *Addington v. Texas*, “we probably can assume no more than that the difference between a preponderance of the evidence and proof beyond a reasonable doubt probably is better understood than either of them in relation to the intermediate standard of clear and convincing evidence.”¹¹⁶ Indeed, studies demonstrate that while jurors understand the difference between a more-likely-than-not (preponderance) standard and a near certainty (beyond a reasonable doubt) standard, “they do not calibrate their decision making to account for the further distinction introduced by the clear and convincing evidence standard.”¹¹⁷ In addition, studies show that expressing legal standards as defined quantities (e.g., denoting a 71% probability for a clear and convincing threshold) improve juror comprehension in creating verdicts more in line with expectations during mock jury experiments.¹¹⁸ However, the legal community eschews defining evidentiary standards in such terms, largely out of fears of watering down standards, which in a criminal context would recognize an “intentional and permissible risk of convicting an innocent defendant.”¹¹⁹ Given the complexity of patent trials and lack of definitive empirical evidence, the ultimate effect of the clear and convincing standard on jury invalidity verdicts remains unclear.¹²⁰ Nonetheless, mock jury experiments reinforce the notion that concerns of a heightened evidentiary standard in shielding bad patents may be exaggerated.¹²¹

D. THE AMERICA INVENTS ACT: NEW AND MORE EFFICIENT AVENUES FOR INVALIDATION

The new American Invents Act addresses some of Microsoft’s concerns relating to the insulation of weak patents through a high evidentiary standard by creating a new avenue for invalidating patents through the PTO in the form of post-grant reviews (“PGRs”).¹²² The restructuring of reexamination proceedings by the AIA, most notably for *inter partes* proceedings, further provides a critical, defensive avenue for would-be defendants to combat

116. *Addington v. Texas*, 441 U.S. 418, 425 (1979).

117. Samuel Issacharoff, *The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law*, 51 VAND. L. REV. 1729, 1744 n.47 (1998).

118. See Dorothy K. Kagehiro & W. Clark Stanton, *Legal vs. Quantified Definitions of Standards of Proof*, 9 LAW & HUM. BEHAV. 159, 174 (1985).

119. *Id.*

120. See Jennifer F. Miller, *Should Juries Hear Complex Patent Cases?*, 2004 DUKE L. & TECH. REV. 004, ¶ 29–44 (2004).

121. See Kagehiro, *supra* note 118, at 174.

122. Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284, 305–13 (2011).

suspect patents.¹²³ The Supreme Court's *ii* ruling, which cemented the clear and convincing standard in invalidity defense challenges during litigation, will further encourage a move toward more PTO-administered invalidations that subject issued patents to a lesser preponderance of the evidence standard under de novo review.¹²⁴ Moreover, PTO examiners give claims their "broadest reasonable interpretation"¹²⁵ in lieu of the "ordinary and customary meaning"¹²⁶ that attaches during litigation. As stated in *In re Morris*:

[T]he PTO applies to verbiage of the proposed claims the broadest reasonable meaning of the words in their ordinary usage as they would be understood by one of ordinary skill in the art, taking into account whatever enlightenment by way of definitions or otherwise that may be afforded by the written description contained in the applicant's specification.¹²⁷

This provision reduces the possibility of having limitations read into claims, thus allowing a more expansive application of prior art during PTO proceedings relative to § 282 invalidity challenges.¹²⁸ Furthermore, the technical expertise of the PTO provides a more favorable forum for more conceptually challenging pieces of prior art and combinations of prior art that may be less accessible to judges and jurors in litigation.¹²⁹ In presenting prior art to lay judges and juries, simplicity and clarity are key strategic considerations for invalidating a patent. To this extent, the use of prior art combinations for obviousness-type arguments under § 103 may face challenges due to complexity, rendering this strategy a dull tool in litigation.¹³⁰ This represents a lost opportunity given that § 103 arguments are often more readily available than anticipation arguments in the universe of prior art, and

123. *Id.*

124. Compare MANUAL OF PATENT EXAMINING PROCEDURE § 706(I) (2007) [hereinafter M.P.E.P.] ("the standard to be applied in all cases is the 'preponderance of the evidence' test. In other words, an examiner should reject a claim if, in view of the prior art and evidence of record, it is more likely than not that the claim is unpatentable."), with *Microsoft Corp. v. i4i Ltd.*, 131 S. Ct. 2238, 2240 (2011) ("§ 282 requires an invalidity defense to be proved by clear and convincing evidence.").

125. *In re Trans Texas Holding Corp.*, 498 F. 3d 1290, 1295 (Fed. Cir. 2007); M.P.E.P. § 2258(I)(G) (2007).

126. *Phillips v. AWH Corp.*, 415 F.3d 1303, 1312 (Fed. Cir. 2005).

127. *In re Morris*, 127 F.3d 1048, 1054 (Fed. Cir. 1997).

128. See M.P.E.P. § 2258(I)(G) (2007) ("limitations in the specification are not read into the claims"); see also Eldora L. Ellison & Jon E. Wright, *Litigation or Reexamination*, WORLD INTELL. PROP. REV., Jan.–Feb. 2010, at 30, 32.

129. See Ellison, *supra* note 128, at 32.

130. See *id.* See generally Theresa Weisenberger, *An "Absence of Meaningful Appellate Review": Juries and Patent Obviousness*, 12 VAND. J. ENT. & TECH. L. 641 (2010).

in some respects are more difficult to overcome.¹³¹ The use of PTO-administered invalidations salvages this tool given examiners' greater degree of technical sophistication and comfort in utilizing § 103-based rejections.¹³²

Overall, the shift from lay jury to office-mediated invalidations will prove beneficial in filtering out unmeritorious patents within the patent system.¹³³

1. *Reexaminations and Inter Partes Reviews: A Proactive Invalidity Tool*

Prior to Congress's creation of the first reexamination statute in 1980, as codified at 35 U.S.C. §§ 301–307, courts could only resolve fundamental issues relating to raising new questions of patentability and the cancellation of claims of issued patents, leading to expensive and inefficient means of combating weak patents.¹³⁴ In response, Congress enacted *ex parte* reexaminations to attain three principal benefits:

First, the new procedure could settle validity disputes more quickly and less expensively than the often protracted litigation involved in such cases. Second, the procedure would allow courts to refer patent validity questions to the expertise of the Patent Office Third, reexamination would reinforce “investor confidence in the certainty of patent rights” by affording the PTO a broader opportunity to review “doubtful patents.”¹³⁵

However, the *ex parte* reexamination process did not prove as popular as originally hoped because third parties could not participate in the proceedings after filing *ex parte* reexamination requests.¹³⁶ Noting that allowing third parties to argue in reexamination would reduce the volume of district court patent cases, Congress expanded the reexamination procedure in 1999 through the American Inventors Protection Act by creating *inter partes* reexamination proceedings.¹³⁷ Unlike *ex parte* proceedings, a third-party requestor may reply to Office Actions as well as patent owner responses.¹³⁸ However, unlike *ex parte* reexaminations, third party requestors who are also

131. An anticipatory piece of prior art must disclose every claim limitation of a patent, whereas prior art used in an obviousness-type rejection need only be combined to cumulatively render a claim obvious. 35 U.S.C. §§ 102–103 (2007). See *KSR Int'l Co. v. Teleflex, Inc.*, 550 U.S. 398, 399 (2007); Bill Naifeh, *The Advantages of Narrow Patent Claiming*, THE PATENT LIGHT (March 9, 2010), <http://www.patentlight.com/?p=137>.

132. See Ellison, *supra* note 128, at 32.

133. See *infra* Section III.D.1, 2.

134. See *Patlex Corp. v. Mossinghoff*, 758 F.2d 594, 602 (Fed. Cir. 1985).

135. *Id.* (citing 126 CONG. REC. 29,895 (1980) (statement of Rep. Kastenmeier)).

136. See 106 CONG. REC. E1789 (1999) (daily ed. Aug. 15, 1999) (statement of Hon. Howard Coble).

137. *Id.* at E1790.

138. Compare 35 U.S.C. § 314(b)(2) (2006), with 37 C.F.R. § 1.550(g) (2007).

parties in litigation may face estoppel issues if an *inter partes* request raises the same issues during the course of litigation.¹³⁹ Nevertheless, since estoppel only applies after the PTO reaches a final decision and after all appeals are exhausted, estoppel has little practical effect given the long pendency of reexaminations¹⁴⁰ and the potential for third parties to appeal decisions to the Board of Patent Appeals and Interferences (“BPAI”) and the Federal Circuit.¹⁴¹

Despite this, reexaminations remained unpopular until the advent of the Central Reexamination Unit (“CRU”) in July of 2005.¹⁴² Requestors previously disfavored reexaminations, in part because they often involved the same Examiner who originally granted the patent, thus imparting a bias on requests that resulted in a greater frequency of allowances and a consequent squandering of valuable prior art.¹⁴³ However, the creation of the CRU allayed this worry by assigning requests “to an examiner different from the Examiner(s) who examined the patent application.”¹⁴⁴

The high success rate of challenging claims by third party requestors relative to litigation further popularized the use of reexaminations. While courts upheld patent validity in approximately two-thirds of infringement trials, the PTO cancelled or amended nearly 76% of all claims challenged by a third party requestor in an *ex parte* reexamination and 87% of claims in an *inter partes* reexamination.¹⁴⁵ Although 61% and 39% of claims represent claim changes in *ex parte* and *inter partes* reexaminations, respectively, this narrowing could theoretically allow potential defendants to circumvent infringement liability.¹⁴⁶ Notably, 48% of patents subject to *inter partes* reexamination have

139. See 35 U.S.C. § 315(c) (2006).

140. The average pendency of *inter partes* reexaminations as of Sep. 30, 2011 is 36.2 months. *Inter Partes Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/IP_quarterly_report_September_2011.pdf.

141. 35 U.S.C. § 315(b) (2006).

142. See *Inter Partes Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/IP_quarterly_report_September_2011.pdf.

143. See *Change in Policy of Examiner Assignment in Ex Parte Reexamination Proceedings and Establishment of Patentability Review Conferences in Ex Parte Reexamination Proceedings*, U.S. PATENT & TRADEMARK OFFICE (Aug. 4, 2000), <http://www.uspto.gov/web/offices/com/sol/og/2000/week35/patreex.htm>.

144. M.P.E.P §§ 2236(I) and 2636(I)(A) (2010).

145. Kimberly A. Moore, *Judges, Juries, and Patent Cases—An Empirical Peek Inside the Black Box*, 99 MICH. L. REV. 365, 375–76 (2000); *Ex Parte Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/EP_quarterly_report_Sept_2011.pdf; *Inter Partes Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/IP_quarterly_report_September_2011.pdf.

146. *Ex Parte Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/EP_quarterly_report_Sept_2011.pdf; *Inter Partes*

had all claims canceled, which reflects the involved nature of the proceedings.¹⁴⁷ In light of these statistics, the annual number of *ex parte* filings in 2011 increased approximately 50%, while the annual number of *inter partes* filings increased nearly six fold in 2011 relative to filings in 2005.¹⁴⁸

The AIA will change the current *inter partes* reexamination structure into the *inter partes* review (“IPR”) as of September 2012, though it will retain many of the same strategic benefits of the reexamination process with a few key changes.¹⁴⁹ In a subtle shift, the threshold for granting an IPR request will change from a “substantial new question of patentability” to a “reasonable likelihood that petitioner would prevail on at least one claim.”¹⁵⁰ Notably, IPRs will go before the Patent Trials and Appeals Board (“PTAB”) in lieu of the central reexamination unit, and third parties may only request IPRs after the nine-month window for filing a post-grant review has lapsed, as discussed in Section III.D.2, *infra*.¹⁵¹ The board will consist of administrative patent judges who have “competent legal knowledge and scientific ability,” thus retaining the benefit of technical expertise in analyzing prior art.¹⁵² IPRs will be heard by at least three members of the PTAB, and appeals will go directly to the Federal Circuit.¹⁵³ Additionally, IPRs will allow parties limited discovery of relevant evidence, such as the deposition of witnesses submitting affidavits or declarations.¹⁵⁴ In light of these additional features, IPRs will bear much higher costs in terms of both filing fees and associated attorney fees relative to their older counterparts.¹⁵⁵ However, since threatened parties know the patent claims asserted against them, IPRs offer a requestor an effective and economical tool to avoid infringement liability relative to litigation.

Reexamination Filing Data, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/IP_quarterly_report_September_2011.pdf.

147. *Id.*

148. *See id.*

149. *Compare* Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284, 299–305 (2011), *with* 35 U.S.C. §§ 311–318 (2006), *and* 37 C.F.R. §§ 1.902–1.997 (2006).

150. Technically, this standard is more difficult to meet than the existing standard, “however, this shift in standard may be a distinction without a practical difference.” Eldora L. Ellison & Deborah Sterling, *The Impact of the America Invents Act on Patent Challenges at the USPTO*, WORLD INTELL. PROP. REV., Nov.-Dec. 2011, at 36, 37; *see also* Leahy-Smith America Invents Act, 125 Stat. at 300.

151. Leahy-Smith America Invents Act, 125 Stat. at 299–305.

152. *Id.* at 313.

153. *Id.* at 299–305.

154. *Id.* at 302–03.

155. Scott A. McKeown, *How Much Will Post Grant Proceedings at the USPTO Cost?*, PATENTS POST-GRANT (Oct. 13, 2011), <http://www.patentspostgrant.com/lang/en/2011/10/how-much-will-post-grant-proceedings-at-the-uspto-cost>.

Perhaps the most advantageous aspect of the new legislation is that *inter partes* reviews will conclude within one year after institution,¹⁵⁶ with an additional six months for cause, providing an expedited process for invalidation for those seeking a quick invalidity resolution. However, third parties concurrently involved in litigation may give added weight to concerns about estoppel applying to § 282 challenges for arguments made during review proceedings due to the streamlined nature of the IPRs. Any final, adverse decision will more likely be completed before the end of any concurrent litigation, thus having a preclusive effect. This may warrant a more prudent approach towards separating out invalidity arguments. For instance, third parties may still use *ex parte* reexaminations if they are concerned about estoppel or cost issues, with the tradeoff of likely having a reduced success rate relative to PGRs and IPRs.¹⁵⁷

2. Post-grant Reviews: A Strong, but Limited Preemptive Tool

The post-grant review provisions of the AIA provide another tool for potential infringers to combat weak patents, enabling third parties to invalidate patents through the PTO within nine months of a patent's issuance.¹⁵⁸ Importantly, PGRs allow individuals a full arsenal of invalidity arguments under §§ 101–103, and § 112, such as the use of an on sale bar (at issue in *i4i*) or failure to comply with the written description and enablement requirements—all under a preponderance of the evidence standard.¹⁵⁹ This overcomes the deficiencies in using reexaminations for patent invalidation, which rely solely on prior art patents or written publications and can take years to reach a final conclusion.¹⁶⁰ Importantly, as the Patent Office notes, “by using the Office’s expertise, these challenges could be adjudicated for less money and in less time than by civil suit. This will enhance the patent system as a whole by strengthening those patents that survive the review and eliminating those patents which contain unpatentable subject matter.”¹⁶¹ The PTAB, discussed in Section III.D.1, *supra*, conducts the PGR proceedings.¹⁶² The board institutes a PGR if the evidence presented would demonstrate

156. Leahy-Smith America Invents Act, 125 Stat. at 302.

157. See *supra* Section III.D.1; *infra* Section III.D.2.

158. Leahy-Smith America Invents Act, 125 Stat. at 306.

159. *Id.*

160. See *Ex Parte Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/EP_quarterly_report_Sept_2011.pdf; *Inter Partes Reexamination Filing Data*, U.S. PATENT & TRADEMARK OFFICE (Sept. 30, 2011), http://www.uspto.gov/patents/IP_quarterly_report_September_2011.pdf.

161. *Post-Grant Review of Patent Claims*, U.S. PATENT & TRADEMARK OFFICE (Sept. 20, 2007), <http://www.uspto.gov/web/offices/com/strat21/action/sr2.htm>.

162. Leahy-Smith America Invents Act, 125 Stat. at 309.

that it is more likely than not that at least one of the challenged claims is unpatentable or if the petition raises a novel or unsettled legal question.¹⁶³ Designed to reach a conclusion within a year to a year and a half, which is shorter than typical civil trial and reexamination time frames, the proceedings include streamlined hearings, the possibility for live cross-examination, and the opportunity for limited discovery of evidence related to factual assertions advanced by the parties.¹⁶⁴ These provisions are similar to the provisions for IPRs.¹⁶⁵

However, the PGR's nine-month window certainly curtails its effectiveness, and was likely enacted to balance the values of maintaining secure property rights for patent holders with the need for reducing the occurrence of weak patents within the patent system.¹⁶⁶ This narrow window places the pressure on would-be defendants to maintain a high level of vigilance regarding newly issued patents—a considerable task that would require a nearly constant infringement and invalidation analysis for all relevant issued patents. The high transaction costs of this approach will likely limit PGRs to third parties with the foresight to identify patents that carry the highest risk of future litigation, which is a narrow subset of issued patents within industries that bear transparent litigation risks. For instance, licensees notified of newly issued patents that affect their current royalty agreements may find the PGR process useful as a defensive measure against aggressive licensors. However, the complexity and ambiguity of many issued claims, most notably in the software industry, would ultimately exacerbate this process, since the scope of claims often remains opaque until they are asserted.¹⁶⁷ Additionally, since the statutory defenses of § 282 define the grounds for PGRs, obviousness-type double patenting rejections¹⁶⁸ are excluded from this process, thereby limiting their use for invalidity challenges in reexaminations and IPRs.

163. *Id.* at 306.

164. *Id.* at 308–09.

165. *Id.* at 302–03.

166. *Id.* at 306.

167. See JAMES BESSEN & MICHAEL J. MEURER, PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATORS AT RISK 12–13 (2008).

168. Double patenting rejections concern patent holders who seek to extend the term of patent coverage by obtaining multiple patents on obvious variations of a single patent. M.P.E.P. § 804 (2007). This limitation on the use of this defense has notable benefits for the biotechnology and pharmaceutical industries, which more readily face these issues when attaining multiple patents for singular, blockbuster drugs. See Scott A. McKeown, *Post Grant Review Grounds*, PATENTS POST-GRANT (Apr. 1, 2011), <http://www.patentspostgrant.com/lang/en/2011/04/additional-grounds-of-post-grant-review-expanded-in-house-bill>.

Significantly adding to the strategic decision of pursuing PGRs are the monetary costs of the process. Certainly, PGRs, as well as IPRs, will prove much less costly than litigation considering that the average cost of patent litigation that reaches the Federal Circuit is over \$3 million.¹⁶⁹ However, in light of the expedited timeframe of PGRs, the assignment of three APJs to every filing, and the added discovery and the quasi-litigation features of the process, costs will likely soar relative to pre-AIA reexamination proceedings. The American Intellectual Property Law Association estimated that the cost of an average *inter partes* patent reexamination is \$278,000, including attorney fees and an \$8800 government filing fee.¹⁷⁰ Heightened filing fees for PGRs and increased attorney fees due to the new features of the process could easily double this cost for unsettled, fully adjudicated reviews. Costing more than an estimated half a million dollars, PGRs will likely have limited use as a preemptive invalidity tool to avoid infringement liability.¹⁷¹ From a cost-benefit standpoint, only the most egregious and straightforward cases of infringement would merit investing such substantial costs to avoid liability. Clients who do not feel threatened would likely find it more economical to wait until claims are asserted and then seek a stay of litigation pending review. However, the narrow window for a PGR would make this scenario unlikely. Additionally, individuals employing PGRs face significant estoppel dangers given the expanded invalidity grounds and expedited nature of the process.¹⁷² Since third parties must file reviews within nine months after issuance, the issues adjudicated during PGRs will likely exhaust them for use in any subsequent litigation. Thus, parties will employ extreme caution when using strongest prior art for fear of squandering it for later use.

Certainly, PGRs will not significantly replace the increasing popularity of reexaminations, which, as a litigation defense, offer the distinct advantage of knowing which patents litigants assert against a party. Nonetheless, PGRs will likely provide a useful addition to the repertoire of patent invalidity strategies to mitigate the presence of “bad” patents, while bolstering the validity and consequent strength of legitimate patents.

169. AM. INTELLECTUAL PROP. LAW ASS'N, REPORT OF THE ECONOMIC SURVEY 29 (2009).

170. *Id.* at 33.

171. Scott A. McKeown, *How Much Will Post Grant Proceedings at the USPTO Cost?*, PATENTS POST-GRANT (Oct. 13, 2011), <http://www.patentspostgrant.com/lang/en/2011/10/how-much-will-post-grant-proceedings-at-the-uspto-cost>.

172. *See* Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284, 306–08 (2011).

IV. CONCLUSION

The Supreme Court's holding, in the wake of the America Invents Act, will beneficially alter the calculus of invalidity defense strategies. Reduced evidentiary standards, greater technical expertise, and more streamlined reviews at the PTO will encourage defendants to seek invalidation outside of litigation. Nonetheless, the practical reality of the *ii* ruling will likely have a diminished impact on invalidity challenges during trial in light of the subtle distinction of evidentiary standards in the eyes of jurors, the rarity of evidentiary standard-determinative decisions, and the ability to give jury instructions emphasizing the weight of new art. For combatting weak patents, Congress and the courts should focus on crafting policies that necessarily impact decision-making at the PTO-level, rather than focusing on the procedural aspects underlying court invalidity decisions. The America Invents Act represents a step in the right direction.

GLOBAL-TECH APPLIANCES, INC. v. SEB S.A.: **DISCOVERING WILLFULLY BLIND TERRITORY IN** **INDUCED PATENT INFRINGEMENT**

Yvonne Lee[†]

Patent infringement is a well-established statutory tort that holds an individual liable for infringement if he, without authorization, engages either directly or indirectly in an activity that is covered by every element in a claim of another's patent.¹ In cases of direct patent infringement, it does not matter if an infringer knew of or intended to infringe the patent in question.² Patent laws have always provided that the alleged infringer's scienter is not relevant in a direct patent infringement analysis.³

Less clear are cases of induced patent infringement, where a third party instructs, directs, or advises someone to infringe another's patent.⁴ Induced patent infringement was codified as a statutory tort in 35 U.S.C. § 271(b) and provides liability for an individual or entity who "actively induces infringement of a patent."⁵ Unlike direct patent infringement, which is clearly a strict liability offense,⁶ courts wrestled for over fifty years after the codification of 35 U.S.C. § 271(b) with what, if any, requirements there were as to a third party's actual intent to infringe or actual knowledge of infringement.⁷ The Federal Circuit, in its landmark decision, *DSU Med. Corp. v. JMS Co.*, resolved this issue and held that the statutory mandate of

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1. See 35 U.S.C. § 271(a) (2006) ("[W]hoever without authority makes, uses, offers to sell, or sells any patented invention . . . infringes the patent."); see also Charles W. Adams, *Indirect Infringement from a Tort Law Perspective*, 42 U. RICH. L. REV. 635, 636–37 (2008).

2. 5 DONALD CHISUM, CHISUM ON PATENTS § 17.01 (Matthew Bender 2011).

3. See ROBERT PATRICK MERGES & JOHN FITZGERALD DUFFY, PATENT LAW AND POLICY: CASES AND MATERIALS 797–98 (5th ed. 2011).

4. See *Goodwall Constr. v. Beers Constr.*, 503 F. Supp. 153 (N.D. Ga. 1981).

5. 35 U.S.C. § 271(b) ("Whoever actively induces infringement of a patent shall be liable as an infringer."). Congress codified induced infringement as a statutory offense in 1952 when it enacted 35 U.S.C. 271(b). See *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 485 n.6 (1964).

6. See Mark A. Lemley, *Inducing Patent Infringement*, 39 U.C. DAVIS L. REV. 225, 235 (2005); see also MERGES, *supra* note 3, at 597 ("Note that [35 U.S.C. § 271(a)] does *not* require any proof of *access* to the inventor's work or any *intent* to infringe.").

7. See Lemley, *supra* note 6, at 228–41.

“actively induces” required both intent and knowledge.⁸ Although the Federal Circuit held that both intent and knowledge were necessary components for induced patent infringement liability, neither the Federal Circuit nor the Supreme Court ever decided what level of knowledge was required until *SEB S.A. v. Montgomery Ward & Co* and *Global-Tech Appliances, Inc. v. SEB S.A.*, respectively.⁹

Montgomery Ward presented the Federal Circuit, for the first time, with a ripe factual situation in which to address the level of knowledge required for induced patent infringement.¹⁰ *Montgomery Ward* involved an alleged infringer in the deep fryer industry who had a high level of knowledge of his industry and the patent system and withheld material information from his counsel during a freedom to operate search.¹¹ The Federal Circuit upheld the lower court’s finding of induced patent infringement and held that the standard for knowledge was something more than “should have known,” and something less than actual knowledge.¹² Drawing from constitutional tort law, the court held that the appropriate level of knowledge required for induced patent infringement was deliberate indifference, or disregard of an obvious risk, to the fact that a product would be used in an infringing manner was the appropriate level of knowledge for induced patent infringement.¹³

The Supreme Court granted writ of certiorari in *Global-Tech Appliances, Inc. v. SEB S.A.*,¹⁴ and affirmed the Federal Circuit’s conclusion of induced patent infringement in *Montgomery Ward*; however, the Supreme Court rejected the Federal Circuit’s holding of deliberate indifference as a sufficient substitute for actual knowledge.¹⁵ Drawing from criminal law jurisprudence,

8. See *DSU Med. Corp. v. JMS Co.*, 471 F.3d 1293, 1306 (Fed. Cir. 2006). The Supreme Court also held that active inducement required both intent to infringe and actual knowledge of infringement in *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2068 (2011). For a thorough discussion of the evolution of intent and knowledge as requirements of active inducement liability, see Lemley, *supra* note 6.

9. See *SEB S.A. v. Montgomery Ward & Co.*, 594 F.3d 1360, 1376 (Fed. Cir. 2010), *aff’d sub nom.* *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (2011).

10. See *id.*

11. *Id.* at 1377.

12. *Id.* at 1376–77.

13. *Id.* at 1376 (applying the standard from cases dealing with Eighth Amendment violations).

14. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (2011), *aff’g* *SEB S.A. v. Montgomery Ward & Co.*, 594 F.3d 1360 (Fed. Cir. 2010).

15. *Global-Tech*, 131 S. Ct. at 2068; see also *Montgomery Ward*, 594 F.3d at 1377. Since *Global-Tech* was the first time the Supreme Court heard an induced patent infringement case, the Court also held that induced patent infringement required that the defendant have both intent to infringe and knowledge that his actions would induce infringing acts. See *Global-Tech*, 131 S. Ct. at 2067.

the Supreme Court held instead that liability for induced patent infringement under 35 U.S.C. § 271(b) required either a defendant's actual knowledge or "willful blindness" to the fact that his product would be used in an infringing manner.¹⁶ The Court held that willful blindness, as compared to deliberate indifference, requires both that the defendant subjectively believe that there is a high probability that his product infringes and that the defendant take *deliberate* actions to avoid learning of that fact.¹⁷

The Supreme Court found the Federal Circuit's deliberate indifference test inappropriate because the deliberate indifference test permitted a court to find knowledge when there was merely a known risk of infringement; and it also allowed a court to find knowledge even when the defendant took no active steps to avoid learning of the infringing nature of the activities.¹⁸ Concerned about industries—such as the semi-conductor industry—where almost every innovation is patented, the Supreme Court noted that a deliberate indifference standard would make it virtually impossible for companies to operate without fear of being found to avoid an obvious risk.¹⁹

This Note explores the effectiveness of the Supreme Court's holding of willful blindness as a tighter standard for knowledge than the Federal Circuit's standard of deliberate indifference in criminal law and as applied to induced infringement. Part I of this Note examines the *Montgomery Ward* and *Global-Tech* decisions—specifically, it considers the courts' holdings of deliberate indifference and willful blindness. Part II examines appellate courts' application of the doctrine of willful blindness in a criminal law context and explores possible implications criminal law holdings have on induced patent infringement cases. Part III concludes with a summary of what facts prove dispositive in a willful blindness analysis for cases of induced patent infringement.

I. THE STANDARD FOR KNOWLEDGE IN CASES OF INDUCED PATENT INFRINGEMENT

Montgomery Ward and *Global-Tech* marked the first time either the Federal Circuit or the Supreme Court addressed what level of knowledge was

16. *Global-Tech*, 131 S. Ct. at 2068.

17. *Id.* at 2070.

18. *Id.* at 2071.

19. Transcript of Oral Argument at 14, *Global-Tech*, 131 S. Ct. 2060 (2011) (No. 10-6) (J. Roberts) (commenting that "if there are 420,000 [patents in the semiconductor industry], you're never going to know with any degree of comfort that you're not going to infringe something").

necessary in the context of induced patent infringement.²⁰ This Part explores the rationale behind the Federal Circuit and Supreme Court's articulations of deliberate indifference and willful blindness standards, respectively, in induced patent infringement cases. Section I.A gives a brief description of the facts and procedural history of the case. Section I.B examines the Federal Circuit holding of deliberate indifference and its application to the facts in this case. Section I.C examines the Supreme Court holding of willful blindness, its application to the facts in this case, as well as the Court's rationale for adopting the doctrine.

A. FACTS AND PROCEDURAL HISTORY

This case centered on a patent infringement claim over a deep fryer.²¹ The Hong Kong-based defendant, Pentalpha, was a maker of home appliances, and a subsidiary of Global-Tech Appliances, Inc. ("Global-Tech").²² The plaintiff, SEB S.A. ("SEB"), was a French maker of home appliances.²³ In 1997, Pentalpha received a contract from Sunbeam, one of SEB S.A.'s U.S. competitors, to develop a deep fryer with cool-touch features similar to a fryer SEB sold.²⁴ To comply with the order, Pentalpha purchased an unbranded SEB, cool-touch fryer in Hong Kong.²⁵ SEB owned a patent on its cool-touch fryer, U.S. Patent No. 4,995,312 (the "312 patent").²⁶ Pentalpha reverse engineered SEB's fryer and made a duplicate of the fryer, copying all of the fryer's innovative features.²⁷ Before selling its new fryer to Sunbeam, Pentalpha retained an attorney to conduct a freedom to operate search, but neglected to tell the attorney that they copied SEB's fryer.²⁸ The attorney's search came up empty, and he issued Pentalpha an opinion letter saying their fryer did not infringe any patents.²⁹ Pentalpha's president was allegedly familiar with the U.S. patent system and was aware that SEB also participated in obtaining patents.³⁰ In addition, Pentalpha's

20. See *SEB S.A. v. Montgomery Ward & Co.*, 594 F.3d 1360, 1376 (Fed. Cir. 2010).

21. *Global-Tech*, 131 S. Ct. at 2063.

22. *Id.* at 2064.

23. *Id.* at 2063.

24. *Id.* at 2064.

25. *Id.*

26. *SEB S.A. v. Montgomery Ward & Co.*, 594 F.3d 1360, 1375 (Fed. Cir. 2010).

27. *Global-Tech*, 131 S. Ct. at 2064.

28. *Id.*

29. *Id.*

30. *Montgomery Ward*, 594 F.3d at 1377.

president had former business collaborations with SEB.³¹ Pentalpha was also aware that Sunbeam planned to sell the fryers in the United States.³²

SEB sued Sunbeam in 1998 for infringement of the '312 patent, when Sunbeam began selling its fryers in the United States.³³ Even after Sunbeam notified Pentalpha of the suit, Pentalpha continued selling its fryer to other customers, including Montgomery Ward.³⁴ SEB subsequently sued Pentalpha and Montgomery Ward in 1999.³⁵ In 2006, a jury found Pentalpha liable for willful and induced infringement and awarded SEB \$4.65 million in damages.³⁶ Pentalpha appealed several issues, including the lower court's denial of its motion for a judgment as a matter of law as to the induced infringement claim.³⁷ Pentalpha claimed that this motion was appropriate as to the induced infringement claim because it had no actual knowledge of the patent.³⁸

B. THE FEDERAL CIRCUIT AND DELIBERATE INDIFFERENCE

In *SEB S.A. v. Montgomery Ward & Co.*, the Federal Circuit affirmed the induced infringement finding against Pentalpha and held that deliberate indifference was sufficient to satisfy the knowledge requirement under § 271(b).³⁹ Looking at Supreme Court constitutional tort jurisprudence, the Federal Circuit stressed that deliberate indifference was not a “should have known” standard and required the defendant to have a subjective and active disregard of a known risk.⁴⁰ The court reasoned that a deliberate indifference standard would not be overly broad, as a defendant could escape liability if he could show that he was genuinely “unaware even of an obvious risk.”⁴¹ The court noted that “deliberate indifference” or deliberately avoiding a known risk, was defined in a criminal law context as “not different from actual knowledge, but [] a form of actual knowledge.”⁴² Applying the deliberate indifference standard to this case, the court found that Pentalpha copying of SEB's fryer, failing to tell its attorney of the copying, and

31. *Id.*

32. *Id.* at 1375.

33. *Id.* at 1366.

34. *Id.*

35. *Id.* at 1365.

36. *Id.*

37. *Id.* at 1367–68.

38. *Id.* at 1367.

39. *Id.* at 1378.

40. *Id.* at 1376 (citing *Farmer v. Brennan*, 511 U.S. 825, 840 (1994)).

41. *Id.* at 1376–77.

42. *Id.* at 1377 (quoting *United States v. Carani*, 492 F.3d 867, 873 (7th Cir. 2007), a criminal law case where a defendant's willful blindness was at issue).

Pentalpha's familiarity with U.S. patent law "would be highly suggestive of deliberate indifference in most circumstances."⁴³ As such, the court affirmed the jury verdict of induced infringement.⁴⁴

C. THE SUPREME COURT AND WILLFUL BLINDNESS

The Supreme Court affirmed the Federal Circuit's conclusion; however, the Court rejected the Federal Circuit's standard of deliberate indifference.⁴⁵ Citing the long history of acceptance the doctrine of willful blindness had in other courts of appeals and the doctrine's narrower scope as compared to deliberate indifference, the Supreme Court held willful blindness was the appropriate level of intent required under § 271(b).⁴⁶

The Court noted that most courts of appeals required a defendant to satisfy two prongs in order to be found willfully blind.⁴⁷ The court held that willful blindness in cases of induced patent infringement required the same two-prong analysis: (1) "the defendant must subjectively believe that there is a high probability that a fact exists;" and (2) "the defendant must take deliberate actions to avoid learning of that fact."⁴⁸ The court found that Pentalpha's market research, awareness of the fryer's innovative qualities, and awareness that it was sold in the United States were sufficient to show a high probability that Pentalpha was aware of the patent.⁴⁹ The Court further found that producing a copy notwithstanding knowledge of the competing product and non-disclosure to counsel about the knowledge constituted deliberate actions by Pentalpha to avoid learning of the fact of SEB's patent.⁵⁰ As such, the Court found that Pentalpha was willfully blind to SEB's patent and thus satisfied the knowledge requirement under § 271(b).⁵¹

Other than a long history of acceptance in most of the courts of appeals, the Court also reasoned that willful blindness was the appropriate standard because it had a "more limited scope" than deliberate indifference.⁵² The Court noted that it was concerned that a deliberate indifference standard would require the defendant to have a level of diligence that would be practically impossible to meet in industries where almost every advance in

43. *Id.*

44. *Id.* at 1378.

45. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2071 (2011).

46. *Id.*

47. *Id.* at 2070.

48. *Id.*

49. *Id.* at 2071–72.

50. *Id.*

51. *Id.* at 2072.

52. *Id.* at 2070.

technology is patented.⁵³ Specifically, the Court noted that in industries like the semi-conductor industry, where almost every new innovation was patented and infringing a patent would almost always be a known risk, it would be difficult for companies to proceed if they were found to have knowledge simply by releasing a new product.⁵⁴ The court found that a willful blindness standard differed from a deliberate indifference standard in two ways: (1) it demanded a defendant's subjective high probability of risk rather than a known risk of infringement; and (2) it required a defendant to take deliberate action, as opposed to no active steps, to avoid learning of the infringing nature of the activities.⁵⁵

Given the variety and breadth of willful blindness jurisprudence in criminal law, Part II explores the application of willful blindness to certain criminal law fact patterns and examines how that application may elucidate the meaning of willful blindness in induced patent infringement.

II. WILLFUL BLINDNESS IN CRIMINAL LAW AND ITS IMPLICATIONS TO INDUCED PATENT INFRINGEMENT

In *Global-Tech*, the Court stressed that almost all of the courts of appeals agreed that a willful blindness analysis consisted of two prongs: (1) “the defendant must subjectively believe that there is a high probability that a fact exists;” and (2) “the defendant must take deliberate actions to avoid learning of that fact.”⁵⁶ Since the court referred to this uniform holding among the courts of appeals, it is useful to examine how circuits have applied this standard to fact patterns that are relevant to induced patent infringement.⁵⁷ Specifically, the Court's jurisprudence with regard to the role of outside experts, the expertise of the defendant, relationships between plaintiffs and defendants, and what actions/inactions constitute deliberate avoidance, inform hypothetical situations that may arise in induced patent infringement.⁵⁸ Section II.A examines which fact patterns in criminal law weigh in favor of, and against, finding a high probability that the defendant knew that a fact existed and compares how some fact patterns in criminal law

53. Transcript of Oral Argument at 14, *Global-Tech*, 131 S. Ct. 2060 (2011) (J. Roberts) (commenting that “if there are 420,000 [patents in the semiconductor industry], you're never going to know with any degree of comfort that you're not going to infringe something”).

54. *See id.*

55. *Global-Tech*, 131 S. Ct. at 2071.

56. *See id.* at 2070.

57. *See id.*

58. *See infra* Section II.A.1.

might apply to induced patent infringement. Section II.B proceeds similarly with regard to examining what actions defendants take that constitute deliberate actions to avoid learning of facts.

A. HIGH PROBABILITY THAT A FACT EXISTS

In criminal law cases, one of the most important distinctions noted by courts in determining whether a defendant had a high probability of knowledge is whether the defendant had general or specific knowledge. Consistent with the *Global-Tech* holding, courts find a high probability of knowledge if the defendant had specific knowledge of illegal activity, and do not find a high probability of knowledge if the defendant only had general knowledge of the activity. The factors that contribute to this distinction will be explored, *infra*. Section II.A.1 explores various appellate courts' applications of the general/specific knowledge distinction in criminal law cases. Section II.A.2 explores the implication of this distinction in induced patent infringement cases.

1. *How Courts Interpret the First Prong in Criminal Law Cases*

In determining whether the defendant had general or specific knowledge, courts consider the relationship the defendant had with the plaintiff, the outcome of expert opinions, and the defendant's amount of inherent expertise. The following cases illustrate how these factors affect courts' holdings as to specific or general knowledge.

United States v. Carrillo is a case where a personal relationship proved dispositive in the holding.⁵⁹ Here, the Seventh Circuit affirmed the district court conclusion that a jury appropriately inferred knowledge through willful blindness, given that the defendant had knowledge of her cohort's previous drug dealings.⁶⁰ The trial court gave the willful blindness instruction to the jury in regard to one of the co-defendants, Miranda.⁶¹ Miranda, romantically involved with Carrillo, flew down to Mexico on a ticket paid by Carrillo, allegedly to attend a party; drove a drug-filled, newly gifted Cadillac from Carrillo to the border where the border patrol searched the car and failed to find drugs; and proceeded back to Chicago, whereupon Carrillo took the car, and she received \$5000.⁶² Miranda claimed she did not know there were any

59. *United States v. Carrillo*, 435 F.3d 767, 784 (7th Cir. 2006).

60. *Id.* at 785.

61. *Id.* at 779.

62. *Id.* at 771–72.

drugs in the car when DEA agents searched the Cadillac—still registered to Miranda—and found traces of drugs.⁶³

The Seventh Circuit considered the following facts in its analysis: that Miranda flew on a free ticket, never attended the party, received a free car, saw the car searched by border patrol, and received \$5000. The court found that these facts implied that Miranda had general “knowledge that things are not as they seem,” however, they did not convey enough specific knowledge to demonstrate a high probability of knowledge that there were drugs in the car.⁶⁴ Another factor weighing against a high probability of knowledge was the border patrol’s unfruitful search of the car: “because if trained law enforcement officers could not discern that the black Cadillac was stuffed with illegal drugs, it seems difficult to infer that Miranda did.”⁶⁵ Ultimately, however, the court found that Miranda’s romantic relationship with Carrillo supported the lower court’s finding of willful blindness as it “provide[d] a whole new context for Miranda’s trip to Mexico.”⁶⁶ The Seventh Circuit affirmed the district court’s finding that Miranda’s romantic relationship with Carrillo implied that she had specific knowledge of his drug dealings and supported a jury finding that she had a high probability of knowledge that her trip to Mexico involved drug trafficking.⁶⁷

In contrast, the First Circuit in *United States v. Perez-Melendez* concluded that the defendant’s inconsistent statements and a high probability of awareness of some illegal activity in general was not enough evidence to support a jury finding that the defendant was willfully blind beyond a reasonable doubt as to drug possession.⁶⁸ Law enforcement officials received a tip that a truck Perez-Melendez drove contained large quantities of cocaine.⁶⁹ Officials stopped Perez-Melendez’s truck, ordered him and his passenger out of the truck, and with Perez-Melendez’s consent, searched the truck.⁷⁰ The officials found pallets of paper wrapped in plastic and could not identify if there were narcotics present.⁷¹ Only with the help of agents and drug sniffing dogs at a special facility back at the office were agents able to

63. *Id.* at 774.

64. *Id.* at 783.

65. *Id.*

66. *Id.* at 784.

67. *Id.*

68. *United States v. Perez-Melendez*, 599 F.3d 31, 45–46 (1st Cir. 2010).

69. *Id.* at 34.

70. *Id.*

71. *Id.*

determine that there was \$1,600,000 worth of cocaine tucked in the pallets of paper.⁷²

The court acknowledged that when officials questioned Perez-Melendez, he contradicted himself, his passenger, and a customer service employee for the truck company with regard to who rented the truck, who provided instructions as to where and when to drive, and the extent to which he worked in the past with his passenger.⁷³ However, the court found dispositive that Perez-Melendez drove the truck during normal hours through an industrial zone, Perez-Melendez was not paid excessively for the job, and that the vehicle was not equipped with weapons.⁷⁴ The court noted that the government “succeeded in establishing, *at most*, that appellants knew or were willfully blind to the fact that *something* illegal was afoot.”⁷⁵ However, notwithstanding Perez-Melendez’s inconsistent statements, the court concluded that there was not enough evidence to show Perez-Melendez was willfully blind as to the existence of the drugs, *specifically*, because his behavior fell within acceptable limits for normal business, and that “the cocaine was concealed so well in packaging . . . that a team of law enforcement agents could not detect it themselves and needed a trained canine to do so.”⁷⁶

In *United States v. Wasserson*, a case where the defendant’s own expertise was dispositive, the Third Circuit reinstated a jury verdict against the defendant because the court found that the defendant “was subjectively aware of the high probability,” and therefore willfully blind to the fact that a contractor disposed of hazardous wastes from his warehouse in an unpermitted facility.⁷⁷ Wasserson, the defendant, owned and operated a warehouse for more than a decade and had extensive knowledge regarding the disposal of hazardous wastes, including the need for proper transport vehicles, disposal facilities, and government-mandated manifests.⁷⁸ Wasserson also knew that the proper disposal of hazardous wastes was expensive.⁷⁹ When Wasserson decided to clear out the warehouse, he asked an employee, Hughes, to find someone to handle the waste disposal.⁸⁰ Unlike

72. *Id.*

73. *Id.* at 42.

74. *Id.* at 44–45.

75. *Id.* at 45 (emphasis added).

76. *Id.* at 44.

77. *See* *United States v. Wasserson*, 418 F.3d 225, 237 (3d Cir. 2005). The court found that the defendant’s willful blindness was also attributable to deliberate actions he took to avoid learning of the waste disposal in addition to his high probability of knowledge of that fact. *Id.* at 238.

78. *Id.* at 237–38.

79. *Id.* at 238.

80. *Id.*

Wasserson, Hughes was not familiar with proper hazardous waste disposal procedures.⁸¹ Not knowing that he needed to hire someone with hazardous waste disposal experience, Hughes hired a general waste disposal contractor out of the yellow pages to handle the waste disposal.⁸² Hughes did not inform the contractor of the hazardous nature of the waste, nor did Hughes ask the contractor if he had any experience in handling hazardous waste.⁸³ When Wasserson received the quote from the contractor, he did not question the quote, which was well below average for what Wasserson knew typical hazardous waste disposal to cost.⁸⁴ The court concluded that evidence of Hughes's ignorance to waste disposal procedures, the contractor's lack of knowledge with regard to the situation, Wasserson's expertise in the matter, and Wasserson's knowledge that the price quoted by the contractor was well below average for hazardous waste, was enough to show that Wasserson had a high probability of knowledge, constituting willful blindness to improper hazardous waste disposal.⁸⁵

As illustrated in the cases discussed *supra*, appellate courts in criminal law cases commonly weigh three factors to determine whether a defendant had general or specific knowledge. The first factor that can tip the scales from general knowledge to specific knowledge is a defendant's relationship or familiarity with a plaintiff or his business, even if the relationship is not directly related to the matter at hand. For example, in *Carrillo*, even though the defendant's suspicious trip in and of itself was not enough to show a high probability of knowledge that she participated in drug possession and trafficking, the court found that the defendant's romantic relationship with the co-defendant was dispositive and supported a conclusion that she had specific knowledge of his drug trafficking business.⁸⁶ In contrast, even though the *Perez-Melendez* court noted that the defendant's inconsistent statements indicated that there a high likelihood that the defendant knew "that something illegal was afoot," the court found that general knowledge of illegal behavior was not enough to show a high probability of the specific fact that the truck he drove contained drugs.⁸⁷ Although there was some evidence that the defendant worked with the drug dealer in the past, there was nothing that indicated that the defendant knew his associate was a drug dealer.⁸⁸

81. *Id.*

82. *Id.* at 229.

83. *Id.* at 238–39.

84. *Id.* at 239.

85. *Id.* at 238–39.

86. *United States v. Carrillo*, 435 F.3d 767, 783 (7th Cir. 2006).

87. *United States v. Perez-Melendez*, 599 F.3d 31, 45 (1st Cir. 2010).

88. *Id.* at 46–47.

The courts of appeals also found the role of an expert determinative in criminal law cases involving the first prong of the willful blindness doctrine; specifically that the inability of an expert to acknowledge circumstances or successfully perform tasks related to his or her expertise weighed against finding specific knowledge. The weaker of the two expert factors is the inability of an expert to find evidence of illegal activity as with the unsuccessful drug searches by law enforcement in both *Carrillo* and *Perez-Melendez*.⁸⁹ Even though it weighs against finding specific knowledge, that factor alone is not enough to swing the pendulum back to general knowledge if there are other factors in play, such as a personal relationship with the defendant, as in *Carrillo*.⁹⁰

The expertise of the *defendant* (as opposed to a third-party expert), however, can be dispositive in a specific/general knowledge analysis. In *Wasserson*, the court found that the defendant had a high level of expertise in dealing with hazardous waste disposal.⁹¹ Notwithstanding that the defendant used an outside expert, a contractor for waste disposal that an associate found in the yellow pages, the court found that the defendant's own expertise and knowledge regarding hazardous waste disposal was sufficiently high that he would have had a high probability of knowledge of improper waste disposal from his facility.⁹²

2. *Application of First-Prong, Criminal Law Principles to Induced Patent Infringement*

The three factors discussed *supra* that influence a general/specific knowledge analysis in criminal law jurisprudence will likely have applicability when courts consider this issue in cases of induced patent infringement post *Global-Tech*. For example, the unsuccessful drug searches in *Carrillo* and *Perez-Melendez* may have a parallel in induced patent infringement: an unsuccessful search for prior art when an attorney conducts a right-to-use analysis.⁹³ Also, the *Wasserson* defendant's expertise in a particular form and procedure of waste disposal may translate into patent law as a defendant who has expertise with a particular product and awareness of its inventor/owner.⁹⁴ Finally, the *Carrillo* defendant's personal relationship with the co-defendant may translate

89. See *Perez-Melendez*, 599 F.3d at 44; *Carrillo*, 435 F.3d at 783.

90. See *Carrillo*, 435 F.3d at 784.

91. See *United States v. Wasserson*, 418 F.3d 225, 237–38 (3d Cir. 2005).

92. See *id.* at 229, 238–39.

93. See *Perez-Melendez*, 599 F.3d at 44; *Carrillo*, 435 F.3d at 783.

94. See *Wasserson*, 418 F.3d at 238–39.

into the patent law context where a defendant has prior dealings or intimate knowledge of the workings of the patentee in question.⁹⁵

In *Global-Tech*, all three factors are present. Similar to the unsuccessful drug searches in *Carrillo* and *Perez-Melendez*, the attorney's unsuccessful search for a relevant patent weighs against a finding of specific knowledge in *Global-Tech*.⁹⁶ This factor is mitigated, as discussed *infra*, because of Pentalpha's deliberate withholding of information.⁹⁷ Weighing in favor of finding specific knowledge are the prior business dealings Pentalpha had with SEB, which are similar to the close relationship the *Carrillo* defendant had with her drug-dealing co-defendant.⁹⁸ However, the most determinative factor in *Global-Tech* is that, like the *Wasserson* defendant, Pentalpha was an expert with the SEB fryer, given that Pentalpha knew SEB was the manufacturer of the product it reverse engineered, and knew that SEB sold the product in the United States.⁹⁹

In a way, the facts in *Global-Tech* provide an "easy" case to analyze under this prong because of the amount of information or expertise Pentalpha had on SEB's fryer. Changing the *Global-Tech* facts slightly, what if Pentalpha copied a fryer that had no markings whatsoever indicating that SEB manufactured it? Would the fact that Pentalpha had general knowledge of the deep fryer market be enough to show a high probability of knowledge that it infringed a valid patent?

The *Carrillo* and *Perez-Melendez* holdings indicate that without knowing specifically that SEB manufactured the fryer, Pentalpha would not have had a high probability of knowledge of SEB's patent.¹⁰⁰ However, as in *Carrillo*, where a court found the defendant's romantic relationship with the co-defendant determinative, a hypothetical *Global-Tech* court may still find Pentalpha to have a requisite high probability of knowledge if the court found Pentalpha's history of prior dealings or other close business ties with SEB to indicate that they would know about the fryer patent.¹⁰¹ It is likely that future determinations of a high probability of knowledge in an induced patent infringement case will rest first on what specific knowledge the alleged infringer had of the patentee's product. Absent specific knowledge, prior

95. See *Carrillo*, 435 F.3d at 783.

96. Compare *Perez-Melendez*, 599 F.3d at 44, and *Carrillo*, 435 F.3d at 783, with *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2071–72 (2011).

97. Compare *Carrillo*, 435 F.3d at 783, with *Global-Tech*, 131 S. Ct. 2071–72.

98. Compare *Carrillo*, 435 F.3d at 783, with *Montgomery Ward*, 594 F.3d at 1377.

99. Compare *Wasserson*, 418 F.3d at 238–39, with *Montgomery Ward*, 594 F.3d at 1377.

100. See *supra* notes 64, 74–75 and accompanying text.

101. See *Carrillo*, 435 F.3d at 783.

dealings and past business relationships may be determinative of finding a high probability of knowledge.

Building on the same hypothetical, what if there were no markings on the fryer, Pentalpha only had general knowledge of the fryer industry, and an attorney's right-to-use search came up empty? Although the probability was high that Pentalpha's attorney would have found the patent given the name of the manufacturer in the actual case,¹⁰² what if, in this hypothetical, the probability of finding a patent was marginally low even after providing the attorney with all pertinent information? Would all the other *Global-Tech* factors still weigh in favor of finding a high probability of knowledge?

As discussed *supra*, the appellate courts' holdings in *Perez-Melendez*, *Carrillo*, and *Wasserson* suggest that the answer lies in balancing all three factors. For example, the *Perez-Melendez* court found the inability of law enforcement agents to find drugs in the defendant's car on the first search to invalidate a jury finding of high probability of knowledge.¹⁰³ Likewise, the *Carrillo* court found the inability of border patrol to find drugs in the defendant's car to weigh against a finding of high probability of knowledge, but not to overrule the possibility outright.¹⁰⁴ One explanation for the apparent discrepancy, however, is that the law enforcement agents in *Perez-Melendez* could not find the drugs after engaging in a more rigorous (and targeted) search of the defendant's car than the car search in *Carrillo*.¹⁰⁵ The more likely explanation for the discrepancy is that there was more evidence

102. The Supreme Court assumes that had Pentalpha informed its attorney that SEB manufactured the model product it copied, that the attorney would have had "a high probability" of finding the patent. See Transcript of Oral Argument at 10, *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (2011) (No. 10-6) (J. Sotomayor) (noting the probability is "probably ninety percent" while Petitioner's counsel noting the probability "would [only] be greater than fifty percent"). A recent search conducted on Google Patents yielded the following results: seven hits with search terms "SEB S.A. fryer" including the '312 patent; and 430 hits with search terms "electric fryer," including the '312 patent. See GOOGLE PATENTS, http://www.google.com/advanced_patent_search (search limited to patents filed by August 1997). A search conducted on the USPTO website resulted in twenty-four hits with search terms "SEB S.A. fryer," including the '312 patent and 915 hits with search terms "electric fryer," including the '312 patent. See *USPTO Patent Full-Text and Image Database*, U.S. PATENT & TRADEMARK OFFICE, <http://patft.uspto.gov/netahtml/PTO/search-bool.html> (last visited on Feb. 25, 2012, 9:06 AM) (search not limited to any filing date). Even though patent searching methodology was different in 1997, both searches indicate that had Pentalpha disclosed to its attorney that it copied an SEB fryer, the attorney would likely have had a high probability of finding the patent.

103. *United States v. Perez-Melendez*, 599 F.3d 31, 44 (1st Cir. 2010).

104. Compare *Perez-Melendez*, 599 F.3d at 44, with *United States v. Carrillo*, 435 F.3d 767, 782–84 (7th Cir. 2006) (finding that notwithstanding the inability of border patrol to find drugs in the defendant's car, a finding of high probability of knowledge was appropriate).

105. Compare *Perez-Melendez*, 599 F.3d at 34 with *Carrillo*, 435 F.3d at 771–72.

that the *Carrillo* defendant had a closer relationship to the direct perpetrator than in *Perez-Melendez*, probably countering the effect of the expert not being able to locate the drugs.¹⁰⁶ Carrying over these principles to induced patent infringement suggests that counsel's fruitless search for a patent can be evidence that weighs against a finding a high probability of knowledge. Just as an expert's more rigorous search for drugs yielded a lesser probability of knowledge, perhaps the more complete and rigorous search conducted by counsel would yield a lesser probability of knowledge. However, notwithstanding a right-to-use opinion by counsel, the more important factor in a probability of knowledge analysis, like the situation in *Carrillo*, is when the defendant has a close enough relationship with the patentee and the patentee's business to be on notice of any patents that may be infringed. Even a right-to-use opinion may not protect an alleged infringer who had enough ties with the patentee to be on notice. Finally, just as in *Wasserson*, another important factor in a probability of knowledge analysis is the defendant's level of expertise with regard to a potential product.¹⁰⁷ *Wasserson* illustrates the principle that all other factors aside, the defendant's own expertise in the field can lead to a finding of specific knowledge.¹⁰⁸ This suggests that regardless of obtaining right-to-use opinions, a very strong and complete understanding of a product and of the patent system can make an individual liable under the first prong of the willful blindness doctrine.

B. DELIBERATE ACTIONS TO AVOID LEARNING OF A FACT

As with the first prong in the willful blindness doctrine, certain appellate court holdings in criminal law cases regarding the second prong of the doctrine also have relevance to cases of induced patent infringement. The second prong of a willful blindness analysis either takes the form of "overt physical acts" or "evidence of purely psychological avoidance."¹⁰⁹ Overt physical acts are efforts by the defendant to "insulate himself from the [crime] so that he could deny knowledge of it."¹¹⁰ A defendant commits an overt act to avoid learning of a fact if he "purposely contrive[s] to avoid learning all of the facts in order to have a defense in the event of a

106. Compare *Perez-Melendez*, 599 F.3d at 42, with *Carrillo*, 435 F.3d at 783.

107. See *United States v. Wasserson*, 418 F.3d 225, 238–39 (3d Cir. 2005).

108. See *id.*

109. *Carrillo*, 435 F.3d at 780 (quoting *United States v. Craig*, 178 F.3d 891, 896 (7th Cir. 1999)).

110. *United States v. Diaz*, 864 F.2d 544, 551 (7th Cir. 1988).

subsequent prosecution.”¹¹¹ When a defendant commits an overt act, “there is evidence the defendant physically acted to avoid knowledge.”¹¹²

Alternatively, psychological avoidance involves the “cutting off of [the defendant’s] normal curiosity by an effort of will.”¹¹³ Psychological avoidance usually involves a defendant who “consciously refuse[s] to take basic investigatory steps.”¹¹⁴ The government, to demonstrate psychological avoidance, only needs to adduce “evidence that warning signs existed sufficient to put a reasonably prudent person on inquiry notice.”¹¹⁵

Criminal law jurisprudence suggests that in a second prong analysis in cases of induced patent infringement, parties can be willfully blind for either committing an overt act, such as withholding information from counsel in *Global-Tech*, or for psychologically avoiding sufficiently obvious signs, such as recognizing incompetent opinions from counsel or neglecting to obtain opinions entirely. As discussed, *infra*, the intricacies of psychological avoidance in criminal law may have more relevance to induced patent infringement than cases of overt actions.

Sections II.B.1 and II.B.2 discuss how courts apply the principles of overt actions and psychological avoidance in a criminal law context. Section II.B.3 discusses how criminal law application of these principles has relevance to cases of induced patent infringement.

1. *How Courts Interpret Overt Physical Actions in Criminal Law Willful Blindness Analysis*

The following cases illustrate the types of physical evidence sufficient to show that a defendant committed an overt act under the second prong of a willful blindness analysis. First, in *United States v. Diaz*, the Seventh Circuit affirmed the district court’s conclusion that a defendant’s deliberate avoidance of the scene of the crime and deliberate non-participation when present at the scene was sufficient evidence to support a jury verdict that the defendant was willfully blind to trafficking drugs.¹¹⁶ Drug dealers who (inadvertently) sold cocaine to DEA agents claimed that the defendant, Diaz, was their supplier.¹¹⁷ The dealers testified that most deals took place in close

111. *United States v. Brandon*, 17 F.3d 409, 452 (1st Cir. 1994) (citing *United States v. Rivera*, 944 F.2d 1563, 1571 (11th Cir. 1991)).

112. *Carrillo*, 435 F.3d at 780.

113. *Id.*

114. *United States v. St. Michael’s Credit Union*, 880 F.2d 579, 585 (1st Cir. 1989).

115. *United States v. Singh*, 222 F.3d 6, 11 (1st Cir. 2000).

116. *United States v. Diaz*, 864 F.2d 544, 551 (7th Cir. 1988).

117. *Id.* at 546.

proximity to Diaz's house so that Diaz could keep watch.¹¹⁸ In a sting operation DEA agents managed to lure Diaz to the scene of the transaction, but Diaz participated only by staying with his car and keeping his car hood up during the transaction.¹¹⁹ When the agents apprehended Diaz, he claimed to be in the neighborhood to visit friends, and at the scene of the transaction because his car broke down and he was there waiting for a mechanic.¹²⁰ Even though the mechanic testified that Diaz called, telephone records indicated there were no calls placed to the mechanic; conversely, there was a history of telephone calls between Diaz and the other drug dealers.¹²¹ The court concluded that Diaz's deliberate avoidance of the scene during some transactions and purposeful non-participation in a transaction where he was present constituted ample evidence of an overt physical act.¹²² As such, the court sustained the jury's finding of knowledge based on willful blindness.¹²³

Similarly, in *United States v. Brandon*, the First Circuit concluded that a defendant's deliberate avoidance in discussing dischargeable mortgages with buyers to be an overt act that supported a willful blindness jury instruction for bank fraud.¹²⁴ Landman, one of the co-defendants, claimed that he had no knowledge of a conspiracy to defraud a bank by misrepresenting the existence of down payments made on behalf of investors.¹²⁵ Landman, an escrow agent, had the responsibility of receiving and dispersing funds for Dean Street Development, a company established by one of the co-defendants to buy, sell, and manage real estate.¹²⁶ Dean Street allowed potential owners to buy property with no money down by falsifying to the bank the existence of a down payment.¹²⁷ One method of falsifying the down payment was to have the owners take out a second mortgage and then discharge the mortgage.¹²⁸ Even though Landman disclaimed any knowledge of this plan, there was evidence that Landman told several buyers he did not want to know anything about their second mortgages nor did he want the

118. *Id.*

119. *Id.* at 546–47. The prosecution alleged that keeping the hood up on one's car during a drug deal was normal practice for the industry to keep buyers from seeing the suppliers in the transaction. *Id.* at 546.

120. *Id.*

121. *Id.* at 546–47.

122. *Id.* at 551.

123. *Id.*

124. *United States v. Brandon*, 17 F.3d 409, 452–53 (1st Cir. 1994).

125. *Id.* at 452.

126. *Id.*

127. *Id.* at 419.

128. *Id.* at 419–20.

buyers to discuss dischargeable second mortgages in front of him.¹²⁹ The court found Landman's avoidance of discussing dischargeable second mortgages with customers to be an overt act to avoid knowledge of the conspiracy.¹³⁰ As such, the court concluded that Landman took a deliberate action that justified a willful blindness jury instruction.¹³¹

2. *How Courts Interpret Psychological Avoidance in a Criminal Law Willful Blindness Analysis*

Psychological avoidance is different from an overt action in that it involves a failure to take basic investigatory steps rather than avoiding the illegal act directly. In the cases discussed *supra*, a defendant's failure to notice obvious red flags or patterns given a certain amount of experience is considered to be psychological avoidance. Even though conscious avoidance is not necessary, a certain amount of notice is required for the action to satisfy the second prong.

In *United States v. Carani*, the Seventh Circuit held that a defendant's deliberate avoidance of taking the basic investigatory steps of reading file descriptors to distinguish between adult and child pornography to be psychological avoidance sufficient to support a jury instruction of willful blindness.¹³² The defendant, Carani, used Kazaa, a peer-to-peer file-sharing program, to download files to his computer.¹³³ Kazaa allowed users both to download and upload files, and did so automatically under a default setting.¹³⁴ The Cybercrimes Unit of the Department of Homeland Security obtained a warrant to search Carani's residence and found thousands of child pornography videos on Carani's computer, in a folder representing that the files were available for both downloading and uploading.¹³⁵ In an oral interview with officials, Carani admitted that he purposefully downloaded the child pornography; however, in a conflicting written statement, he claimed that he downloaded child pornography inadvertently when searching for adult pornography.¹³⁶ Many of the child pornography videos Carani downloaded had descriptive titles and search word descriptors, indicating the content in the video.¹³⁷ Carani further claimed that he was not familiar with

129. *Id.* at 452.

130. *Id.* at 453.

131. *Id.* at 452.

132. *United States v. Carani*, 492 F.3d 867, 874 (7th Cir. 2007).

133. *Id.* at 869.

134. *Id.*

135. *Id.* at 869–70.

136. *Id.* at 870.

137. *Id.* at 873–74.

computers and that he did not realize the child pornography videos he viewed remained in a folder available for other Kazaa users to download.¹³⁸ The court discounted the defendant's claim that he lacked computer-savvy given the thousands of videos on his computer and concluded that there was enough evidence that the defendant must have deliberately cut off his curiosity not to notice the child pornography videos with so many titles "quite literally, right in front of his face."¹³⁹

Similarly, in *United States v. St. Michael's Credit Union*, the First Circuit emphasized that a defendant's position as treasurer in a credit union, combined with access to certain tax forms, was evidence that she had both notice and experience, and that failure to file the forms properly was psychological avoidance for the purposes of tax evasion.¹⁴⁰ The defendant's responsibility as a treasurer for a small financial institution, St. Michael's, was to account for all of the institution's financial transactions.¹⁴¹ During an audit of the credit union, the auditor informed the defendant that pursuant to the Currency Transactions Reporting Act, St. Michael's needed to file a Currency Transactions Report ("CTR") for every transaction in excess of \$10,000.¹⁴² The defendant was unaware that she needed to file CTRs prior to the auditor's visit, but received notice when he brought to her attention two transactions she needed to report.¹⁴³ On the backs of the two CTRs the defendant filed were details on the criminal liability for failure to properly file a report.¹⁴⁴ In a subsequent audit of the financial institution, an IRS agent found that the defendant had not filed CTRs for over thirty transactions over \$10,000.¹⁴⁵ While not finding any one factor determinative, the court concluded that even if the defendant really did not have knowledge of the thirty transactions, the notice from the first audit coupled with the

138. *Id.* at 870.

139. *Id.* at 874.

140. *United States v. St. Michael's Credit Union*, 880 F.2d 579, 585 (1st Cir. 1989).

141. *Id.* at 582.

142. *Id.* at 581–82; 31 C.F.R. § 103.22(b) (2010) ("Each financial institution . . . shall file a report of each deposit, withdrawal, exchange of currency or other payment or transfer, by, through, or to such financial institution, which involves a transaction in currency of more than \$10,000 . . .").

143. *St. Michael's Credit Union*, 880 F.2d at 582.

144. *Id.* at 583; 31 U.S.C. § 5322(b) (2010) ("A failure to file a CTR may be prosecuted as a felony when the omission occurs 'while [the defendant is] violating another law of the United States, or as part of a pattern of illegal activity involving transactions of more than \$100,000 in a 12-month period . . .'").

145. *St. Michael's Credit Union*, 880 F.2d at 583.

defendant's experience as a treasurer was enough to show a purposeful psychological avoidance and hence, deliberate ignorance.¹⁴⁶

In *United States v. Singh*, the First Circuit concluded that the lower court's willful blindness instruction was appropriate for a defendant who ignored a series of red flags that he was obtaining a social security card illegally.¹⁴⁷ The defendant entered the United States on a tourist visa, which allowed him to stay in the country for a maximum of six months, but did not allow him to work.¹⁴⁸ While his visa was still valid, the defendant, with the help of his aunt, filled out an application for a social security card that also made clear he was a "Legal Alien Not Allowed to Work."¹⁴⁹ The defendant claimed he needed the help of his aunt to fill out the application because he had weak oral and written English skills.¹⁵⁰ Approximately six months after his visa expired, the defendant paid a firm in New York \$300 for a counterfeit I-94 form with a fictitious visa expiration date and a completed social security application indicating that the defendant was a legal alien allowed to work in the country.¹⁵¹ The firm drove the defendant to a social security office where a clerk alerted the authorities when the defendant handed her the signed, phony documents.¹⁵² Notwithstanding the possibility that the defendant lacked the ability to read the forms and applications, the court found that the "red flags" in this case were the defendant paying for a form when he previously obtained one for free, the defendant leaving his passport with an agency for a period of time, the defendant receiving a form that allowed him to work when the previous form did not, and the defendant accepting a ride to a remote locale to process his application.¹⁵³ As such, the court concluded that the defendant deliberately chose to ignore the "warning signs [] sufficient to put a reasonably prudent person on inquiry notice," and upheld a jury's finding of guilt based on willful blindness.¹⁵⁴

3. *Application of the Second-Prong: Relating Criminal Law Principles to Induced Patent Infringement*

The Supreme Court's holding in *Global-Tech* that Pentalpha took deliberate action to avoid finding SEB's patent falls into the category of an

146. *Id.* at 585.

147. *United States v. Singh*, 222 F.3d 6, 11 (1st Cir. 2000).

148. *Id.* at 8.

149. *Id.*

150. *Id.* at 9.

151. *Id.* at 8–9.

152. *Id.* at 9.

153. *Id.* at 11.

154. *Id.*

overt act.¹⁵⁵ Just as in *Diaz* and *Brandon*, where there was physical evidence that the defendants deliberately acted to avoid learning of a drug transaction and a dischargeable second mortgage respectively, the fact that Pentalpha withheld from its patent attorney that SEB manufactured the fryer they copied, was similarly evidence that Pentalpha deliberately acted to avoid learning of the existence of SEB's patent.¹⁵⁶ The *Diaz* and *Brandon* courts held that the defendants' avoidance by overt acts served to "insulate [themselves] from the [crimes] so that [they] could deny knowledge of it"¹⁵⁷ and "in order to have a defense in the event of a subsequent prosecution."¹⁵⁸ Consistent with the *Diaz* and *Brandon* courts, the Supreme Court held that Pentalpha's non-disclosure to its attorney was to "manufacture a claim of plausible deniability in the event that his company was later accused of patent infringement."¹⁵⁹

Since there was an overt act by *Global-Tech*, a psychological avoidance analysis is not relevant given the facts of the case.¹⁶⁰ However, the facts of *Global-Tech* are not necessarily typical of most litigated cases. Returning to a question posited *supra* Section II.A.2, what if instead of omitting information when it consulted its attorney, Pentalpha neglected to obtain an opinion from counsel entirely? What if Pentalpha sought an uninformed or flawed opinion? Would either failure to obtain an opinion from counsel or obtaining an uninformed opinion constitute a deliberate act under a psychological avoidance standard?

In *St. Michael's*, the court emphasized that notice from a prior audit coupled with the defendant's experience as a treasurer was enough to show purposeful psychological avoidance.¹⁶¹ The court's holding in *St. Michael's* implies that if Pentalpha had neglected to obtain opinion from counsel, Pentalpha would, in addition to its experience in the field of deep fryers, also need to be on notice that its fryer might infringe.¹⁶² In *St. Michael's*, the defendant received prior notice regarding the same matter—the need to file CTRs for transaction over ten thousand dollars.¹⁶³ This suggests that when a

155. Compare *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2071–72 (2011), with *United States v. Diaz*, 864 F.2d 544, 551 (7th Cir. 1988), and *United States v. Brandon*, 17 F.3d 409, 452–53 (1st Cir. 1994).

156. Compare *Global-Tech*, 131 S. Ct. at 2071–72, with *Diaz*, 864 F.2d at 551, and *Brandon*, 17 F.3d at 452–53.

157. See *Diaz*, 864 F.2d at 551.

158. See *Brandon*, 17 F.3d at 452.

159. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2071 (2011).

160. See *supra* notes 155–159 and accompanying text.

161. See *United States v. St. Michael's Credit Union*, 880 F.2d 579, 585 (1st Cir. 1989).

162. See *id.* at 581–82.

163. See *id.*

defendant in a patent infringement suit does not obtain opinion from counsel, previous infringement actions/settlements with the plaintiff or previous infringement actions/settlements in the industry may provide enough notice to show a defendant's purposeful psychological avoidance.

In a similar case, the *Carani* court found that a defendant's failure to notice suggestive file headers on the files it downloaded, coupled with the defendant's familiarity with downloading files, suggested psychological avoidance about downloading child pornography.¹⁶⁴ The *Carani* holding implies that a court would find Pentalpha's hypothetical failure to obtain opinion from counsel to be psychological avoidance of infringing SEB's patent because Pentalpha knew SEB's patented product was innovative and on sale in the United States and because Pentalpha was familiar with the U.S. patent system.¹⁶⁵ Like the *Carani* defendant who was well-versed in computers and should have had an idea that file headers related to video content, an alleged infringer who knows a product is innovative and knows that a lot of patents exist in that industry should realize that an innovative product may have a patent. For such a defendant, a willful blindness standard implies that he would be committing psychological avoidance by not taking the investigatory step of getting a right-to-use opinion.

In *Singh*, the court concluded that the circumstances surrounding a defendant's solicitation of counsel and documents from an immigration agency supported an inference that the defendant purposefully avoided "red flags."¹⁶⁶ The court's holding in *Singh* suggests that if Pentalpha had obtained an uninformed or flawed opinion, it may be culpable for psychological avoidance if there were red flags that indicated the opinion would be defective in some way. The *Singh* court found that the red flags in the case were the defendant paying for a form when he previously obtained one for free, the defendant leaving his passport with an agency for a period of time, the defendant receiving a form that allowed him to work when the previous form did not, and the defendant accepting a ride to a remote locale to process his application.¹⁶⁷ As applied to a patent infringement case, the *Singh* holding may imply that a defendant who is aware that he has obtained an opinion that is contrary to reasonable claim interpretation or who seeks an

164. See *United States v. Carani*, 492 F.3d 867, 874 (7th Cir. 2007).

165. See *id.*

166. See *United States v. Singh*, 222 F.3d 6, 11 (1st Cir. 2000).

167. See *supra* note 153 and accompanying text.

opinion from a non-orthodox source is at greater risk of being found to have purposefully avoided obtaining an informed and valid opinion.¹⁶⁸

Given criminal jurisprudence regarding the second prong of willful infringement, the takeaway in applying the second prong to cases of induced patent infringement is that an alleged infringer who is experienced in the field or otherwise informed will probably not be able to escape liability by either neglecting to obtain an opinion or obtaining an uninformed opinion. Even though the *Global-Tech* facts only illustrated the application of the second prong to an overt act, criminal law jurisprudence indicates that a failure to recognize obvious signs may also suffice for second prong liability.

III. CONCLUSION

In *Global-Tech*, the Supreme Court imported the doctrine of willful blindness from criminal law and stated that willful blindness was the appropriate substitute in lieu of actual knowledge in cases of induced patent infringement.¹⁶⁹ In doing so, the court reasoned that willful blindness would cast a narrower net for potential infringers than the Federal Circuit's deliberate indifference standard.¹⁷⁰ Although the willful blindness standard does seem to narrow the first prong to instances of specific knowledge, rather than general knowledge, it is less certain how much a deliberate action is actually necessary to find a defendant knowledgeable through his willful blindness. As such, it is not clear how much narrower the doctrine of willful blindness is compared to deliberate indifference; luckily, the implications the doctrine has for practitioners are more obvious.

For future litigants, the first prong in a willful blindness analysis is the most important. The relevant factors in determining whether the defendant had general or specific knowledge are the defendant's expertise in the relevant field, the relationship between the defendant and the patentee, and any relevant findings or lack thereof by experts. When a defendant has significant agencies with the patentee or when the defendant has expertise in

168. See Marta E. Delsignore, *Patent Opinions*, in FUNDAMENTALS OF PATENT PROSECUTION 2008: A BOOT CAMP FOR CLAIM DRAFTING & AMENDMENT WRITING 285, 291–94 (2008). For a more detailed analysis of what type of expert testimony is proper during a claim construction hearing, see Peter S. Menell, Matthew D. Powers & Steven C. Carlson, *Patent Claim Construction: A Modern Synthesis and Structured Framework*, 25 BERKELEY TECH. L.J. 711, 729 (2010) (“Parties should ground expert opinions both in the intrinsic evidence and have support in other independent, reliable sources. Where these criteria are lacking, courts should not rely upon these expert opinions.”).

169. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2068 (2011).

170. *Id.* at 2070.

a field, it is more likely that a court will find that the defendant has specific knowledge rather than general knowledge of infringement.

Since the second prong allows for both action and inaction, it is essential that a defendant proceed with due diligence at all times. As with the high probability of knowledge requirement in the first prong, notice is arguably the most important factor in the second prong analysis. In future cases of induced patent infringement, for all defendants, especially those who are well-versed in their industry and acquainted with the patent system, obtaining an opinion from counsel, and full disclosure to counsel are essential.

BRINGING EQUITY BACK TO THE INEQUITABLE CONDUCT DOCTRINE?

Priscilla G. Taylor[†]

In hopes of recapturing the equitable spirit of the inequitable conduct doctrine, the Federal Circuit substantially reformed the doctrine in its en banc decision in *Therasense, Inc. v. Becton, Dickinson and Co.*¹ The inequitable conduct doctrine is based on a patent applicant's duty of candor before the PTO and, where this duty is breached, serves as an affirmative defense for an alleged infringer.² Prior to *Therasense*, the broad standards for the doctrine's application encouraged unsupported allegations in the courts and inundated patent examiners with duplicative and extraneous information.³ The court narrowed the inequitable conduct defense by significantly raising the standards for showing both intent and materiality and by eliminating the long-standing "sliding scale" step of the defense.⁴

Therasense addressed many of the perceived problems that the defense had created for both the courts and the Patent and Trademark Office ("PTO"). The *Therasense* decision was largely motivated by goals of efficiency for the courts and the PTO.⁵ The court also voiced concerns of fairness for

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1. *Therasense, Inc. v. Becton, Dickinson and Co.*, 649 F.3d 1276 (Fed. Cir. 2011).

2. See, e.g., Benjamin Brown, *Inequitable Conduct: A Standard in Motion*, 19 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 593 (2009); Robert J. Goldman, *Evolution of the Inequitable Conduct Defense in Patent Litigation*, 7 HARV. J.L. & TECH. 37 (1993); Katherine Nolan-Stevaux, *Inequitable Conduct Claims in the 21st Century: Combating the Plague*, 20 BERKELEY TECH. L.J. 147 (2005); J. Randall R. Rader, *Always at the Margin: Inequitable Conduct in Flux*, 59 AM. U. L. REV. 777 (2010).

3. *Therasense*, 649 F.3d at 1289. See generally, Lisa A. Dolak, *Beware the Inequitable Conduct Charge! (Why Practitioners Submit What They Submit)*, 91 J. PAT. & TRADEMARK OFF. SOC'Y 558 (2009) (discussing the broadening of the inequitable conduct doctrine and its relation to over-submission at the PTO); Christian E. Mammen, *Controlling the "Plague": Reforming the Doctrine of Inequitable Conduct*, 24 BERKELEY TECH. L.J. 1329, 1330–44 (2009) (discussing the expansion of the inequitable conduct doctrine and the consequent encouragement of unwarranted inequitable conduct claims); Rader, *supra* note 2, at 783 (discussing how the "gradual evolution away from the roots of the inequitable conduct doctrine inspired litigants to use inequitable conduct as a strategic part of a defense against patent infringement").

4. *Therasense*, 649 F.3d at 1290–92.

5. *Id.* at 1290 (noting the "increased adjudication cost and complexity, reduced likelihood of settlement, burdened courts, strained PTO resources, increased PTO backlog,

patentees faced with inequitable conduct allegations, reiterating that the defense is an equitable one that “hinges on basic fairness.”⁶ Although the Federal Circuit may arguably have missed its mark when aiming to create efficiency and fairness within the inequitable conduct doctrine, the majority’s decision took, at minimum, a significant step in this direction and provided clarity to practitioners.

This Note first explores the development of the inequitable conduct doctrine from its inception, the problems it has created for the courts and the PTO in the ensuing years, and how the Federal Circuit addressed those problems in its en banc decision in *Therasense*. Part II then looks at the practical implications of the new law developed in *Therasense* in light of *Exergen Corp. v. Wal-Mart Stores, Inc.*,⁷ the PTO’s recent proposed revision to its Rule of Disclosure,⁸ and the Leahy-Smith America Invents Act (“Leahy-Smith AIA”).⁹ Part III explores the interpretation of the Federal Circuit’s decision by district courts in the months following *Therasense*. Finally, Part IV reviews academic and practitioner commentary, assessing the *Therasense* opinion as welcome but inadequate. Although the Federal Circuit may not have fixed the many problems of the inequitable conduct doctrine in one fell swoop, it did provide clarity and took a significant step in the right direction.

I. HISTORY OF THE INEQUITABLE CONDUCT DOCTRINE

The inequitable conduct doctrine is a judicially created, equitable defense to patent infringement.¹⁰ The defense requires that the accused infringer show that the patentee, “with intent to mislead or deceive the examiner, fail[ed] to disclose material information or submitted materially false information.”¹¹ If an accused infringer prevails in this defense, the entire patent, and possibly related patents, is deemed unenforceable.¹² This

and impaired patent quality” as primary reasons for redirecting the inequitable conduct doctrine).

6. *Id.*

7. *Exergen Corp. v. Wal-Mart Stores, Inc.*, 575 F.3d 1312 (Fed. Cir. 2009).

8. 37 C.F.R. § 1.56(b) (1992).

9. Leahy-Smith America Invents Act, Pub. L. No. 112-29 (2011) (to be codified at 35 U.S.C. § 257).

10. *See, e.g.*, Goldman, *supra* note 2, at 45–51.

11. *Therasense*, 649 F.3d at 1287; *Digital Control, Inc. v. Charles Mach. Works*, 437 F.3d 1309, 1313 (Fed. Cir. 2006).

12. *Therasense*, 649 F.3d at 1288–89.

powerful remedy has been deemed the “atomic bomb” of patent law.¹³ The inequitable conduct doctrine has long been the subject of criticism and reform proposals.¹⁴ Although intended to encourage transparency and full disclosure in communications with the PTO,¹⁵ the intended benefits of the doctrine have arguably been far outweighed by the many detrimental consequences it has had on the patent system, both before the courts and at the PTO.¹⁶ This Part traces the evolution of the inequitable conduct doctrine, the significant broadening of the initial standards that led up to the narrowing in *Therasense*, and the problems these standards created for the courts and the PTO.

A. EVOLUTION OF THE INEQUITABLE CONDUCT DEFENSE

The inequitable conduct doctrine evolved from three Supreme Court decisions that applied the equitable doctrine of unclean hands to patent cases.¹⁷ Under this doctrine, a patentee seeking to enforce his patent rights must not come before the court with “unclean hands” from intentionally misleading the PTO to obtain the patent.¹⁸ Although each case in this trio involved particularly egregious behavior,¹⁹ the inequitable conduct doctrine has evolved to “embrace a broader scope of misconduct.”²⁰ At its broadest, the doctrine encompassed not only affirmative acts intended to deceive the PTO and the courts,²¹ “but also the mere nondisclosure of information to the PTO.”²² The inequitable conduct doctrine further evolved from the

13. *Aventis Pharma S.A. v. Amphastar Pharm., Inc.* 525 F.3d 1334, 1349 (Fed. Cir. 2008) (Rader, J., dissenting).

14. See generally Christopher A. Cotropia, *Modernizing Patent Law’s Inequitable Conduct Doctrine*, 24 BERKELEY TECH. L.J. 723 (2009); Dolak, *supra* note 3; Mammen, *supra* note 3; Nolan-Stevaux, *supra* note 2.

15. *Therasense*, 649 F.3d at 1288.

16. See *infra* Section I.B.

17. *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806 (1945) (finding unclean hands where the patentee had suppressed evidence of perjury at the PTO and attempted to enforce the perjury-tainted patent); *Hazel Atlas Glass Co. v. Hartford Empire Co.*, 322 U.S. 238 (1944) (finding unclean hands where a patentee manufactured a false article in support of its patent application and later suppressed the evidence), *overruled on other grounds by* *Standard Oil Co. v. United States*, 429 U.S. 17 (1976); *Keystone Driller Co. v. Gen. Excavator Co.*, 290 U.S. 240 (1933) (finding unclean hands where the patentee submitted a false affidavit to the PTO to overcome a prior use).

18. See, e.g., J.V.B., *He Who Comes Into Equity Must Come With Clean Hands*, 4 A.L.R. 44 (originally published in 1919); Mammen, *supra* note 3, at 1334.

19. See *supra* note 17.

20. *Therasense*, 649 F.3d at 1287.

21. See *supra* note 17.

22. *Therasense*, 649 F.3d at 1287; see *Kingsdown Med. Consultants, Lt. v. Hollister, Inc.*, 863 F.2d 867, 876 (Fed. Cir. 1988) (en banc) (citing *In re Jerabek*, 789 F.3d 866, 891 (Fed.

unclean hands doctrine by implementing a much stronger remedy—unenforceability of the entire patent rather than mere dismissal of the suit.²³

Before *Therasense*, three elements comprised a prima facie claim of inequitable conduct: (1) a specific intent to deceive the PTO, (2) a misrepresentation or omission of material information, and (3) a subsequent balancing of the findings of materiality and intent on a “sliding scale.”²⁴ The minimal requirements for showing both materiality and intent to deceive have fluctuated over time.²⁵

1. *Specific Intent To Deceive the PTO*

Prior to *Therasense*, the “intent prong” of the inequitable conduct inquiry required a showing of specific intent to deceive the PTO.²⁶ The inequitable conduct claim is essentially a fraud claim,²⁷ therefore a showing of deceptive intent is a key element. Because direct evidence of intent to deceive is very rarely available, the Federal Circuit has consistently allowed claimants to prove intent to deceive by indirect and circumstantial evidence.²⁸ However, the court has been clear that “materiality does not presume intent.”²⁹ Thus, the materiality of an action, standing alone, cannot prove deceptive intent.

Cir. 1986); *Driscoll v. Cebalo*, 731 F.2d 878, 885 (Fed. Cir. 1984) (pointing to previous Federal Circuit opinions that held mere gross negligence could suffice for intent to deceive).

23. Compare *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806 (1945) (dismissing suit for a finding of unclean hands), with *Aventis Pharma S.A. v. Amphastar Pharm., Inc.*, 525 F.3d 1334 (Fed. Cir. 2008) (affirming a district court judgment holding a patent unenforceable for inequitable conduct where there was a finding of intent to deceive); *Therasense*, 649 F.3d at 1287.

24. See, e.g., *Mammen*, *supra* note 3, at 1332.

25. See Derek J. Brader, *Distilling a Rule for Inferring Intent to Deceive the Patent Office*, 83 TEMP. L. REV. 529 (2011); Brown, *supra* note 2; Elizabeth Peters, *Are We Living In A Material World?: An Analysis Of The Federal Circuit's Materiality Standard Under The Patent Doctrine Of Inequitable Conduct*, 93 IOWA L. REV. 1519 (2008); Rader, *supra* note 2.

26. See generally Thomas L. Irving, Lauren L. Stevens, Scott M.K. Lee & Alexis N. Simpson, *The Evolution of Intent: A Review of Patent Law Cases Invoking The Doctrine of Inequitable Conduct From Precision to Exergen*, 35 U. DAYTON L. REV. 303 (2010); see, e.g., *Larson Mfg. Co. of South Dakota, Inc. v. Aluminart Prods. Ltd.*, 559 F.3d 1317, 1340 (Fed. Cir. 2009); *Star Scientific, Inc. v. R.J. Reynolds Tobacco Co.*, 537 F.3d 1357, 1366 (Fed. Cir. 2008); *Cargill, Inc. v. Canbra Foods, Ltd.*, 476 F.3d 1359, 1363 (Fed. Cir. 2007). In *Therasense*, the Federal Circuit reiterated that “the accused infringer must prove that the patentee acted with the specific intent to deceive the PTO.” *Therasense*, 649 F.3d at 1290.

27. See, e.g., *Goldman*, *supra* note 2, at 45–51; Rader, *supra* note 2.

28. See, e.g., *Larson Mfg. Co. of South Dakota*, 559 F.3d at 1340; *Star Scientific*, 537 F.3d at 1366; *Cargill*, 476 F.3d at 1364; *Ferring B.V. v. Barr Laboratories, Inc.*, 437 F.3d 1181, 1191 (Fed. Cir. 2006).

29. *Larson Mfg. Co. of South Dakota*, 559 F.3d at 1340; *Star Scientific*, 537 F.3d at 1366.

Similarly, nondisclosure, by itself, does not satisfy the intent prong,³⁰ and evidence of good faith may dictate against a finding of deceptive intent.³¹

Before *Therasense*, Federal Circuit case law was varied and inconsistent on the *standard* for showing intent.³² In *Burlington Industries, Inc. v. Dayco Corp.*, the Federal Circuit stated that the “nondisclosure of facts of which the applicant should have known the materiality may justify an inference of intent to mislead in appropriate cases.”³³ However, six months later in *Kingsdown Medical Consultants, Ltd. v. Hollister, Inc.* the Federal Circuit concluded that “a finding that particular conduct amounts to ‘gross negligence’ does not of itself justify an inference of intent to deceive.”³⁴ Although *Burlington* seemed to advocate a “should have known” intent standard,³⁵ *Kingsdown* went in the opposite direction, stating that “gross negligence” is not enough to show intent to deceive.³⁶ *Kingsdown* was the high water mark of the Federal Circuit’s intent cases up until *Therasense*.³⁷ From *Kingsdown*, a line of cases applying a somewhat lower standard began to develop.³⁸

Most recently, in *Ferring B.V. v. Barr Laboratories, Inc.*,³⁹ the Federal Circuit revitalized the “should have known” test from *Burlington*. The Federal Circuit held that in certain cases, summary judgment is appropriate if there has been a “failure to supply highly material information and if the summary judgment record establishes that (1) the applicant knew of the information; (2) the applicant knew or should have known of the materiality of the information; and (3) the applicant has not provided a credible explanation for the withholding.”⁴⁰ Thus, under *Ferring*, it seemed that a mere omission of material information could amount to a showing of deceptive intent if the actor should have known that the information was material.

30. *Larson Mfg. Co. of South Dakota*, 559 F.3d at 1340.

31. *Id.* at 1341.

32. See Brader, *supra* note 25, at 537; Mammen, *supra* note 3, at 1338–42.

33. *Burlington Indus., Inc. v. Dayco Corp.*, 849 F.2d 1418, 1421 (Fed. Cir. 1988) (decided June 14th).

34. *Kingsdown Med. Consultants, Ltd. v. Hollister, Inc.* 863 F.2d 867, 876 (Fed. Cir. 1988) (en banc) (decided Dec. 21st).

35. *Burlington*, 849 F.2d at 1421.

36. *Kingsdown*, 863 F.2d at 876.

37. Z. Peng, Stacy Lewis, Deborah Herzfeld, Jill MacAlpine & Tom Irving, *A Panacea for Inequitable Conduct Problems or Kingsdown Version 2.0? The Therasense Decision and a Look into the Future of U.S. Patent Law Reform*, 16 V.A. J.L. & TECH. 373, 388 (2011).

38. See, e.g., *Ferring B.V. v. Barr Labs., Inc.*, 437 F.3d 1181 (Fed. Cir. 2006); *Novo Nordisk Pharms., Inc. v. Bio-Tech. Gen. Corp.* 424 F.3d 1347 (Fed. Cir. 2005); *Critikon, Inc. v. Becton Dickinson Vascular Access, Inc.* 120 F.3d 1253 (Fed. Cir. 1997).

39. *Ferring*, 437 F.3d 1181.

40. *Id.* at 1191.

2. *A Misrepresentation or Omission of Material Information*

The “materiality prong” of the inequitable conduct inquiry has long been guided by the PTO’s Rule 56 of the Rules of Practice in Patent Cases.⁴¹ Also known as the Rule of Disclosure, Rule 56 was first promulgated in 1949 and provided guidelines for prior art disclosure before an examiner.⁴² The 1949 rule stated that “any application fraudulently filed or in connection with which any fraud is practiced or attempted on the PTO, may be stricken.”⁴³ Rule 56 has undergone several revisions over the years. The 1977 version of Rule 56 defined information as material “where there is a substantial likelihood that a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent.”⁴⁴ The rule was amended again in 1992 in an attempt to provide a clearer and more objective standard.⁴⁵ The 1992 version of Rule 56 defines information as material when either “(1) [i]t establishes, by itself or in combination with other information, a *prima facie* case of unpatentability of a claim; or (2) [i]t refutes, or is inconsistent with, a position applicant takes in: (i) [o]pposing an argument of unpatentability relied on by the Office, or (ii) [a]sserting an argument of patentability.”⁴⁶

Although the Federal Circuit has historically relied on the PTO’s Rule 56 to define the test for materiality, the court has vacillated on which version of Rule 56 should be used.⁴⁷ Up through the Federal Circuit’s 2006 *Purdue Pharma L.P. v. Endo Pharmaceuticals Inc.* decision, the court consistently held that the 1977 “reasonable examiner” test applied to patents prosecuted before March 16, 1992, the effective date of the PTO’s 1992 amendment, and the 1992 version of Rule 56 applied to all patents prosecuted following March 16, 1992.⁴⁸ *Purdue Pharma* was decided on February 1, 2006. One week later, on February 8, the Federal Circuit stated in *Digital Control Inc. v. Charles Machine Works* that the 1992 version of Rule 56 was “not intended to replace

41. 37 C.F.R. § 1.56(b) (1992); *see, e.g.*, Mammen, *supra* note 3, at 1334–38; Peters, *supra* note 25, at 1530–39.

42. 37 C.F.R. § 1.56 (1992).

43. 37 C.F.R. § 1.56 (1949).

44. 37 C.F.R. § 1.56(a) (1977).

45. Duty of Disclosure, 56 Fed. Reg. 37,321 (Aug. 6, 1991) (to be codified at 37 C.F.R. pt. 1 and 10).

46. 37 C.F.R. § 1.56(b) (1992).

47. *See generally* David Hricik & Seth Trimble, *Congratulations on Your Hallucinations: Why The PTO’s 1992 Amendment to § 1.56 Is Irrelevant to Inequitable Conduct*, 38 AIPLA Q.J. 1 (2010); Mammen, *supra* note 3, at 1334–38; Peters, *supra* note 25, at 1530–39.

48. *See, e.g.*, *Purdue Pharm. L.P. v. Endo Pharms. Inc.*, 438 F.3d 1123, 1129 (Fed. Cir. 2006); Mammen, *supra* note 3, at 1334–38.

or supplant the ‘reasonable examiner’ standard,” and that the “reasonable examiner” standard should continue to exist as one of the tests for materiality.⁴⁹ Thus, it seemed that the 1977 “reasonable examiner” standard could be used as a test for materiality generally and not only prior to March 16, 1992. However, the following week, on February 15, the Federal Circuit, in *Ferring*, reiterated that the 1977 “reasonable examiner” version of Rule 56 applied only to patents prosecuted prior to the 1992 revision.⁵⁰ The *Ferring* majority noted that the court’s previous decision in *Digital Control* was a departure from their precedent.⁵¹ Nevertheless, in *Star Scientific, Inc. v. R.J. Reynolds Tobacco Co.*, the Federal Circuit’s most recent materiality decision before *Therasense*, the court again endorsed the 1977 “reasonable examiner” test as the controlling standard for defining materiality for patents prosecuted both before and after March 16, 1992.⁵²

3. *The Sliding Scale*

Once minimum thresholds of both materiality and intent to deceive were shown, a court then had to balance these elements to determine whether the misconduct was sufficiently culpable to hold the patent unenforceable.⁵³ This “sliding scale” of the inequitable conduct doctrine was introduced in *American Hoist & Derrick Co. v. Sowa & Sons, Inc.* in 1984.⁵⁴ The Federal Circuit later provided a detailed explanation of the balancing process in *Star*

49. *Digital Control Inc. v. Charles Mach. Works*, 437 F.3d 1309, 1316 (Fed. Cir. 2006) (“That the new Rule 56 was not intended to replace or supplant the “reasonable examiner” standard is supported by the PTO’s comment during the passage of the new rule. The PTO noted that the rule ‘has been amended to present a clear and more objective definition of what information the Office considers material to patentability’ and further that ‘[t]he rules do not define fraud or inequitable conduct which have elements both of materiality and of intent.’”).

50. *Ferring B.V. v. Barr Labs., Inc.*, 437 F.3d 1181, 1187 n.6 (Fed. Cir. 2006) (noting that “[a]lthough the PTO amended the language of 37 C.F.R. § 1.56 in 1992, we have continued to use the pre-1992 language regarding materiality for evaluating patents that were prosecuted before the amendment.”).

51. *Ferring*, 437 F.3d at 1202 n.3 (Newman, J., dissenting).

52. *Star Scientific, Inc. v. R.J. Reynolds Tobacco Co.*, 537 F.3d 1357, 1367 (Fed. Cir. 2008) (holding that “information is material when a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent” (internal quotations omitted)).

53. *See, e.g., Star Scientific*, 537 F.3d at 1367.

54. *American Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1363 (1984) (“Questions of ‘materiality’ and ‘culpability’ are often interrelated and intertwined, so that a lesser showing of the materiality of the withheld information may suffice when an intentional scheme to defraud is established, whereas a greater showing of the materiality of withheld information would necessarily create an inference that its nondisclosure was ‘wrongful.’”).

Scientific.⁵⁵ Threshold levels of both intent to deceive and materiality had to be established by clear and convincing evidence before a district court could exercise any discretion.⁵⁶ Thus, a district court could not hold a patent unenforceable, regardless of the equities, unless the minimum thresholds were reached.⁵⁷ During the balancing stage, the district court balanced the substance of the facts proven by clear and convincing evidence, with the equities of the case.⁵⁸ The inquiry during the balancing stage was whether, given the proven facts and all the equities of the case, the penalty of unenforceability should be imposed.⁵⁹ “[T]he more material the omission or the misrepresentation, the lower the level of intent [was] required to establish inequitable conduct, and vice versa.”⁶⁰ The balancing of materiality and intent, in deciding whether to hold a patent unenforceable for inequitable conduct, was committed to the district court’s discretion.⁶¹ Significantly, the sliding scale has been used to find inequitable conduct where there is less than clear and convincing evidence of intent.⁶²

B. THE INEQUITABLE CONDUCT DOCTRINE BEFORE *THERASENSE*:
“THE PLAGUE”

Thus, prior to *Therasense*, the inequitable conduct doctrine had evolved from a narrow category of exceptional cases involving egregious misconduct⁶³ into a broad standard that encompassed even mere

55. *Star Scientific*, 537 F.3d at 1367.

56. *Id.* at 1367.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.* (internal quotations omitted).

61. *Id.*; see also *supra* note 48.

62. See, e.g., *Praxair, Inc. v. ATMI, Inc.*, 543 F.3d 1306 (Fed. Cir. 2008) (inferring intent to deceive where “(1) [] the RFO art was highly material to the prosecution of the #115 patent, (2) that the applicants knew of the RFO art and knew or should have known of its materiality, and (3) that the patentee has failed to come forward with any credible good faith explanation for the applicants’ failure to disclose prior art use of RFOs to the PTO”); *Dippin’ Dots, Inc. v. Mosey*, 476 F.3d 1337 (Fed. Cir. 2007) (finding that the “combination of action and omission permits an inference of the minimum, threshold level of intent required for inequitable conduct. The evidence to support a finding of intent may not be particularly strong here However, the district court was permitted to balance the relatively weak evidence of intent together with the strong evidence that DDI’s omission was highly material to the issuance of the #156 patent and to find that on balance, inequitable conduct had occurred); *Bristol-Myers Squibb Co. v. Rhone-Poulenc Rorer, Inc.*, 326 F.3d 1226 (Fed. Cir. 2003) (“Intent to mislead does not require direct evidence, and is typically inferred from the facts . . . where withheld information is material and the patentee knew or should have known of that materiality, he or she can expect to have great difficulty in establishing subjective good faith sufficient to overcome an inference of intent to mislead.”).

63. See *infra* note 17.

negligence.⁶⁴ This broad standard, paired with the doctrine's exceptional remedy of unenforceability, encouraged inequitable conduct allegations and ultimately caused countless problems for the courts and PTO.⁶⁵

The Federal Circuit has more than once described the inequitable conduct doctrine as an "absolute plague."⁶⁶ The court has stated that the defense "has been overplayed, is appearing in nearly every patent suit, and is cluttering up the patent system."⁶⁷ Judge Rader referred to the doctrine as an "ubiquitous weed that infects every prosecution and litigation involving patents."⁶⁸ Although intended to encourage honesty and sufficient disclosure at the PTO,⁶⁹ the doctrine has had many undesirable effects on the patent system.⁷⁰ The *Therasense* majority cited, among others, "increased adjudication cost and complexity, reduced likelihood of settlement, burdened courts, strained PTO resources, increased PTO backlog, and impaired patent quality" as some of the unintended consequences of the inequitable conduct doctrine.⁷¹

The inequitable conduct doctrine has become a burden on the courts by encouraging litigation. The inequitable conduct defense has become a popular litigation tactic due to several strategic advantages the defense provides.⁷² One of these strategic advantages is the broad remedy that results if it is successfully raised.⁷³ The remedy has been called an "atomic bomb"⁷⁴

64. *See* *Driscoll v. Cebalo*, 731 F.2d 878, 885 (Fed. Cir. 1984) ("Where they knew, or should have known, that the withheld reference would be material to the PTO's consideration, their failure to disclose the reference is sufficient proof of the existence of an intent to mislead the PTO.").

65. *See, e.g.*, *Mammen, supra* note 3, at 1332 ("One advantage is the possibility of a broad remedy With those advantages, together with an increasing murkiness in the elements and boundaries of the defense, it is little wonder that accused infringers look for any opportunity to inject the inequitable conduct defense into patent litigation"); Rader, *supra* note 2, at 783 ("This gradual evolution away from the roots of the inequitable conduct doctrine inspired litigants to use inequitable conduct as a strategic part of a defense against patent infringement. . . . The Federal Circuit, even early in its history, recognized this misuse of the fraud doctrine as a 'plague.'").

66. *See, e.g.*, *Kingsdown Med. Consultants, Ltd. v. Hollister, Inc.* 863 F.2d 867, 876 n.15 (Fed. Cir. 1988) (en banc); *Burlington Indus., Inc. v. Dayco Corp.*, 849 F.2d 1418, 1422 (Fed. Cir. 1988).

67. *Kimberly Clark Corp. v. Johnson & Johnson*, 745 F.2d 1437, 1454 (Fed. Cir. 1984).

68. Rader, *supra* note 2, at 780.

69. *See, e.g.*, *Goldman, supra* note 2, at 45–51.

70. *Infra* note 3.

71. *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, 1290 (Fed. Cir. 2011).

72. *See generally* *Mammen, supra* note 3, at 1345–47; Rader, *supra* note 2, at 783; Melissa F. Wasserman, *Limiting The Inequitable Conduct Defense*, 13 VA. J.L. & TECH 7 (2008).

73. *See, e.g.*, *Mammen, supra* note 3, at 1345–46; *Cotropia, supra* note 14, at 737.

because the entire patent is declared unenforceable, even if inequitable conduct is only shown for a single claim that is not at issue in the infringement action.⁷⁵ Another tactical litigation advantage the defense achieves is the opportunity to impugn the character of an inventor and cast a shadow over the patentee for the remainder of the trial.⁷⁶ Additionally, an accused infringer is able to gain access to privileged information during discovery by asserting the inequitable conduct defense.⁷⁷ A charge of inequitable conduct can expand discovery into corporate practices before patent filing, as well as disqualify the prosecuting attorney from the patentee's litigation team.⁷⁸

Due to the significant tactical advantages the inequitable conduct defense provides and the low substantive standards for the defense, inequitable conduct claims have become a standard pleading practice in patent cases.⁷⁹ In fact, the Federal Circuit has noted that “reputable lawyers seem to feel compelled to make the charge against other reputable lawyers on the slenderest grounds, to represent their client’s interests adequately.”⁸⁰

The inequitable conduct defense has also been a burden on the PTO.⁸¹ Patent applicants are incentivized to submit “everything of even remote

74. *Aventis Pharm. S.A. v. Amphastar Pharm., Inc.*, 525 F.3d 1334, 1349 (Fed. Cir. 2008) (Rader, J., dissenting).

75. Mammen, *supra* note 3, at 1345.

76. *See, e.g.*, Rader, *supra* note 2, at 783; Mammen, *supra* note 3, at 1346.

77. *See, e.g.*, Rader, *supra* note 2, at 783 (“[a]n allegation of inequitable conduct opened the door to vast discovery into the circumstances of the patent prosecution, leveled an embarrassing charge of fraud as a counterweight to the presumption of patent validity, and even disqualified the prosecuting attorney (who may be a witness) from the patentee’s litigation team”); *Aventis Pharma S.A. v. Amphastar Pharmaceuticals, Inc.*, 525 F.3d 1334, 1349–50 (Fed. Cir. 2008) (noting that “[t]he allegation of inequitable conduct opens new avenues of discovery” in patent litigation).

78. *See* NAT’L RESEARCH COUNCIL OF THE NAT’L ACADS., *A PATENT SYSTEM FOR THE 21ST CENTURY* 122 (S.A. Merrill et. al. eds., 2004).

79. Rader, *supra* note 2, at 783.

80. *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, 1289 (Fed. Cir. 2011).

81. *See, e.g.*, J.M. Kuhn, *Information Overload at the U.S. Patent and Trademark Office: Reframing the Duty of Disclosure in Patent Law as a Search and Filter Problem*, 13 *YALE J. L. & TECH.* 90 (2010–2011); E.S. Flores & S.E. Warren, Jr., *Inequitable Conduct, Fraud, and Your License to Practice Before the United States Patent & Trademark Office*, 8 *TEX. INTELL. PROP. L.J.* 299, 308 (2000) (“Many practitioners believe that under current inequitable conduct standards the safest course is to disclose information even if they believe ‘references . . . are cumulative or less material than [information] already before the Examiner’ for fear that an infringer will succeed in raising an inequitable conduct defense.”); Am. Bar. Ass’n Section of Intell. Prop. Law, *A Section White Paper: Agenda For 21st Century Patent Reform*, 18 (May 1, 2007), available at <http://www.americanbar.org/content/dam/aba/migrated/intelprop/home/PatentReformWP.authcheckdam.pdf> (“Applicants disclose too much prior art for the

relevance in one's possession to the PTO" due to the severe penalties that accompany a finding of inequitable conduct.⁸² The result is that patent examiners often have significantly more references to sort through than is necessary for prosecution of the patent.⁸³ Given the limited time that patent examiners may spend on an application, this inundation leads to impaired patent quality.⁸⁴ Other side effects include inefficiency, an increasing backlog of patent applications, and strain on already limited resources at the PTO.⁸⁵

Due to the significant burdens the inequitable conduct doctrine had produced for the courts and the PTO, the Federal Circuit stepped up and addressed these issues by tightening the standards for the defense in *Therasense*.

II. THE FEDERAL CIRCUIT'S DECISION IN *THERASENSE*

Therasense involved a patent for disposable blood glucose test strips for diabetes management: U.S. Patent No. 5,820,551 ("the '551 patent").⁸⁶ The prior art for the '551 patent generally required either a diffusion-limiting or a protective membrane to cover the strip.⁸⁷ During filing, after repeated rejections the patentee submitted revised claims for a strip that did not require a membrane, in order to overcome the prior art.⁸⁸ However, one prior art reference describing blood glucose test strips, U.S. Patent No. 4,545,382 ("the '382 patent"), also belonging to the patentee, suggested "optionally, but preferably" using a protective membrane.⁸⁹ In order to overcome this prior art reference, the examiner requested an affidavit showing that a person of ordinary skill in the art for the '382 patent would understand the "optionally, but preferably" language to actually require a protective membrane.⁹⁰ The patentee submitted to the PTO a declaration to that effect.⁹¹

PTO to meaningfully consider, and do not explain its significance, all out of fear that to do otherwise risks a claim of inequitable conduct.").

82. *Cotropia*, *supra* note 14, at 768.

83. *Id.* at 770.

84. *See Therasense*, 649 F.3d at 1289–90; K. Mack, *Reforming Inequitable Conduct To Improve Patent Quality: Cleansing Unclean Hands*, 21 BERKELEY TECH. L.J. 147, 148 (2006).

85. *See Therasense*, 649 F.3d at 1290.

86. *Id.* at 1282.

87. *Id.* at 1283.

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

However, several years earlier in prosecuting the European counterpart to the '382 patent, the patentee declared to the European Patent Office ("EPO") that the "optional, but preferable" protective membrane was indeed optional.⁹² The patentee did not disclose this EPO declaration to the PTO years later during prosecution of the '551 patent, when the examiner requested the affidavit stating that the membrane was required.⁹³

In 2004, Becton, Dickinson and Co. ("Becton") sued Therasense, Inc. (now Abbot Diabetes Care, Inc.) and Abbott Laboratories (collectively "Abbott") for a declaratory judgment of noninfringement of Abbott's patents, U.S. Patent Nos. 6,143,164 ("the '164 patent") and 6,592,745 ("the '745 patent").⁹⁴ Abbott countersued Becton, alleging infringement of its '164, '745, and '551 patents.⁹⁵ Abbott also sued Becton's supplier and Bayer Healthcare LLC ("Bayer") for infringement.⁹⁶ These cases were consolidated in the Northern District of California.⁹⁷

The district court granted Becton summary judgment of noninfringement for the '164 and '745 Abbott patents.⁹⁸ Following a bench trial, the district court found four of the claims in the '551 patent invalid for obviousness.⁹⁹ The court also held the entire '551 patent unenforceable for inequitable conduct because Abbott had not disclosed to the PTO, in prosecuting the '551 patent, its declarations submitted to the EPO years earlier regarding its '382 patent.¹⁰⁰ Abbot appealed the judgments of noninfringement, invalidity, and unenforceability. The Federal Circuit affirmed the district court's judgments. Abbott petitioned for rehearing en banc and the Federal Circuit granted the petition.¹⁰¹

In the majority en banc opinion by Chief Judge Rader, the court discussed the many detrimental effects caused by the broad inequitable conduct defense.¹⁰² Judge Rader noted that in the past, the court had allowed the intent requirement to be met by low standards (gross negligence or negligence alone had been enough) and had adopted a broad view of

92. *Id.* at 1283–84.

93. *Id.* at 1285.

94. *Id.* at 1284.

95. *Id.*

96. *Id.*

97. *Id.*

98. The court found most of the claims in the '745 patent invalid due to anticipation. *Id.* at 1284–85.

99. *Id.* at 1285.

100. *Id.*

101. *Id.*

102. *Id.* at 1289–90.

materiality (using a “reasonable examiner” standard).¹⁰³ Also, intent and materiality were placed on a sliding scale.¹⁰⁴ The sliding scale further lowered the standard for showing inequitable conduct because a stronger showing of materiality could suffice with a weaker showing of intent, and vice versa.¹⁰⁵ Judge Rader noted that although the court originally implemented these low standards to foster honesty at the PTO, the low standards had encouraged the overuse of the inequitable conduct doctrine as a litigation strategy, discouraged settlement, and detracted attention from the merits of the case.¹⁰⁶ Moreover, the inequitable conduct doctrine had burdened the PTO by incentivizing applicants to “bury” examiners in prior art references.¹⁰⁷

In an effort to redirect the inequitable conduct defense, the court raised the standards for finding both intent and materiality.¹⁰⁸ First, to satisfy the intent prong of the inequitable conduct defense, an accused infringer must prove that the patentee acted with the “specific intent to deceive” the PTO.¹⁰⁹ Gross negligence or negligence under a “should have known” standard is no longer enough.¹¹⁰ In the case of nondisclosure of information, an accused infringer must prove by “clear and convincing evidence” that the applicant knew of the reference, knew that it was material, and made a deliberate decision to withhold it.¹¹¹ Recognizing that direct evidence of deceptive intent is rare, the Federal Circuit held that intent may be inferred from indirect and circumstantial evidence.¹¹²

To meet the “clear and convincing evidence” standard, the specific intent to deceive must be the “single most reasonable inference” that can be drawn from the evidence, and the evidence must be sufficient to *require* a finding of “deceitful intent in light of the circumstances.”¹¹³ As a corollary, intent to deceive cannot be found where multiple reasonable inferences may be drawn from the evidence.¹¹⁴ The court also held that a “patentee need not offer any good faith explanation” until the alleging party has met its burden of proving the threshold level of intent by clear and convincing evidence.¹¹⁵ Moreover,

103. *Id.* at 1287–88.

104. *Id.* at 1288.

105. *Id.*

106. *Id.*

107. *Id.* at 1298–90.

108. *Id.* at 1290–93.

109. *Id.* at 1290.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* at 1290–91.

115. *Id.* at 1291 (internal quotations omitted).

intent cannot be inferred from materiality alone—intent and materiality are separate requirements.¹¹⁶

Second, with regard to the materiality prong of the inequitable conduct test, the court held that “the materiality required to establish inequitable conduct is but-for materiality.”¹¹⁷ That is, if the PTO would not have allowed a claim in light of the undisclosed prior art, then that prior art is “but-for material.”¹¹⁸ In determining the materiality of withheld information, “the court must determine whether the PTO would have allowed the claim if it had been aware of the undisclosed reference.”¹¹⁹ Thus to arrive at their decision, a court must apply the PTO’s “preponderance of the evidence standard and give claims their broadest reasonable construction.”¹²⁰ The Manual of Patent Examining Procedures indicates that the standard to be applied in all cases is the “preponderance of the evidence” test.¹²¹ “[A]n examiner should reject a claim if, in view of the prior art and evidence of record, it is more likely than not that the claim is unpatentable.”¹²² The majority opinion explained that equity dictates that a remedy “should be commensurate with the violation” and therefore a patent should only be deemed unenforceable on inequitable conduct grounds when “the patentee’s misconduct resulted in the unfair benefit of receiving an unwarranted claim.”¹²³

The court added an exception to the but-for test in cases of affirmative egregious misconduct.¹²⁴ Conduct is material, regardless of the but-for requirement, if a patentee has “engaged in affirmative acts of egregious misconduct,” such as filing an intentionally false affidavit.¹²⁵ However, mere nondisclosure of prior art references to the PTO or failure to mention prior art references in an affidavit, without more, does not constitute affirmative egregious misconduct and does not fall under the exception to the but-for materiality standard.¹²⁶

116. *Id.* at 1290.

117. *Id.* at 1291.

118. *Id.*

119. *Id.*

120. *Id.* at 1291–92.

121. Manual of Patent Examining Procedure § 706.1 (2001).

122. *Id.*

123. *Therasense*, 649 F.3d at 1292.

124. *Id.* at 1292.

125. *Id.*

126. *Id.* at 1292–93.

The Federal Circuit also eliminated the long-standing sliding scale step of the inequitable conduct doctrine analysis.¹²⁷ The court stated that intent and materiality are separate requirements and therefore “a weak showing of intent may not be found sufficient based on a strong showing of materiality, and vice versa.”¹²⁸ The evidence of intent to deceive must be weighed separately from the evidence of materiality.¹²⁹ The court vacated and remanded for further proceedings consistent with the opinion.¹³⁰

Judge O’Malley filed a concurring-in-part and dissenting-in-part opinion.¹³¹ Judge O’Malley took issue with the majority’s “hard and fast rules” and pointed out that “flexibility rather than rigidity has distinguished equitable jurisdiction.”¹³² Furthermore, Judge O’Malley advocated that the proper remedy for a given instance of inequitable conduct should not be a singular penalty of unenforceability but should be left to the discretion of the courts.¹³³ For example, a court should have discretion to render fewer than all claims unenforceable, simply dismiss the action, or create a reasonable remedy commensurate with the violation.¹³⁴ These are penalties that a court might choose to impose in lieu of complete unenforceability.

Finally, Judge O’Malley proposed her own materiality standard: conduct should be deemed material where “(1) but for the conduct . . . the patent would not have issued . . . ; (2) the conduct constitutes a false or misleading representation of fact . . . ; or (3) the district court finds that the behavior is so offensive that the court is left with a firm conviction that the integrity of the PTO process as to the application . . . was wholly undermined.”¹³⁵ Judge O’Malley’s materiality standard follows the majority’s except for the addition of conduct that “constitutes a false or misleading representation of fact.”¹³⁶

Judge O’Malley also noted that the majority could have addressed their concern with unsupported allegations of inequitable conduct in the courts in other ways, such as careful application of the pleading requirements set forth in *Exergen*,¹³⁷ “early case management techniques designed to identify and test

127. *Id.* at 1290.

128. *Id.*

129. *Id.*

130. *Id.* at 1296.

131. *Id.*

132. *Id.* at 1297 (internal quotations omitted).

133. *Id.* at 1299.

134. *Id.*

135. *Id.* at 1300.

136. *Id.*

137. In *Exergen*, the Federal Circuit stated that Federal Rule of Civil Procedure 9(b) applies to allegations of inequitable conduct. *Exergen Corp. v. Wal-Mart Stores, Inc.*, 575 F.3d 1312, 1326 (Fed. Cir. 2009). To satisfy Rule 9(b), an allegation must identify the “who,

unsupported inequitable conduct claims, orders to stay discovery or consideration of such [inequitable conduct] claims pending all other determinations in the case,” and sanctions.¹³⁸

Judge Bryson filed a dissenting opinion, which Judges Gajarsa, Dyk, and Prost joined.¹³⁹ J. Bryson noted that there was substantial agreement with the majority’s holdings regarding intent and the sliding scale.¹⁴⁰ However, the dissent strongly disagreed with the majority opinion on the issue of the proper test to apply in determining whether conduct is sufficiently material to render a patent unenforceable.¹⁴¹ The dissent noted that the Federal Circuit had long “looked to the PTO’s disclosure rule, Rule 56,¹⁴² as the standard for defining materiality in inequitable conduct cases involving a failure to disclose material information,” and advocated adherence to that standard.¹⁴³ To support his position, Judge Bryson argued that “the PTO is in the best position to know what information examiners need to conduct effective and efficient examinations.”¹⁴⁴ Moreover, the dissent claimed that the majority’s new “but for” materiality test was too restrictive to serve the purposes of disclosure to the PTO that the doctrine of inequitable conduct was designed to promote.¹⁴⁵ The dissent also noted that the majority’s opinion had no support in Federal Circuit precedent.¹⁴⁶

The dissent expressed the belief that the current problems with the inequitable conduct doctrine could be addressed by reaffirming the principles from “the early years” of the Federal Circuit, “in light of the provisions of

what, when, where, and how of the material misrepresentation or omission committed before the PTO.” *Id.* at 1328. Additionally, the complainant must provide sufficient allegations of the underlying facts from which a court could reasonably infer that “a specific individual (1) knew of the withheld information or of the falsity of the material misrepresentation, and (2) withheld or misrepresented this information with a specific intent to deceive the PTO.” *Id.* at 1326–29.

138. *Therasense*, 649 F.3d at 1302.

139. *Id.*

140. *Id.* (“First, the parties to this case and most of the amici agree that proof of inequitable conduct should require a showing of specific intent to deceive the PTO; negligence or even gross negligence should not be enough. Second, the parties and most of the amici agree that a party invoking the defense of inequitable conduct should be required to prove both specific intent and materiality by clear and convincing evidence; there should be no ‘sliding scale’ whereby a strong showing as to one element can make up for weaker proof as to the other.”).

141. *Id.* at 1302–03.

142. 37 C.F.R. § 1.56 (1992).

143. *Therasense*, 649 F.3d at 1303.

144. *Id.*

145. *Id.*

146. *Id.* at 1304.

the current PTO disclosure rule.”¹⁴⁷ The dissent advocated strict adherence to the pleading requirements of Federal Rule of Civil Procedure 9(b), which requires detailed factual averments.¹⁴⁸ The dissent also noted that sanctions provided by Federal Rule of Civil Procedure 11 are available to provide additional safeguards against the problems recognized by the majority.¹⁴⁹ Finally, the dissent noted that the majority’s new materiality standard is at odds with materiality standards in analogous contexts: securities law, criminal proceedings, and common law actions for fraud do not rely on a but-for materiality test.¹⁵⁰

III. THE INEQUITABLE CONDUCT DOCTRINE AFTER *THERASENSE*

The Federal Circuit attempted to strike a delicate balance in the *Therasense* decision. The original goal of encouraging full disclosure and honesty before the PTO is still an important one, both for the sake of efficiency at the PTO and for the sake of integrity in our patent system. However, equally important are the fairness and efficiency goals of preventing unsupported inequitable conduct allegations and preventing applicants from inundating patent examiners with extraneous and duplicative information during prosecution.

In order to evaluate whether the *Therasense* majority struck the appropriate balance, the decision—like all court opinions—cannot be read in isolation. Several adjacent legal developments have direct bearing on the application of *Therasense*. First, the pleading standards for a claim of inequitable conduct, not addressed in *Therasense*, were discussed in the 2009 *Exergen* case.¹⁵¹ Additionally, in the months following the Federal Circuit’s *Therasense* decision, the PTO proposed a revision of their Rule 56, which expressly adopted the majority’s but-for materiality test.¹⁵² Finally, the recently enacted Leahy-Smith America Invents Act (“Leahy-Smith AIA”), also addresses inequitable conduct.

A. THE NEW STANDARD

Under the new materiality test, announced in *Therasense* and adopted by the PTO in its proposed revision to Rule 56, prior art is but-for material if

147. *Id.*

148. *Id.* at 1304–05.

149. *Id.* at 1305.

150. *Id.* at 1314–17.

151. *Exergen Corp. v. Wal-Mart Stores, Inc.*, 575 F.3d 1312 (Fed. Cir. 2009).

152. Proposed Revision, 76 Fed. Reg. 43,631 (July 21, 2011).

the PTO would not have allowed a claim had it been aware of the undisclosed prior art.¹⁵³ Thus in applying the Federal Circuit's new materiality test, a judge must recreate the conditions of a PTO examination to determine the materiality of a withheld reference. The inquiry is whether, by a preponderance of the evidence, given the broadest reasonable construction of the claim, the claim would not have issued if the PTO examiner had seen the withheld information. It has been suggested that, similar to the way many courts now hold *Markman* hearings, courts may begin to hold "*Therasense* hearings" in which the court will find the broadest reasonable construction for a particular claim and then determine whether under a preponderance of the evidence standard that the claim would not have been allowed by the PTO had it been aware of the undisclosed information.¹⁵⁴

The Federal Circuit previously raised the intent standard *Kingsdown* in an attempt to reduce the flood of inequitable conduct allegations.¹⁵⁵ However, the high standard quickly eroded, and inequitable conduct allegations continued.¹⁵⁶ A significant amount of time has passed since the Federal Circuit's *Kingsdown* decision in 1988 and the inequitable conduct doctrine continues to be a problem for the courts and PTO.¹⁵⁷ Although *Kingsdown* failed, *Therasense* may have a significantly better chance for success as it comprehensively reformed the doctrine. Rather than just raising the intent standard or the materiality standard, the Federal Circuit in *Therasense* clearly dictated standards for both of these key elements of the inequitable conduct defense, as well as specifically pointed to standards that were henceforth abolished. The Federal Circuit created a set of coherent standards in *Therasense* that provide substantial direction in comparison to the continuously vacillating inequitable conduct standards prior to *Therasense*.¹⁵⁸ The court's holistic approach may well prove more effective and enduring than its predecessor, *Kingsdown*.

B. *THERASENSE* AND *EXERGEN*

Despite the comprehensive approach the *Therasense* court took, they did not discuss the interaction of their heightened standards for finding

153. *Id.* at 1292.

154. Peng, *supra* note 37, at 397 (emphasis omitted).

155. *Kingsdown Med. Consultants, Lt. v. Hollister, Inc.*, 863 F. 2d 867, 876 (Fed. Cir. 1988).

156. Peng, *supra* note 37, at 387 ("[t]he last en banc inequitable conduct decision in *Kingsdown* did not prove successful in choking off garden-variety allegations of inequitable conduct.").

157. See *supra* Section I.B.

158. *Id.*

inequitable conduct with the Federal Circuit's *Exergen* standards for pleading inequitable conduct. Although these two sets of standards are applied at different stages in a trial, *Therasense* must be understood within the context of *Exergen*.

In 2009, the Federal Circuit substantially raised the pleading standards for inequitable conduct claims in *Exergen*.¹⁵⁹ In *Exergen*, the defendant sought leave under Federal Rule of Civil Procedure 15(a) to allege inequitable conduct as an affirmative defense and counterclaim.¹⁶⁰ The district court denied the motion, "stating that the proposed pleading failed to allege inequitable conduct with particularity under Rule 9(b)."¹⁶¹ On appeal, the Federal Circuit held that the materiality prong of inequitable conduct must be pled with "particularity" under Rule 9(b).¹⁶² This standard is satisfied by identifying the specific "who, what, when, where and how" of the material misrepresentation or omission committed before the PTO.¹⁶³ The standard for pleading intent is somewhat lower—knowledge and intent may be averred generally under 9(b).¹⁶⁴ This standard is satisfied by "providing sufficient underlying facts from which a court could reasonably infer that a specific individual (1) knew of the withheld material information or of the falsity of the material misrepresentation, and (2) withheld or misrepresented this information with a specific intent to deceive the PTO."¹⁶⁵ The Federal Circuit agreed with the district court that the defendant's pleading was deficient under this new standard, "with respect to both the particularity of the facts alleged and the reasonableness of the inference of scienter."¹⁶⁶

C. REVISION OF RULE 56

The *Therasense* opinion included a strong dissent, joined by four of the Federal Circuit justices.¹⁶⁷ The key issue that separated the majority opinion and the dissent was the departure of the majority from the PTO's Rule 56 as the materiality standard in the inequitable conduct inquiry. The dissent

159. *See Exergen Corp. v. Wal-Mart Stores, Inc.*, 575 F.3d 1312 (Fed. Cir. 2009).

160. *Exergen*, 575 F.3d at 1317.

161. *Id.* Rule 9(b) states that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." FED. R. CIV. P. 9(b).

162. *Exergen*, 575 F.3d at 1317.

163. *Id.* at 1327.

164. *Id.* at 1328–29.

165. *Id.*

166. *Id.* at 1329.

167. The dissent was filed by Circuit Judge Bryson, joined by Circuit Judges Gajarsa, Dyk and Prost; Circuit Judge O'Malley filed a concurrence. *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, 1302 (Fed. Cir. 2011).

argued that the PTO was “in the best position to know what information examiners need to conduct effective and efficient examinations.”¹⁶⁸ The dissent also argued that the majority’s new but-for materiality standard was a clear departure from Federal Circuit precedent.¹⁶⁹ However in the months following the decision, the PTO proposed to amend Rule 56 to expressly adopt the but-for materiality standard as set forth by the majority in *Therasense*.¹⁷⁰ In light of this proposed revision, the key issue that separated the majority and the dissent may have become moot.

Less than two months after *Therasense*, the PTO expressed approval and acceptance of the new standard.¹⁷¹ The PTO recognized that the new standard is less inclusive than the pre-*Therasense* Rule 56, but wrote that “the ‘but-for-plus’ standard from *Therasense* will result in patent applicants providing the most relevant information and reduce the incentive for applicants to submit information disclosure statements containing only marginally relevant information out of an abundance of caution.”¹⁷² The new standard, the PTO continued, “will continue to prevent applicants from . . . breaching their duty of candor and good faith.”¹⁷³ The PTO noted that although they had previously considered and rejected a pure “but-for” materiality standard, the exception the majority created for affirmative egregious misconduct “addresse[d] the Office’s long-standing concern” with the possibility of “unscrupulous conduct.”¹⁷⁴

Due to its approval and a desire for uniformity within the patent system, the PTO proposed to amend Rules 56(b) and 55(b) to adopt the standard of materiality set forth by the majority opinion.¹⁷⁵ The PTO specifically cited to, and adopted, the standard set forth in *Therasense*:

168. *See supra* Part II.

169. *Id.*

170. Proposed Revision, 76 Fed. Reg. 43,631 (July 21, 2011).

171. *Id.*

172. *Id.* at 43,632.

173. *Id.* The PTO’s Rule 56(a) describes the duty of candor:

Each individual associated with the filing and prosecution of a patent application has a duty of candor and good faith in dealing with the Office, which includes a duty to disclose to the Office all information known to that individual to be material to patentability as defined in this section . . . no patent will be granted on an application in connection with which fraud on the Office was practiced or attempted or the duty of disclosure was violated through bad faith or intentional misconduct.

37 C.F.R. § 1.56(a) (1992).

174. Proposed Revision, 76 Fed. Reg. 43,631, 43,632 (July 21, 2011).

175. *Id.* at 43,632.

Section 1.56(b) as proposed to be amended would provide that information is material to patentability if it is material under the standard set forth in *Therasense*, and that information is material to patentability under *Therasense* if (1) The Office would not allow a claim if it were aware of the information, applying the preponderance of the evidence standard and giving the claim its broadest possible construction; or (2) the applicant engages in affirmative egregious misconduct before the Office as to the information. As stated in *Therasense*, neither mere nondisclosure of information to the Office nor failure to mention information in an affidavit, declaration, or other statement to the Office constitutes affirmative egregious misconduct.¹⁷⁶

The PTO agreed with the dissent that the *Therasense* decision was a clear severance of the “historical connection” between the materiality standards of the inequitable conduct doctrine and the PTO’s rule of disclosure.¹⁷⁷ Although it was not under any obligation to adopt the *Therasense* standard, the PTO cited harmony and simplicity within the patent system as primary motivation for their proposed revision.¹⁷⁸ It also mentioned concern about patent applicants having to meet one standard for materiality in defending inequitable conduct allegations and another standard for fulfilling the duty to disclose before the PTO.¹⁷⁹

In light of the PTO’s recent proposed revision to Rule 56, the arguments that the dissent articulated against a but-for materiality standard appear to have fallen by the wayside. The dissent primarily argued that (1) the decision of what information examiners need to conduct effective and efficient examinations should be left to the PTO, and (2) that the materiality standard has historically been tied to the PTO’s Rule 56.¹⁸⁰ By proposing this revision, the PTO has articulated that the information they need to conduct effective and efficient examinations *is* provided by the standard set forth in *Therasense*. Furthermore, by revising Rule 56 to replicate the *Therasense* standard, the new but-for materiality standard is once again tied to Rule 56, as the dissent advocated for.

This development is significant for the reason that the *Therasense* decision came from a bare majority, a 6–5 decision, and that the departure from the PTO’s Rule 56 as a materiality standard was the critical disagreement

176. *Id.* at 43,633.

177. *Id.*

178. *Id.*

179. *Id.*

180. *See supra* Part II.

between the majority of six justices, and the dissent of four.¹⁸¹ With the dissent's principal arguments now moot, it stands to reason that *Therasense* now may stand on substantially stronger ground. Given the Federal Circuit's tendency to vacillate on inequitable conduct standards,¹⁸² with at least ten justices now in agreement on what the standards should be, it may be that *Therasense* is here to stay.

D. LEAHY-SMITH AMERICA INVENTS ACT

The recent enactment of the Leahy-Smith AIA significantly revised the patent statute.¹⁸³ The Leahy-Smith AIA is the culmination of many years of patent reform proposals, and it is the first comprehensive revision to the patent laws in nearly sixty years—since the Patent Act of 1952. Although provisions in the Act only indirectly affect the inequitable conduct doctrine, the presence of these provisions may directly affect a court's assessment of an inequitable conduct defense and may significantly affect a patentee's disclosure strategy at the PTO.

The new act includes a provision for supplemental examinations, under which a patentee may request the PTO to consider, reconsider, or correct information.¹⁸⁴ Thus, if a patentee becomes aware of new information or discovers old information relevant to his patent or even suspects impending litigation and wishes to clear the record, the patentee may request a supplemental examination. In a supplemental examination, the Director of the PTO will conduct an examination and determine whether a new question of patentability is raised.¹⁸⁵

Leahy-Smith AIA amends 35 U.S.C § 287 to state:

[A] patent owner may request supplemental examination of a patent in the Office to consider, reconsider, or correct information believed to be relevant to the patent, in accordance with such requirements as the Director may establish. Within 3 months after the date a request for supplemental examination meeting the requirements of this section is received, the Director shall conduct the supplemental examination and shall conclude such supplemental examination by issuing a certificate indicating

181. Six justices joined the *Therasense* majority; one justice filed a concurrence, and four justices dissented. *See Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276 (Fed. Cir. 2011).

182. *See supra* Section I.A.

183. *See Leahy-Smith America Invents Act*, Pub. L. No. 112-29 (2011) (to be codified at 35 U.S.C. § 257).

184. *Id.* at § 12(a).

185. *Id.*

whether the information presented in the request raises a substantial new question of patentability.¹⁸⁶

If a substantial new question of patentability is raised, then the Director must order the re-examination of the patent.¹⁸⁷ The amendment to § 287 also states:

[A] patent shall not be held unenforceable on the basis of conduct relating to information that had not been considered, was inadequately considered, or was incorrect in a prior examination of the patent if the information was considered, reconsidered, or corrected during a supplemental examination of the patent. The making of a request under subsection (a), or in the absence thereof, shall not be relevant to enforceability of the patent under section 282.¹⁸⁸

This provision also includes a limitation such that a patentee cannot request a supplemental examination if an adequate allegation of inequitable conduct has already been asserted against the patentee.¹⁸⁹ A patentee cannot wait until an inequitable conduct allegation has been asserted against him, to request a supplemental examination in order to clear his name.

Although the new act doesn't specifically address inequitable conduct doctrine reform, it does seem to offer some protection to well-meaning patentees. Patentees who make honest presentations to the PTO and later discover relevant information that could be used by an opponent as grounds for an inequitable conduct allegation are provided with a path to rectify any mistakes or oversights. However, it may be that the provision is also useful to a patentee who intentionally withholds information from the PTO and later, under threat of impending litigation, redeems the patent through a supplemental examination proceeding. The supplemental examination provision essentially gives a patentee a second chance to come clean before the PTO. A court could take the presence of this additional safeguard as a factor weighing against the patentee in an inequitable conduct claim, reasoning that the patentee has already had an opportunity to redeem himself.

Another theory is that the supplemental examination provision of the Leahy-Smith may act as a "patent amnesty program."¹⁹⁰ Rantanen and

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. See Jason Rantanen & Lee Petherbridge, Commentary, *Toward a System of Invention Registration: The Leahy-Smith America Invents Act*, 110 MICH. L. REV. FIRST IMPRESSIONS 24

Petherbridge argue that the Act encourages patent applicants to employ unscrupulous strategies to obtain a patent and then “cure” the tainted patent through a supplemental examination request when litigation appears imminent.¹⁹¹ The supplemental examination, they write, is little more than a mechanism to provide amnesty to issued patents that were obtained inequitably.¹⁹² The authors believe that this “patent amnesty” jeopardizes American innovation, job creation, and economic competitiveness.¹⁹³

It seems that, at best, the Leahy-Smith AIA supplemental examination provision could become a double-edged sword for patentees. On the one hand, they are provided with a route to absolve any unintentional breaches of their duty of candor at the PTO. On the other hand, a judge might take this “second chance” into account when assessing an inequitable conduct claim against the patentee. At worst, it is possible that the supplemental examination provision could actually increase instances of inequitable conduct before the PTO. In this scenario, the tightened *Therasense* standards for finding inequitable conduct may prove to be too high.

E. IN THE DISTRICT COURT

In the few months that have followed the *Therasense* decision, district courts have been quick to apply the new standard laid out by the Federal

(2011), available at <http://www.michiganlawreview.org/articles/toward-a-system-of-invention-registration-the-leahy-smith-america-invents-act>.

191. *Id.* (“For example, potential descriptions of a claimed invention in a prior art printed publication, or possible instances of prior patenting of the claimed invention by another, that are known to a patent applicant, and that might have a high probability of barring a patent or limiting claim scope, may not be disclosed during the initial examination. Similarly, sales and public uses that are known to a patent applicant and that may have a high probability of barring the patentability of a claimed invention may be withheld at least until supplemental examination if the applicant likes (and perhaps longer depending on an applicant’s risk tolerance). Even the use of false data to obtain the patent in the initial examination can be exonerated by filing a supplemental examination request.”).

192. *Id.* (“Under the AIA, therefore, a patent owner may now obtain a patent through the ex parte examination process despite conduct that would be abhorrent under traditional understandings of a patent applicant’s obligation to be equitable in dealing with the public. The owner may then immunize the conduct using supplemental examination should litigation appear on the horizon.”).

193. *Id.* (“[I]t does so by potentially increasing the cost of competition, making research and development more expensive, and making market entry more difficult and risky. At the same time, and somewhat perversely, it creates an environment in which organizing capital around a patent or modestly sized patent portfolio might make less sense than it did before the AIA.”).

Circuit. Courts have taken note of the heightened intent and materiality standards and overturned prior findings of inequitable conduct.¹⁹⁴

For example, in *Metris U.S.A., Inc. v. Faro Technologies, Inc.*, a Massachusetts district court held that a patentee's failure to disclose information was not material under the new *Therasense* standard and thus the patentee did not engage in inequitable conduct.¹⁹⁵ Prior to *Therasense*, the patentee had alleged infringement against a competitor for devices used in an apparatus for scanning and modeling three-dimensional objects.¹⁹⁶ The accused infringer subsequently brought forth an inequitable conduct defense.¹⁹⁷ The court initially found, under pre-*Therasense* standards, that the inventor intended to deceive the PTO by withholding information and, furthermore, that the withheld information was material and thus the patent was unenforceable due to inequitable conduct.¹⁹⁸ However, following *Therasense*, the district court ordered further briefing on the patent claims and reexamined its prior holding of unenforceability. The court reiterated the Federal Circuit's holding that "to prevail on a claim of inequitable conduct the accused infringer must prove that the patentee acted with the specific intent to deceive the PTO."¹⁹⁹ The court reversed its earlier decision and found that the inequitable conduct defense could not succeed under the "stringent standard" of *Therasense*.²⁰⁰ Although the prior finding of intent to deceive withstood *Therasense*, the information withheld by the inventor did not rise to the new "but-for" standard of materiality.²⁰¹ The court further held that the patentee's conduct did not amount to affirmative egregious misconduct so as to fall within the exception carved out by the Federal Circuit.²⁰²

In *Pfizer, Inc. v. Teva Pharmaceuticals USA, Inc.*, a Virginia district court held that an attorney's failure to produce a Statement of Claim to the PTO did not constitute inequitable conduct under the new *Therasense* standard.²⁰³ The patentee alleged imminent infringement of a certain pharmaceutical

194. See, e.g., *Metris U.S.A., Inc. v. Faro Tech., Inc.*, No. 08-CV-11187-PBS, 2011 WL 4346852 (D. Mass. 2011); *Pfizer, Inc. v. Teva Pharm. USA, Inc.*, No. 2:10CV128, 2011 WL 3563112 (E.D. Va. 2011).

195. *Metris U.S.A.*, 2011 WL 4346852, at *4.

196. *Id.* at *1.

197. *Id.*

198. *Id.* at *2.

199. *Id.* at *1 (quoting *Therasense*).

200. *Id.*

201. *Id.* at *2.

202. *Id.* at *4.

203. *Pfizer, Inc. v. Teva Pharm. USA, Inc.*, No. 2:10CV128, 2011 WL 3563112, *33 (E.D. Va. 2011).

compound patent (the '012 patent), by its competitor.²⁰⁴ The competitor defended the allegation by claiming that the patent was invalid because of inequitable conduct committed by the patentee during prosecution.²⁰⁵ During prosecution of the patent, the patentee's attorney received a Statement of Claim from another competitor, suing under the patentee's Canadian version of the U.S. application and alleging invalidity.²⁰⁶ The patentee's attorney withheld this Statement of Claim from the PTO during prosecution.²⁰⁷

In coming to a decision regarding the inequitable conduct allegation, the court looked to the Federal Circuit's *Therasense* decision.²⁰⁸ The court noted that under *Therasense*, "in order to substantiate a claim of inequitable conduct, 'the accused infringer must prove by clear and convincing evidence that the applicant knew of the references, knew that it was material, and made a deliberate decision to withhold it.'"²⁰⁹ Looking to the facts of the case, the court determined that the information withheld, "hardly approaches" the *Therasense* but-for materiality.²¹⁰ Similarly, the court found that there was no evidence to suggest that the patentee's attorney had any intent to deceive the PTO in failing to disclose the statement of claim because (1) he had no such duty in the first place and (2) such intent is hardly the single most likely inference from his actions.²¹¹ Consequently, the court held that the

204. *Id.* at *1.

205. *Id.* at *33.

206. *Id.* at *35.

207. *Id.*

208. *Id.*

209. *Id.* at *37 (quoting *Therasense*).

210. *Id.* at *38 ("First, the Bayer Statement of Claim concerned a patent under Canadian law, law which has not been shown to have anything in common with or any bearing on the law of the United States as regards validity of patents. . . . Second, the Bayer Statement of Claim related to the Canadian patent, a patent which was issued under different standards than the '012 patent in the United States. Third, the Bayer Statement of Claim appears to be merely a rote recitation of causes of action and does not contain any factual contentions or references which could have informed the patent examiner in the United States. Fourth, and finally, it is emblematic of how little relevance the Bayer Statement of Claim has to the prosecution of the '012 patent in the United States that the patent examiner specifically requested not to receive any other foreign references similar to those already submitted.").

211. *Id.* at *38–39 ("*Therasense* commands the court to determine whether the party challenging the patent has made a showing by clear and convincing evidence that the intent to deceive the PTO is 'the single most reasonable inference able to be drawn from the evidence.' The only inference the court can draw from the evidence presented at trial was that Mr. O'Rourke was a busy young law partner who devised a somewhat 'sloppy' system for sorting foreign litigation material. Teva unendingly repeats the incantation that Mr. O'Rourke engaged in [a] 'scheme of willful blindness.' It is as if Teva hopes to conjure up the flame of inequitable conduct from thin air. Instead the court sees this claim of inequitable conduct for what it is: an attempt to induce the court to believe that if enough smoke is created, there must be a fire. The court sees through this smokescreen and finds

competitor had failed to make a showing of inequitable conduct by clear and convincing evidence.²¹² The district court noted that the present case was the “archetype of the action” the Federal Circuit was targeting with its *Therasense* decision.²¹³ The court described *Therasense* as a “bulwark against the waste of resources by both the judiciary and litigants.”²¹⁴

It is still unclear what district courts’ reception of *Therasense* will be in the long term. However, in the few inequitable conduct cases that have been decided post-*Therasense*, the Federal Circuit’s decision appears to be welcome, which may be an indication of its future reception.

IV. WILL *THERASENSE* BRING EQUITY BACK TO THE INEQUITABLE CONDUCT DOCTRINE?

It is too soon to determine whether the *Therasense* decision will radically reform the doctrine as hoped, or if its effect will be more attenuated. Members of the legal community—both academics and practitioners—have already weighed in on the decision.²¹⁵ The clear consensus is that although the clarity the Federal Circuit provided in *Therasense* is welcome, the decision falls far short of creating the ultimate solution that the court aimed for.²¹⁶ Nevertheless, the Federal Circuit has taken a significant step in the right direction.

A. *THERASENSE* MAY NOT BE AN ADEQUATE CURE FOR “THE PLAGUE”

Scholars seem to think that *Therasense* will have some positive effects, but that these effects are overstated by the court majority. Although there is

that Teva has failed to bring any evidence to the court’s attention which shows that Mr. O’Rourke acted with the specific intent to deceive the PTO.”).

212. *Id.* at *37–39.

213. *Id.* at *39. (“In sum, this court finds that this case is the archetype of the action the Federal Circuit was aiming to curtail with the tightening of the standards in *Therasense*.”).

214. *Id.*

215. See, e.g., Thomas F. Cotter, *An Economic Analysis of Patent Law’s Inequitable Conduct Doctrine*, 53 ARIZ. L. REV. 735 (2011); Lee F. Johnston, *The Therasense Decision: Just What the Doctor Ordered or Will the Inequitable Conduct Plague Mutate and Survive?*, 23 NO. 9 INTELL. PROP. & TECH. L.J. 14 (2011); Joseph A. Micallef, *Therasense and the New Order*, 1063 PLI/Pat 731 (2011); Peng, *supra* note 37, at 373.

216. Cotter, *supra* note 215, at 735 (“[p]ost-*Therasense*, the doctrine poorly defines many of the variables affecting a rational applicant’s decisionmaking process and thus potentially encourages risk-averse agents to overdisclose”); Johnston, *supra* note 215, at 14 (“[t]he new rules could lead to problems of their own and ultimately result in Supreme Court intervention”); Micallef, *supra* note 215, at 733 (“*Therasense* may have settled very little”); Peng, *supra* note 37, at 376 (“[t]he standards articulated in *Therasense* are welcomed by the patent community . . . however . . . *Therasense* may not be the panacea many wish it to be”).

disagreement over the utility of the specific holdings of *Therasense*, the heightened standards for the defense have generally been welcomed by the patent community.²¹⁷ Practitioners also appreciate the clarity that the Federal Circuit offered.²¹⁸ Some authors believe that the combination of heightened pleading standards²¹⁹ and the stringent proof standards found in *Therasense* together will reduce assertions of inequitable conduct.²²⁰ Another author predicted a wave of summary judgment motions in pending inequitable conduct cases following the *Therasense* decision.²²¹ Although what the decision actually accomplishes remains to be seen, it has at least put the patent community on notice that the current status quo is unacceptable and that the courts are determined to effect change in the application of inequitable conduct.²²²

For scholars, the list of what *Therasense* did *not* accomplish is substantially longer. Although one of the Federal Circuit's primary goals was to decrease the frequency of inequitable conduct allegations, one author predicts that allegations will not decline.²²³ None of the *Therasense* holdings affect an accused infringer's ability to *plead* the defense. Simply raising the standards for *finding* inequitable conduct may be insufficient to decrease the number of inequitable conduct *pleadings*.²²⁴ Additionally, but-for materiality may be easier to allege than the court majority would like to believe.²²⁵ In inequitable conduct allegations, materiality is often asserted based on anticipation or obviousness, which are inherently flexible notions.²²⁶ Also, the but-for materiality standard is reviewed under a preponderance of the evidence standard, and the broadest reasonable interpretation of the claims.²²⁷ The "preponderance of the evidence" standard is significantly lower than "clear and convincing evidence."

In the *Therasense* opinion, the Federal Circuit operated on the underlying assumption that raising the standards for finding inequitable conduct would concurrently optimize disclosure practices at the PTO. However, one author contradicts this assumption, arguing that the conditions that trigger a finding

217. Peng, *supra* note 37, at 376.

218. *Id.* at 389.

219. *See* *Ashcroft v. Iqbal*, 129 U.S. 1937, 1949–50 (2009); *Exergen Corp. v. Wal-Mart Stores, Inc.*, 575 F.3d 1312, 1326 (Fed. Cir. 2009).

220. Micallef, *supra* note 215, at 750; Peng, *supra* note 37, at 389.

221. Johnston, *supra* note 215, at 16.

222. *Id.*

223. Peng, *supra* note 37, at 387.

224. *Id.* at 389.

225. Micallef, *supra* note 215, at 750.

226. *Id.*

227. *Id.*

of inequitable conduct post-*Therasense* are at best “only a rough proxy for the conditions defining optimal disclosure.”²²⁸ After a thorough economic analysis of the inequitable conduct doctrine, this author concludes that the variables affecting a rational applicant’s decision-making process are ill-defined in the doctrine and therefore the new standards may actually encourage applicants to over-disclose at the PTO.²²⁹

Therasense may have other unintended effects as well. The *Therasense* dissent predicted that the majority’s “affirmative acts of egregious misconduct” exception to their but-for materiality standard would “become fertile ground for litigation in the future.”²³⁰ The dissent’s concern was over the difficulty in drawing a line between “egregious misconduct” and less-than-egregious misconduct.²³¹ The lack of a clear distinction here could, in itself, encourage additional litigation in this area.²³² Others have agreed, stating that the decision may have “spawned more litigation tactics than it laid to rest.”²³³

In light of the significant criticism the *Therasense* decision has received, it is not surprising that some scholars have predicted that the Federal Circuit’s recent decision is “unlikely to be the last word on the subject.”²³⁴ In the end, the *Therasense* decision seems that it “may not be the panacea many wish it to be.”²³⁵

B. *THERASENSE* PROVIDED VISIBILITY AND CLARITY

Despite scholars’ predictions, it is still too early to determine the effects of the *Therasense* decision in actual practice. The inequitable conduct doctrine is complex and intricate, as it attempts to construct rational incentives for actors who do not always act rationally. Many different thoughtful and insightful opinions have been written discussing what redemptive path the inequitable doctrine must take, not the least of which are the concurrence

228. Cotter, *supra* note 215, at 735.

229. *Id.*; see also Peng, *supra* note 37, at 390 (“[t]he Federal Circuit’s ‘but-for’ materiality may in fact encourage applicants to continue to submit significant amounts of prior art during prosecution”).

230. *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, n.3 (Fed. Cir. 2011).

231. *Id.*

232. *Id.*

233. Johnston, *supra* note 215, at 16; see also Peng, *supra* note 37, at 396 (“*Therasense* may in fact have the unintended consequence of making litigation more complicated.”).

234. Micallef, *supra* note 215, at 757, see also Peng, *supra* note 37, at 389 (“[s]ince inequitable conduct charges are unique to specific facts and circumstances, case law may wobble in the future as judges look for words to brand as inequitable conduct what they see as bad conduct”).

235. Peng, *supra* note 37, at 376.

and dissent in *Therasense*. The en banc decision garnered only a bare majority.²³⁶ There are many different views on the subject precisely because the answer to the problem is not straightforward. The probability that the *Therasense* opinion struck the perfect chord—if there is one to be struck—is necessarily low.

However, the *Therasense* decision is still a valuable one. The inequitable conduct doctrine before *Therasense* was a vacillating mess, where a patentee could face the grave charge of inequitable conduct without even knowing under which set of standards he would be judged.²³⁷ The *Therasense* court has provided a comprehensive set of guidelines under which practitioners and patentees alike can readily identify the standards they are held to.

The second valuable element that the *Therasense* decision provides is visibility. The Federal Circuit took the case en banc and plainly and thoroughly criticized the entire inequitable conduct doctrine. Although academics and practitioners have long been calling for reform, in *Therasense* the Federal Circuit has stepped up and comprehensively addressed the issues in this highly anticipated decision. Even the concurrence and dissent in *Therasense* agreed with the majority that the inequitable conduct doctrine must be reined in. Fine-tuning the rules to finally achieve the right balance may take time, but the Federal Circuit has made its end goal clear. Although the decision may not have provided the cure to the “plague,” by bringing the problems to light, the court took a notable step in that direction.

V. CONCLUSION

The Federal Circuit has significantly restructured the inequitable conduct defense through its en banc decision in *Therasense*. In an effort to rein in rampant inequitable conduct allegations in the courts and stem the tide of prior art references flowing into the PTO, the Federal Circuit raised the standards for both intent and materiality. The court abolished the “should have known” intent standard and held that a specific intent to deceive must be the single most reasonable inference able to be drawn from the evidence. The court implemented a but-for materiality standard, and eliminated the long-standing sliding-scale step of the inequitable conduct inquiry. The Federal Circuit’s revision of the inequitable conduct doctrine was comprehensive, however this new standard must be appreciated within the

236. *Therasense* had a 6–5 majority. See *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276 (Fed. Cir. 2011).

237. See *supra* Section I.A.

context of the *Exergen* pleading standards, the PTO's proposed revision of Rule 56, and the recently enacted Leahy-Smith AIA.

Although the Federal Circuit attempted to provide a cure to the inequitable conduct "plague" in its *Therasense* opinion, it probably fell short. However, what *Therasense* has done is to provide a set of clear, workable guidelines to practitioners. And perhaps more importantly, it has provided visibility for the problems in the inequitable conduct doctrine and the goals of the Federal Circuit with respect to them.

UNKNOTTING *UNILOC*

Edward Torous[†]

Greek mythology tells the story of the Gordian Knot. According to the myth, whoever managed to untie the massive, complex knot would rule all of Asia.¹ For hundreds of years, people attempted to unravel the knot to no avail.² No one could figure out the purpose or path of each intertwined strand of fiber, and the knot remained fixed until the arrival of Alexander the Great.³ Alexander, instead of trying to loosen the knot, simply took out his sword and cut the knot in half.⁴

While not quite as complex, patent damages can be equally knotting and vexing.⁵ Complex systems, such as computers or mobile phones, present a particularly difficult issue in calculating patent damages. Such consumer electronic devices, like the Gordian Knot, are extremely intricate: they are made of many subcomponents—such as memory chips, microprocessors, and radio antennas—that are covered by patents.⁶ For example, Apple has over 200 patents covering the iPhone and its subcomponents alone.⁷ If one of those 200 patents, say a patent covering a radio antenna,⁸ were infringed, how much would be owed to Apple? At first blush the answer appears to be the value of the radio antenna. But if it cannot be purchased separately in an

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1. KATHLEEN N. DALY, GREEK AND ROMAN MYTHOLOGY A TO Z 60–61 (3d ed. 2009).

2. *Id.*

3. *Id.*

4. *See id.*

5. This is not the first comparison between patents and the Gordian Knot. *See, e.g.,* Arrhythmia Research Tech., Inc. v. Corazonix Corp., 958 F.2d 1053, 1061 (Fed. Cir. 1992) (Rader, J., concurring).

6. *See, e.g.,* Quanta Computer, Inc. v. LG Elecs., Inc., 553 U.S. 617, 621 (2008) (noting the myriad subcomponents in a computer system and a number of patents covering some of these subcomponents).

7. *See* Lindsey Gilroy & Tammy D’Amato, *How Many Patents Does It Take To Build an iPhone?*, INTELLECTUAL PROPERTY TODAY (Nov. 2009), <http://www.iptoday.com/issues/2009/11/articles/how-many-patents-take-build-iPhone.asp>.

8. *See, e.g.,* U.S. Patent Application No. 20,100,304,702 (filed June 1, 2009) (Apple’s patent application covering a radio receiver).

electronics store, a radio antenna is difficult to price.⁹ Adding to the confusion, a consumer desperate to make a phone call or check email would likely pay an above-market premium for a radio antenna. These and other difficult questions interfere with attempts to accurately value a radio antenna patent.

In an effort to bring clarity to this knotted question, this Note focuses on how to calculate damages for infringement of a patented subcomponent in a complex system. Like the strands of the Gordian Knot, subcomponents in a complex system are often complexly intertwined with each other in puzzling ways that make damages calculations difficult and obtuse.¹⁰ In hopes of emulating Alexander's sword, this Note proposes one way of slicing through the complexity and calculating damages in a complex system. Part I surveys how damages are calculated in patent litigation. It briefly describes the possibility of using lost profits, but focuses on the much more common "reasonable royalty" damages measure as well as the two main methods used to arrive at an appropriate royalty amount. Part II reviews recent legal decisions, including *Uniloc USA, Inc. v. Microsoft Corp.*, and how they affect damages calculations in a complex system. In particular, it focuses on two aspects of those recent decisions: (1) maintaining apportionment to ensure that any reasonable royalty fits the economics of a transaction and the harm caused by infringement; and (2) choosing the most appropriate method for arriving at a royalty rate. Finally, Part III proposes a method, which conforms to recent legal decisions, for calculating damages in a complex system.

I. EXAMINING THE SWORD: HOW PATENT DAMAGES ARE CALCULATED

Under its constitutional grant of authority, Congress enacted § 284 of the Patent Act, which authorizes damages for patent infringement.¹¹ Specifically, § 284 authorizes courts to "award the claimant damages adequate to

9. Radio receivers are not usually sold individually. Instead, receivers are included in complex systems such as mobile phones. *See, e.g., id.* (noting that the radio receiver can be "implemented as part of a larger system, such as a mobile phone or a multimedia player").

10. Faced with having to compute the value of one patent within Microsoft Office, Judge Marilyn Huff remarked that "[t]his case illustrates the difficulty of properly valuing a small patented component, without a stand-alone market, within a larger program." *Lucent Techs., Inc. v. Microsoft Corp.*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *1 (S.D. Cal. Nov. 10, 2011).

11. 35 U.S.C. § 284 (2006); *see* SKENYON ET AL., PATENT DAMAGES AND PRACTICE § 1:3 (2008).

compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.”¹² In theory, a patent owner can seek damages either by establishing lost profits or a reasonable royalty.¹³ But in practice, the patentee typically seeks a reasonable royalty, employing one of two methods: the analytical method, or the more common hypothetical negotiation method.

A. LOST PROFITS: A METHOD FOR CALCULATING PATENT DAMAGES

The less frequent measure of damages in an infringement suit is lost profits. A patentee seeking lost profits looks for a monetary amount equivalent to the amount of profits that would have been earned through sales *but for* the patent infringement.¹⁴ The law requires but-for causation in order for a patentee to recover,¹⁵ and generally, plaintiffs prove damages by demonstrating “(1) demand for the patented product; (2) absence of acceptable non-infringing substitutes; (3) manufacturing and marketing capability to exploit the demand; and (4) the amount of the profit it would have made.”¹⁶

But if the patentee fails to pass this four-factor causation test, there is a good chance he will be barred from recovering under a lost profits theory.¹⁷ For example, patentees, such as non-practicing entities who do not create or sell any products, are not eligible for lost profits.¹⁸ Even if a patentee creates

12. 35 U.S.C. § 284.

13. Mark A. Lemley, *Distinguishing Lost Profits from Reasonable Royalties*, 51 WM. & MARY L. REV. 655 (2009); see also WILLIAM C. ROOKLIDGE ET AL., COMPENSATORY DAMAGE ISSUES IN PATENT INFRINGEMENT CASES: A POCKET GUIDE FOR FEDERAL DISTRICT COURT JUDGES 5 (2011), available at [http://www.fjc.gov/public/pdf.nsf/lookup/damagespatent.pdf/\\$file/damagespatent.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/damagespatent.pdf/$file/damagespatent.pdf) (noting that a patentee can seek an established royalty).

14. Jerry A. Hausman et al., *Patent Damages and Real Options: How Judicial Characterization of Noninfringing Alternatives Reduces Incentives To Innovate*, 22 BERKELEY TECH. L.J. 825, 833 (2007).

15. *Rite-Hite Corp. v. Kelley Co., Inc.*, 56 F.3d 1538, 1545 (Fed. Cir. 1995); see also *Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, 575 F.2d 1152, 1156 (6th Cir. 1978).

16. *Panduit*, 575 F.2d at 1156.

17. See, e.g., *Crystal Semiconductor Corp. v. TriTech Microelectronics Int’l, Inc.*, 246 F.3d 1336, 1360–61 (Fed. Cir. 2001) (holding lost profits unavailable when lost sales could not be demonstrated); *SmithKline Diagnostics, Inc. v. Helena Labs. Corp.*, 926 F.2d 1161, 1165 (Fed. Cir. 1991) (upholding a trial court’s ruling that lost profits were not available because the plaintiff had failed to prove the last three *Panduit* factors).

18. See Amy L. Landers, *Let the Games Begin: Incentives to Innovation in the New Economy of Intellectual Property Law*, 46 SANTA CLARA L. REV. 307, 323 (2006); Mark A. Lemley, *Distinguishing Lost Profits from Reasonable Royalties*, 51 WM. & MARY L. REV. 655, 657–61 (2009).

or sells a product that practices the patent, calculating lost profits is difficult because the patentee may not “sell a product that directly competes with that of the infringer, [or] the patentee’s sales [may have] failed for reasons unrelated to the infringer’s violation of a patent right,” such as failure to sell the product.¹⁹ Because of these and other difficulties in proving lost profits, a patentee usually seeks to recover under a reasonable royalty theory,²⁰ which eliminates the troublesome requirements of but-for causation, accurate profits and demand projections, and near identical products—conditions that rarely, if ever, exist in the real world.²¹

B. REASONABLE ROYALTY: THE STANDARD METHOD FOR CALCULATING PATENT DAMAGES

A reasonable royalty is a work of judicial fiction: a court *ex post* awards a monetary amount based on the “result of hypothetical negotiations” between the patentee and the infringer.²² Because the text of the Patent Act notes that damages should be “in no event less than a reasonable royalty,” the royalty awarded may exceed the licensing rate to which the two parties would have agreed in the “hypothetical negotiation.” In fact, such a “reasonable royalty” may be so high as to exceed the patentee’s lost profits²³ or exceed the infringer’s profits derived from infringement.²⁴ Some “reasonable royalty” awards have even become so large that scholars characterize them as punitive damages.²⁵ These various possibilities for a reasonable royalty render the damages calculation an inexact science, which “necessarily involves an element of approximation and uncertainty.”²⁶ In an effort to bring

19. Landers, *supra* note 18, at 323.

20. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1312 (Fed. Cir. 2011) (“A reasonable royalty is the predominant measure of damages in patent infringement cases.”); ROOKLIDGE, *supra* note 13, at 6 (“In almost every patent case, the patent owner seeks reasonable royalty damages . . .”).

21. *See generally* SKENYON, *supra* note 11, § 3:3.

22. *Rite-Hite Corp. v. Kelley Co., Inc.*, 56 F.3d 1538, 1554 (Fed. Cir. 1995).

23. *See* Landers, *supra* note 18, at 324. In practice, a “reasonable royalty” may be much larger than the result of a likely negotiation. SKENYON, *supra* note 11, § 1:3 (“Reasonable royalty damages can be far different from any pre-infringement, real-world royalty the parties would have actually negotiated. Indeed, the Federal Circuit has routinely affirmed ‘reasonable royalty’ awards that are obviously well in excess of what the parties would have actually agreed to as a result of licensing negotiations prior to infringement.”).

24. SKENYON, *supra* note 11, § 3:2; Landers, *supra* note 18, at 350–51 (citing *Golight, Inc. v. Wal-Mart Stores, Inc.*, 355 F.3d 1327, 1338 (Fed. Cir. 2008)).

25. *See* Eric E. Bensen & Danielle M. White, *Using Apportionment To Rein in the Georgia-Pacific Factors*, 9 COLUM. SCI. & TECH. L. REV. 1, 3 (2008).

26. *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1325 (Fed. Cir. 2009) (citing *Unisplay, S.A. v. Am. Elec. Sign Co., Inc.*, 69 F.3d 512, 517 n.7 (Fed. Cir. 1995)).

predictability and order to the damages calculations in spite of these ambiguities, courts have generally adopted two ways to calculate a reasonable royalty: (1) the less common analytical approach, which requires accurate infringer profit projections, and (2) the more common willing licensor/willing licensee approach²⁷—colloquially known as the hypothetical negotiation approach.²⁸

1. *Analytical Approach: A Method for Calculating a Reasonable Royalty*

In the analytical approach, a court will accept profit projections to calculate the additional profits lost to infringement.²⁹ The first step in the analytical approach is to determine, from the infringer's internal business documents, her expected profits from the infringing product.³⁰ Next, this profit is then reduced by the normal profit, based on industry standards and other heuristics, of a non-infringing alternative.³¹ The result of this calculation is the applicable reasonable royalty.³² Unlike the previously discussed analytical approach, there is no but-for causation requirement.³³

For example, in *TWM Manufacturing Co., Inc. v. Dura Corp.*, the defendant's internal documents showed a profit projection of 37 to 42 percent on sales of the infringing product.³⁴ In the particular industry, a non-infringing alternative usually had 6.56 to 12.5 percent profit margin.³⁵ Thus the profit margin was proportionately reduced, and the court awarded the defendant a 30 percent share of the profits of all infringing products.³⁶ Because this approach requires the existence of accurate profit projections,³⁷ which are

27. David W. Opperbeck, *Patent Damages Reform and the Shape of Patent Law*, 89 B.U. L. REV. 127, 133 (2009).

28. See *Methodologies for Determining Reasonable Royalty Damages*, FISH & RICHARDSON, <http://www.fr.com/reasonableroyalty/> (last visited Feb. 24, 2012).

29. See SKENYON, *supra* note 11, § 3:8 (noting, in addition, that the analytical approach “really has nothing at all to do with any hypothetical licensing negotiation”).

30. *Id.*; Opperbeck, *supra* note 27, at 133 n.35 (citing Roger D. Blair & Thomas F. Cotter, *Rethinking Patent Damages*, 10 TEX. INTEL. PROP. L.J. 1, 38–42 (2001) (suggesting that profits could be calculated by subtracting the difference in the rate of return on non-infringing merchandise from infringing merchandise)).

31. SKENYON, *supra* note 11, § 3:8. See generally *TWM Mfg. Co., Inc. v. Dura Corp.*, 789 F.2d 895 (Fed. Cir. 1986) (outlining the steps of the analytical approach).

32. SKENYON, *supra* note 11, § 3:8.

33. See *id.*

34. *TWM Mfg.*, 789 F.2d at 899.

35. *Id.*

36. *Id.*

37. See *Hughes Tool Co. v. Dresser Indus., Inc.*, 816 F.2d 1549, 1557 (Fed. Cir. 1987) (rejecting a profit projection that was ruled inaccurate).

difficult to ascertain,³⁸ courts use it less often than the hypothetical negotiation approach.³⁹

2. *Hypothetical Negotiation Approach: The Standard Method for Calculating a Reasonable Royalty*

In the hypothetical negotiation approach, the reasonable royalty is the product of what the courts call the “royalty base” and the “royalty rate.”⁴⁰ The royalty base is “the revenue pool implicated by the infringement,” which can be determined by looking at the retail market of the sub-component,⁴¹ and the royalty rate is the “the percentage of that pool ‘adequate to compensate’ the [patentee] for that infringement.”⁴² For example, if a computer contains a microprocessor that infringes a patent, the royalty base is equivalent to the revenue generated by the inclusion of the infringing microprocessor, and the “royalty rate” is equivalent to the percentage of the generated revenue that would have been required to license the infringed patent. If the royalty base and royalty rate are accurate, the arithmetic product of the two is an accurate reasonable royalty per infringement.⁴³ This example can be expressed algebraically as:

$$\text{ReasonableRoyaltyPerInfringment} = \text{RoyaltyBase} \times \text{RoyaltyRate}$$

A total reasonable royalty can be calculated by multiplying the per infringement reasonable royalty by the quantity of infringement.⁴⁴ Traditionally, the term “reasonable royalty” refers to the total measure instead of the per-unit measure.⁴⁵ This total measure is expressed algebraically as:

$$\text{ReasonableRoyalty} = (\text{RoyaltyBase} \times \text{RoyaltyRate}) \times \text{QuantityOfInfringement}$$

38. SKENYON, *supra* note 11, § 3:8.

39. Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301, 1324 (Fed. Cir. 2009) (noting that the hypothetical approach is “more common”); *see* SKENYON, *supra* note 11, § 3:9 (noting that the hypothetical negotiating approach is “more familiar”). *But see Methodologies for Determining Reasonable Royalty Damages*, *supra* note 28 (“The existence of such a document as found in TWM is not all that unusual, at least in larger companies.”).

40. Cornell Univ. v. Hewlett-Packard Co., 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009), *amended*, 01-CV-1974, 2009 WL 1405208 (N.D.N.Y. May 15, 2009). This decision was written by then Circuit Judge Rader sitting by designation. *See id.*

41. *See id.* at 286–87.

42. *Id.*

43. Landers, *supra* note 18, at 323–24.

44. *See id.*

45. *See, e.g.,* Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, 1311 (Fed. Cir. 2011) (referring to a total reasonable royalty as simply a reasonable royalty); *Lucent*, 580 F.3d at 1325.

But using the hypothetical negotiation approach to calculate a reasonable royalty requires accurately calculating the underlying royalty base⁴⁶ and royalty rate.⁴⁷ Calculating the royalty base and royalty rate presents such unique challenges that “[d]etermining a fair and reasonable royalty is often . . . a difficult judicial chore, seeming often to involve more the talents of a conjurer than those of a judge.”⁴⁸ The source of this challenge is the difficulty a court faces in recreating the dynamics of a negotiation, after the fact.⁴⁹

To surmount this challenge, courts have adopted an analysis that examines a number of factors that they have found useful in recreating a negotiation. The district court in *Georgia-Pacific Corp. v. U.S. Plywood Corp.* examined fifteen such factors⁵⁰ to determine what sort of economic evidence is relevant in determining a reasonable royalty under the hypothetical negotiation analysis.⁵¹ While there is no set method for using the *Georgia-Pacific* factors, expert witnesses and courts commonly adjust the royalty rate or resulting reasonable royalty after examining how the factors apply to the case at hand.⁵² In addition to the *Georgia-Pacific* factors, courts have also relied upon a variety of methodologies to calculate a reasonable royalty.

a) The Proportional Relationship Between the Royalty Base and the Royalty Rate

Regardless of how the royalty base and royalty rate are calculated, the two are inherently linked. Recall that a reasonable royalty is the arithmetic product of the royalty base, the royalty rate, and the quantity of infringement.⁵³ Basic algebra holds that an increase in the royalty base can be

46. See, e.g., *Uniloc*, 632 F.3d at 1292 (highlighting the difficulty in calculating a royalty base).

47. See generally *Lucent*, 580 F.3d at 1324–25 (showing the difficulty in calculating a royalty rate); *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009).

48. Landers, *supra* note 18, at 328 (quoting *Fromson v. W. Litho Plate & Supply Co.*, 853 F.2d 1568, 1574 (Fed. Cir. 1988) *overruled on other grounds by* *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v. Dana Corp.*, 383 F.3d 1337 (Fed. Cir. 2004)).

49. See *Uniloc*, 632 F.3d at 1313 (noting one criticism of a tool used to help calculate a reasonable royalty was the “fails to account for the unique relationship between the parties”).

50. Bensen & White, *supra* note 25, at 2. For the sake of brevity, the factors have been omitted from this Note. The factors can be found at *Georgia-Pac. Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970) *modified sub nom.* *Georgia-Pac. Corp. v. U.S. Plywood-Champion Papers, Inc.*, 446 F.2d 295 (2d Cir. 1971).

51. SKENYON, *supra* note 11, § 3:13.

52. See *Uniloc*, 632 F.3d at 1311 (using the *Georgia-Pacific* factors to adjust the royalty rate); *Lucent Techs., Inc. v. Microsoft Corp. (Lucent II)*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *6 (S.D. Cal. Nov. 10 2011) (using the *Georgia-Pacific* factors to check the reasonable royalty).

53. See *supra* note 43.

offset by a proportional decrease in the royalty rate, or vice versa, with a zero net effect on the reasonable royalty. The following example demonstrates this principle. Assume a royalty base of \$1,000, a royalty rate of 50 percent, and 100 infringing products. The reasonable royalty would be calculated as follows:

$$\text{ReasonableRoyalty} = (\$1000 \times .5) \times 100 = \$500 \times 100 = \$50,000$$

Now, modify this example by doubling the royalty base to \$2,000, halving the royalty rate to 25 percent, and maintaining 100 infringing products. The reasonable royalty is unaffected:

$$\text{ReasonableRoyalty} = (\$2,000 \times .25) \times 100 = \$500 \times 100 = \$50,000$$

In other words, an underestimated royalty rate can offset an overestimated royalty base, and vice versa.⁵⁴

b) The Apportionment Requirement: Putting the Reasonable in Reasonable Royalty

An important and reoccurring concept in hypothetical negotiations is apportionment.⁵⁵ In 1853, the United States Supreme Court decided two patent cases, *Livingston v. Woodworth* and *Seymour v. McCormick*, holding in both that damages in a patent case were to be limited to “actual gains and profits” associated with the infringement.⁵⁶ In other words, monetary awards were to be apportioned to the harm caused by infringement of a patent.⁵⁷

While the holdings of *Livingston* and *Seymour* have never been overturned, courts have relaxed the apportionment requirement.⁵⁸ This decline in apportionment is evident in reasonable royalty awards that exceed profits gained through infringement.⁵⁹ Moreover, even though apportionment is

54. *See* Lucent Techs., Inc. v. Gateway, Inc., 580 F.3d 1301, 1338–39 (Fed. Cir. 2009) (“Simply put, the base used in a running royalty calculation can always be the value of the entire commercial embodiment, as long as the magnitude of the rate is within an acceptable range (as determined by the evidence).”).

55. *See generally* Bensen & White, *supra* note 25 (describing the history and importance of apportionment in patent law).

56. *Id.* at 8–9 (citing *Livingston v. Woodworth*, 56 U.S. 546, 555–59 (1853); *Seymour v. McCormick*, 57 U.S. 480, 485–91 (1853)).

57. *Id.* at 9.

58. *Id.* at 21–22.

59. *Id.* at 22; *see, e.g.*, *Golight, Inc. v. Wal-Mart Stores, Inc.*, 355 F.3d 1327, 1338 (Fed. Cir. 2008) (finding that a \$31.80 per unit reasonable royalty was not unreasonable, even though the infringer expected to profit only \$8.00 per unit).

embodied in the tenth and the thirteenth *Georgia-Pacific* factors, the other factors do not require apportionment.⁶⁰

Another reason for the decline in apportionment is greater acceptance of the “entire market value” rule.⁶¹ A patentee who argues for entire market value seeks all profits from an embodying device.⁶² But despite their acceptance in theory of entire market value, courts have placed limits on its use, allowing patentees to win heightened damages under the rule only when the infringing patent is the “basis for customer demand” for the embodying device or “substantially create[s] the value of the component parts” in the embodying device.⁶³ This creates a significant hurdle for patentees wishing to use the rule as a basis for damages. For example, if a computer contains a microprocessor that infringes a patent, the patentee would try to argue that since the inclusion of the infringing microprocessors substantially drove sales of computers, then the “entire market value” rule should apply. The rule would then take the appropriate royalty base to be not just the additional revenue generated by inclusion of the component, but rather *all* the revenue generated by the sale of the whole computer system.⁶⁴ Critics of the entire market value rule have noted that it has been liberally applied⁶⁵ and that it ignores the value of the other components in an infringing device.⁶⁶

Despite the decline in use, apportionment has again become a highly visible issue.⁶⁷ In 2007, both houses of Congress considered patent reform bills that required apportionment amongst other patent law reforms.⁶⁸ These bills would have required that awards be apportioned “only to that economic value properly attributable to the patent’s specific contribution over the prior art.”⁶⁹ However, the successful 2011 patent reform act, the Leahy-Smith

60. *See Georgia-Pac. Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970).

61. Bensen & White, *supra* note 25, at 2, 18–19; *see, e.g.*, *State Indus., Inc. v. Mor-Flo Indus., Inc.*, 883 F.2d 1573, 1580 (Fed. Cir. 1989) (upholding the trial court’s decision to allow a patentee to seek all profits associated with sales of heaters, where the infringing patent only covered foam included inside heaters).

62. *See Rite-Hite Corp. v. Kelley Co., Inc.*, 56 F.3d 1538, 1549 (Fed. Cir. 1995).

63. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011) (quoting *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1336 (Fed. Cir. 2009); *Rite-Hite*, 56 F.3d at 1549–50)).

64. *See Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279 (N.D.N.Y. 2009).

65. Landers, *supra* note 18, at 357–59.

66. Lemley, *supra* note 18, at 662–63.

67. *See Chris Marchese & Olga May, Runaway Patent Damages Awards: Is Statutory Reform on the Way?*, L.A. DAILY J., Aug. 13, 2010, at 7.

68. S. 1145 § 4, 110th Cong. (2007); H.R. 1908 § 5, 110th Cong. (2007).

69. S. 1145 § 4, 110th Cong. (2007); H.R. 1908 § 5, 110th Cong. (2007).

America Invents Act of 2011, does not include an apportionment requirement.⁷⁰

c) The 25 Percent Rule of Thumb: The Intersection of Apportionment and Reasonable Royalty

Ignoring apportionment, courts prior to the *Uniloc* decision had created and applied the so-called “25 percent rule of thumb.” *Uniloc* has since struck down the rule as an impermissible method of determining the reasonable royalty, but it is still important to understand how the method works given the history of its application and the reason why *Uniloc* ultimately struck it down. This 25 percent rule provided that the profits from the royalty base should, regardless of the nature or importance of the patent, be distributed 25 percent to the patent owner and 75 percent to the creator of the embodying product.⁷¹ This 25-percent-of-the-profit amount would be divided by the total revenue in order to generate a royalty rate.⁷² In other words, the 25 percent rule of thumb was a shorthand method for generating a royalty rate in a reasonable royalty calculation.⁷³ Expressed algebraically, the 25 percent rule of thumb calculates the royalty as follows:

$$\text{RoyaltyRate} = (0.25 \times (\text{ProfitMargin} \times \text{RoyaltyBase})) \div \text{TotalRevenue}$$

But why 25 percent? Why not diminish the profit base to 10 percent or increase it to 50 percent? The answer is historical. Robert Goldscheider invented the rule of thumb and settled on 25 percent while working as an attorney in Switzerland in 1959.⁷⁴ Goldscheider, who at the time helped negotiate licensing agreements for large technology companies, “noticed a pattern between the 5% royalty rate paid by each of the licensees and their respective pre-tax profitability rates. Such profitability was approximately 20% in each case.”⁷⁵ Based on this, he concluded “that 5% was a healthy royalty rate, and [he] was interested to note that it usually constituted about 25% of the profitability ultimately achieved by the various licensees.”⁷⁶

70. Leahy-Smith America Invents Act of 2011, Pub. L. No. 112-29, 125 Stat. 284 (codified as amended in scattered sections of 35 U.S.C.).

71. *See Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1313 (Fed. Cir. 2011).

72. *See id.* at 1312–13 (citing Robert Goldscheider et al., *Use Of the 25 Per Cent Rule in Valuing IP*, 37 LES NOUVELLES 123, 123 (Dec. 2002)).

73. *Id.*

74. Robert Goldscheider, *The Classic 25 Rule and the Art of Intellectual Property Licensing*, 6 DUKE L. & TECH. REV. 1, 7–10 (2011).

75. *Id.* at 9.

76. *Id.*

Although courts had tacitly accepted the 25 percent rule of thumb for determining a royalty rate, even prior to *Uniloc*, the rule was not without its critics.⁷⁷ They argued that (1) the rule ignores apportionment principles and the role of the patent in the embodying product;⁷⁸ (2) it ignores the identities and bargaining strengths of each party;⁷⁹ and (3) it ignores the reality of how negotiations actually occur.⁸⁰ In part to address these concerns, the Federal Circuit, when it decided *Uniloc*, increased its scrutiny of damages awards, rejected the 25 percent rule of thumb, and set the stage for a new method of determining the reasonable royalty.

II. SHARPENING THE SWORD: *UNILOC* AND THE LAW

In 2009, perhaps motivated by the failure of Congress to pass patent reform or by the threat of Congress passing wide-reaching patent reform, the Federal Circuit began to closely scrutinize damage awards in patent cases.⁸¹ The Federal Circuit's scrutiny focused on (1) maintaining apportionment to ensure that any reasonable royalty fits the economics of a transaction and the harm caused by infringement; and (2) choosing the most appropriate method to arrive at a royalty rate. The most recent product of this scrutiny is the court's rejection of the 25 percent rule of thumb in the *Uniloc* case.⁸²

A. CASE LAW SINCE 2009 REQUIRES AN APPORTIONED ROYALTY BASE

One of the first cases to take on the charge of apportionment, *Cornell University v. Hewlett-Packard Co.*, then Circuit Judge Rader, sitting by designation, held, in a 2009 judgment as a matter of law ("JMOL") motion, that the royalty base claimed by the plaintiff and based on sales of an infringing microprocessor, was incorrectly calculated because it failed to apportion the royalty base correctly.⁸³ The microprocessor at issue included a subcomponent that infringed a method patent.⁸⁴ This method patent covered the ordering of calculations within a microprocessor.⁸⁵ Because there was no

77. See *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1313 (Fed. Cir. 2011).

78. *Id.*

79. *Id.*

80. *Id.* at 1313–14.

81. See Roy Epstein & Paul Malherbe, *Reasonable Royalty Patent Infringement Damages After Uniloc*, AIPLA QUARTERLY, Winter 2011, at 4–7.

82. *Uniloc*, 632 F.3d at 1320.

83. 609 F. Supp. 2d 279, 283.

84. *Id.*

85. Specifically, the patent covered "multiple and out-of-order computer processor instructions in a single machine clock cycle. This technique employs a dispatch stack and

retail market for the sub-component, it could not be priced, and thus made a poor royalty base.⁸⁶ Faced with this dilemma, Judge Rader held that the correct royalty base was the “smallest salable infringing unit with close relation to the claimed invention—namely the [micro]processor itself.”⁸⁷ Yet the patentee had not selected the smallest salable unit, the microprocessor, as its royalty base. Instead, the patentee had selected a motherboard that included the microprocessor as its royalty base.⁸⁸ The patentee argued to no avail that the overestimation of the royalty base could be offset by a lower royalty rate.⁸⁹ Judge Rader flatly rejected this logic, stating that “[t]his argument rings hollow as a threshold matter” and “is legally incorrect.”⁹⁰

A few months later, the Federal Circuit also underscored the importance of apportioning the royalty base in *Lucent Technologies, Inc. v. Gateway, Inc.*⁹¹ In *Lucent*, then Chief Judge Michel, writing for a unanimous court, rejected a reasonable royalty jury award of \$357,693,056.18 because the award was not supported by “substantial evidence.”⁹² The over a third of a billion dollar reasonable royalty award was the result of a hypothetical negotiation, over a patent that covered a “date picker” computer algorithm.⁹³ Microsoft’s Outlook, Money, and Windows Mobile products were found to infringe this

precedence count memory. By achieving multiple and out-of-order processing, this invention enhances the throughput of processors with multiple functional units.” *Id.*

86. *See id.*

87. *Id.* at 288.

88. *Id.* at 287. Here, the patentee was seeking the largest possible royalty base: the entire market value. The entire market value allows for the recovery of the value of the whole embodying product if the infringing component meets the following requirements:

- (1) the infringing components must be the basis for customer demand for the entire machine including the parts beyond the claimed invention;
- (2) the individual infringing and non-infringing components must be sold together so that they constitute a functional unit or are parts of a complete machine or single assembly of parts; and
- (3) the individual infringing and non-infringing components must be analogous to a single functioning unit.

Id. at 286 (citation omitted).

89. *Id.* at 289.

90. *Id.*

91. 580 F.3d 1301 (Fed. Cir. 2009).

92. *Id.* at 1335.

93. *See id.* at 1308, 1338. A date picker allows a computer user to select a date by clicking on its visual representation in a calendar. *Id.* at 1317 (“[A date picker] displays a monthly calendar as a grid of numbered dates, along with graphical controls that allow the user to scroll to adjacent months or skip directly to a different month and year. Once the user defines a date with the tool, the software enters the numerical day, month, and year into the corresponding field in the appointment form.”).

patent because they incorporated a virtual calendar that incorporated a date picker.⁹⁴ The patentee originally claimed that the appropriate royalty base was a computer with Microsoft's infringing software installed on it.⁹⁵ This royalty base was rejected as an unacceptable overestimation.⁹⁶ In attempt to better apportion the royalty base, the patentee proposed that Microsoft's Outlook, Money, and Windows Mobile were appropriate royalty bases.⁹⁷ However, the decrease in the royalty base was accompanied by an increase in the royalty rate that left the total reasonable royalty unaffected.⁹⁸ This unchanged reasonable royalty was legally unacceptable to the Federal Circuit.⁹⁹

At first blush, the legal threads of *Cornell* and *Lucent* seem to be parallel in holding that a royalty base must be narrowly apportioned, based on the "smallest salable infringing unit," and not over-estimated by using the full value of an infringing product when an infringing feature constitutes merely a small part of a complex piece of hardware or software. But closer examination of the two decisions reveals a problematic knot. In *Lucent*, Chief Judge Michel remarked that the royalty base could still be over-estimated "as long as the magnitude of the [royalty] rate is within an acceptable [decreased] range."¹⁰⁰ This is in stark contrast to then Circuit Judge Rader's holding in *Cornell*: that an increased royalty base could not offset an under-estimated royalty rate.¹⁰¹

94. *Id.* at 1317.

95. *Id.* at 1338.

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 1339. Here, the patentee was again seeking the largest possible royalty base, through the entire market value rule.

101. When asked in an interview about this apparent inconsistency, Judge Michel responded:

The *Lucent* opinion focused on what market values are available, and as I recall that case there was really no subassembly that had a market value so that the only accurate number that was available was the sales price of the total device times the number of sales of that device made. Now . . . in *Cornell* there seems to be a suggestion that you can't use an overall sales price of a device where the patent only covers only something less than the total device. But I think it depends on, number one, if there is any other number that's available that's provable and proven and, number two, it depends on whether there is a proper discounting that will commensurate with the value added by the part of the total product that is covered by the patent.

Paul C. Michel, Former C.J. Fed. Cir., Remarks at *Calculating Damages in a Post Uniloc World* Panel (Mar. 1, 2011).

To summarize, pre-*Uniloc* caselaw already insisted on a royalty base that is apportioned to the harm caused by infringement. In a complex system, such as a computer, this is accomplished by restricting the royalty base to the “smallest salable infringing unit.” But one question that remained was whether an overestimation in the royalty base can be offset by an appropriate reduction in the royalty rate.¹⁰²

B. CASE LAW SINCE 2009 HAS ALSO HEIGHTENED EVIDENCE REQUIREMENTS FOR DAMAGE CALCULATIONS

Numerous Federal Circuit cases since 2009 have emphasized the need for more specific and factual evidence in damage calculations.¹⁰³ In *Lucent*, in addition to rejecting the proposed royalty base, the Federal Circuit rejected some evidence used to calculate the reasonable royalty award.¹⁰⁴ In particular, the Federal Circuit noted that licensing agreements within the same industry, alone, would not suffice as comparable unless the relevant technologies were comparable.¹⁰⁵ Instead, a more nuanced and detailed analysis that looks at the individual components and financial structuring of a licensing agreement is required.¹⁰⁶

After *Lucent*, the Federal Circuit continued to increase the rigor of required damage analysis in *ResQNet.com, Inc. v. Lansa, Inc.*¹⁰⁷ and *Wordtech Systems, Inc v. Integrated Networks Solutions, Inc.*¹⁰⁸ In *ResQNet.com*, the Federal Circuit held that licensing agreements to provide “finished software products and source code, as well as services such as training, maintenance, marketing, and upgrades” had no “link” to a hypothetical negotiation concerning

102. Compare *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 289 (N.D.N.Y. 2009) (holding that an underestimated royalty rate is “legally incorrect”), with *Lucent*, 580 F.3d at 1339 (holding that an underestimated royalty rate is acceptable “as long as the magnitude of the [royalty] rate is within an acceptable [decreased] range”).

103. See, e.g., *Lucent*, 580 F.3d at 1335 (rejecting an award because the “jury’s damages award is not supported by substantial evidence, but is based mainly on speculation or guesswork”).

104. A number of different methods for calculating the reasonable royalty had been proposed at trial. See *id.* at 1323–40.

105. *Id.* at 1329 (“[A] lump-sum damages award cannot stand solely on evidence which amounts to little more than a recitation of royalty numbers, one of which is arguably in the ballpark of the jury’s award, particularly when it is doubtful that the technology of those license agreements is in any way similar to the technology being litigated here.”).

106. See *id.* at 1325–32. Accordingly, a licensing agreement that licenses a pool of patents is not indicative of the value of an individual patent that has little resemblance to any patent in the pool. See *id.* at 1328.

107. 594 F.3d 860 (Fed. Cir. 2010).

108. 609 F.3d 1308 (Fed. Cir. 2010).

software that controls a computer's user interface.¹⁰⁹ The court succinctly noted that for a comparable license to be relevant, any "technological and economic differences" must be accounted for.¹¹⁰ And in *Wordtech*, the Federal Circuit rejected a hypothetical royalty that was based, in part, on averaging the cost of two comparable licenses together.¹¹¹ Thus, prior to *Uniloc*, the Federal Circuit had already increased the evidentiary threshold required to prove damages.¹¹²

C. *UNILOC*: REJECTION OF THE 25 PERCENT RULE AND HEIGHTENED SCRUTINY OF THE ROYALTY RATE

Against this backdrop of increased scrutiny, *Uniloc's* rejection of the 25 percent rule of thumb is not surprising.¹¹³ In the *Uniloc* case, Microsoft was found to have infringed Uniloc's '216¹¹⁴ software registration patent with its Production Activation feature in Microsoft Windows and Microsoft Office.¹¹⁵ At issue before the Federal Circuit was the validity of a \$388 million reasonable royalty award that a jury had awarded the patentee, Uniloc, at trial.¹¹⁶ Defending this sum, Uniloc's expert witness determined from internal Microsoft documents that the value of the Product Activation feature was \$10 per copy of Microsoft Windows or Microsoft Office.¹¹⁷ Using the 25 percent rule of thumb, the expert concluded that Uniloc would retain 25 percent of this profit, or \$2.50 per Product Activation feature.¹¹⁸ \$2.50 represented 2.9 percent of the total revenue per sale of Microsoft Windows and Microsoft Office; in other words the royalty rate was 2.9 percent.¹¹⁹ Before continuing, the expert applied the *Georgia-Pacific* factors, found them to offset each other, and as a result, the factors did not change

109. *ResQNet.com*, 594 F.3d at 870.

110. *Id.* at 873.

111. *Wordtech*, 609 F.3d at 1322.

112. *See e.g.*, *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).

113. *See Landers, supra* note 18, at 333–34 (noting that while the rule of thumb did have supporters it faced significant criticism for being economically unsound).

114. U.S. Patent No. 5,490,216 (filed Sep. 21, 1993).

115. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1296–97 (Fed. Cir. 2011). Product Activation is likely familiar to many (frustrated) Microsoft Windows and Microsoft Office users. This feature required a user, after thirty days of use, to enter a twenty-five digit alphanumeric key. This key was distributed with either Microsoft Windows or Microsoft Office, but had a knack for easily being lost.

116. *Id.* at 1311.

117. *Id.*

118. *Id.*

119. *Id.*

the royalty rate.¹²⁰ The expert witness then concluded that the quantity of infringement was 225,978,721 or the number of new copies of Microsoft Windows and Office sold.¹²¹ Arguing that the entire market value rule applied, the expert witness found the total royalty base to be \$19.28 billion, or the total revenue of Microsoft Windows and Office.¹²² This is equivalent to \$85.13 per copy of Microsoft Windows or Office.¹²³ Uniloc's expert witness then calculated a reasonable royalty of \$564,946,803.¹²⁴ This figure can be expressed algebraically as:

$$\begin{aligned} \text{ReasonableRoyalty} &= (\text{RoyaltyBase} \times \text{RoyaltyRate}) \times \text{QuantityOfInfringement} \\ &= (85.31 \times .029) \times 225,978,721 \approx \$564,946,803. \end{aligned} \supseteq 125$$

Even though the jury awarded Uniloc less than the \$565 million its expert calculated, the Federal Circuit concluded that the jury award of \$388 million was based on the expert's faulty calculations.¹²⁶ Defendant Microsoft had unsuccessfully objected to the expert's testimony and use of the 25 percent rule of thumb in limine because of the *Daubert* case.¹²⁷ In *Daubert*, the Supreme Court held that a trial court could only admit expert testimony if the testimony was pertinent to the case at hand.¹²⁸ Specifically, the Supreme Court concluded that "[e]xpert testimony which does not relate to any issue in the case is not relevant and, ergo, non-helpful" and not admissible under Federal Rule of Evidence 702.¹²⁹ While *Daubert* focused on expert testimony that was scientific in nature,¹³⁰ the Court, in *Kumho Tire*, expanded the scope of its ruling to all expert testimony, not just scientific expert testimony.¹³¹ Following the jury award, Microsoft appealed the expert's use of the 25 percent rule of thumb as well as the jury's reasonable royalty award.¹³²

120. *Id.*

121. *Id.*

122. *Id.* at 1318.

123. Dividing 19,280,000,000 by 225,978,721 infringing units results in a per-unit royalty base of \$85.31.

124. *Uniloc*, 632 F.3d at 1311. This sum is greater than the amount awarded by the jury at trial.

125. *Id.* The product of 85.31, .029, and 225,978,721 is slightly less than 564,946,803. This is because of rounding in the per-unit base of 85.31 to two significant digits.

126. *Id.* at 1311 ("The jury here awarded Uniloc \$388 million, based on the testimony of Uniloc's expert, Dr. Gemini. Dr. Gemini opined that damages should be \$564,946,803.").

127. *Id.* at 1300.

128. *Daubert v. Merrell Dow Pharm.*, 509 U.S. 579, 589–91 (1993).

129. *Id.* at 591.

130. *Id.* at 582–84.

131. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 147–51 (1999).

132. *Id.*

Relying on this legal standard, the *Uniloc* court rejected the 25 percent rule of thumb.¹³³ The *Uniloc* court found that the rule of thumb's generalized calculation ignored the facts and issues that might shape the calculation of a royalty rate in a specific case.¹³⁴ The court unequivocally held that "as a matter of Federal Circuit law[,] . . . the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation."¹³⁵ Moreover, the court concluded that "[e]vidence relying on the 25 percent rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue."¹³⁶ Thus, the Federal Circuit concluded that Uniloc's expert testimony should have been excluded and the jury award, based on this testimony, nullified.¹³⁷

Equally relevant, the Federal Circuit rejected the use of the entire market value in the *Uniloc* case and held that an overestimated royalty base could not be offset by an appropriately decreased royalty rate. The *Uniloc* court noted that an overestimated royalty base could not be corrected for "simply by asserting a low enough royalty rate."¹³⁸ In other words, Chief Judge Rader's *Cornell* analysis trumped Chief Judge Michel's *Lucent* analysis.¹³⁹

III. WIELDING THE SWORD: CALCULATING DAMAGES AFTER *UNILOC*

When the *Uniloc* court definitively struck down the 25 percent rule of thumb, it failed to provide guidance on what metrics should replace it.¹⁴⁰ The only insight provided was that "there must be a basis in fact to associate the royalty rates used in prior licenses to the particular hypothetical negotiation at issue in the case."¹⁴¹ However, this guidance has hardly been enough; uncertainty in how to calculate a royalty rate coupled with required

133. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1315 (Fed. Cir. 2011).

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 1317–18.

138. *Id.* at 1320.

139. *Compare id.*, with *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1339 (Fed. Cir. 2009) (holding that an underestimated royalty rate is acceptable "as long as the magnitude of the [royalty] rate is within an acceptable [decreased] range").

140. Despite the Federal Circuit's unequivocal language, some courts may still be utilizing the rule of thumb. See *Is "The 25 Percent Rule" Still Alive After Uniloc?*, PATENT LAWYER BLOG (Sep. 27, 2011), <http://patentlaw.jmbm.com/2011/09/is-the-25-percent-rule-still-a.html>.

141. *Uniloc*, 632 F.3d at 1317.

apportioning of the royalty base and stricter evidentiary standards for damages has caused trial courts to struggle in calculating reasonable royalties.¹⁴²

This Note argues that one way to cut through this uncertainty, and determine a reasonable royalty that satisfies the increased scrutiny of *Uniloc* and its predecessors, is to follow the four-step method the *Lucent* case (“*Lucent II*”) used on remand.¹⁴³ The method proceeds in four steps: (1) correctly apportion the royalty base by finding the appropriate “smallest salable unit;” (2) determine the profit margin on that base; (3) multiply the profit margin by the number of affected units to find a ceiling on a reasonable royalty award; and (4) divide the ceiling between the patentee and the infringer according to a profit division factor based on business realities and other negotiating factors. The amount divided to the patentee is the reasonable royalty. Or expressed algebraically:

$$\text{ReasonableRoyalty} = (\text{ApportionedRoyaltyBase} \times \text{ProfitMargin}) \times \text{NumberOfAffectedUnits} \times \text{ProfitDivisonFactor}$$

This Part outlines the *Lucent II* court’s method for calculating a reasonable royalty and articulates why this method is a practical and effective means of cleaving the knotted question of calculating damages and is likely to withstand *Uniloc* scrutiny.

A. STEP ONE: CORRECTLY APPORTION THE ROYALTY BASE

Uniloc and its predecessors demand that any calculation of damages include a correctly apportioned royalty base.¹⁴⁴ *Uniloc*’s implicit endorsement of Chief Judge Rader’s methodology in *Cornell* indicates that when there is no direct market for the infringing subcomponent, the appropriate royalty base

142. See, e.g., *Lucent II*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *1 (S.D. Cal. Nov. 10 2011). (“This case illustrates the difficulty of properly valuing a small patented component, without a stand-alone market, within a larger program.”); see also Thomas Cotter, *Four Principles for Calculating Reasonable Royalties in Patent Infringement Litigation*, 27 SANTA CLARA COMPUTER & HIGH TECH L.J. (forthcoming 2011) (“Whether cases such as *Lucent* and *Uniloc* will stem the calls for legislative reform—and whether future Federal Circuit panels will adhere to the economic logic of these decisions—nevertheless remains to be seen.”).

143. See *Lucent II*, 2011 WL 5513225. As of December 2011, this ruling is being appealed to the Federal Circuit. However, shortly after being filed, the appeal was dismissed. *Lucent Techs., Inc. v. Microsoft Corp. (Lucent III)*, No. 2012-1081, 2012 WL 762996 (Fed. Cir. Jan. 18, 2012).

144. See, e.g., *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1320 (Fed. Cir. 2011); *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 289 (N.D.N.Y. 2009).

is the smallest salable unit that includes the infringing subcomponent.¹⁴⁵ *Cornell's* and *Uniloc's* prohibition on over-estimation of the royalty base emphasizes the significance of a correctly apportioned royalty base.¹⁴⁶

Correctly apportioning the royalty base is key to determining a correct royalty rate and reasonable royalty award. The royalty base affects both the royalty rate and the overall reasonable royalty because it determines what is being bargained for.¹⁴⁷ For example, the royalty rate on which two negotiating entities eventually agree when licensing a whole computer (the computer being the royalty base) might be significantly less than the royalty rate when licensing a computer microprocessor (the chip being the royalty base) because of greater competition in the computer market than in the microprocessor market.¹⁴⁸ Making the correct determination at this stage is critical because selection of the royalty base affects the application of several of the *Georgia-Pacific* factors, which are in turn used to adjust royalty rates.¹⁴⁹ Finally, since a reasonable royalty is the product of a royalty base and a royalty rate, the more accurate the royalty base, the more accurate the product, the reasonable royalty.¹⁵⁰

The *Lucent II* court's analysis focuses much of its attention on apportioning the correct royalty base. Recall, the *Lucent* case centered on a date picker patent and was remanded for a new trial on damages.¹⁵¹ At the conclusion of the new damages trial, the jury awarded the patentee \$70 million for infringement of the date picker algorithm in Microsoft Outlook.¹⁵² In her post jury-award JMOL analysis, District Judge Marilyn Huff focused her apportionment analysis on determining the value of the smallest salable unit, which was Microsoft Outlook.¹⁵³

In an attempt to accurately apportion the value of the royalty base, Judge Huff laboriously estimated the revenue generated by Microsoft Outlook. This was not an easy task because Microsoft usually sells Outlook as part of its Office suite—only a quarter of a million stand-alone copies of Microsoft

145. See *Cornell*, 609 F.Supp.2d at 288. It should be noted that the smallest salable unit itself could be an overestimation of the royalty base.

146. *Id.*; *Uniloc*, 632 F.3d at 1320.

147. See *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1338 (Fed. Cir. 2009).

148. See *id.* at 1332–35.

149. See *id.* (specifically, factors eight, eleven, twelve, and thirteen).

150. See Landers, *supra* note 18, at 323–24.

151. *Lucent*, 580 F.3d at 1340.

152. See *Lucent II*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *1 (S.D. Cal. Nov. 10, 2011). While Microsoft Money and Windows Mobile also infringed on the date picker algorithm, “the vast majority of the claimed damages” focused on Microsoft Office.” *Id.*

153. See *id.*

Outlook were sold, compared with over 100 million copies of Microsoft Outlook sold as part of Microsoft Office.¹⁵⁴ The patentee tried to argue that each sale of Microsoft Office generated \$67 of revenue from Microsoft Outlook,¹⁵⁵ while Microsoft argued that each sale of Office generated only \$13.45 in revenues attributable to Outlook.¹⁵⁶ The court rejected the plaintiff's apportionment scheme, reasoning that it unrealistically valued the other Microsoft Office programs—Word, Excel, and PowerPoint—at only \$31.¹⁵⁷ The court similarly rejected Microsoft's apportionment scheme as undervaluing Microsoft Outlook.¹⁵⁸ Ultimately, the Court found that the appropriately apportioned royalty base was \$24.55, or approximately a quarter of Microsoft Office's revenue.¹⁵⁹

The level of detail *Lucent II* exhibited in determining the royalty base underscores the necessity of apportionment. Recall, at the first trial, the patentee had argued that the correct royalty base was a computer loaded with Microsoft's software.¹⁶⁰ Now, even though Microsoft Outlook was rarely sold without Microsoft Office, there was no disagreement that it was the smallest salable unit and the appropriate royalty base; rather the disagreement in *Lucent II* was only over the value of Microsoft Outlook.¹⁶¹

Thus the first step in generating an accurate reasonable royalty is to generate an accurate royalty base.¹⁶² Apportionment is crucial; only the revenue associated with the smallest salable unit that contains the infringing

154. *Id.* at *4, *9. 241,800 stand-alone copies of Microsoft Outlook were sold. 109.5 million copies of Microsoft Outlook were sold with Microsoft Office. *Id.* at *1.

155. *Id.* at *5 (“[Patentee’s damages expert] testified that his use of \$67 as the value for Outlook sold as part of Office was corroborated by a 2010 Microsoft pricing document. The internal document showed that the difference in retail prices between Office with Outlook (\$279.99) and Office without Outlook (\$149.99) was \$130, roughly the retail price of stand-alone Outlook at that time (\$139.99).”).

156. *Id.* at *10.

157. *Id.* at *11.

158. *Id.* at *11.

159. *Id.* (“The Court concludes that the evidence supports, at most, allocating 25% of the Office revenue to Outlook, representing one-fourth of Office products—Outlook, Word, Excel, and PowerPoint. This allocation yields a per-unit revenue attributable to Outlook within Office of \$24.55 by multiplying the \$98.19 per unit revenue of Outlook by 25%.”).

160. *See* *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1338 (Fed. Cir. 2009).

161. *See* *Lucent II*, 2011 WL 5513225, at *4–6.

162. *See, e.g.*, *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 288 (N.D.N.Y. 2009).

product may be considered.¹⁶³ Significant evidence will be required to demonstrate this revenue stream.¹⁶⁴

B. STEP TWO: DETERMINE THE PROFIT-ADJUSTED ROYALTY BASE

The next step is to determine what amount of the total revenue associated with the royalty base is profit.¹⁶⁵ This is determined by adjusting the royalty base by the appropriate profit margin:¹⁶⁶

$$\text{ProfitAdjustedRoyaltyBase} = \text{ApporitionedRoyaltyBase} \times \text{ProfitMargin}$$

Evidence of the infringer's profit margin should be readily discoverable. Since the royalty base is based on a salable unit, internal corporate documents likely exist as to the profitability of the unit. In both *Uniloc* and *Lucent II* such internal documents revealed those profit margins.¹⁶⁷

There are a number of factors to consider in calculating profit margins. Depending on the nature of the infringement, profit margins increase.¹⁶⁸ This may occur if infringement leads to an increase in profits¹⁶⁹ or decrease in costs¹⁷⁰ for the infringer. Federal Circuit law indicates that a patentee can recover these internal savings or profits even if there are no additional sales.¹⁷¹ To compensate for these savings, the profit margin rate should be appropriately adjusted. However, in instances where infringement affects

163. *Id.*

164. *See, e.g., Lucent II*, 2011 WL 5513225, at *10–11.

165. *Id.* at *5.

166. While Federal Circuit law does not cap reasonable royalty awards at the profits derived from infringement, post *Uniloc*, it is still appropriate to reduce the royalty base by the profit margin. *See id.* at *5. *Golight, Inc. v. Wal-Mart Stores, Inc.* holds that a reasonable royalty award can be in excess of the profits derived from the infringing product. 355 F.3d 1327, 1338 (Fed. Cir. 2004). But recall, the 25 percent rule of thumb divided *profits* not revenue. Goldscheider, *supra* note 74, at 7–10. Given the Federal Circuit's emphasis on apportionment and accurately calculating damages, it seems unlikely that a replacement for the 25 percent rule of thumb would expand liability beyond profits derived from infringement. Moreover, this Note is only proposing *one* valid method for calculating a reasonable royalty post *Uniloc*. Other valid methods might well include calculations in excess of profit.

167. *See Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1311 (Fed. Cir. 2011) (showing that the royalty base had already been adjusted by the profit margin); *Lucent II*, 2011 WL 5513225, at *5.

168. *See, e.g., Uniloc*, 632 F.3d at 1311.

169. *See id.*

170. *See, e.g., Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1080 (Fed. Cir. 1983).

171. *See id.* at 1080 (holding that here decreased manufacture costs due to infringement were cause for a reasonable royalty, even though infringement did not lead to more total sales).

sales and does not affect internal costs, the profit margin should not be adjusted and instead should remain at the regular profit margin for the royalty base.¹⁷²

Once a profit margin is determined, the apportioned royalty base should be multiplied by the profit margin to produce the profits associated with the royalty base or the profits adjusted royalty base. Thus in *Lucent II*, the court adjusted the \$24.55 royalty base by a 76.2 percent profit margin.¹⁷³ The profit-adjusted royalty base was therefore \$18.71.¹⁷⁴

C. STEP THREE: DETERMINE THE TOTAL PROFIT-ADJUSTED ROYALTY BASE

The next step is to multiply the profit-adjusted royalty base by the number of affected units to determine the total profit-adjusted royalty base. This calculation takes a per-salable-unit metric, the profit-adjusted royalty base, and multiplies it by the total number of affected units:

$$\text{TotalProfitAdjustedRoyaltyBase} = \text{ProfitAdjustedRoyaltyBase} \times \text{NumberOfAffectedUnits}$$

However, two questions arise from this equation. First, what is the appropriate method for measuring the number of affected units? Second, why should the calculation reflect the number of affected units instead of the total number of infringing units?

1. *How To Measure the Number of Affected Units*

Because of the different ways that infringement can change the economics of a product sale, there are two ways to measure the number of affected units. Infringement may either increase demand for the infringing product, or it may change the infringer's costs or profits of selling the product with the infringing feature.¹⁷⁵ For example, infringement in *Lucent II* increased the sales of Microsoft's Outlook. Meanwhile infringement in *Uniloc* drove no additional sales, but added ten dollars in value to each sale of Microsoft Windows and Microsoft Office by reducing the ease of making

172. See *Lucent II*, 2011 WL 5513225, at *5 (stating that here infringement only increased sales, thus the profit margin used was not adjusted).

173. *Id.*

174. The *Lucent II* court actually reduced the base at a later stage. By the associative property of multiplication, where the reduction occurs does not affect the final result. For simplicity's sake, the reduction is made in the second step. See *id.* at *11–12.

175. Compare *id.* at *4, with *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1296–97 (Fed. Cir. 2011).

illicit copies.¹⁷⁶ These scenarios require different analysis of the number of affected units.

a) Measuring the Number of Affected Units when Infringement Increases Demand

When infringement increases demand of an infringing unit, a useful tool to measure that demand is a consumer survey.¹⁷⁷ Consumer surveys are widely used in other fields of intellectual property litigation, especially trademark disputes, where surveys of consumers' perceptions are routine in proving secondary meaning.¹⁷⁸ In the patent context, courts have consistently used surveys in determining whether consumer demand supports the use of the entire market value rule. In fact, surveys are so crucial to proving consumer demand that in *Cornell*, the lack of a survey measuring demand caused then Judge Raider, sitting by designation, to reject the use of the entire market value.¹⁷⁹ Moreover, in *i4i Ltd. Partnership v. Microsoft Corp.*, the Federal Circuit held that a consumer survey measuring consumer demand via usage studies was admissible under *Daubert*.¹⁸⁰

However, survey authors must be sure to write surveys that illuminate consumer demand, not preference. In *Fractus S.A. v. Samsung Electronics Co., Ltd.*, a patentee commissioned two surveys to determine the consumer value of a cellular telephone antenna.¹⁸¹ The patentee claimed that the antenna on the defendant's cellular telephones violated its patented multi-band, internal antenna technology.¹⁸² The two consumer surveys concluded "that over 90% of respondents prefer an internal cell phone antenna versus an external antenna" and that "an internal antenna contributes between \$16.02 and \$29.96 to the value of a cell phone."¹⁸³ However, this information was

176. *Uniloc*, 632 F.3d at 1296–97.

177. See, e.g., *Lucent II*, 2011 WL 5513225, at *5.

178. See, e.g., *Zatarains, Inc. v. Oak Grove Smokehouse, Inc.*, 698 F.2d 786, 795 (5th Cir. 1983) ("The authorities are in agreement that survey evidence is the most direct and persuasive way of establishing secondary meaning.").

179. *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 288 (N.D.N.Y. 2009) ("Cornell did not offer a single demand curve or any market evidence indicating that Cornell's invention drove demand for bricks. The absence of such evidence is unavoidable when hypothetical revenues unrelated to actual product sales form the foundation of a royalty base proffer. Reliance on hypothetical sales or estimated revenues is entirely permissible in connection with a reasonable royalty analysis.").

180. *i4i Ltd. P'ship v. Microsoft Corp.*, 598 F.3d 831, 855–56 (Fed. Cir. 2010) *cert. granted*, 131 S. Ct. 647, (2010) *aff'd*, 131 S. Ct. 2238 (2011).

181. No. 6:09-CV-203-LED-JDL, slip op. at 1–3 (E.D. Tex. Apr. 29, 2011).

182. *Id.* at 2.

183. *Id.* at 1–2.

excluded from trial because the surveys measured consumer preference, not demand.¹⁸⁴

Following this trend, the patentee in *Lucent II* created a consumer survey that accurately measured the demand created by the inclusion of the infringing date picker in Microsoft Outlook. Specifically, the patentee's survey revealed that 7 percent of all purchasers who used the date picker feature would not have purchased Microsoft Outlook if it did not contain a date picker feature.¹⁸⁵ This 7 percent rate was multiplied by 43 percent, or the percentage of Microsoft Outlook users who revealed in the survey that they used the date picker feature.¹⁸⁶ The result was a 3 percent rate, which represented the number of additional sales generated by the inclusion of the date picker.¹⁸⁷ A 3 percent rate of additional sales resulted in 3.3 million more sales of Microsoft Outlook.¹⁸⁸

But surveys are not the only way to measure demand. Any accurate, based in fact, measurement of demand will suffice.¹⁸⁹ The requirement of any instrument, survey or not, is that it measures the demand caused by infringement.

b) Measuring the Number of Affected Units when Infringement Changes Cost Structures

Infringement does not always drive demand. Instead it can change cost structures by increasing profits¹⁹⁰ or decreasing costs of all units sold.¹⁹¹ In these scenarios, the number of affected units is the total number of infringing units.¹⁹² This makes intuitive sense because a change in cost structure affects *all* units.

Regardless of how the number of affected units is measured, in step three, the number of affected units should be multiplied by the profit-

184. *See id.*

185. *Lucent II*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *4–5 (S.D. Cal. Nov. 10 2011).

186. *Id.*

187. *Id.*

188. *Id.*

189. *See* *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 288 (N.D.N.Y. 2009).

190. *See, e.g., Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1311 (Fed. Cir. 2011) (finding that infringement caused Microsoft Windows to be more profitable).

191. *See, e.g., Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1080 (Fed. Cir. 1983) (finding that infringement caused decrease in cost).

192. *See generally Uniloc*, 632 F.3d at 1292 (finding that the size of the royalty base was the total of all sales of Microsoft Windows and Microsoft Office—225,978,721 units).

adjusted royalty base, derived in step two, to generate a measure of the total profit-adjusted royalty base. In *Lucent II*, the court multiplied the \$18.71 profit-adjusted royalty base by 3.3 million, which resulted in a \$52.6 million total profit-adjusted royalty base—after being reduced for foregone profits.¹⁹³ A total profit-adjusted royalty base, such as the \$52.6 million in *Lucent II*, represents a ceiling on a reasonable royalty award.¹⁹⁴

2. *Why Examining the Number of Affected Units, Instead of the Total Number of Infringing Units, is Appropriate*

The court in *Lucent II* based its damages calculations on the number of sales motivated by infringement—not the total number of infringing units.¹⁹⁵ Specifically, the court determined that there were 3,300,000 additional sales because of the infringement¹⁹⁶ and based its damages calculations on this number, not on the total 109,500,00 copies of Microsoft Outlook that nonetheless included infringing source code.¹⁹⁷ This means that Microsoft was penalized zero dollars for violating the date picker patent on 106,200,000 million copies of Microsoft Outlook. This result seems at odds with the black letter law “that whoever without authority makes, uses, offers to sell, or sells any patented invention . . . infringes a patent.”¹⁹⁸

But inspection of case law suggests this limitation is not abnormal. First, Chief Judge Rader’s definition of royalty base in *Cornell* limits the royalty base to the “revenue pool implicated by the infringement.”¹⁹⁹ Sales unaffected by infringement do not affect or implicate revenue. Second, rejection of entire market value analysis in *Cornell*, *Lucent*, and *Uniloc* suggest a sustained effort to award damages commensurate to the harm caused by infringement.²⁰⁰ Third, limiting damages calculations to the number of affected units is consistent with the historical trend of apportionment detailed in *Livingston v. Woodworth* and *Seymour v. McCormick*, which limits damages to “actual gains and profits” associated with the infringement.²⁰¹

193. See *Lucent II*, 2011 WL 5513225, at *4–5, *11–12.

194. *Id.* at *11–12.

195. See *id.* at *4.

196. *Id.*

197. See *id.*

198. 35 U.S.C. § 271(a) (2006) (emphasis added).

199. *Cornell Univ. v. Hewlett-Packard Co.*, 609 F. Supp. 2d 279, 286 (N.D.N.Y. 2009).

200. See *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1320 (Fed. Cir. 2011); *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1338 (Fed. Cir. 2009); *Cornell*, 609 F. Supp. 2d at 289.

201. *Livingston v. Woodworth*, 56 U.S. 546, 559 (1853); *Seymour v. McCormick*, 57 U.S. 480 (1853).

D. STEP FOUR: DIVIDE THE TOTAL ADJUSTED ROYALTY BASE
AMONGST THE PARTIES

The final step in calculating an appropriate reasonable royalty is to analyze the hypothetical negotiation in order to divide the total profit-adjusted royalty base among the parties. Given the nature of negotiation, it is unlikely that negotiation factors such as the identities and bargaining strengths of each party can ever be reduced to a formula or heuristic.²⁰² Therefore, proper division of the total profit-adjusted royalty base likely requires the use of expert testimony analyzing the bargaining positions and strengths of each party in a hypothetical negotiation.²⁰³

Because the total profit-adjusted royalty base represents a ceiling on the possible damages award, the defendant in *Lucent II* at most faced \$52.6 million damage award.²⁰⁴ Compare this with the initial district court award of \$357 million.²⁰⁵ Careful apportionment and calculation of the royalty base, as described in steps one through three, *supra*, capped the damages associated with the maximum royalty rate at a dollar figure nearly *one-seventh* the previous amount.²⁰⁶ Also striking is that using the method described greatly reduces the need to rely on expert witness testimony because it focuses on verifiable metrics rather than making subjective assertions about comparable licensing agreements.

While expert testimony is likely to vary from case to case under the method described, expert witnesses will likely focus on the negotiation forces between the two parties rather than drawing tenuous comparisons with existing comparable agreements. For example, in *Lucent II* the court allowed the patentee to offer an expert witness testifying to the “business realities” of a hypothetical negotiation and focusing on the “parties’ various interests and alternatives to reaching an agreement.”²⁰⁷ The defendant similarly offered an expert witness who roughly used the same interests and alternatives

202. *See Uniloc*, 632 F.3d at 1313 (noting criticisms of the 25 percent rule of thumb formula).

203. *See Cotter*, *supra* note 142 (“One way out of this dilemma would be for courts to permit an expert witness to testify (where appropriate) concerning the amount the willing licensee would have paid, based in part on the expert’s analysis of the existence and strength of other patents potentially reading on the end product.”).

204. *Lucent II*, No. 07-CV-02000-H (CAB), 2011 WL 5513225, at *11–12 (S.D. Cal. Nov. 10 2011).

205. *Lucent*, 580 F.3d at 1308.

206. *Lucent II*, 2011 WL 5513225, at *11–12 (the final award was \$26.3 million).

207. *Id.* at *6.

paradigm.²⁰⁸ Yet, the two experts reached vastly different conclusions. Persuaded by neither expert, the judge seemingly split the difference, awarding half of the total profit-adjusted royalty base, \$26.3 million, to the patentee.²⁰⁹ Splitting the difference or awarding each side fifty percent of the total adjusted royalty is equivalent to a 0.5 profit division factor. Thus the equation:

$$\text{ReasonableRoyalty} = (\text{ApportionedRoyaltyBase} \times \text{ProfitMargin}) \times \text{NumberOfAffectedUnits} \times \text{ProfitDivisonFactor}$$

Simplifies to:

$$\begin{aligned} \text{ReasonableRoyalty} &\approx (\$24.55 \times .762) \times 3,300,000 \times 0.5^{210} \\ \text{ReasonableRoyalty} &\approx \$26,300,000 \end{aligned}$$

IV. CONCLUSION: CLEANING THE SWORD

Instead of cutting through the knot, *Uniloc* added yet another twist to calculating a reasonable royalty. Eliminating the 25 percent rule of thumb increases the difficulty of calculating a royalty rate.²¹¹ In turn, this makes calculating a reasonable royalty even more obtuse and less predictable.²¹² These limitations, along with the inherent technical intricacy of a complex system, make calculating a reasonable royalty a tightly wound problem.²¹³

This Note argues that a reasonable royalty award can be calculated in such a complex system by aggressively apportioning the royalty base to the smallest salable unit, under Judge Rader's guidance in *Cornell*.²¹⁴ An accurate royalty base limits a reasonable royalty award by providing a maximum bound on the award.²¹⁵ This bound can be quite significant: accurate apportioning in *Lucent II* reduced the maximum possible award from over

208. *Id.* at *6 n.4.

209. *See id.* at *11–12.

210. The product does not quite equal the reasonable royalty because forgone profits have not been deducted.

211. *See Lucent II*, 2011 WL 5513225, at *1.

212. *See supra* Section II.A.

213. *See, e.g., Lucent II*, 2011 WL 5513225, at *1 (“This case illustrates the difficulty of properly valuing a small patented component, without a stand-alone market, within a larger program.”).

214. *See supra* Section III.A.

215. *See supra* Section III.C.

\$350 million to just over \$50 million.²¹⁶ Effectively, this bound limits the impact of expert testimony on how profits should be shared between the patentee and the infringer; regardless of how persuasive an expert witness is, a reasonable royalty will never exceed the apportioned royalty base.²¹⁷

Is this the only sword for cutting through the damages knot? Surely not.²¹⁸ Like the scores who tried to untangle or cut through the Gordian Knot, there will be many attempts to elegantly unravel patent damages. But this is a sharp and readily available method for cutting through the morass of patent damages.

216. Compare *Lucent II*, 2011 WL 5513225, at *10–11 (nearly \$50 million award), with *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1308 (Fed. Cir. 2009) (over \$350 million award).

217. See *Lucent II*, 2011 WL 5513225, at *10–11.

218. See Cotter, *supra* note 142 (“Whether cases such as *Lucent* and *Uniloc* will stem the calls for legislative reform—and whether future Federal Circuit panels will adhere to the economic logic of these decisions—nevertheless remains to be seen.”).

NON-PRACTICING COMPLAINANTS AT THE ITC: DOMESTIC INDUSTRY OR NOT?

Wei Wang[†]

A imports smartphones and tablet PCs into the United States. *B* holds intellectual property rights that cover those widgets, but *B* does not produce any widgets domestically. Should our patent law and international trade regime always, never, or sometimes allow *B* to stop importation of those widgets by *A*? This is the question facing the International Trade Commission (“ITC” or “Commission”) more and more often, as non-practicing complainants like *B* file for investigations by the Commission requesting that very remedy.¹ Moreover, in order to access the ITC forum, an IP owner must satisfy a threshold requirement of demonstrating the existence of a “domestic industry” in the United States.² And non-practicing IP owners now frequently assert “domestic industry” based on the “licensing” activity language in § 337(a)(3)(C) of the Tariff Act of 1930 (19 U.S.C. § 1337).³ In response, the Commission appears to have sought to heighten the requirements for establishing licensing-based domestic industry in its *Coaxial Cable*⁴ and *Multimedia Display*⁵ opinions. The Commission made notable refinements to its previous rules regarding (1) the use of prior litigation activity as evidence to establish domestic industry; (2) allocation of portfolio licensing investment to the patents in suit; and (3) treatment of royalty payments.⁶

Current ITC precedent requires that a non-practicing patent owner seeking to access the ITC based on licensing activity demonstrate that (1) it “has made a substantial investment in its licensing program and (2) there is a sufficient nexus between the patent at issue and the alleged domestic

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1. See discussion *infra* Section I.C.2.

2. E.g., Certain Coaxial Cable Connectors & Components Thereof (*Coaxial Cable*), USITC Inv. No. 337-TA-650, Commission Opinion at 37 (Apr. 14, 2010) (citing 19 U.S.C. § 1337(a)(2)).

3. See discussion *infra* Section I.C.

4. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion.

5. Certain Multimedia Display & Navigation Devices & Sys. (*Multimedia Display*), USITC Inv. No. 337-TA-694, Commission Opinion (Aug. 8, 2011).

6. See discussion *infra* Section III.

licensing industry.”⁷ The realities of licensing practice in technology-dominated industries, however, mean that meeting these seemingly innocuous requirements is anything but straightforward. For example, if *B*, in our example above, obtained a licensing agreement through settlement in a prior litigation with *C*, can the expenses associated with the litigation be used as evidence of a domestic industry when *B* files a complaint against *A*?⁸ Another complication relates to portfolio licensing practice: if the patents in suit belong to a portfolio, can the complainant use the licensing expenses directed towards the entire portfolio as evidence to demonstrate the existence of domestic industry of the asserted patents?⁹ Yet another issue concerns the Commission’s treatment of royalty payments: should the Commission treat royalty payments as a necessary condition to establish “substantial investment” in licensing?¹⁰ As shown in Sections III–IV, *infra*, in light of the rising number of complaints filed by non-practicing complainants asserting licensing-based domestic industry, the Commission sought to clarify and refine the rules governing these issues with its two latest decisions.

In *Coaxial Cable*, the Commission held that “patent infringement litigation activities taken alone” do not satisfy the domestic industry requirement and established the “clear link test,” which requires the showing of a “clear link” between prior litigation activity and licensing the patents in suit.¹¹

In *Multimedia Display*, the Commission held that if a complainant’s licensing activity is only partially related to licensing the patents in suit, as in the case of portfolio licensing, the Commission will require the complainant to show a strong nexus between the activity and licensing the asserted patents in the United States (“strong nexus test”).¹² As to royalty payments,

7. Certain Short-Wavelength Light Emitting Diodes (*Light Emitting Diodes II*), USITC Inv. 337-TA-640, Initial Determination at 5 (May 8, 2009).

8. See, e.g., Staff Petition for Review at 1, *Light Emitting Diodes II*, USITC Inv. No. 337-TA-640 (May 19, 2009) (granting the complainant’s motion for summary determination that a domestic industry existed based primarily on prior litigation expenses).

9. See, e.g., Certain Semiconductor Chips with Minimized Chip Package Size (*Semiconductor Chips II*), USITC Inv. No. 337-TA-630, Initial Determination at 7–8 (Sept. 16, 2008) (finding the existence of domestic industry based on licensing expenses of the entire patent portfolio that included the patents in suit).

10. See, e.g., Certain Stringed Musical Instruments (*Stringed Musical Instruments*), USITC Inv. No. 337-TA-586, Initial Determination on Violation at 19 (Dec. 3, 2007) (holding that complainant failed to establish domestic industry through licensing as the complainant’s licensing efforts had not resulted in any license agreement or royalty payment).

11. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 50–51 (Apr. 14, 2010).

12. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 8 (Aug. 8, 2011).

the Commission clarified that while “royalties received by a complainant can be circumstantial evidence that an investment was made, *they do not constitute the investment itself*,”¹³ an approach quite contrary to some of the Commission’s own precedents.¹⁴

Most notably, in *Multimedia Display*, the Commission distinguished between what it called production-driven licensing activity (activity that “encourages adoption and use of the patented technology to create new products and/or industries”)¹⁵ and revenue-driven licensing activity (activity that “takes advantage of the patent right solely to derive revenue by targeting existing production”).¹⁶ For the first time, the Commission held that “[a]lthough our statute requires us to consider all licensing activities, we give [the complainant’s] revenue-driven licensing activities *less weight*.”¹⁷

This Note analyzes how these latest changes to the domestic industry requirement will impact non-practicing complainants at the ITC. Part I gives a brief overview of ITC litigation and recounts the trend of the rising number of ITC complaints filed by non-practicing complainants based on licensing activity under § 337(a)(3)(C). Part II explores the characteristics of five common types of non-practicing complainants at the ITC: (1) research and development entities or “idea shops,” (2) independent inventors, (3) startups, (4) patent assertion entities (“PAEs”), and (5) practicing companies with an offensive patenting strategy. It will focus on these entities’ business practice related to “engineering, research and development, or licensing,”¹⁸ as well as litigation. Part III reviews the evolution and latest developments of the requirements for establishing domestic industry at the ITC based on licensing activity. Part IV then applies these latest developments to the various types of non-practicing complainants, finding that the “clear link” and “strong nexus” tests and the refinement to the treatment of royalty payments will affect different non-practicing complainants with varying degrees of impact. Part V evaluates the likely impact of these latest developments on non-practicing complainants; finds that not all of them are consistent with public policy; and proposes possible alternatives that hopefully are better aligned with public policy considerations. In particular, this Note concludes that the Commission should (1) develop a “pattern of licensing” test instead of requiring a “clear link,” (2) emphasize intrinsic

13. *Id.* at 24 (emphasis added).

14. *See* discussion *infra* Section III.D.

15. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 25 n.20.

16. *Id.*

17. *Id.* (emphasis added).

18. 19 U.S.C. § 1337(a)(3)(C) (2006).

technological characteristics of a patent portfolio in determining the existence of “strong nexus” between portfolio licensing expense and the patents in suit, (3) view royalty payments and cross-licenses as telling indicators of “substantial investment,” and (4) evaluate the production/revenue-driven dichotomy by focusing on the overall effect of a complainant’s licensing activities.

I. RISE IN ITC CASES BROUGHT BY NON-PRACTICING COMPLAINANTS

A. BRIEF OVERVIEW OF ITC LITIGATION

The ITC is an independent, quasi-judicial federal agency of the United States with trade expertise.¹⁹ It has the authority to issue remedies against certain “unfair trade practices,” such as patent infringement,²⁰ under § 337.²¹

Through an ITC investigation, intellectual property (“IP”) owners have an avenue outside of the federal court system to defend their exclusive rights and stop infringing imports from entering the United States.²² Parties involved in a § 337 investigation generally include: complainants, who file complaints at the ITC asking the Commission to initiate an investigation; respondents, who take the place of defendants in the federal courts; administrative law judges (“ALJs”),²³ who control the fact-finding trial phase of the investigation and issue an initial determination (“ID”); the Office of Unfair Import Investigations (“OUII”) and its staff attorneys,²⁴ who look out for the public interest as an unbiased third party,²⁵ and the six Commissioners, who upon the parties’ request for review, may vote to “review the ID and affirm, modify, set aside or remand it in whole or in

19. *About the USITC*, U.S. INT’L TRADE COMM’N, http://www.usitc.gov/press_room/about_usitc.htm (last visited Feb. 11, 2012).

20. Taras M. Czebiniak, Note, *When Congress Gives Two Hats, Which Do You Wear? Choosing Between Domestic Industry Protection and IP Enforcement in § 337 Investigations*, 26 BERKELEY TECH. L.J. 93, 95 (2011).

21. “Section 337” is commonly used to refer to 19 U.S.C. § 1337, which codifies § 337 of the Tariff Act of 1930. *Id.* at 94 n.8.

22. *Id.* at 96.

23. *See* 19 C.F.R. § 210.3 (2012).

24. In January 2011, the ITC Chairman announced plans for restructuring its staffing models to meet the increasing patent litigation workload. The plan prioritizes Staff participation around issues “unique” to § 337 proceedings, including determinations regarding domestic industry, exclusion orders, the public interest, and bonding. *See Supplement to the ITC’s Strategic Human Capital Plan, 2009–2013*, U.S. INT’L TRADE COMM’N 23 (Jan. 2011), http://usitc.gov/intellectual_property/documents/2009_13_SHCP.pdf (last visited Feb. 14, 2012).

25. Czebiniak, *supra* note 20, at 97.

part.”²⁶ The Court of Appeals for the Federal Circuit may review the ITC’s final determination.²⁷

The ITC cannot award monetary damages under § 337²⁸; instead, it may issue what is called an “exclusion order” to deny entry of certain goods into the United States.²⁹ There are two types of exclusion orders: the limited exclusion order, which applies only to those parties noticed as respondents to a particular complaint, and the general exclusion order, which applies to all goods of a certain description regardless of the importer’s identity.³⁰ A limited exclusion order is the default remedy, whereas the general exclusion order requires a higher showing of the scope of the potential harm.³¹ ITC exclusion orders are enforced at the border by U.S. Customs and Borders Protection.³²

In an ITC action based on patent infringement, the Commission will issue an exclusion order upon a finding of infringement, unless the Commission finds that the infringing articles should not be excluded from entering the United States after considering the effect of such exclusion on “the public health and welfare, competitive conditions in the United States economy, the production of like or directly competitive articles in the United States, and United States consumers.”³³ Exclusion orders will bar importation of infringing products into the United States, thereby removing the infringing products from the U.S. market. In this sense, an exclusion order has the same effect as injunctive relief obtained by a plaintiff in a district court action.

B. EXPANDING § 337’S PROTECTION TO LICENSING-BASED INDUSTRY

1. *The Historical Domestic Industry Requirement*

The core task of the ITC is to shield domestic industry from unfair trade practices that may undercut and hurt such industry.³⁴ Thus an IP owner seeking an exclusion order from the ITC must satisfy a threshold requirement of demonstrating the existence of a “domestic industry” in the

26. *Id.*

27. 19 U.S.C. § 1337(c) (2006).

28. *Section 337 Investigations: Answers to Frequently Asked Questions*, U.S. INT’L TRADE COMM’N 24 (Mar. 2009), http://www.usitc.gov/intellectual_property/documents/337_faqs.pdf (last visited Feb. 14, 2012).

29. *Id.*

30. *Id.*

31. Czebiniak, *supra* note 20, at 102.

32. *Id.*

33. 19 U.S.C. § 1337(d)(1) (2006).

34. Czebiniak, *supra* note 20, at 107.

United States.³⁵ This is similar to obtaining standing at the federal courts.³⁶ Prior to 1988, in order for a domestic industry to exist, a “patent must be *exploited by production* in the United States . . . [and] where unfair methods and acts have resulted in conceivable losses of sales, a tendency to substantially injure such industry has been established.”³⁷ The type of exploitation activities include “manufacture or production or serving of the patented item”³⁸

Historically, in every investigation the Commission applied a two-prong test to determine whether a § 337 complainant satisfied the domestic industry requirement.³⁹ The test consisted of a technical prong and an economic prong.⁴⁰ The technical prong requires that the complainant’s activities relate to articles that practice the patented invention.⁴¹ The economic prong measures the investment that the complainant has made in the United States for exploiting the patents in suit.⁴² But significant changes to the language of § 337 in 1988 required a modification of this test.

2. *The Gremlins Case Triggered the 1988 Amendment to § 337*

In the *Gremlins* case, Warner Brothers filed a copyright-based § 337 complaint against unlicensed entities that imported articles depicting characters from the movie “*Gremlins*.”⁴³ Warner Brothers had an established division dedicated to the licensing program, and it had successfully licensed its copyrights to domestic producers of similar articles.⁴⁴ However, the ITC determined that Warner Brothers had not established a domestic industry in part because licensing activities did not constitute an industry.⁴⁵ The Commission further held that Warner Brothers’ licensees’ production of articles that reproduced the copyrighted image could not satisfy domestic

35. *Id.* at 108.

36. The Federal Circuit has also started to use standing as a way to limit the complexity and breadth of the ITC appeals it hears. See Daniel E. Valencia, *Appeals from the International Trade Commission: What Standing Requirement?*, 27 BERKELEY TECH. L.J. (forthcoming 2012) (manuscript at 2–3).

37. H.R. REP. NO. 93-571, at 76 (1973) (emphasis added).

38. Certain Products with Gremlins Character Depictions (*Gremlins*), USITC Inv. No. 337-TA-201, Commission Opinion at 5–6 (Jan. 16, 1986).

39. Czebiniak, *supra* note 20, at 109.

40. *Id.*

41. See, e.g., Certain Ammonium Octamolybdate Isomers, USITC Inv. No. 337-TA-477, Commission Opinion at 25 (Jan. 5, 2004); Certain Wind Turbines & Components Thereof, USITC Inv. No. 337-TA-376, Commission Opinion at 8–9 (Oct. 28, 1997).

42. Czebiniak, *supra* note 20, at 110.

43. *Gremlins*, USITC Inv. No. 337-TA-201, Commission Opinion at 1.

44. *Id.* at 9.

45. *Id.* at 7–11.

industry either, because such production was done overseas.⁴⁶ The Commission thus determined that no violation of § 337 had occurred.

Congress was disappointed with the Commission's decision in *Gremlins*, which drove Congress to amend § 337 to extend the statute's protection to IP owners who engaged in activities such as licensing or research and development, but not actual production of the covered article.⁴⁷ In introducing the bill, Representative Kastenmeier explained why § 337 should be reworked to include licensing-based domestic industry: "Such a change will enable universities and small businesses who do not have the capital to actually make the goods in the United States to still have access to the ITC forum for the protection of their rights."⁴⁸

Subsequently, in 1988 Congress added subsection (C) to the domestic industry requirement under § 337:

[A]n industry in the United States shall be considered to exist if there is in the United States, with respect to the articles protected by the patent, copyright, trademark, mask work, or design concerned—

(A) significant investment in plant and equipment;

(B) significant employment of labor or capital; or

(C) *substantial investment* in its *exploitation*, including engineering, research and development, or *licensing*.⁴⁹

Thus the amendment opened the ITC forum to both traditional entities that invest in plant and equipment⁵⁰ or employ labor and capital⁵¹ in the United States, as well as entities with little or no traditional investment but that engage in commercializing their intellectual property through licensing or research and development.⁵²

46. *Id.* at 14–15.

47. *See, e.g.*, 132 CONG. REC. 7119 (1986) (statement of Rep. Robert Kastenmeier). Representative Kastenmeier sought to "avoid unfortunate results which have occurred in some recent cases, such as *Gremlins*" through amendments to § 337(a). *Id.*

48. *Id.*

49. 19 U.S.C. § 1337(a)(3) (2006) (emphasis added).

50. *Id.* § 1337(a)(3)(A).

51. *Id.* § 1337(a)(3)(B).

52. *Id.* § 1337(a)(3)(C).

3. *Elimination of the Technical Prong Requirement for Licensing-based Domestic Industry*

As discussed in Section I.B.1, *supra*, complainants seeking to access the ITC traditionally needed to satisfy both the economic prong and technical prong of the domestic industry requirement. However, entities asserting domestic industry through licensing under the amended § 337(a)(3)(C) often do not have an article that practices the patented invention, and so the Commission decided that the traditional technical prong of the domestic industry requirement does not apply to those entities.⁵³ This means that the complainant is not required to show that it or its licensees practice the patent in suit.

Instead, the Commission employs a “simpler test”⁵⁴ to determine whether a complainant has established a domestic industry under subsection (C). A complainant asserting § 337(a)(3)(C) needs to satisfy only the economic prong of the domestic industry requirement⁵⁵ by demonstrating that (1) it “has made a substantial investment in its licensing program and (2) there is a sufficient nexus between the patent at issue and the alleged domestic licensing industry.”⁵⁶ It is this simpler test that comes into play when a non-practicing complainant seeks an ITC investigation of allegedly infringing imports.

C. RELIANCE OF NON-PRACTICING ITC COMPLAINANTS ON LICENSING

In recent years, and particularly following the U.S. Supreme Court’s *eBay v. MercExchange*⁵⁷ decision, non-practicing complainants have increasingly turned to the ITC in their efforts to obtain injunctive relief against infringers.⁵⁸ These complainants often rely on their licensing activities under subsection (C) to satisfy the domestic industry requirement.⁵⁹ This Section briefly explores the possible driving force behind the trend of increasing non-practicing complainants at the ITC.

53. Certain Semiconductor Chips (*Semiconductor Chips I*), USITC Inv. No. 337-TA-432, Initial Determination at 11 (Jan. 24, 2001).

54. *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Initial Determination on Violation at 19–20 (Dec. 3, 2007).

55. See Certain Light Emitting Diodes & Prods. Containing Same (*Light Emitting Diodes I*), USITC Inv. No. 337-TA-512, Initial Determination at 134 (May 10, 2005) (“[T]he domestic industry analysis under criterion (C) subsumes within it a technical-prong aspect.”).

56. *Light Emitting Diodes II*, USITC Inv. No. 337-TA-640, Initial Determination at 5 (May 8, 2009).

57. *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).

58. See discussion *infra* Section I.C.2.

59. See discussion *infra* Section I.C.2.

1. *The ITC Does Not Follow eBay*

The U.S. Supreme Court's decision in *eBay* is widely regarded to have limited the ability of non-practicing entities ("NPEs") to secure an injunction in a federal district court.⁶⁰ In *eBay*, the Court held that district courts must apply the traditional four-factor test in determining whether to issue injunctive relief in patent infringement suits, upon a finding of infringement and validity.⁶¹ Of the four factors, the requirement that a plaintiff demonstrate "irreparable injury" has proved most detrimental to NPEs' ability to secure an injunction. This is because an NPE is usually unable to demonstrate a loss of market share for patented goods or services since they do not produce or provide those goods or services—the existence of such a market is often a crucial piece of evidence for showing irreparable injury.⁶² However, the Commission refused to adopt the *eBay* four-factor test in deciding whether to issue an exclusion order—which acts like an injunctive remedy—at the ITC, a position that the Federal Circuit later affirmed in *Spansion, Inc. v. International Trade Commission*.⁶³ As shown in Section I.C.2, *infra*, this effectively makes the ITC a more favorable forum for NPEs who seek injunctive relief.

In *Spansion*, Tessera Inc. filed a complaint with the ITC against seven respondents who allegedly imported or sold semiconductor chips that infringed Tessera's patents on chip packaging.⁶⁴ After a finding of infringement, respondent Spansion urged the Commission to consider the *eBay* factors before issuing an exclusion order.⁶⁵ Specifically, they urged the Commission to consider that "Tessera is simply a licensor and does not actually practice the invention"⁶⁶ and to conclude that there was no irreparable harm and that an injunction was inappropriate under *eBay*.⁶⁷ The

60. See, e.g., Yixin H. Tang, *Recent Development: The Future of Patent Enforcement After eBay v. MercExchange*, 20 HARV. J.L. & TECH. 235, 236 (2006) ("[T]he Court effectively made it much harder for patent holders who do not practice their patented inventions to obtain a permanent injunction . . .").

61. *eBay*, 547 U.S. at 394.

62. See *Paice LLC v. Toyota Motor Corp.*, No. 2:04-CV-211-DF, 2006 WL 2385139, at *3–5 (E.D. Tex. Aug. 16, 2006) (finding no irreparable harm because Paice LLC failed to demonstrate that Toyota's infringing activity caused the failure of its licensing practices, since the two did not compete in the same market, with one in the market of technology licensing and the other in the market of automobile manufacturing and sales).

63. *Spansion Inc. v. Int'l Trade Comm'n*, 629 F.3d 1331 (Fed. Cir. 2010).

64. *Id.* at 1336.

65. *Id.* at 1357.

66. *Id.*

67. *Id.* at 1357–58.

Commission ruled that *eBay* does not apply to ITC remedy determinations.⁶⁸ Instead, the ITC focuses entirely on the statutorily mandated public interest factors listed in § 337: “public health and welfare, competitive conditions in the United States economy, the production of like or directly competitive articles in the United States, and United States consumers.”⁶⁹ Finding that none of these were implicated in the investigation, the Commission granted the exclusion order.⁷⁰

The Federal Circuit affirmed, recognizing that, unlike district courts’ discretionary power to grant injunctive relief, Congress intended injunctive relief to be the normal remedy for a § 337 violation, and that a showing of irreparable harm is not required to receive such injunctive relief.⁷¹ Moreover, “[t]he difference between exclusion orders granted under § 337 and injunctions granted under the Patent Act, 35 U.S.C. § 283, follows ‘the long-standing principle that importation is treated differently than domestic activity.’”⁷²

The *Spansion* decision affirmed the different standards for granting injunctions in a district court and issuing exclusion orders at the ITC.⁷³ Under these different standards, a patent owner may obtain an exclusion order from the ITC even when it may not be entitled to an injunction under *eBay*.⁷⁴ These differences are particularly significant to non-practicing patent owners seeking injunctive relief, who may have great difficulty proving “irreparable harm” in a district court.⁷⁵ A 2011 FTC report on the evolving IP marketplace (“FTC Report”) finds that, among post-*eBay* patentees that do not practice their patents, district courts have granted only 50% of

68. *Id.* at 1358.

69. *Id.*; *see also* 19 U.S.C. § 1337(d)(1) (2006).

70. *Spansion*, 629 F.3d at 1358.

71. *Id.* at 1358–59 (“Congress amended Section 337 by passing the Omnibus Trade and Competitiveness Act of 1988 . . . explicitly removing the requirement of proof of injury to the domestic industry and making it unnecessary to show irreparable harm to the patentee in the case of infringement by importation.”).

72. *Id.* at 1359.

73. *See id.* at 1358 (“Congress intended injunctive relief to be the normal remedy for a Section 337 violation and that a showing of irreparable harm is not required to receive such injunctive relief.”); *cf.* *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 391–92 (2006) (holding that the well-established four-factor test for permanent injunctions also applies to disputes arising under the Patent Act, including the requirement that plaintiff has suffered irreparable harm).

74. Colleen V. Chien, *Protecting Domestic Industries at the ITC*, 28 SANTA CLARA COMPUTER & HIGH TECH. L.J. 169, 173 (2011).

75. *See Paice LLC v. Toyota Motor Corp.*, No. 2:04-CV-211-DF, 2006 WL 2385139, at *3–5 (E.D. Tex. Aug. 16, 2006).

requested injunctions where the patentees won,⁷⁶ compared with 100% in the year prior to *eBay*.⁷⁷ In contrast, a finding of infringement at the ITC almost always leads to an exclusion order.⁷⁸ At least one study has pointed to this divergence between the ITC and the district court as a reason for the increasing popularity of the ITC among non-practicing patent owners.⁷⁹

2. *Non-practicing Patentees Increasingly Turn to the ITC*

After *Spansion*, although non-practicing patent owners arguably have a better chance of obtaining exclusion orders at the ITC than obtaining injunctive relief at the district court, they must first overcome the threshold hurdle of establishing domestic industry at the ITC, a hurdle which does not exist at the district court. Non-practicing patent owners do not practice the patents in suit and therefore lack any investments in manufacturing, either through investments in plant and equipment⁸⁰ or employment of labor or capital.⁸¹ In order to satisfy the domestic industry requirement, non-practicing patent owners have frequently relied on “licensing” activity under § 337(a)(3)(C).⁸²

A study of § 337 complaints filed between 2000 and August 2010 shows both an increasing number and increasing percentage of ITC complaints where the complainants asserted domestic industry based on licensing.⁸³ Although it is impossible to precisely determine the exact contribution of patentees looking to avoid the *eBay* analysis to the increase in ITC complaints,⁸⁴ this trend has drawn close attention of academics, practitioners,

76. FED. TRADE COMM’N, THE EVOLVING IP MARKETPLACE: ALIGNING PATENT NOTICE AND REMEDIES WITH COMPETITION 256 (2011), available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf> [hereinafter FTC REPORT] (“A longer term review of the post-*eBay* case law reveals that as of March 1, 2010, courts had heard thirteen requests for permanent injunctions where the opinion suggests that the patent owner is one of several types of non-practicing entities, including a university, research institute and independent inventor. Of those thirteen cases, district courts granted an injunction seven times.”).

77. Nicholas G. Papastavros & Maia H. Harris, *Do Predictions Come True? KSR, eBay, and the Real Impact on Patent License Negotiations*, INTELL. PROP. TODAY, July 2008, at 8.

78. FTC REPORT, *supra* note 76, at 242 n.131 (finding that “[t]he ITC has used [the public interest] provision to deny an injunction only three times . . . [where all three] cases involved issues of public health or broad public interest”).

79. Chien, *supra* note 74, at 172–73.

80. 19 U.S.C. § 1337(a)(3)(A) (2006).

81. *Id.* § 1337(a)(3)(B).

82. Robert D. Fram & Ashley Miller, *The Rise of Non-practicing Entity Litigation at the ITC: The State of the Law and Litigation Strategy* 11 (Sept. 19, 2010) (unpublished manuscript) (on file with author).

83. *Id.* at 910.

84. FTC REPORT, *supra* note 76, at 240.

and the Federal Trade Commission,⁸⁵ and serves as backdrop for the ITC's recent opinions that appear to have sought to heighten the domestic industry requirement for licensing activity. But who, exactly, are these non-practicing ITC complainants?

II. NON-PRACTICING COMPLAINANTS AT THE ITC

This Part explores the characteristics of five types of typical non-practicing complainants at the ITC: (1) research and development entities, or “idea shops;”⁸⁶ (2) independent inventors; (3) startups; (4) patent assertion entities;⁸⁷ and (5) practicing companies with an offensive patenting strategy.

To clarify terminology, this Note uses the term “non-practicing complainants” to describe patent owners who file complaints at the ITC based on a patent that they do not practice. By using this term, the focus of the analysis is on the *acts* of the complainants regarding the specific patents in suit.⁸⁸ Non-practicing complainants may include NPEs, who generally do not practice *any* of their patents, as well as practicing entities, who assert patents in areas where the company no longer operates or never did.⁸⁹ Although generally “it is not specific entities but rather specific tactics or practices that are most relevant,”⁹⁰ business models of an entity may, in many cases, dictate how entities behave in accordance with new developments of the law. Therefore in order to accurately predict how the change in the domestic industry requirement will shape the behaviors of non-practicing complainants, it is helpful to understand their various business practices, particularly those relevant to “engineering, research and development, or licensing,”⁹¹ as well as litigation activities, through which a patentee compels royalty payments from accused infringers.

85. See FTC REPORT, *supra* note 76, at 2, 186.

86. Robert P. Merges, *The Trouble with Trolls: Innovation, Rent-Seeking, and Patent Law Reform*, 24 BERKELEY TECH. L.J. 1583, 1599 (2009) (defining a pure idea shop as “one that sells its innovations in disembodied form”).

87. Colleen V. Chien, *From Arms Race to Marketplace: The Complex Patent Ecosystem and Its Implications for the Patent System*, 62 HASTINGS L.J. 297, 328 (2010) (“Patent-assertion entities are focused on the enforcement, rather than the active development or commercialization of their patents.”).

88. Mark A. Lemley, *Are Universities Patent Trolls*, 18 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 611, 630 (2008) (“Instead of singling out bad actors [trolls], we should focus on bad acts and the laws that make them possible.”).

89. See Chien, *supra* note 87, at 322–23 (giving examples of practicing entities who implement offensive patent strategies).

90. Merges, *supra* note 86, at 1610.

91. 19 U.S.C. § 1337(a)(3)(C) (2006).

A. PATENT ASSERTION ENTITIES

Patent assertion entities are entities that focus on the enforcement, and not the active development or commercialization of their patents.⁹² They can be further divided into two categories: small portfolio companies and mass patent aggregators.⁹³ Although Professor Chien also included independent inventors in the category of patent assertion entities,⁹⁴ this Note treats independent inventors as a separate category due to the different characteristics that independent inventors exhibit with respect to their licensing activities and the complex policy considerations specifically afforded to independent inventors.

1. *Small Portfolio Companies*

Small portfolio companies focus their investment at identifying, acquiring, and enforcing valuable patents against existing, successful products.⁹⁵ These entities usually selectively purchase small portfolios of patents.⁹⁶ However, these specially-selected patents account for a substantial percentage of the most litigated patents⁹⁷ and are arguably the most valuable patents available.⁹⁸

After acquiring a portfolio of valuable patents, small portfolio companies usually operate based on a *litigation-first* model, rather than a *licensing-first* model.⁹⁹ This means that instead of engaging in genuine efforts to negotiate licensing agreements with potential licensees that may adopt the patented technology, small portfolio companies will strategically time the filing of their

92. Chien, *supra* note 87, at 328.

93. *Id.*; Robin Feldman & Tom Ewing, *The Giants Among Us*, 1 STAN. TECH. L. REV. (forthcoming 2012) (manuscript at 2–3) (stating that the mass patent aggregator is “an entirely different beast” than small patent assertion entities).

94. Chien, *supra* note 87, at 328.

95. *Id.* at 330; Feldman, *supra* note 93, at 2–3. The idea of acquiring valuable patents is based on the assumption that patents have an objective value that can be estimated from intrinsic qualities of the patent. See John R. Allison et al., *Extreme Value or Trolls on Top? The Characteristics of the Most Litigated Patents*, 158 U. PA. L. REV. 102, 112 (2009) (showing that “the most litigated patents differ fundamentally in virtually every respect from even the once-litigated patents,” including number of continuation applications, number of self-citations, etc.).

96. Chien, *supra* note 87, at 330 (“For example . . . , Las Vegas-based Synchrome Technologies has sued Samsung, Panasonic and other electronics device makers based on a portfolio of fewer than ten patents.”).

97. Allison et al., *supra* note 95, at 124.

98. *Id.* at 103 (stating that “most valuable” refers to private value, or value to the owner); see also Chien, *supra* note 87, at 318 (explaining that small portfolio companies’ patent portfolios “tend to have a higher proportion of ‘crown jewels’”).

99. See Chien, *supra* note 87, at 319.

lawsuits to occur after some companies are already committed to the technology in their products.¹⁰⁰ By doing so, small portfolio companies advantageously position themselves in court and optimize their chances of winning the infringement claim while having little to lose.¹⁰¹ For their opponents, on the other hand, the stakes can be extremely high: a district court judge may order them to pay a large amount of damages, or they may risk losing access to the U.S. market once the ITC issues an exclusion order. Over the years, small portfolio companies have been able to employ these tactics to extract sizable royalties from unwilling licensees, either through court-imposed royalty payments or through settlement negotiations and agreements.¹⁰² Saxon Innovations, LLC is an example of a small portfolio company that has successfully brought suits at the ITC.¹⁰³

2. *Mass Patent Aggregator*

Mass patent aggregators operate similarly to small portfolio companies, but on a much more sophisticated scale.¹⁰⁴ The largest mass patent aggregators are Acacia and Intellectual Ventures (“IV”).¹⁰⁵ These entities usually have deep-pocket investors, such as big technology companies and investment banks, enabling them to purchase a large number of patents from virtually all types of patentees.¹⁰⁶ For example, as recently as May 2011, IV is estimated to have a portfolio of 30,000 to 60,000 patents and patent applications worldwide.¹⁰⁷

Perhaps the most prominent characteristic of mass patent aggregators is that they engage in a wide range of different activities. For example, IV acquires IP rights, licenses patents for fees and equity investments,¹⁰⁸ and

100. Chien, *supra* note 87, at 319.

101. *See id.* at 318 (“[Patentees] that do not make products . . . are not burdened by the need to manage investor expectations or minimize disruption to the company’s core business.”).

102. *See, e.g.*, Rob Kelley, *BlackBerry Maker, NTP Ink \$612 Million Settlement*, CNN MONEY (Mar. 3, 2006, 7:29 PM), http://money.cnn.com/2006/03/03/technology/rimm_ntp/ (describing a patent-assertion entity that obtained \$612 million in a settlement arising from a patent infringement suit against BlackBerry).

103. *See* Chien, *supra* note 87, at 343 (stating that Saxon owns a patent portfolio of about 200 patents); *see, e.g.*, Complaint at 1, Certain Electronic Devices, Including Handheld, Wireless Comm’ns Devices, USITC Inv. No. 337-TA-667 (Apr. 30, 2009) (stating that Saxon brought the suit to the ITC).

104. Feldman et al., *supra* note 93, at 3–4.

105. Chien, *supra* note 87, at 328.

106. Feldman, *supra* note 93, at 3–4.

107. *Id.* at 11.

108. Chien, *supra* note 87, at 329.

enforces patents by litigation.¹⁰⁹ In recent years, IV also opened up its own research and development division.¹¹⁰ Similarly, Acacia's strategy is to generate revenue through licensing or litigating patents.¹¹¹ It generally splits the revenues it receives, giving half to the inventor and retaining half for itself.¹¹²

B. PRACTICING COMPANIES WITH AN OFFENSIVE PATENTING STRATEGY

Historically, practicing companies that generate revenue from product sales have implemented a defensive patenting strategy, typically by developing a large trove of patents (often through their own research and development) for cross-licensing.¹¹³ This strategy has the dual benefits of avoiding licensing fees and preventing competitors from blocking their products.¹¹⁴ A defensive patenting strategy affords practicing companies freedom to operate in a particular market, which furthers technological adoption.¹¹⁵ Empirical observations show that companies with a defensive IP strategy usually do not initiate lawsuits.¹¹⁶

However, throughout the lifetime of an issued patent, practicing companies may shift their patenting strategy and use a once-defensive patent to selectively monetize and enforce their IP right in areas where they no longer or never did operate, employing the same tactics as patent-assertion entities.¹¹⁷ For instance, licensing a technology may be the most efficient way

109. Feldman, *supra* note 93, at 30.

110. See Allen W. Wang, Note, *Rise of the Patent Intermediaries*, 25 BERKELEY TECH. L. J. 159, 181 (2010) (explaining that some of IV's intellectual property is developed internally, instead of being acquired from outside sources); see also Feldman & Ewing, *supra* note 93, at 40 (noting that IV set up an internal lab).

111. Chien, *supra* note 87, at 320.

112. Letter from Paul Ryan, Chief Exec. Officer, Acacia Research, to the Fed. Trade Comm'n 1 (May 13, 2009), available at <http://www.ftc.gov/os/comments/iphearings/540872-00048.pdf>.

113. Chien, *supra* note 87, at 321 (citing Cisco as an example of a high-tech company that implements a defensive patenting strategy).

114. *Id.*

115. *Id.*

116. *Id.* at 322.

117. See *id.* at 324–25. There is disagreement among scholars about the likelihood that a practicing entity with a large patent portfolio may transition from defensive accumulation to offensive patent monetization and enforcement. Compare Wang, *supra* note 110, at 175 (“A successful defensive aggregator with a massive portfolio would possibly have only the conscience of its leadership to prevent it from becoming an aggressive and litigious licensor and NPE [non-practicing entity] in its own right.”) with Chien, *supra* note 87, at 326 (“[M]aking the transition from defensive accumulation to patent monetization is neither easy nor automatic.”).

for a company to recoup its R&D expenses.¹¹⁸ Similarly, an early-stage technology may have been patented without much further development.¹¹⁹ With respect to such patents, the companies are non-practicing. When they assert such patents at the ITC, they effectively become non-practicing complainants, notwithstanding their investments in practicing other technologies unrelated to the patents in suit.¹²⁰ As an example, Motorola Inc. recently brought a suit at the ITC asserting domestic industry based on licensing activity for a patent that it did not practice.¹²¹

Practicing entities transitioning from a defensive to an offensive patenting strategy usually possess a large portfolio of patents, historically accumulated for defensive purposes.¹²² Such patent portfolios are typically of high volume, low cost, and uneven quality with respect to individual patents.¹²³ In addition, such patent portfolios are often associated with a trail of cross-licensing negotiations and agreements. During cross-licensing negotiations, because of both parties' obsession with the number of patents in the patent portfolios rather than the content of the patents, companies might sample a few typical patents in each of the portfolios, but they very rarely scrutinize each patent individually.¹²⁴

C. RESEARCH AND DEVELOPMENT ENTITIES

Research and development entities, or "idea shops," are entities that develop their own technologies and then sell the innovations in "disembodied form," rather than embedding innovation in manufactured products.¹²⁵ This category includes universities who develop technologies in their labs and earn licensing revenues through technology-transfer offices.¹²⁶ This category also includes companies like Rambus, which invests heavily in

118. Chien, *supra* note 87, at 322.

119. *Id.* at 322.

120. *Id.* at 322 ("When they assert such patents, companies have been accused of being corporate 'trolls.'").

121. *See* Certain Wireless Comm'n Devices, Portable Music & Data Processing Devices, Computers & Components Thereof, USITC Inv. No. 337-TA-745, Initial Determination at 1 (June 22, 2011).

122. Chien, *supra* note 87, at 325 (showing stages of a company's patent strategy which include a transition from defensive accumulation to offensive patent monetization).

123. *Id.* at 338 (showing that defensive patenting emphasizes "the quantity of patents, rather than the quality of any individual patent").

124. *Id.* at 308 ("As general counsel of TI famously put it, 'for [TI] to know what's in [its patent] portfolio, we think, is just a mind-boggling, budget-busting exercise to try to figure . . . out with any degree of accuracy at all.'").

125. Merges, *supra* note 86, at 1599.

126. Lemley, *supra* note 88, at 614 ("Patents are now a significant contributor to some university bottom lines.").

research and development and has a revenue stream based primarily on royalty payments.¹²⁷ The 2011 FTC Report identified technology transfer from specialized research and development entities to larger manufacturing firms as an “increasingly important pathway of open innovation.”¹²⁸

One type of R&D entity is the university. Universities tend to patent “on the very earliest stages of technology.”¹²⁹ Their licensing efforts are generally directed towards technology transfer for commercialization, rather than rent-seeking.¹³⁰

Unlike universities, research and development companies have a more *hybrid practice* regarding their licensing activities. For example, Rambus has a well-established licensing program seeking to bring its innovations to the marketplace through technology transfer.¹³¹ At the same time, it enforces its patents very actively, filing strings of lawsuits at both district courts and the ITC when accused infringers refuse to take a license.¹³² Another notable characteristic of R&D companies is that they usually license a portfolio of patents covering a specific field of technology, rather than licensing individual patents.¹³³ Unlike defensive patent portfolios accumulated by practicing entities that focus on quantity rather than quality of patents, the patent portfolios of R&D companies bear the primary function of enabling its licensees to practice a particular technology without worrying about

127. In fiscal year 2007, eighty-six percent of Rambus’s revenue came from royalty. *See* Standard & Poor’s Corporate Descriptions, Rambus Inc., at 3 (Feb. 11, 2012) (LEXIS, Standard & Poor’s Corporate Descriptions Plus News).

128. FTC REPORT, *supra* note 76, at 37.

129. Lemley, *supra* note 88, at 615 (“Universities, which account for 1% of patents on average across all fields, account for 12% of all patents in nanotechnology, and more than two-thirds of . . . the basic building block patents in nanotechnology.”).

130. Chien, *supra* note 87, at 327 (“The standard paradigm of university technology transfer is to license patents *ex ante* . . . rather than to wait until a company has independently developed and commercialized an infringing product.”). *But see* Lemley, *supra* note 88, at 618 (“[U]niversities are increasingly enforcing their patents. Recent years have seen high-profile cases litigated to judgment by [universities].”).

131. *See Rambus Licensing*, RAMBUS INC., <http://www.rambus.com/us/about/licensing/index.html> (last visited Mar. 20, 2012).

132. *See* Hoover’s Company Records—In-depth Records, Rambus Inc., at 4 (Feb. 8, 2012) (LEXIS, Hoover’s Company Records—In-depth Records) (“Rambus became embroiled in a series of intellectual-property lawsuits with major memory makers around the world.”).

133. *See, e.g.*, Certain Semiconductor Chips (*Semiconductor Chips III*), USITC Inv. No. 337-TA-661, Order No. 21, Initial Determination at 7 (Oct. 7, 2009) (noting that Rambus licensed the Concurrent Interface Technology license portfolio and XDR Technology license portfolio, each covering a specific technology field).

further investments in new licenses.¹³⁴ Thus an R&D company usually carefully chooses closely-related patents for its portfolio to ensure sufficient coverage of a technology field. R&D companies are also more likely than practicing entities to invest in high-quality patent prosecution in order to preserve the validity of their patents that in many cases constitute the company's primary asset.¹³⁵ Over the years, R&D companies such as Rambus have successfully brought multiple suits to the ITC.¹³⁶

D. INDEPENDENT INVENTORS

Independent inventors present a curious case at the ITC. On one hand, independent inventors seem to fall well within the group that the 1988 Amendment sought to benefit.¹³⁷ On the other hand, independent inventors are among the most avid litigants in the patent system,¹³⁸ often working together with contingency-fee lawyers.¹³⁹ One scholar actually characterizes independent inventors as “trolls” when they “turn[] their focus away from the active development or practice of their patents and [move] towards patent enforcement.”¹⁴⁰

One study offers a viable explanation why independent inventors are actively engaged in patent litigation: these investors typically have developed the patents that they are asserting and are therefore more personally involved in enforcing the patents.¹⁴¹ There is, however, another explanation: independent inventors may have a difficult time convincing manufacturers to take a license and commercialize the patented technology.¹⁴² As a result,

134. *U.S. Philips Corp. v. Int'l Trade Comm'n*, 424 F.3d 1179, 1192–93 (Fed. Cir. 2005) (demonstrating the benefits of package licensing).

135. See Bronwyn H. Hall & Rosemarie Ham Ziedonis, *The Patent Paradox Revisited: An Empirical Study of Patenting in the U.S. Semiconductor Industry, 1979–1995*, 32 RAND J. ECON. 101, 110 (2001) (unlike manufacturers who stock up patents as bargaining chips, design firms' patenting appears to be driven by a desire to secure strong, “bulletproof” proprietary rights to technologies).

136. See, e.g., *Semiconductor Chips III*, USITC Inv. No. 337-TA-661, Initial Determination at 1.

137. See 132 CONG. REC. 7119 (statement of Rep. Kastenmeier) (“Such a change will enable universities and small businesses *who do not have the capital to actually make the goods* in the United States to still have access to the ITC forum for the protection of their rights.”) (emphasis added).

138. Allison et al., *supra* note 95, at 126 (showing that individual inventors or individual-inventor-started companies “account for 74.4% of the most litigated patent lawsuits”).

139. Chien, *supra* note 87, at 331.

140. *Id.* at 330.

141. *Id.* at 331.

142. See Peter Whalley, *The Social Practice of Independent Inventing*, 16 SCI. TECH. & HUM. VALUES 208, 225 (1991) (describing the mistrust between manufacturers and independent

litigation may, at times, be the only recourse for independent inventors to obtain a license and exploit the patented technology, as is likely the situation with the independent inventor in *Stringed Musical Instruments*.¹⁴³

E. STARTUPS

Startups are young companies that have yet to establish their operating history.¹⁴⁴ Like independent inventors, startups usually have a small patent portfolio, as they are short on both time and funding for patent accumulation. However, unlike independent inventors who lack the capital to commercialize their technologies, start-ups are typically formed to pursue commercialization opportunities, usually through venture capital financing.¹⁴⁵ According to the 2008 Berkeley Patent Survey, a startup secures patents primarily to prevent others from copying the technology and to protect its first-mover advantage in the marketplace.¹⁴⁶ Monetizing patents through licensing revenue is among the lowest priorities for startups.¹⁴⁷

Historically, startups have not been active patent litigants at either district courts or the ITC.¹⁴⁸ However, in a recent ITC investigation, a startup company Motiva tried to gain access to the ITC and obtain an exclusion order against foreign competitors, in an effort “to be the exclusive entity with the rights to use the technology embodied by the asserted patents.”¹⁴⁹

inventors that leads to the exclusion of independent inventors from commercializing the patented technology).

143. See *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Initial Determination on Violation at 2–3, 19, 23 (Dec. 3, 2007) (stating that independent inventor failed to obtain any licensing agreements over a period of nearly 20 years despite continuous efforts to obtain licenses, whereas he secured two settlements after filing a complaint at the ITC).

144. Antonio Davila et al., *Venture Capital Financing and the Growth of Startup Firms*, 18 J. BUS. VENTURING 689, 690–91 (2003).

145. *Id.*

146. Stuart J.H. Graham et al., *High Technology Entrepreneurs and the Patent System: Results of the 2008 Berkeley Patent Survey*, 24 BERKELEY TECH. L.J. 1255, 1288, 1297 (2009).

147. *Id.* at 1300–01.

148. Allison et al., *supra* note 95, at 123 tbl.7 (showing startups have no part in either the “most litigated patents” or the “once-litigated patents” category).

149. See *Certain Video Game Sys. & Controllers (Video Game Systems)*, USITC Inv. No. 337-TA-743, Commission Opinion at 10 (Apr. 14, 2011) (relating that startup Motiva sued Nintendo because “Nintendo’s Wii caused all the interest in [Motiva’s] technology to fade and that [litigation] against Nintendo was a necessary step to establish its claim to the technology . . . in order to bring its technology to market”).

III. ESTABLISHING DOMESTIC INDUSTRY BASED ON LICENSING ACTIVITY

As mentioned in Section I.B.3, *supra*, a non-practicing complainant seeking to access the ITC needs to satisfy only the economic prong, and not the technical prong, of the domestic industry requirement by demonstrating (1) a substantial investment in “engineering, research and development, or licensing” and (2) that there is a “nexus” between the activities upon which it relies and the asserted patent. A complainant does not need to show that it, or one of its licensees, is practicing the patent in suit under § 337(a)(3)(C).¹⁵⁰ This Part reviews the history and the latest development of the requirements for establishing domestic industry at the ITC based on licensing activity.¹⁵¹

Controversies as to what kind of licensing activity is sufficient to establish domestic industry have focused on: (1) pure licensing activity; (2) enforcement/litigation activity with which a patent owner compels royalty payments from accused infringers; (3) portfolio licensing activity; (4) royalty payments; and (5) a licensee’s production-type activity.¹⁵² In its two recent decisions *Coaxial Cable*¹⁵³ and *Multimedia Display*,¹⁵⁴ the Commission sought to heighten the requirement for asserting domestic industry based on licensing activities. The two opinions reaffirmed that pure licensing activities alone can constitute substantial investment, whereas they made notable changes regarding the treatment of enforcement/litigation activity, portfolio licensing activity, and royalty payments.¹⁵⁵ The Commission also, for the first time, made a point of distinguishing so-called revenue-driven licensing activity from production-driven licensing activity, even though the statute does not make such a distinction.¹⁵⁶ Finally, the so-called potential “backdoor” opened by a licensee’s activity is largely left intact by the Commission’s latest movement.¹⁵⁷

150. *See supra* Section I.B.3.

151. This Section includes both cases where complainants alleged satisfaction of the domestic industry requirement solely through licensing activities and cases where complainants alleged both licensing and R&D activities.

152. *See* discussion *infra* Sections III.A–D, F.

153. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion (Apr. 14, 2010).

154. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion (Aug. 8, 2011).

155. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 50–51; *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 8, 24.

156. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 25.

157. *See* discussion *infra* Section III.F.

A. PURE LICENSING ACTIVITY

Entities that engage in pure licensing activity without practicing the patented technology may satisfy the requirement for domestic industry.¹⁵⁸ After the 1988 Amendment to § 337, the Commission held in *Semiconductor Chips I* that licensing activity alone could constitute “substantial investment” for purpose of establishing domestic industry under § 337(a)(3)(C).¹⁵⁹ In that case, the ALJ granted complainant Tessera’s motion for summary determination on domestic industry even though Tessera’s only claim regarding domestic industry was its licensing activity and it had never practiced the technology in suit.¹⁶⁰ The exact number of licenses and employees involved and the amount of the royalty payments made were redacted in the public version of the order. However, the order did state that Tessera licensed the patents in suit to several companies, employed internal licensing and contract attorneys to negotiate and draft licenses related to the technology at issue, incurred cost of licensing, and negotiated with most of the semiconductor manufacturers in the world.¹⁶¹ The Commission found that all of these activities were relevant evidence for satisfying the domestic industry requirement.¹⁶² Nothing in *Coaxial Cable* and *Multimedia Display* indicates that the Commission intends to change this rule regarding pure licensing activity.

B. LITIGATION EXPENSES

Prior to *Coaxial Cable* the Commission never explicitly excluded litigation expenses through which an entity compels royalty payments, from the consideration of “substantial investment” under § 337(a)(3)(C). For example, in *Light Emitting Diodes II*, the ALJ granted the complainant’s motion for summary determination that a domestic industry existed based primarily on the complainant’s enforcement/litigation activity.¹⁶³ In reaching its conclusion, the ALJ gave great weight to the multiple licenses that the complainant had managed to obtain through a series of prior district court

158. See, e.g., *Semiconductor Chips I*, USITC Inv. No. 337-TA-432, Initial Determination at 13 (Jan. 24, 2001).

159. See *id.* at 12–13.

160. *Id.* at 5, 15.

161. *Id.* at 7–9, 14.

162. *Id.* at 14–15.

163. Staff Petition for Review at 1, *Light Emitting Diodes II*, USITC Inv. No. 337-TA-640 (May 19, 2009) (“Complainant’s legal expenses . . . primarily consist of fees paid to outside counsel to bring infringement suits, coupled with royalty income received as a result of such litigation.”).

litigations.¹⁶⁴ Although the Commission issued a notice of review for the ALJ's initial determination, the investigation was terminated as a result of settlement before the Commission could issue its opinion.

Coaxial Cable specifically addressed the extent to which a complainant could satisfy the domestic industry requirement by relying on its prior litigation activity for enforcing the patent in suit.¹⁶⁵ In *Coaxial Cable*, the complainant PPC had been involved in multiple district court lawsuits and had only obtained one license at the conclusion of one of its litigations.¹⁶⁶ PPC contended that the money it had spent during the years of litigation leading up to the eventual license should be treated as an investment in licensing.¹⁶⁷

The Commission disagreed.¹⁶⁸ It held that “patent infringement litigation activities *taken alone*” do not satisfy the domestic industry requirement, and “[a]llowing patent infringement litigation activities alone to constitute a domestic industry would place the bar for establishing a domestic industry so low as to effectively render it meaningless.”¹⁶⁹ However, instead of establishing a categorical rule excluding litigation expenses as evidence to meet the domestic industry requirement, the Commission set forth a test that requires a “clear link” between each litigation activity and the licensing efforts regarding a particular patent in suit (“clear link” test).¹⁷⁰ Such activities may include “drafting and sending cease and desist letters, filing and conducting a patent infringement litigation, conducting settlement negotiations, and negotiating, drafting, and executing a license.”¹⁷¹ And only activities that occur *before* filing of an ITC complaint are relevant to whether a domestic industry exists under §337(a)(3).¹⁷²

The Federal Circuit affirmed.¹⁷³ “[R]ecogniz[ing] that the Commission is fundamentally a trade forum, not an intellectual property forum,” the Federal

164. *Id.* at 10.

165. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 43–44 (Apr. 14, 2010).

166. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Remand Initial Determination at 8–9 (May 17, 2010).

167. *Id.*

168. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 45.

169. *Id.* at 45–46 (emphasis added).

170. *Id.* at 50–51 (“A complainant must clearly link each activity to licensing efforts concerning the asserted patent.”).

171. *Id.* at 50.

172. *Id.* at 51 n.17 (emphasis added).

173. *John Mezzalingua Assocs. Inc. v. Int’l Trade Comm’n*, 660 F.3d 1322, 1324 (Fed. Cir. 2011) (appealing the Commission’s decision in *Coaxial Cable*, USITC Inv. No. 337-TA-650).

Circuit concluded that only intellectual property owners who actively engage in exploitation of the intellectual property should have access to the ITC.¹⁷⁴ As such, the majority agreed with the Commission that patent litigation expenditures “do not automatically constitute evidence of the existence of [domestic industry]”¹⁷⁵ Even if a lawsuit eventually leads up to a license agreement between the litigation adversaries, not all litigation expenses may be attributed to licensing effort.¹⁷⁶ The complainant must also establish that its litigation activities are “directed toward” licensing the specific patent in suit.¹⁷⁷

Applying the rule to the facts of the investigation, the Federal Circuit held that the complainant PPC in *Coaxial Cable* failed to satisfy the economic prong of the domestic industry requirement.¹⁷⁸ With respect to one of the litigations eventually leading up to the license agreement, which PPC relied on principally, the Federal Circuit emphasized the ALJ’s finding “that there was no evidence that PPC had offered to license the patent . . . before commencing litigation, no evidence that PPC had sent a cease and desist letter mentioning the possibility of a settlement, and no evidence that PPC had conducted either settlement or licensing negotiations during the lawsuit itself.”¹⁷⁹ The two-year delay from the date PPC obtained a favorable jury verdict until the date PPC licensed the patent in suit to its litigation opponent suggested that PPC’s purpose in litigation was not to obtain a license, but to stop its opponent from manufacturing the infringing products.¹⁸⁰ PPC’s lack of a formal licensing program also cut against finding “substantial investment” in licensing.¹⁸¹ Furthermore, the court found that the ALJ was correct in disregarding PPC’s statement that industry members were “generally reluctant to accept a license” until the patentee obtained a favorable jury verdict, as it merely reflected “the state of mind of competitors.”¹⁸²

174. *Id.* at 1328 (citing H.R. REP. NO. 100-40, at 157 (1987)).

175. *Id.*

176. *Id.* at 1329.

177. *Id.* (“The administrative law judge . . . examined PPC’s legal bills in all three cases and credited entries that had a work description related to ‘licensing’ or ‘settlement’ toward PPC’s investment in licensing.”).

178. *See id.* at 1331.

179. *Id.* at 1325, 1328.

180. *Id.* at 1329.

181. *Id.* at 1330.

182. *Id.* at 1328.

C. PORTFOLIO LICENSING

Historically, when a complainant directed its licensing efforts toward a patent portfolio instead of specific patents in suit, the Commission took into consideration the entire amount of portfolio licensing expenses so long as the portfolio *included* the patents in suit. For example, in *Semiconductor Chips II*, the ALJ granted complainant Tessera's motion for summary determination that it had satisfied the domestic industry requirement based on licensing.¹⁸³ There, the three patents in suit were part of Tessera's TCC technology license portfolio.¹⁸⁴ In response to the respondents' conclusion "that Tessera has failed to show that the licensing revenues generated from TCC technology licensing portfolio . . . [were] specifically related to the patents in suit,"¹⁸⁵ the ALJ held that a "nexus" existed between Tessera's portfolio licensing activities and the patents in suit, when the patents in suit were "part of the TCC technology license portfolio."¹⁸⁶ Accordingly, the ALJ rejected respondents' argument that Tessera must segregate the amount of licensing revenues attributable to the asserted patents.¹⁸⁷

In contrast, the Commission made it clear in *Multimedia Display* that the mere fact that a patent portfolio includes the patents in suit is not enough to justify taking into consideration the entire portfolio licensing expense.¹⁸⁸ In *Multimedia Display*, the complainant, Pioneer Corporation ("Pioneer"), filed a complaint against Honeywell International Inc. and Garmin, asserting three patents based on licensing activity that were part of a large patent portfolio.¹⁸⁹

The Commission reversed the ALJ's finding that the economic prong of the domestic industry requirement was satisfied for the asserted patents,¹⁹⁰ holding that "if a complainant's activity is only partially related to licensing the asserted patent," as in the case of portfolio licensing, the complainant must show a *strong nexus* between the activity and licensing the asserted patents in the United States ("strong nexus test").¹⁹¹ A complainant may be

183. *Semiconductor Chips II*, USITC Inv. No. 337-TA-630, Initial Determination at 1, 5 (Sept. 16, 2008). The Commission subsequently decided not to review the ALJ's Initial Determination granting Tessera's motion for summary determination that it had satisfied the domestic industry requirement. *Semiconductor Chips II*, USITC Inv. No. 337-TA-630, Commission Notice at 1 (Oct. 8, 2008).

184. *Id.* at 7.

185. *Id.* at 6.

186. *Id.* at 8.

187. *Id.* at 7.

188. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 2, 5 (Aug. 8, 2011).

189. *Id.* at 5.

190. *Id.* at 1.

191. *Id.* at 8, 25.

able to establish a strong nexus between licensing the portfolio and licensing the asserted patents by showing that its portfolio licensing activities are “particularly focused on the asserted patent among the group of patents in the portfolio or through other evidence that demonstrates the relative importance or value of the asserted patent within the portfolio.”¹⁹²

Applying the “strong nexus” test to the facts of the case, the Commission found only “an attenuated nexus between Pioneer’s in-house activities and the asserted patents” because, although the licenses covered the patents in suit and therefore had some link to the patents, Pioneer’s in-house activities were largely directed toward the entire navigation technology portfolio, without expressly identifying the asserted patents.¹⁹³ Furthermore, Pioneer presented no evidence of “how the asserted patents fit together congruently with the other patents in the portfolio,”¹⁹⁴ when the technological scope of its navigation portfolio was broad compared to the narrow focus of the asserted patents.¹⁹⁵

The Commission found a “relatively strong” nexus between Pioneer’s outside counsel activities and the asserted patents, because the outside counsel activities, as shown in Pioneer’s invoices, appeared to be related to products incorporating the patented technology.¹⁹⁶ However, the Commission found that Pioneer’s expenses in licensing the asserted patents through outside counsel was “significantly less” than its total outside counsel expenses, as some outside counsel activities were directed towards litigation.¹⁹⁷ In conclusion, the Commission decided that Pioneer failed to satisfy the “strong nexus” requirement and therefore could not assert the entire amount of portfolio licensing expenses as evidence of “substantial investment,” even though the portfolio included the patents in suit.¹⁹⁸

192. *Id.* at 9. Several factors are relevant in assessing the strength of the nexus between a complainant’s portfolio licensing activities and licensing asserted patents: (1) “[W]hether the licensee’s efforts relate to ‘an article protected by’ the [asserted] patent under section 337(a)(2)–(3);” (2) “The number of patents in the portfolio” (“All things being equal, the nexus between licensing activities and an asserted patent may be stronger when the asserted patent is among a relatively small group of licensed patents”); (3) “The relative value contributed by the asserted patent to the portfolio;” (4) “The prominence of the asserted patent in licensing discussions, negotiations and any resulting license agreement;” (5) “The scope of technology covered by the portfolio compared to the scope of the asserted patent.” *Id.* at 10, 11.

193. *Id.* at 19.

194. *Id.* at 20.

195. *Id.* at 19–20.

196. *Id.* at 22.

197. *Id.* at 23.

198. *Id.* at 23.

D. ROYALTY PAYMENTS

As royalty payments are almost always associated with a successful licensing effort, the Commission would traditionally give great weight to the evidence of existing royalty payments. In some cases, royalty payments were deemed part of the complainant's licensing investment.¹⁹⁹ On the other hand, lack of a successful license that brings in royalty payments could prevent a finding of substantial investment, regardless of the amount of unsuccessful efforts the patent owner put in. For example, in *Stringed Musical Instruments*, the ALJ found, and the Commission affirmed, that an independent inventor failed to demonstrate "substantial investment" in licensing.²⁰⁰ Over a period of nearly twenty years, the complainant actively engaged in licensing negotiations for a patent he had obtained, but he had not been able to obtain any licenses prior to filing the complaint.²⁰¹ He had also spent nearly \$10,000 developing various prototypes, attended trade shows to promote the technology, and collaborated with various companies and manufacturers.²⁰² The ALJ nevertheless deemed the complainant's failure to demonstrate substantial licensing revenue, or royalty payments, as crucial evidence in ultimately denying a finding of domestic industry.²⁰³

In *Multimedia Display*, however, the Commission clarified that "[a]lthough royalties received by a complainant can be *circumstantial evidence* that an investment was made, they do not constitute the investment itself."²⁰⁴ Accordingly, although the complainant Pioneer did receive royalties of "arguably considerable" value from a "worldwide license covering over 1,600 patent documents" and a cross-license for one of the respondents' patents, the Commission determined that the royalty received by Pioneer and the cross-license were "relatively minimal in significance" considering "the context of the broad geographical ['worldwide'] and technological scope of the license."²⁰⁵

199. See, e.g., *Light Emitting Diodes II*, USITC Inv. No. 337-TA-640, Initial Determination at 11 (May 8, 2009) (finding the royalty payment received by complainant "substantial").

200. *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Initial Determination at 19 (Dec. 3, 2007); *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Commission Opinion at 27 (May 16, 2008).

201. *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Initial Determination at 23.

202. *Id.* at 13–19.

203. *Id.* at 24.

204. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 24 (Aug. 8, 2011) (emphasis added).

205. *Id.* at 25.

E. PRODUCTION-DRIVEN VERSUS REVENUE-DRIVEN LICENSING
DICHOTOMY

Perhaps the most notable change in the legal standard of establishing licensing-based domestic industry is the Commission's dichotomy of so-called production-driven licensing activity and revenue-driven licensing activity. In *Multimedia Display*, the Commission examined the complainant Pioneer's activities as a whole to determine whether they represent a "substantial investment" under the statute.²⁰⁶ There, for the first time, the Commission stated that

Pioneer's activities, on the whole, reflect a revenue-driven licensing model targeting existing production rather than the industry-creating, production-driven licensing activity that Congress meant to encourage. . . . Although our statute requires us to consider all "licensing" activities, we give Pioneer's revenue-driven licensing activities less weight.²⁰⁷

The Commission defined production-driven licensing activity as activity "which encourages adoption and use of the patented technology to create new products and/or industries,"²⁰⁸ and revenue-driven licensing activity as activity "which takes advantage of the patent right solely to derive revenue by targeting existing production."²⁰⁹ This is the "production/revenue dichotomy." However, the Commission did not identify any relevant factors or contours for distinguishing production-driven from revenue-driven licensing activities, leaving the application of the dichotomy ambiguous.

Applying this dichotomy, the Commission found that Pioneer's activities, taken as a whole, related "only minimally" to licensing the "asserted patents" in the United States.²¹⁰ Based on the above finding, the Commission held that Pioneer's activities were too limited in light of its resources and the relevant market to be considered "substantial" under § 337(a)(3)(C).²¹¹ Therefore the Commission reversed the ALJ's finding that a domestic industry existed.²¹²

F. LICENSEE'S ACTIVITIES

As an alternative to establishing domestic industry based on the complainant's own licensing activities under § 337(a)(3)(C), the Commission

206. *Id.*

207. *Id.*

208. *Id.* at 25 n.20.

209. *Id.*

210. *Id.* at 25.

211. *Id.*

212. *Id.*

also allows a non-practicing complainant to rely on its licensee's domestic activities to satisfy the economic prong of the domestic industry requirement.²¹³ This is the so-called "backdoor" opened by licensees' activities.²¹⁴ However, non-practicing complainants seeking to gain access to the ITC through their licensees' production-type activity must meet both the economic prong and the technical prong of the domestic industry requirement.²¹⁵

The recent *Electronic Devices* investigation illustrates this use. The complainant, Saxon Innovations, LLC ("Saxon"), a small portfolio company, sought to prove its domestic industry based on the activities of its licensees AMD and Motorola.²¹⁶ The ALJ granted Saxon's "summary determination that it [had] met the economic prong of the domestic industry requirement based on its licensee Motorola's production-type activities."²¹⁷ The ALJ also noted that as a separate matter, Saxon needed to meet the technical prong of the domestic industry requirement by proving that Motorola actually practiced the technology in suit.²¹⁸

IV. IMPACT OF THE NEW DEVELOPMENTS ON VARIOUS NON-PRACTICING COMPLAINANTS

As discussed in Part III, *supra*, the latest developments at the ITC reaffirmed that pure licensing activities alone can constitute substantial investment and also left intact the potential "backdoor" opened by licensees' activities, however, the Commission made notable changes regarding the treatment of litigation activity, portfolio licensing activity, and royalty payments.²¹⁹ The Commission also, for the first time, made a point of distinguishing so-called revenue-driven licensing activity from production-driven licensing activity.²²⁰ One might interpret these developments as the Commission's efforts to keep trolling out of the ITC. To evaluate how

213. See, e.g., Certain Electronic Devices (*Electronic Devices*), USITC Inv. Nos. 337-TA-673, 337-TA-667 (consolidated), Order No. 49C, Initial Determination at 1, 12 (Oct. 15, 2009).

214. Fram, *supra* note 82, at 25.

215. See *Electronic Devices*, USITC Inv. Nos. 337-TA-673, 337-TA-667 (consolidated), Initial Determination at 12, 12 n.5; see also Fram, *supra* note 82, at 27.

216. Complaint at 8, 11, *Electronic Devices*, USITC Inv. Nos. 337-TA-673, 337-TA-667 (consolidated) (Apr. 30, 2009).

217. *Electronic Devices*, USITC Inv. Nos. 337-TA-673, 337-TA-667 (consolidated), Initial Determination at 1.

218. *Id.* at 12 n.5.

219. See *supra* Sections III.A–D, F.

220. See *supra* Section III.E.

effective these efforts may be, this Part explores the impact of the changes on various types of non-practicing complainants and predicts how their business practices may shift in response. For example, the “clear link” requirement for litigation expenses will most likely limit the ability of patent assertion entities, as well as that of independent inventors, to establish domestic industry. And the “strong nexus” requirement for portfolio expenses will most likely be an obstacle for practicing entities with an offensive patenting strategy and for mass patent aggregators, given the high-volume, low-quality patent portfolios that they often possess. The “strong nexus” rule may also disadvantage some R&D entities whose businesses involve portfolio licensing as standard practice. This Note argues that while the latest developments likely work more or less effectively against trolling, they may unexpectedly exclude truly innovative entities from the ITC and thus negatively impact socially desirable technology innovations.

A. PATENT ASSERTION ENTITIES

1. *The “Clear Link” Requirement Will Limit Small Portfolio Companies’ Access to the ITC*

Patent assertion entities focus on patent enforcement and litigation rather than the active development or commercialization of their patents.²²¹ As such, the “clear link” requirement for litigation expense²²² will likely limit the ability of both small portfolio companies and mass patent aggregators to establish domestic industry, but limit that ability to a different extent for each.

Small portfolio companies may have a more difficult time than mass patent aggregators to establish a “clear link” between their litigation activities and licensing. Like the complainant in *Mezzalingua*, who “had no formal licensing program” and did not offer “to license the patent to any party” before litigation,²²³ small portfolio companies, which generally rely heavily on litigation, are also unlikely to follow the licensing-first model in their rent-seeking business.²²⁴ In this case, small portfolio companies’ litigation expenses, which understandably constitute a significant portion of the companies’ overall expenses, may be cast aside in the “substantial investment” determination for failing to satisfy the “clear link” requirement, as the requirement looks much more favorably on the practices of a

221. *See supra* Section II.A.

222. *See supra* Section III.B.

223. *John Mezzalingua Assocs. Inc. v. Int’l Trade Comm’n*, 660 F.3d 1322, 1330 (Fed. Cir. 2011).

224. *See supra* Section II.A.1.

licensing-first approach. This reduces the amount of investment small portfolio companies may rely on to establish domestic industry and undercuts their ability to gain access to the ITC, so long as they continue eschewing the licensing-first approach.

The effect of the “clear link” requirement on mass patent aggregators is less certain because most mass patent aggregators do have a formal licensing program despite being active litigants at the court. Thus they may take a licensing-first approach for some patents and a litigation-first approach for others. The decision about whether their litigation expenses are clearly linked to licensing would have to be made on a case-by-case basis. Nevertheless, the “clear link” requirement may prompt mass patent aggregators to shift their practice from a litigation-first model towards a licensing-first model, resulting in less litigations overall.

However, both the Commission’s opinion in *Coaxial Cable* and the subsequent Federal Circuit opinion in *Mezzalingua* left open the question of what exactly must be proved to establish a “clear link” between litigation expenses and licensing. For instance, the Commission stated that “drafting and sending cease and desist letters” and offering to license before initiating a lawsuit could be valid evidence for establishing the “clear link.”²²⁵ But investment in such efforts may be “nothing more than approaching another party to ask if they would like to take a license.”²²⁶ This might provide an opportunity for PAEs to game the system: a small portfolio company may spend minimum efforts “sending cease and desist letters”²²⁷ and offering licenses to just one potential licensee prior to bringing the lawsuit. It would then rely on such efforts to establish the “clear link” between litigation activity and licensing its IP, since the Commission does not look at the *parties* to an investigation but rather to efforts made in respect of an *IP right* being asserted. Thus a more specific and heightened standard for the “clear link” test is called for; Section V.A, *infra*, offers and analyzes one such possible test.

2. *The “Strong Nexus” Requirement Threatens Mass Patent Aggregators’ Access to the ITC*

In addition to the threat posed by the “clear link” test, the “strong nexus” requirement for portfolio licensing expenses²²⁸ may, at times, threaten

225. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 50 (Apr. 14, 2010).

226. Nvidia Brief at 15, *Multimedia Display*, USITC Inv. No. 337-TA-694 (May 24, 2011).

227. *Coaxial Cable*, USITC Inv. No. 337-TA-650, Commission Opinion at 50.

228. See *supra* Section III.C.

mass patent aggregators' ability to establish domestic industry through licensing. Because mass patent aggregators acquire patents from various sources, some of their patent portfolios may have come from practicing companies that previously accumulated them for defensive purposes. Such patent portfolios are often of high volume, low quality, and poor coherency.²²⁹ Thus it may be difficult to establish a "strong nexus" between licensing activity directed towards such patent portfolios and a handful of specific patents in suit, thereby reducing the likelihood that the Commission will find such activity to constitute "substantial investment." On the other hand, small portfolio companies are less likely to be negatively influenced by the "strong nexus" requirement because they generally focus on a small group of high-quality and coherent patents.

3. *The Production/Revenue Dichotomy Will Negatively Impact Both Small Portfolio Companies and Mass Patent Aggregators*

The PAE business model suggests that the entity will typically assert patents against existing industry and products. This is especially so at the ITC, given that the Commission cannot award monetary damages directly. At the ITC, PAEs' best chance to recoup their investment in the lawsuit would be to target mature products with which the respondents have the most to lose, and then extract settlement payment with the imminent threat of an exclusion order. The Commission's production/revenue dichotomy will have a deterrent effect on such rent-seeking activities; however, the effect is uncertain due to the ambiguities related to the mechanism of the dichotomy.²³⁰

B. PRACTICING COMPANIES WITH AN OFFENSIVE PATENTING STRATEGY

The "strong-nexus" requirement for portfolio licensing expenses will likely impact practicing companies employing an offensive patenting strategy even more than it will impact mass patent aggregators. As their standard business practice, practicing companies accumulate a large number of high-volume, low-quality patent portfolios, used primarily for defensive cross-licensing.²³¹ When they assert one or two patents out of hundreds or even thousands of patents in a portfolio and attempt to rely on the entire portfolio licensing expense to demonstrate "substantial investment," they will find themselves in a situation similar to that of the *Multimedia Display* complainant,

229. See *supra* Section II.B.

230. See *supra* Section III.E.

231. See *supra* Section II.B.

facing a judge unsympathetic to their arguments in favor of establishing domestic industry through licensing.²³²

Further, the Commission's latest treatment of royalty payments as mere "circumstantial evidence," and not "the investment itself,"²³³ may also negatively influence practicing entities with an offensive patenting strategy. As well illustrated in *Multimedia Display*, the mere fact that a patentee received considerable royalty payments for its large patent portfolio may no longer be deemed strong evidence for establishing domestic industry.²³⁴ The Commission may even find this type of evidence to be "minimal" in light "of the broad geographical and technological scope of the license."²³⁵

However, unlike mass patent aggregators, whose practice focuses on patent enforcement, practicing companies do invest considerable sums of money in research and development.²³⁶ It is often impossible for practicing entities to practice *every* technology resulting from R&D, given the limitation of their manufacturing resources. Their "patent enforcement programs, by providing a return on R&D expenses, can underwrite and . . . encourage socially desirable innovation."²³⁷ A legal rule that overly restrains practicing entities' patent-enforcement ability might introduce new uncertainties into corporate officials' decision-making processes regarding research and development and indirectly chill at least some innovation.

C. RESEARCH AND DEVELOPMENT ENTITIES

Until recently, the Commission has consistently found R&D entities, like Rambus, who employ a formal licensing program for commercializing their innovating ideas, to "satisf[y] the domestic industry requirement based on

232. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 25 (Aug. 8, 2011); *see, e.g.*, *Certain Wireless Comm'n Devices, Portable Music & Data Processing Devices, Computers & Components Thereof*, USITC Inv. No. 337-TA-745, Commission Notice to Review, Vacate, and Remand (July 22, 2011) (reviewing and vacating the ALJ's initial determination granting Motorola's motion for summary determination that it satisfied the domestic industry requirement based on licensing industry). The case was remanded to the ALJ in keeping with *Multimedia Display*. *Id.*

233. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 24.

234. *Id.*

235. *Id.* at 24–25.

236. FTC REPORT, *supra* note 76, at 34 n.8 ("Cisco invests more than \$5 billion annually in R&D. . . . Sun reinvests between 15 and 20 percent of its annual revenues back into R&D annually.").

237. Chien, *supra* note 87, at 325.

[their] licensing activities.”²³⁸ However, some of the new rules, in practice, may be interpreted in such a way that disadvantages such R&D entities.

For example, portfolio licensing is a standard practice of R&D entities, and a single R&D entity may have multiple technology-centered portfolios available for licensing.²³⁹ As discussed in Part II, *supra*, R&D entities’ patent portfolios are often of higher quality and better internal coherency, as they enable and protect licensees’ freedom to practice a certain technology. The Commission’s “strong nexus” requirement for portfolio expense asks whether the asserted patent is “particularly important or valuable within the portfolio” and gives great weight to evidence such as whether the patent has been “discussed during the licensing negotiation.”²⁴⁰

But this requirement does not seem to reflect the business realities of R&D entities, and, in fact, it would hurt the socially desirable ability of such entities doing important innovative work to further commercialize a particular technology. This is so because, at times, a patent portfolio directed towards a specific technology may consist of a group of essential patents,²⁴¹ none of which is more important than another.²⁴² Moreover, “[o]nce the overall strength and value of a portfolio has been established in a particular segment of the market, it is not unusual that” parties would conduct and conclude a licensing negotiation “without any discussions of particular patents.”²⁴³ Emphasizing such evidence rather than the intrinsic technological characteristics of the patent portfolio might unnecessarily burden R&D entities as they try to come up with evidence that may be nonexistent in their normal business practice.

Furthermore, despite R&D entities’ established licensing programs and efforts to commercialize their patented technologies, there have always been players who try to practice the technology without paying first.²⁴⁴ In their

238. *See, e.g., Semiconductor Chips III*, USITC Inv. No. 337-TA-661, Order No. 21, Initial Determination at 3 (Oct. 7, 2009).

239. *See supra* Section II.C.

240. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 10.

241. *See* U.S. Philips Corp. v. Int’l Trade Comm’n, 424 F.3d 1179, 1194 (Fed. Cir. 2005).

242. *See, e.g., MPEG-2*, Business Review Letter, 1997 DOJBRL LEXIS 14, at *10 (Dep’t of Justice Jun. 26, 1997) (combining 27 patents that are needed to meet an international standard).

243. Qualcomm Brief at 7, *Multimedia Display*, USITC Inv. No. 337-TA-694 (May 23, 2011).

244. *See, e.g., Rambus Inc.’s Responses to Complaint Counsel’s Proposed Findings of Fact* at 546, *In re Rambus Inc.*, No. 9302 (F.T.C. Oct. 1, 2003), available at <http://www.ftc.gov/os/adjpro/d9302/031001ResponsetoCCsFactsvol2.pdf> (quoting memo from a Siemens employee stating that “[o]ne day all computers will (have to) be built like this, but hopefully without the royalties going to Rambus”).

efforts to demand royalty payments from such players, R&D entities will inevitably target the *existing* products of such players. Historically, the Commission has not treated R&D entities' enforcement activities targeting existing products differently from their technology-transfer activities that focus primarily on creating new products or industry.²⁴⁵ However, under the Commission's new production/revenue dichotomy, those enforcement activities directed towards existing products may be deemed to be revenue-driven and given "less weight."²⁴⁶ Although the mechanism of the production/revenue dichotomy is still unclear, it is hardly justifiable if the Commission gives R&D entities' revenue-driven licensing activities "less weight" simply because a bad player has managed to get away with the patented technology for free and actually made a product out of it.

D. INDEPENDENT INVENTORS

Independent inventors represent the most active patent litigants.²⁴⁷ For the same reason stated in the case of patent assertion entities, the "clear link" requirement for litigation expense will also create hurdles for independent inventors seeking to enforce their IP rights at the ITC.

However, litigation may, at times, be the only way for truly independent inventors to obtain a license agreement for their invention.²⁴⁸ In the past, an ALJ rejected an independent inventor's efforts to establish "substantial investment" based on twenty years of continuous efforts to obtain licenses, reasoning that none of those efforts resulted in any license agreements.²⁴⁹ In another case, the ALJ was satisfied that a different independent inventor's litigation expenses and royalty payments arising out of a string of litigations met the domestic industry requirement.²⁵⁰

Under the current "clear link" test for litigation expenses, it is likely that the second independent inventor would fail to establish "substantial

245. *See, e.g.*, Certain Digital Satellite Sys. (DSS) Receivers & Components, USITC Inv. No. 337-TA-392, Initial Determination at 10–11 (Oct. 31, 1997) (treating complainant's enforcement activities targeting the Weather Channel's existing products the same way as their technology-transfer activities with Sony and StarSight).

246. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 25.

247. *See supra* Section II.D.

248. *See supra* Section II.D; *supra* note 143.

249. *See Stringed Musical Instruments*, USITC Inv. No. 337-TA-586, Initial Determination on Violation at 23 (Dec. 3, 2007) ("McCabe's investment over the span of nearly 20 years was limited to a few prototypes and short collaborations and discussions with various companies and manufacturers . . . which failed to produce any commercial products or result in any license agreements.")

250. Staff Petition for Review at 1, *Light Emitting Diodes II*, USITC Inv. No. 337-TA-640 (May 19, 2009).

investment” in licensing because almost all of her expenses were directed towards enforcement through litigation. The first inventor’s case is more challenging: the inventor’s efforts to continuously engage manufacturing entities for collaboration opportunities over the years to commercialize the patented technology seemed to represent precisely the type of production-driven licensing activity which the Commission and Congress seek to encourage. It seems unjustified, or even unfair, to completely discredit such efforts in determining “substantial investment,” simply because they did not yield any return.²⁵¹ Ironically, this would be analogous to keeping out of the ITC those thinly capitalized small enterprises that motivated Representative Kastenmeier to support the 1988 amendment to § 337 in the first place.²⁵²

On the other hand, the Commission’s latest treatment of royalty payments as “circumstantial evidence,” and not the investment itself²⁵³ may benefit independent inventors such as the first inventor, because royalty payments, as mere “circumstantial evidence,” clearly can no longer be a necessary condition to establishing domestic industry through licensing. This may afford independent inventors who engage in genuine efforts to bring the patented technology to market, but without success, an opportunity to rely on their *unsuccessful* licensing activities to establish domestic industry at the ITC.

E. STARTUPS

Although startups traditionally have not been active litigants at the ITC,²⁵⁴ the Commission’s clear preference for production-driven activities, reflected in the production/revenue dichotomy, might make the ITC a more easily accessible forum to startups. In a recent case, where a startup asserted domestic industry based on licensing, the Commission reviewed and vacated the ALJ’s initial determination that a domestic industry did not exist, despite the fact that the startup’s only domestic activities were its district court litigation against respondents and its patent prosecution activities and that it never tried to license the asserted patents.²⁵⁵ The Commission remanded the

251. See Staff Petition for Review at 10–13, *Stringed Musical Instruments*, USITC Inv. No. 337-TA-586 (Apr. 2, 2008) (finding domestic industry requirement met because, among other reasons, “the record clearly demonstrates a sustained and substantial effort by McCabe to obtain licensees for his patents over many years”).

252. See discussion *supra* Section I.B.2.

253. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 24 (Aug. 8, 2011).

254. See *supra* Section II.E.

255. *Video Game Systems*, USITC Inv. No. 337-TA-743, Commission Opinion at 1, 4 (Apr. 14, 2011).

case back to ALJ, noting that “it may be that [the complainant] Motiva’s only recourse was to sue Nintendo to bring its product to market and that its litigation activities may in fact be related to ‘licensing’ under section 337(a)(3)(C).”²⁵⁶ It is not clear whether startups will take advantage of the ITC’s preference for production-driven activities and follow independent inventors’ contingency-fee model to bring more suits at the ITC as a tactic to fend off competitors.

F. SUMMARY

Table 1 summarizes the likely impact of each of these recent developments in establishing licensing-based domestic industry on non-practicing complainants, by indicating whether the new development will make it *easier* for the type of complainant to establish domestic industry (“E”) or make it more *difficult* (“D”).

256. *Id.* at 10. On remand, the ALJ again found an industry does not exist in the US. *See Video Game Systems*, USITC Inv. No. 337-TA-743, Notice Regarding Initial Determination on Remand at 1–2 (Nov. 2, 2011). A public version of the initial determination is not available as of November 29, 2011.

Table 1: Summary of Impact on Non-practicing Complainants

	PAE		Practicing company with an offensive patenting strategy	R&D entity	Independent Inventor	Startups
	Small portfolio company	Mass patent aggregator				
“Clear link” requirement for litigation expense	D				D	
“Strong nexus” requirement for portfolio licensing expense		D	D	D		
Royalty payments deemed “circumstantial evidence”			D		E	
Production/ Revenue-driven dichotomy	D	D		D		E

Table 1 shows that, on the whole, non-practicing complainants will have a more difficult time establishing domestic industry following these latest developments, which broadly means that the changes have the effect of making the ITC a less attractive litigation forum for most types of non-practicing complainants.

V. SCRUTINIZING THE NEW RULES

In Part IV, *supra*, this Note explores the potential impact on various non-practicing complainants brought by the new rules set forth in *Coaxial Cable* and *Multimedia Display* regarding licensing-based domestic industry. Some of these effects are consistent with public policy, and others are arguably not. In light of the predicted impact, this Part revisits and scrutinizes the new rules and proposes possible alternatives that are better aligned with public policy considerations.

A. REPLACE THE “CLEAR LINK” TEST WITH A “PATTERN OF LICENSING” APPROACH BASED ON NON-LITIGATION ACTIVITIES

The “clear link” requirement for litigation expenses may limit the ability of patent assertion entities, as well as that of independent inventors, to establish domestic industry. However, as it is not clear what level of pre-litigation activities is needed to establish the “clear link” between litigation and licensing, patent assertion entities may get around the rule by spending a minimum amount of resources on pre-litigation activities, later pointing to those activities as evidence of a “clear link” between litigation and licensing.²⁵⁷ This result frustrates the very policy interest underlying the “clear link” requirement that is against the business of rent seeking.²⁵⁸

In order to prevent patent assertion entities from gaming the rule and sneaking pure litigation expenses back into the “substantial investment” consideration, the Commission should adopt a more specific and heightened standard as a prerequisite to using litigation expense for demonstrating domestic industry: complainants should establish a *pattern of licensing* based solely on non-litigation activities involving the patents in suit, proving that litigation is merely an *extension* of the complainants’ underlying and legitimate licensing activities.

This is essentially a two-part test: first, the complainant needs to make a *prima facie* showing that a pattern of licensing exists based on non-litigation activities, such as having a formal licensing department, personnel dedicated to drafting and negotiating licensing agreements, and a history of licensing negotiations; only when the complainant successfully establishes this pattern of licensing will the Commission turn to the actual litigation activities and examine whether litigation may be considered as an extension of the complainant’s licensing program, based on factors such as whether the complainant offers licenses to accused infringers prior to bringing the litigation or whether the complainant conducts settlement or licensing negotiations during the litigation.

The effect of this change on patent assertion entities would be to make establishing domestic industry more difficult by requiring an additional showing of a pattern of licensing based on *pure* licensing activities, before a complainant is even allowed to attempt linking litigation to licensing. Thus this test focuses on the underlying pure licensing activities that serve as the foundation of a licensing industry, at the same time taking into consideration

257. *See supra* Section IV.A.1.

258. *See supra* Section IV.A.1.

litigation expense which, at times, may be a necessary recourse against bad players.

Further, the Commission should allow a complainant to rely on both successful and unsuccessful licensing efforts to establish a pattern of licensing, in order to allow independent inventors, such as the one in *Stringed Musical Instruments*, to establish domestic industry, even if they have been wholly unsuccessful in their efforts to obtain licensees, and have no other options but to litigate.

B. FOCUS ON THE INTRINSIC TECHNOLOGICAL CHARACTERISTICS OF A PATENT PORTFOLIO

As discussed in Part IV, *supra*, requiring a “strong nexus” between portfolio licensing expenses and the specific patents in suit will most likely become an effective obstacle against the rent-seeking practices of both practicing entities with an offensive patenting strategy and mass patent aggregators, given the high-volume, low-quality patent portfolios that they often possess. However, this rule might also disadvantage R&D entities if the Commission continues to determine the “importance and value” of the asserted patent based primarily on extrinsic evidence, such as whether the patent was discussed during portfolio licensing negotiations,²⁵⁹ with less focus on the patent portfolio’s intrinsic technological characteristics. This is because extrinsic evidence implicating the importance of the patent in suit may not exist in R&D entities’ normal business practice.²⁶⁰

To address this issue, the Commission should instead focus on the intrinsic technological characteristics of the patent portfolio in deciding whether a strong nexus exists. “Evidence showing how the asserted patents fit together congruently with other patents in the portfolio covering a specific technology”²⁶¹ should be given the greatest weight, with extrinsic evidence, such as whether the patents in suit have been discussed during a licensing negotiation, relegated to a secondary role. This change will not only protect R&D entities’ socially desirable portfolio licensing practice, but also give companies an incentive to invest in tightly bound, high quality, essential patent portfolios, which will probably reduce overall uncertainty in the marketplace.

Furthermore, although limiting practicing entities’ ability to profit through offensive patent enforcement is consistent with the public policy

259. *See supra* Section III.C.

260. *See supra* Section IV.C.

261. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 12 (Aug. 8, 2011).

against rent seeking, the Commission should act to minimize the potential chilling effect on practicing entities' long-term allocation of R&D resources.²⁶² A "strong nexus" rule focusing on intrinsic technological characteristics will not help practicing entities' ability to establish domestic industry given their high-volume, low-quality patent portfolios. This negative impact may be offset by taking into consideration the value of cross-licensing agreements in the determination of "substantial investment," as discussed in more detail in Section V.C.2, *infra*. In contrast, the less desirable activities of mass patent aggregators would likely remain shut out of the ITC because mass patent aggregators do not typically engage in cross-licensing.

C. TREATMENT OF ROYALTY PAYMENTS

Although royalty payments are deemed "circumstantial evidence" after *Multimedia Display*, this Note suggests that the Commission should maintain that receiving royalty payments is an important factor in determining whether substantial investment has been made and that it should find "substantial investment" based on unsuccessful licensing activities under very narrow circumstances only. However, the Commission should also take into account the intrinsic value of cross-licenses besides royalty payments, as cross-licenses promote the exchange of new ideas and also help minimize transaction costs.

1. *Receipt of Royalty Payments Should Remain an Important Factor in Determining Substantial Investment*

The Commission's latest treatment of royalty payments, as mere "circumstantial evidence" and not the investment itself, might benefit independent inventors, like the one in *Stringed Musical Instruments*, who fail to secure royalty payments despite continuous efforts to obtain licensees. With royalty payments no longer a necessary condition to establish domestic industry through licensing,²⁶³ these independent inventors may have a chance to rely on their investment in unsuccessful licensing efforts to satisfy the "substantial investment" requirement.

However, to avoid opening the floodgate of frivolous complaints filed on the basis of half-hearted licensing efforts that fail to yield any agreement, the Commission should still maintain that the successful negotiation of royalty-bearing licenses remains an important factor in determining whether substantial investment has been made. "[U]nsuccessful licensing activities [may] require nothing more than approaching another party to ask if they

262. See *supra* Section IV.B.

263. See *supra* Section III.D.

would like to take a license,”²⁶⁴ meaning that although the absence of license does not always indicate no licensing effort at all, the licenses are often not difficult to obtain with a meritorious IP right. The Commission should therefore find “substantial investment” based on unsuccessful licensing activities under only very narrow circumstances where the evidence of licensing efforts is clear, such as those of the independent inventor in *Stringed Musical Instruments* who demonstrated continuous and genuine efforts directed at licensing his legitimate rights over the patented technology.²⁶⁵

2. *Recognition of the Value of Cross-licenses in Evaluating Substantiality of Investment*

In addition to viewing royalty payments as important evidence of “substantial investment” in licensing, the Commission should also take into consideration the value of cross-licenses and treat them similarly to royalty payments. Many technology companies grant licenses in exchange for royalty-free cross-licenses, saving transaction costs and promoting the exchange of new ideas, which leads to innovation.²⁶⁶ In that sense, cross-licenses have an intrinsic value to the company, just like royalty payments, and so the two should be viewed somewhat interchangeably when the Commission evaluates “substantial investment” in licensing.²⁶⁷ Taking into account the value of cross-licenses may also help to offset the negative impact imposed by the “strong nexus” requirement on practicing entities’ ability to recoup R&D investment.

D. THE PRODUCTION/REVENUE DICHOTOMY

Finally, by putting forth the production/revenue dichotomy, the Commission expressed a clear preference for production-driven licensing activities that seek to bring patented technology to the marketplace and an aversion to revenue-driven licensing activities that target existing products.²⁶⁸ This is largely consistent with the stated Congressional purpose in enacting the amendments to § 337, and it also roughly traces the Federal Trade Commission’s (“FTC”) distinction between *ex ante* patent transaction²⁶⁹ and

264. Nvidia Brief, *supra* note 226, at 15.

265. See text accompanying *supra* note 249.

266. Qualcomm Brief, *supra* note 243, at 4.

267. *Id.* at 5 (“To deny the Commission’s protection of patents merely because the patent owner chooses to exploit the value of its portfolio through cross-licensing, rather than through a royalty-based licensing program, would disregard an economic reality of the portfolio patent licensing business.”).

268. See *supra* Section III.E.

269. FTC REPORT, *supra* note 76, at 40.

ex post patent transaction.²⁷⁰ In its report on the evolving IP marketplace, the FTC defined *ex ante* patent transactions as

[p]atent transactions that occur as part of a technology transfer agreement [and that] occur *before* the purchaser has obtained the technology through other means. Such *ex ante* patent transactions accompanied by technology transfer have great potential for advancing innovation, creating wealth and increasing competition among technologies.²⁷¹

It defined *ex post* patent transactions as “patent transactions . . . [that] occur *after* the user of the technology has invested in its *independent* invention and development, without input from the patentee.”²⁷² Thus both the FTC and the ITC appear to recognize two types of licensing or transactional activities that bear opposite effects on the public interest that favors the propagation and commercialization of new technology. The two agencies’ preferences for production-driven licensing activities or *ex ante* patent transactions are also aligned.

As discussed in Part IV, *supra*, the production/revenue dichotomy will, to some extent, undercut patent assertion entities’ ability to establish domestic industry based on their rent-seeking licensing activities, though the effect is largely uncertain due to the ambiguities related to how the Commission will apply the dichotomy to a specific set of facts. On the other hand, for R&D entities that engage in both production-driven and revenue-driven licensing activities, it is hardly justifiable to cast aside their licensing investment that targets the existing products of bad players.²⁷³

To give proper weight to hybrid licensing activities, such as those of the R&D entities, application of the production/revenue dichotomy should focus on the *overall* effect of the complainant’s licensing activities on the U.S. market and on U.S. consumers.²⁷⁴

270. *Id.* at 40.

271. *Id.* at 40.

272. *Id.* at 40 n.43. Arguably, the FTC’s *ex post* patent transaction is more narrowly defined than the Commission’s revenue-driven licensing, which includes acts that “take[] advantage of the patent right solely to derive revenue by targeting existing production,” regardless of whether the user of the technology independently invented it. *Multimedia Display*, USITC Inv. No. 337-TA-694, Commission Opinion at 25 n.20 (Aug. 8, 2011).

273. See FTC REPORT, *supra* note 76, at 52 (“*Ex post* patent assertions and transactions also provide essential support to business models based on *ex ante* licensing and technology transfer.”).

274. As the Federal Circuit noted in *Spansion*, protecting the need of U.S. consumers has always been a recurring theme in the Commission’s deep policy consideration. *Spansion, Inc. v. Int’l Trade Comm’n*, 629 F.3d 1331, 1360 (Fed. Cir. 2010).

Take, for example, a small portfolio company's licensing activities. By solely targeting existing products, without any contribution to innovation, such licensing activities will inevitably increase the cost of producing existing products, and U.S. customers may eventually have to bear the burden of those cost increases assuming the existing producer can still operate its business. Such licensing activities which are purely driven by rent seeking have an overall negative effect on the U.S. market and consumers. Therefore, from a policy perspective, these activities would furnish an improper basis upon which to establish domestic industry. If, on the other hand, a different entity type such as an "idea house" comes up with a truly innovative idea and actively seeks to commercialize the product through licensing to manufacturers, the licensing activities will have a positive effect on the U.S. market and consumers because it would lead to the replacement of old products with new ones, and consumers would benefit from access to new technologies and industries that did not exist before.

For R&D entities which engage in a hybrid licensing practice regarding the patents in suit, the components of that practice that are driven purely by rent seeking will likely increase an existing production firm's input costs and may lead to price increases or decreased consumer choice. However, these same entities' other licensing activities, which promote the adoption of the patented technologies into new products, will have an opposite effect. For instance, introducing more new products into the market will increase competition among similar products and drive down prices. Of course, the overall effect of such complainants' licensing activities on the U.S. market and consumers hinges on multiple factors, such as price, product, and accessibility. Complainants seeking to establish domestic industry through licensing activities bear the burden to prove the overall positive effect of their licensing activities on the U.S. market and U.S. consumers.

VI. CONCLUSION

Nearly twenty-five years after the 1988 amendment to § 337 extending the ITC's protection to licensing-based domestic industries, a recent FTC report once again acknowledges the positive effect of licensing and technology transfer on the whole innovation ecosystem. This reaffirms the validity of the congressional intent behind the 1988 amendment, which recognized that certain industries, though not directly engaging in production, are still worthy of the Commission's protection for actively commercializing their intellectual property through licensing. However, after the Federal Circuit's holding that the *eBay* permanent-injunction decision does not apply to the ITC, non-practicing patent owners have been filing a rising number of complaints at the ITC asserting a domestic industry based

on licensing. In accordance with the widely accepted notion that the ITC is fundamentally a trade forum instead of an IP forum, the Commission faces a complex gate-keeping function of identifying worthy complainants that have truly established a licensing-based industry. The complexity arises partly out of the various licensing practices of different entities, as well as the rapid evolution of the licensing industry itself in terms of size, revenue stream, business model, etc.

In its two recent opinions, *Coaxial Cable* and *Multimedia Display*, the Commission seeks to clarify and refine the rules governing the establishment of a domestic industry based on licensing activity. These refinements have had varying degrees of impact on the several types of non-practicing complainants that come before the Commission. For the most part, it looks like the latest changes are consistent with a public policy that is defined with respect to the U.S. innovation policy. However, there remain some ambiguities and unclear applications of the various tests and future investigations will probably further refine these standards.

Notably, the rationale behind the Commission's new production-driven/revenue-driven licensing dichotomy is more akin to a public interest consideration than statutory interpretation. Traditionally, the Commission only considers public interest factors at the conclusion of an ITC litigation, after a finding of both the existence of a domestic industry and infringement. The production/revenue dichotomy may signal the Commission's willingness to take into consideration at least some public interest at the stage of determining domestic industry. Though there is much left to be observed as to how the dichotomy will eventually play out, going forward, such public-policy considerations may be crucial in facilitating the Commission's efforts to properly perform its gate-keeping function.

THE PUBLIC PAID FOR THE INVENTION: WHO OWNS IT?

Robert M. Yeh[†]

The federal government funds a large portion of university research today.¹ Some argue that fairness considerations require default ownership of inventions to go to the tax-paying public who, after all, fills the federal coffers.² Besides public ownership, inventions that arise out of federal funding could conceivably go to four other parties: (1) the government; (2) the contractor-universities; (3) the inventors; and (4) the private entrepreneurs interested in commercializing inventions. The reality today is that contractor-universities own many of the inventions that arise out of federal research funding.³

University ownership became the norm after Congress enacted the Bayh-Dole Act (“BD Act” or “BD”), which laid down a uniform set of ownership rules for federally funded inventions.⁴ The BD Act presumes that universities

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1. For example, in 2009, U.S. universities and colleges spent \$54.9 billion on science and engineering research and development (R&D). Of that amount, about 60%, or \$32.6 billion, came from the federal government. See Ronda Britt, Nat’l Sci. Found., *Universities Report \$55 Billion in Science and Engineering R&D Spending for FY 2009; Redesigned Survey to Launch in 2010*, INFO BRIEF NAT. CTR. FOR SCI. AND ENG’G STATISTICS, Sept. 2010, at 2 tbl. 2, available at <http://www.nsf.gov/statistics/infbrief/nsf10329/nsf10329.pdf>.

2. See, e.g., Partha Dasgupta & Paul A. David, *Towards a New Economics of Science*, 23 RES. POL’Y 487 (1994); Rebecca S. Eisenberg, *Symposium On Regulating Medical Innovation: Public Research and Private Development: Patents and Technology Transfer in Government-Sponsored Research*, 82 VA. L. REV. 1663, 1725–26 (1996); Diana Rhoten & Walter W. Powell, *The Frontiers of Intellectual Property: Expanded Protection vs. New Models of Open Science*, ANN. REV. L. & SOC. SCI. 3, 345–73 (2007).

3. Universities generally require that academic staff, graduate students, and visiting scholars execute invention assignment agreements as a condition for employment or use of university resources. See, e.g., *infra* note 6.

4. 35 U.S.C. §§ 200–212 (2006). The BD Act gives academic institutions and small businesses (and later by executive order no. 12591, large businesses) ability to retain title to inventions arising from federally sponsored research. This Note focuses on federal funding at academic institutions such as universities and research institutes; although the Court’s

own inventions that are developed under their watch.⁵ Universities typically fulfill this ownership presumption by requesting mandatory invention assignment from their employee-inventors.⁶ But when an employee-inventor intentionally or inadvertently assigns an invention to someone else, complications can ensue. This is what transpired in the recent *Stanford v. Roche* case.⁷

While much scholarship in law, sociology, business, and economics explore which entity or entities *should* and *could* optimally own inventions that arise out of federal funding,⁸ this Note addresses two simpler and narrower questions: first, did the Supreme Court reach the right social and economic policy decision in *Stanford* by leaving default legal ownership of inventions to the inventors, and second, what are the practical consequences of the ownership regime laid out in *Stanford*?

To answer these questions, this Note takes the position that federally funded research has the goal of improving social welfare by enabling scientific and technological advances and training the next generation of

holding in *Stanford* on the issue of BD would apply to non-academic and for-profit federal contractors.

5. See, e.g., Edward C. Walterscheid, *The Need for a Uniform Government Patent Policy: The D.O.E. Example*, 3 HARV. J.L. & TECH. 103, 130 (1990).

6. See, e.g., *The Patent Amendment*, UNIV. OF CAL. HUMAN RES. AND BENEFITS, http://atyourservice.ucop.edu/employees/policies_employee_labor_relations/patent-acknowledgment/patent-amendment.html (last modified Feb. 16, 2012) (University of California's mandatory employee invention assignment agreement); Memorandum from the Stanford University Office of the Vice Provost and Dean of Research to Faculty, Staff, Graduate Students, and Postdocs Regarding Updated Patent and Copyright Agreement in the Research Policy Handbook (July 2011), available at <http://rph.stanford.edu/su18.html> (Stanford University's Employee Research Policy Handbook, requiring that "inventions shall be assigned to the University, regardless of the source of funding").

7. Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc., 131 S. Ct. 2188 (2011).

8. See, e.g., Martin Kenney & Donald Patton, *Reconsidering the Bayh-Dole Act and the Current University Invention Ownership Model*, 38 RES. POL'Y 1407, 1408 (2009) (noting "the contributions of three different theoretical research traditions" to the study of BD and university-industry relationships: (1) "evolutionary institutional economics pioneered by Sidney Winter and Richard Nelson and includes Wesley Cohen, David Mowery, Nathan Rosenberg, and their students;" (2) "sociological network analysts roughly grouped around Walter W. Powell;" and (3) "legal tradition examining the current university invention licensing model"). Representative publications in the three different traditions include: DAVID C. MOWERY, RICHARD R. NELSON, BHAVEN N. SAMPAT, & ARVIDS A. ZIEDONIS, *IVORY TOWER AND INDUSTRIAL INNOVATION: UNIVERSITY-INDUSTRY TECHNOLOGY TRANSFER BEFORE AND AFTER THE BAYH-DOLE ACT* (2004) (evolutionary institutional economics tradition); Eisenberg, *supra* note 2 (legal tradition); Rhoten & Powell, *supra* note 2 (sociological network analysis tradition).

scientists and engineers.⁹ The end goal is decidedly not about giving university-contractors the right to profit from patent monopolies. That is a mere side effect that Congress finds necessary for achieving the end goal, but it should not be viewed as immutable if the end goals could be achieved another way.

Given this view of federally funded research, this Note argues that the Supreme Court reached the correct economic and social policy decision in *Stanford*. The decision is good for the innovation community because it appears consistent with current practices by various actors and leaves settled expectations largely undisturbed. The lone exception to the maintenance of the status quo is that some universities, such as Stanford, claim that they can no longer rely on the BD Act to automatically take legal ownership of federally funded inventions from their employees.¹⁰ Leaving aside for the moment the argument that few, if any, universities ever actually relied solely on BD to take ownership of inventions from their employees,¹¹ practically speaking, the inability to rely on BD as a vesting statute can largely be remedied by private contracts. Indeed, several universities including Stanford recently revised their employee invention assignment contracts in response to the *Stanford* decision.¹² Moreover, the universities' resort to private ordering with invention assignment contracts highlights another reason why the Court reached a good policy outcome; this decision leaves open the possibility for alternative arrangements and experimentation on the periphery of the law that would be foreclosed if the Court had held BD to be an automatic vesting statute.

Part I of this Note introduces two key issues raised in *Stanford*. Part II provides some legal context relevant to understanding *Stanford* by briefly reviewing invention ownership, the goals of federal research funding, and the university innovation microcosm. Part III provides additional legal context

9. *Infra* Section II.B.

10. *See* Brief of Petitioner at *46, *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188 (2011) (No. 09-1159), 2010 WL 5385333; Brief of Amici Curiae Assoc. of American Univs. et al. in Support of Petitioner at *33, *Stanford*, 131 S. Ct. 2188 (No. 09-1159), 2010 WL 5385333.

11. Universities, like other employers, invariably ask employees to execute invention assignment agreements after each invention has been reported to the employer. As the Supreme Court pointed out in *Stanford*, this standard practice cuts against the argument that universities have always relied on BD as a vesting statute because the ex post assignment would be redundant and unnecessary if BD were actually a vesting statute. *Stanford*, 131 S. Ct. 2188, 2199 (“[I]t is worth noting that our construction of the Bayh-Dole Act is reflected in the common practice among parties operating under the Act.”).

12. *See infra* Section II.C.

necessary to understanding *Stanford* by introducing the BD Act, its policy objectives of facilitating translation of federally funded invention to privately funded innovation,¹³ and its effects over the last thirty years. Part IV details the *Stanford* litigation, with particular focus on policy arguments made by both parties and amici curiae. Part V discusses implications of the Court's decision and how the decision comports with settled expectations in patent law and contract law. It also uses hypothetical examples to illustrate the practical consequences of *Stanford* versus the likely consequences of a contrary holding. Part VI concludes that the Supreme Court reached the correct economic and policy decision in *Stanford*, despite narrowly focusing the decision on statutory interpretation. Indeed, BD-mandated university ownership would have created new problems as it would have upended various parties' reliance interests in existing contracts.

I. ISSUES RAISED IN *STANFORD V. ROCHE*

In the recent case *Stanford v. Roche*, a Stanford University ("Stanford") researcher, Dr. Mark Holodniy, visited Roche Molecular Systems ("Roche")¹⁴ to learn about a then-novel technique called polymerase chain reaction ("PCR").¹⁵ When he returned to Stanford nine months later, Holodniy combined what he learned at Roche about PCR with Stanford's expertise in human immunodeficiency virus ("HIV") to develop a PCR test for quantifying viral load in HIV positive patients.¹⁶ The key events that gave rise to the entire litigation were that before he ever set foot at Roche, Holodniy executed a Stanford employment contract agreeing to assign all his future inventions to Stanford, but when he later arrived at Roche, Holodniy executed a Visitor Confidentiality Agreement ("VCA") in which he "hereby assign[ed]" to Roche all of his inventions that related to his activities there.¹⁷ As a result of these conflicting assignment contracts, both Roche and Stanford thought they were rightful owners of Holodniy's invention. In due course, Roche's own scientists successfully commercialized the PCR-HIV test invention while Stanford, with Holodniy as one of the named inventors, obtained a patent that purportedly covered the same invention, without

13. In this Note, the term "innovation" refers to the process of taking an invention through various developmental stages to commercialization.

14. Dr. Holodniy actually visited Cetus Corporation ("Cetus"). *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2192 (2011). Roche acquired Cetus' PCR assets after Holodniy's Cetus visits. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

naming any Roche scientists as co-inventors.¹⁸ When Stanford tried to enforce its patent, Roche declined to pay royalties or acquire a license, and so a lawsuit ensued.¹⁹

When the dispute reached the Supreme Court, Stanford argued that because Holodniy's invention was funded in part by the federal government, BD should trump all private contracts that would otherwise determine invention ownership; that is, it argued that BD should automatically vest ownership in Stanford even if Roche had received a valid assignment from Holodniy.²⁰ The Court disagreed with Stanford's arguments, holding that an inventor remains the *ab initio* owner of his federally funded invention regardless of BD, and that BD only comes into the picture after the contractor, in this case Stanford, receives the invention via assignment under ordinary contract law.²¹ Moreover, the Court refused to disturb the Federal Circuit's holding that Stanford's earlier-in-time contract with Holodniy was a mere promise to assign future inventions whereas Roche's later-in-time contract (VCA) with Holodniy effected immediate assignment of all future inchoate inventions.²² Accordingly, under settled contract law, Roche gained ownership of the invention despite its later-in-time contract.²³

The *Stanford* case raises two key issues. The first issue relates to whether BD trumps private contracts. The Supreme Court directly addressed that point by holding that BD does not trump private contracts.²⁴ The second issue concerns what contractual language is necessary to effect a present assignment of a future inchoate invention. While the majority, concurrence, and dissent all noted the existence of this contract interpretation issue, the Court ultimately chose not to disturb the Federal Circuit's *Filmtec* line of cases which hold that specific phrasing with "hereby do assign" or "hereby assign" language is necessary to effect transfer of future, inchoate inventions.²⁵

Consequently, the *Stanford* decision puts universities on notice that if they want to avoid the legal quagmire in *Stanford*, they need to ensure that they

18. *Id.*

19. *Id.*

20. Brief of Petitioner at *25–30, *Stanford*, 131 S. Ct. 2188 (No. 09-1159), 2010 WL 5385333.

21. *Stanford*, 131 S. Ct. at 2192, 2194 n.2.

22. *Id.* at 2194 (citing *Stanford*, 583 F.3d 832, 841–42 (Fed. Cir. 2009)).

23. *Id.*

24. *Id.* at 2192.

25. *Id.* at 2194 n.2; *id.* at 2199 (Sotomayor, J., concurring); *id.* at 2202–03 (Breyer, J., dissenting); see *Filmtec Corp. v. Allied-Signal Inc.*, 939 F.2d 1568, 1572 (Fed. Cir. 1991).

effectively receive ownership via assignment from their employee-inventors. One way to ensure ownership transfer while barring the possibility of unauthorized third party assignment is to have employee-inventors execute contracts guaranteeing present assignment of future inventions using the “hereby do assign” phrasing, instead of mere promises to assign future inventions.²⁶

So if all universities make use of present assignment contracts with the magic “hereby do assign” language, would the effect not be the same as if the Supreme Court simply held that BD gives universities default ownership outright? After all, contractual conveyance using present assignment of future invention language seems functionally equivalent to the statutorily mandated conveyance that Stanford espoused.

The short answer is no. Private ordering under contract law allows certain flexibility that a strict statutory mandate cannot accommodate.²⁷ By leaving assignment up to contract law, this perhaps leaves room for experimentation with various contractual arrangements on the periphery of the law, or even allows efficient breach of contracts where desirable. Furthermore, if the Supreme Court had held for the primacy of BD as a vesting statute, universities would hold a trump card for claiming ownership in any and all inventions that are derived, even in small part, from federal funding.²⁸ Besides, the way inventors, universities, the government, and entrepreneurs/investors currently interact with each other simply does not reflect the view that BD unequivocally trumps private ordering.²⁹ A contrary holding would probably have led to significant uncertainty in pre-existing and future contracts, in particular for inventions funded by multiple sources and collaborations between private and public entities.

26. See *Filmtec*, 939 F.2d at 1570; see also *Stanford*, 583 F.3d at 841–42, *DDB Technologies, L.L.C., v. MLB Advanced Media, L.P.*, 517 F.3d 1284, 1290 (Fed. Cir. 2008); *Speedplay, Inc. v. Bebop, Inc.*, 211 F.3d 1245, 1253 (Fed. Cir. 2000).

27. See generally Sean O'Connor, *Controlling the means of innovation: the centrality of private ordering arrangements for innovators and entrepreneurs*, in *HANDBOOK ON LAW, INNOVATION, AND GROWTH* 274, 274–99 (Robert E. Litan ed., 2011) (“[s]et[ing] out an overview of some of the standard private ordering arrangements in innovation and entrepreneurship” and arguing that the legal system “can jeopardize this critical private ordering ecosystem when they fail to understand the nature of the deal and specific industry standard arrangements”).

28. See S. REP. NO. 96-480, at 21–22 (1979) (reporting that companies “are reluctant to use university research facilities because they fear that any resulting patent rights will be ‘tainted’ if the university is also receiving Federal support in related research”).

29. *Stanford*, 131 S.Ct. at 2199 (noting that “[t]hrough unnecessary to our conclusion, it is worth noting that our construction of the Bayh-Dole Act is reflected in the common practice among parties operating under the Act”).

II. INVENTION OWNERSHIP, FEDERAL RESEARCH FUNDING, AND THE UNIVERSITY INNOVATION MICROCOSM

At its most basic level, *Stanford* concerns an ownership dispute over a highly valuable invention, where parties argued over whether a certain provision of patent law relating to federally funded inventions should take precedence over private contracts.³⁰ This Part provides a legal backdrop to understanding the parties' relative legal positions. It begins with an overview of the default invention ownership regime and emphasizes ownership in the employment setting because this is the scenario most relevant to university inventions that arise from federally funded research. Next, this Part highlights the goals of federally funded research and the significance of federal funding to university innovation. Finally, this Part describes the microcosm of university innovation—specifically, how universities actually interact with their employees, the government funding agencies, and private entrepreneurs throughout the innovation process.

A. THE LAW ON INVENTION OWNERSHIP

One view of publicly funded research looks something like this: federal research grants pay for the inventors' salaries, supplies and equipment; therefore, the tax-paying public ought to own inventions that come out of the inventors' laboratories without having to pay twice—that is, paying a second time in the form of higher monopoly prices charged by patent owners for access to inventions.³¹ The natural reaction under this view would therefore be to give invention ownership to the public so that everyone gets access.³² Some scholars have suggested just such a solution, at least for certain classes of inventions that theoretically would tend to run into the anti-commons problem.³³ Of course, free access for all runs contrary to the basic premise of patent law that sanctions limited monopolies for the promotion of innovation.³⁴

30. *See id.* at 2188–99.

31. *See, e.g.*, S. REP. NO. 96-11, at 44 (1979); Eisenberg, *supra* note 2, at 1666.

32. Eisenberg, *supra* note 2, at 1668–69.

33. *Id.*; *see, e.g.*, Arti K. Rai & Rebecca S. Eisenberg, *The Public Domain: Bayh-Dole Reform and the Progress of Biomedicine*, 66 LAW & CONTEMP. PROBS 289, 314 (2003) (arguing for “restrict[ing] patenting of publicly-funded research when such patenting is more likely to retard than promote subsequent R&D”).

34. U.S. CONST. art. I, § 8, cl. 8 (“To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.”).

As a matter of prudent financial policy, universities generally do not want to give commercially viable inventions freely to the public.³⁵ Rather, universities often take ownership of commercially viable inventions from employee-inventors, patent them, and market them as valuable seeds of innovation to private entities.³⁶ Without the exclusivity granted by patents, entrepreneurs and other private entities would have little incentive to further develop and commercialize university inventions, particularly in areas such as chemical, pharmaceutical, and biotechnology sciences where patent exclusivity is highly valued.³⁷ For this technology transfer process to work efficiently, ownership rights have to be defined. A logical starting place for analyzing the legal ownership framework of publically funded inventions is the laws governing ownership rights to inventions in general.

1. *Interface Between Patent Law and Contract Law*

Patent law, contract law, and common law together determine who owns a patented invention.³⁸ Analysis of invention ownership, no matter the funding source for the invention, requires analysis within this legal framework defined by all three bodies of law. Patent law creates property rights.³⁹ It defines the limits of property rights in patented inventions, provides that initial ownership vests with the inventor, and describes a mechanism for transferring ownership in the form of a written assignment.⁴⁰ Contract law and common law fill in the gaps and allow parties to tailor their

35. Of course, much of the knowledge generated from academic research is not patentable or commercially viable, and therefore importantly, “[b]y far the most prevalent forms of transfer from universities involve knowledge dissemination through publication and teaching, training of a workforce to prepare new employees for today’s technical business sectors, and public service.” Carol Mimura, *Nuance Management of IP Rights: Shaping Industry-University Relationships to Promote Social Impact*, in *WORKING WITHIN THE BOUNDARIES OF INTELLECTUAL PROPERTY* 269, 272 (Rochelle C. Dreyfuss et al. eds., 2010).

36. See, e.g., *id.* at 269–71 (“Universities, however, perform early-stage research and serve to accelerate innovation; they are lead-off runners in a multi-party relay race to commercial endpoints. . . . Cutting edge academic research laboratories typically create early stage, ‘embryonic’ technologies that are far from being actual commercial products.”).

37. See generally Jonathan M. Barnett, *Do Patents Matter? Empirical Evidence on the Incentive Thesis*, in *HANDBOOK ON LAW, INNOVATION, AND GROWTH* 178 (Robert E. Litan ed., 2011) (discussing incentive and dis-incentive thesis for patents’ role in innovation).

38. See Robert P. Merges, *A Transactional View of Property Rights*, 20 *BERKELEY TECH. L.J.* 1477, 1479–1504 (2005).

39. See Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 *HARV. L. REV.* 1089 (1972); Robert P. Merges, *Intellectual Property and the Cost of Commercial Exchange*, 93 *MICH. L. REV.* 1570, 1583 (1996).

40. See Merges, *supra* note 39.

transactions to best fit their respective bargaining positions and efficiently allocate ownership rights.

Patent law grants an inventor initial legal title in his or her invention regardless of who actually paid the inventor to do the inventing.⁴¹ The entity who paid for the inventor to invent can have an equitable ownership claim on the invention under contract law, but does not by default have legal ownership in the first instance under patent law.⁴² Notably, this norm in patent law is not pervasive in all areas of intellectual property (“IP”) law. For example, the work-for-hire doctrine in copyright law gives the employer original legal authorship and ownership in the works that the employees create.⁴³ In contrast, by always giving the inventor immutable inventorship recognition and initial ownership of the invention, patent law emphasizes the inventor’s genius over an employer’s and funder’s tangible contributions, integral to the inventive enterprise as they may be.

Patent law does not stand alone. Parties invariably enter into transactions where contract law provides a mechanism for enforcing personalized rules tailored to particular needs.⁴⁴ Contracting parties create legally cognizable rights and obligations for each other under contract law, such as the right to produce patented widgets and the obligation to pay royalties to the patentee for the widgets produced. Because many inventions today arise in the employment context, researchers typically execute employment contracts that contain clauses requiring present or future assignment of rights to inventions as a precondition for employment.⁴⁵

2. *The Employed Inventor and Assignment of Inventions to the Employer*

Many inventions today are made during the course of employment, where the employer provides the physical and financial resources needed for inventing.⁴⁶ In the vast majority of cases, valid enforceable contracts govern

41. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2192 (2011) (noting that “[s]ince 1790, the patent law has operated on the premise that rights in an invention belong to the inventor”).

42. *Id.* at 2203 (quoting *Comment, Contract Rights as Commercial Security: Present and Future Intangibles*, 67 YALE L.J. 847, 854, n.27 (1958) (“[t]he rule generally applicable grants equitable enforcement to an assignment of an expectancy but demands a further act, either reduction to possession or further assignment of the right when it comes into existence”).

43. Steven Cherensky, *A Penny for Their Thoughts: Employee-Inventors, Preinvention Assignment Agreements, Property, and Personhood*, 81 CALIF. L. REV. 595, 656 (1993).

44. See O’Connor, *supra* note 27.

45. Robert P. Merges, *The Law and Economics of Employee Inventions*, 13 HARV. J.L. & TECH. 1, 2 (1999).

46. *Id.*

the employer-employee invention ownership regime.⁴⁷ Employment contracts typically require that the employee assign all of his/her inventions to the employer as part of the consideration.⁴⁸ Invention ownership rights could be a bargaining chip for the inventor when he negotiates his employment contract. For example, a prominent professor at a research university could conceivably demand a higher share of the licensing revenue from his inventions than a junior faculty member. And universities may compete for faculty talent based in part on how much of the licensing fees they share with their professors.⁴⁹

Where contracts are absent or unenforceable, default ownership rules have developed under common law by way of the hired-to-invent doctrine.⁵⁰ To date, *United States v. Dubilier Condenser Corp.* remains the seminal case on ownership of inventions arising from employment situations.⁵¹ According to the Supreme Court in *Dubilier*, a hired inventor can keep possession of his invention unless he has been hired to invent the very thing that he invented, in which case he is obligated to assign the invention to his employer.⁵² In effect, to trigger mandatory assignment of an employee's invention under common law, *Dubilier* requires that the employer not merely hire the inventor to do research or to invent generally, but hire him specifically to invent a particular invention.⁵³ Although *Dubilier* itself relates to federal government employees, many courts have applied its holding to employment contexts in the private and academic sectors.⁵⁴

47. *Id.*

48. *Id.*

49. See Sean M. O'Connor, *The Aftermath of Stanford v. Roche: Which Law of Assignments Governs?*, INTELLECTUAL PROP. JOURNAL (forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950804 ("Stanford and a few other schools actively promoted their reputations for being the most faculty friendly in this regard and put in place IP policies that backed this reputation up. Such policies and their promotion paid dividends for these schools in terms of star faculty recruitment and retention.").

50. *Merges*, *supra* note 45, at 5.

51. *United States v. Dubilier Condenser Corp.*, 289 U.S. 178, *amended by* 289 U.S. 706 (1933); see *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2195 (2011) (noting that "[o]ur precedents confirm the general rule that rights in an invention belong to the inventor" while citing, among other cases, *Dubilier*, 289 U.S. at 188 (an inventor owns "the product of [his] original thought")); see also Pat K. Chew, *Faculty Generated Inventions: Who Owns the Golden Egg*, 1992 WIS. L. REV. 259, 264 (1992) ("*United States v. Dubilier Condenser Corporation*, decided in 1933, is the seminal case for determining who owns employee-generated inventions. Its principles have been consistently applied to a broad range of employment settings." (internal references omitted)).

52. *Dubilier*, 289 U.S. at 187.

53. Chew, *supra* note 51, at 264.

54. *Id.* at 265.

Both private employment contracts and the common law hired-to-invent doctrine can give equitable ownership to the employer, but in both situations legal ownership remains with the employee-inventor until he executes a written assignment.⁵⁵ Because the law allows an inventor to assign to his employer an invention that has yet to exist, the inventor's ab initio ownership duration could be infinitesimally brief.⁵⁶ That is, by operation of the present assignment contract, an invention passes from the inventor to the employer even before the inventor has conceived the invention.⁵⁷ In practice, the employer would have no idea that the inventor had conceived of an invention unless and until the inventor reported the invention to the employer.

Indeed, the validity of present assignment of inchoate property right has dogged scholars for over a millennium.⁵⁸ In *Stanford*, the majority took notice of this question in a footnote, and both the concurrence and dissent seemed particularly concerned that validity of present assignment of future inventions could hinge on the presence of the short phrase "hereby assign."⁵⁹ But the opinion left this question for another day.⁶⁰ For now, the law on invention ownership seems clear: ownership vests initially with the inventor, regardless of who actually paid for the invention.⁶¹

3. *Status of the University Inventor: Not Hired To Invent*

Under the principles articulated in *Dubilier*, university researchers generally do not qualify as persons "hired to invent."⁶² Academic autonomy demands that universities give their researchers relatively free reign.⁶³ Universities organize their research programs into departments and specialized institutes and centers to encourage research in certain areas, but rarely do they mandate a researcher, professor, or student to create a

55. *See* *Filmtec Corp. v. Allied-Signal Inc.*, 939 F.2d 1568, 1572 (Fed. Cir. 1991).

56. *Id.* ("An assignment of an expectant interest can be a valid assignment.")

57. *Merges*, *supra* note 45, at 3, 7.

58. *See* BABYLONIAN TALMUD, Yevamot 93a (Heb.) (Central text of mainstream Judaism discussing a dispute on whether one can sell fruit that have not yet grown on a tree).

59. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc. et al.*, 131 S. Ct. 2188, 2194 n.2 (2011); *id.* at 2199 (Sotomayor, J., concurring); *id.* at 2202–03 (Breyer, J., dissenting).

60. *See id.*

61. *Stanford*, 131 S.Ct. at 2192. There are a few narrow exceptions, mostly related to federally funded research in areas of national security and defense. *Id.* at 2195.

62. 8 DONALD S. CHISUM, CHISUM ON PATENTS § 22.03 (2010); *Chew*, *supra* note 51, at 266.

63. *Chew*, *supra* note 51, at 305 (discussing conflicts between university ownership of faculty inventions and university academic mission).

specified invention as a condition of employment.⁶⁴ Therefore, absent contractual obligations to assign their inventions, university researchers are the equitable and legal owners of their inventions. As the Court made clear in *Stanford*, absent a valid pre-invention assignment agreement that transferred ownership of inchoate inventions, and regardless of whether an invention falls under the BD Act's purview, an inventor retains ab initio legal ownership rights.⁶⁵

B. THE GOAL OF FEDERALLY FUNDED RESEARCH: INCREASING
OVERALL SOCIAL WELFARE, NOT MONETIZING SPECIFIC
INVENTIONS

Since 2003, the United States government has spent over \$100 billion annually on research and development.⁶⁶ In 2008, for example, overall federal research funding was \$129 billion.⁶⁷ Of that amount, universities and colleges received approximately \$30.2 billion,⁶⁸ National laboratories,⁶⁹ intramural research programs at federal agencies and FFRDCs (Federally Funded Research and Development Centers) received about \$42 billion, while businesses received much of the rest at about \$26 billion.⁷⁰ Importantly, most of university funding, \$23.6 billion out of \$30.2 billion, is earmarked for basic research whereas the bulk of the funding for other sectors is either in applied research or development.⁷¹ Basic research funding is a critical component of innovation because it supports foundational research that is necessary or desirable as a matter of public policy but that the private sector does not

64. *Id.* at 302 (“While research is an important factor in hiring, tenure, and promotion decisions, university faculty are not required to research a specific subject or to produce any particular work product.”).

65. *Stanford*, 131 S. Ct. at 2196 (noting that “[n]owhere in the [BD] Act is title expressly vested in contractors or anyone else; nowhere in the Act are inventors expressly deprived of their interest in federally funded inventions?”).

66. Michael Yamaner, Nat'l Sci. Found., *Federal Funding of Basic and Applied Research Increases in FY 2009*, INFO BRIEF NAT. CTR. FOR SCI. AND ENG'G STATISTICS, Jul. 2011, at 2 tbl. 1, available at <http://www.nsf.gov/statistics/infbrief/nsf11324/nsf11324.pdf>.

67. *Id.*

68. Mark Boroush, Nat'l Sci. Found., *New NSF Estimates Indicate that U.S. R&D Spending Continued to Grow in 2008*, INFO BRIEF NAT. CTR. FOR SCI. AND ENG'G STATISTICS, Jan. 2010, at 6 tbl. 3, available at <http://www.nsf.gov/statistics/infbrief/nsf10312/nsf10312.pdf>.

69. For example, laboratories such as Los Alamos National Laboratory, Argonne National Laboratory, Sandia National Laboratory, Lawrence Berkeley National Laboratory, Lawrence Livermore National Laboratory, Brookhaven National Laboratory.

70. Boroush, *supra* note 68.

71. *Id.*

adequately support.⁷² While few investors are able or willing to invest in high risk original research, many more investors are willing to take the fruits of federally funded basic research to the next level, after the government has borne the cost of taking the initial uncertain steps.⁷³

Advancing scientific knowledge and training new generations of scientists and engineers are two important goals of federal basic research funding.⁷⁴ Though basic research grants generally are not conditioned on successful discovery or invention of specific items, any patentable invention that arises, fortuitously or not, can be viewed as a bonus. Therefore so long as patenting and commercialization do not interfere with the main goals of basic research funding, these activities are tolerated and even encouraged.⁷⁵

Additionally, university research tends to focus on areas too often ignored by the private sector either because the profit horizon is far away or the risk of failure is high.⁷⁶ Some scholars have argued that a strong focus on research topics that are likely to generate patentable inventions is antithetical to the mission of academics to conduct basic research that lays the groundwork for future applied research.⁷⁷ Also, university patenting of

72. See Mimura, *supra* note 35, at 269–73.

73. See *id.*

74. See, e.g., Congress's stated various purposes for the National Science Foundation ("NSF") in the National Science Foundation Act of 1950, 42 U.S.C. § 1862 & §§ 1862a–1862o (2006). For example in one section, Congress stated that

the Foundation, as part of its responsibility for maintaining the vitality of the Nation's academic research, . . . must assist in enhancing the historic linkages between Federal investment in academic research and training and investment in the research capital base by reinvesting in the capital facilities which modern research and education programs require.

§ 1862a(a)(5).

75. See, e.g., Aldo Jeuna & Lionel J.J. Nesta, *University Patenting and Its Effects on Academic Research: The Emerging European Evidence*, 35 RES. POL'Y 790 (2006); Gustavo Crespi, Pablo D'Este, Roberto Fontana, Aldo Geuna, *The Impact of Academic Patenting and Its Impact on University Research and Its Transfer* (International Center For Economic Research, Working Paper No. 1, 2009).

76. See Sean O'Connor, *Navigating The Issues Of Multi-Disciplinary Student Teams Serving University Spin-Offs*, in CROSSING CULTURES & DISCIPLINES, ADVANCES IN THE STUDY OF ENTREPRENEURSHIP, INNOVATION AND ECONOMIC GROWTH SERIES (Gary D. Libecap & Marie C. Thursby eds.) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1684812 ("In the university context, many science and technology innovations are very early stage, and not yet ready to be produced for the market in the form of products or services."). The article implies that for-profit companies would be unwilling to conduct such research themselves or even license those early stage, risky innovations from universities.

77. Chew, *supra* note 51, at 305 (discussing conflict between academic research and commercialization of academic innovations).

upstream discoveries may impede downstream research and applications.⁷⁸ And once a university researcher makes a basic discovery, that discovery must still proceed down a difficult road towards commercialization before it can be of societal benefit.⁷⁹

What this means is that the goal of basic research is not necessarily to endow the public with a new patent on a specific invention, or for the government to generate some nominal royalties from out-licensing a specific invention and offset the burden of supporting basic research in the first place. Nor is it the goal of publicly funded research to give contractors a new lucrative revenue stream with the licensing of blockbuster patents.⁸⁰ The main purpose of publicly funded research, using a research grant on cancer as an example, would not be to patent a new anti-cancer compound. Rather, the goal of such a research grant would be to increase overall social welfare by prolonging life expectancy and quality of care through better cancer treatment, which the government grant enables in cases where private investors find the investment too risky or too much of a long shot. Those long-term benefits arise not from individually patented cancer compounds but rather from a collective pushing of medical boundaries. Viewed this way,

78. See Rai, *supra* note 33, at 297–98. An argument against such skepticism is that the patent system already has a built-in filter (35 U.S.C. § 101 (2006) on patentable subject matter) for preventing patenting of truly upstream discoveries and inventions; whether this filter functions sufficiently to minimize upstream blocking patents is debatable. See *Mayo Collaborative Servs. v. Prometheus Labs., Inc.*, 132 S.Ct. 1289 (2012) (holding that a patent claiming nothing more than a law of nature is invalid under 35 U.S.C. § 101). For further discussion of this debate, see Allen K. Yu, *Within Subject Matter Eligibility—A Disease and A Cure*, 84 S. CALIF. L. REV. 387 (2011).

79. See generally L.M. MURPHY & P.L. EDWARDS, BRIDGING THE VALLEY OF DEATH: TRANSITIONING FROM PUBLIC TO PRIVATE SECTOR FINANCING 9 (2003), available at <http://www.nrel.gov/docs/gen/fy03/34036.pdf> (“Public sector financiers make significant R&D investments in technology and the associated early stage ventures while hoping to entice private sector investors to exercise their option to build on, and to further invest in, the early technology based businesses, thus leading to successful commercialization. The purpose of this paper is to help the two sectors better foster the transition of the entrepreneurial ventures and thereby accelerate the commercialization of clean energy, technology-based products, while improving the yield of these public sector investments.”).

80. See Jeannette Colyvas, Michael Crow, Annetine Gelijns, Roberto Mazzoleni, Richard R. Nelson, Nathan Rothenberg & Bhaven N. Sampat, *How Do University Inventions Get into Practice?*, 48 MGMT. SCI. 61, 68 (2002) (“[I]t is important to note that enhancing university revenues, which was not a central argument for the policies articulated in Bayh-Dole, now clearly is an important objective of universities in their patenting and licensing policies. There is no reason why this objective should mostly be at odds with achieving rapid and widespread technology transfer, which was the articulated purpose of Bayh-Dole. But there is no reason to believe, either, that policies that maximize a university’s revenues are always aligned with those that maximize technology transfer.”).

an invention or a patent on an invention is just the first of several uncertain and costly steps necessary for any scientific breakthrough to reach and truly benefit the public. To say that the public is paying specifically for an invention therefore stops short of appreciating the true scope of federal research funding.

C. THE UNIVERSITY INNOVATION MICROCOSM

For an invention to fulfill its potential and become useful to society, it needs to be developed far beyond the initial conceptual stages.⁸¹ There are at least four parties who must interact in order to commercialize a university invention: the university, inventor-employee, government funding agency, and private investor or entrepreneur. Each brings know-how and resources essential to the innovation enterprise, and the relationships between them are largely governed by contracts.⁸²

Universities take ownership of these inventions for at least two reasons. First, they are often required, as a condition for receiving federal research funding, to put in place a contractual mechanism for gaining ownership of inventions made by their employees.⁸³ Second, universities increasingly depend on licensing fees and royalties to boost income, particularly when their endowments falter in times of recession or when politicians cut school funding for budgetary reasons.⁸⁴

The federal government requires contractor-universities to comply with the terms of its research grants. For example, the National Institutes of Health Grants Policy Statement (“NIHGPS”) stipulates that “[g]rantee employees working under the funding award (e.g., PD/PI) must sign an

81. See generally Colyvas, *supra* note 80 at 68–72 (2002) (deciphering eleven case studies on commercialization of inventions at Columbia and Stanford Universities, the complications of various intellectual property rights arrangements, and the roles of technology licensing offices in success and failure of technology transfer).

82. See generally O'Connor, *supra* note 27 (discussing the central role of private ordering arrangements in enabling innovation).

83. See, e.g., U.S. DEPT. OF HEALTH AND HUMAN SERVS., NAT'L INSTS. OF HEALTH, NIH GRANTS POLICY STATEMENT IIA-89-93 (Oct. 2011), available at http://grants.nih.gov/grants/policy/nihgps_2011/nihgps_2011.pdf.

84. See, e.g., Richard Jensen & Marie Thursby, *Proofs and Prototypes for Sale: The Tale of University Licensing*, 91 AMER. ECON. REV. 240, 245 (2001) (“Technology managers and university administrators (as perceived by TTO managers) consider license revenue more important than any other outcome [among various objectives for out-licensing university inventions].”); Recent Development, *Columbia, Co-transformation, Commercialization & Controversy the Axel Patent Litigation*, 17 HARV. J.L. & TECH. 583 (2004) (noting Columbia University’s profit motive in seeking to extend patent monopoly by repeatedly filing continuation patent applications).

agreement to abide by the terms of the Bayh-Dole Act and the NIHGPS as they relate to intellectual property rights.”⁸⁵ Accordingly, the “[g]rant organizations and consortium participants must have policies in place regarding ownership of intellectual property,” as required by 37 C.F.R. § 401.14(f)(2) (2010).⁸⁶ “Failure of the grantee to comply with any of these or other regulations cited in 37 CFR Part 401 may result in the loss of patent rights or a withholding of additional grant funds.”⁸⁷ The National Science Foundation has similar rules for grantees.⁸⁸ Moreover, the government safeguards the public’s interest by reserving march-in rights, which allow the government to practice or license to a third party any federally funded invention owned by the contractor.⁸⁹

Research institutions typically comply with these grant rules through their employment contracts. University of California’s (“UC”) mandatory oath on patent policy is typical.⁹⁰ It states that in consideration of employment, the inventor acknowledges his “obligation to assign,” and further does “hereby assign, inventions and patents.”⁹¹ Similarly, Stanford’s research policy handbook states that “[a]ll potentially patentable inventions . . . shall be assigned to the University, regardless of the source of funding, if any,” and that the employee shall “hereby assign to Stanford . . . all my right, title and interest in such patentable inventions.”⁹² Notably both UC and Stanford inserted the “hereby assign” phrase into their agreements in response to *Stanford*.⁹³

85. NIH GRANTS POLICY STATEMENT, *supra* note 83, at IIA-90 Exhibit 8.

86. *Id.*

87. *Id.* at IIA-93.

88. NAT’L SCI. FOUND., GRANT POLICY MANUAL § 730 (Jul. 2005), *available at* http://www.nsf.gov/pubs/manuals/gpm05_131/gpm05_131.pdf.

89. 35 U.S.C. § 203 (2006). The government has never exercised its march-in-right. *See infra* note 213.

90. UNIV. OF CAL. HUMAN RES. AND BENEFITS, *The Patent Amendment* (2011), http://atyourservice.ucop.edu/employees/policies_employee_labor_relations/patent-acknowledgment/patent-amendment.html (last visited Mar. 29, 2012).

91. *Id.*

92. Memorandum from the Stanford University Office of the Vice Provost and Dean of Research to faculty, staff, graduate students, and postdocs regarding updated patent and copyright agreement in the Research Policy Handbook (July 2011), *available at* <http://rph.stanford.edu/su18.html>.

93. For University of California, see Letter from Lawrence H. Pitts, Provost and Executive VP of Academic Affairs & Nathan Brostrom, Executive VP of Business Operations, to Members of the University of California Community, Re: Amendment to Patent Acknowledgement or Agreement (Nov. 10, 2011), *available at* http://atyourservice.ucop.edu/employees/policies_employee_labor_relations/patent-acknowledgment/patent_amendment_letter_nov._10.pdf (requiring all employees and

By contrast, other schools such as the Massachusetts Institute of Technology (“M.I.T.”) already used the “hereby assign” language in their assignment contracts before the *Stanford* decision.⁹⁴ M.I.T.’s Invention and Proprietary Information Agreement requires that “[a]ll members of the M.I.T. community . . . who participate in either sponsored research or Institute-funded research . . . agree[] to assign to M.I.T. or its designate his or her title to Intellectual Property.”⁹⁵ The Agreement further states “I will disclose promptly to and assign to, and I hereby assign to, M.I.T. all rights to all inventions . . . which: (i) are developed in the course of or pursuant to a sponsored research.”⁹⁶

To be clear, the latest versions of Stanford, UC, and M.I.T.’s invention assignment agreements (or amendments to such agreements) all contain the “hereby assign” or “hereby do assign” language, and so Stanford, UC, and M.I.T. employees by that contractual language grant their respective universities legal ownership of inchoate inventions at the very moment that they sign those agreements.⁹⁷ But before Stanford and UC revised their assignment agreements in the aftermath of *Stanford*, their assignment agreements did not contain the key “hereby assign” phrasing. Instead, their old agreements contained the “agree to assign” phrasing, which the Federal Circuit held—and the Supreme Court in *Stanford* confirmed—conveyed to the universities only equitable interest in the inventions.⁹⁸ What that means is that under such an arrangement, the inventor has only created an obligation

personnel to sign an amendment to their patent agreement because “[a]s a result of court decisions culminating in the United States Supreme Court decision earlier this year in the case *Stanford v. Roche*, UC’s rights to inventions and patents are at risk because of the Court’s interpretation of the language used in our current Patent Acknowledgment”). And for Stanford University, compare Stanford’s updated research policy handbook that was revised within one month of *Stanford* (*supra* note 92), with Stanford’s pre-*Stanford* research policy handbook that was current as of July 15, 1999 (Stanford University Office of the Vice Provost and Dean of Research, *Inventions, Patents and Licensing (RPH 5.1)*, RESEARCH POLICY HANDBOOK, <http://rph.stanford.edu/5-1.html> (last visited Feb. 5, 2012)).

94. Current version of M.I.T.’s Agreement was last revised on April 14, 2010. *Infra* note 95.

95. M.I.T. TECHNOLOGY LICENSING OFFICE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY INVENTIONS AND PROPRIETARY INFORMATION AGREEMENT (Apr. 2010), available at <http://web.mit.edu/tlo/www/downloads/doc/IPIA.doc>.

96. *Id.*

97. See *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2194 (2011).

98. See *infra* Sections IV.C & IV.D.

to assign to the university, but retains legal right in the invention until he or she executes a post-invention assignment agreement.⁹⁹

Once universities secure legal ownership rights to inventions, including those that are federally funded, entities ranging from startups to mature companies license those inventions. Subsequently, the companies may provide additional funding for collaborative research where IP rights are allocated between the universities and private collaborators according to contractual agreements.¹⁰⁰ The terms of in- and out-licensing agreements are governed by private contracts and invariably contain complex arrangements.¹⁰¹

In short, universities frequently sit at the center of the innovation microcosm where contract law governs inter-entity interactions based on rights created by patent and property laws. Disturbing the parties' understanding of the default ownership rules would inevitably complicate this complex web of contractual relationships. Notably within this microcosm, the inventor is often by far the least legally sophisticated party, and the BD Act further complicates what is already a difficult to comprehend set of legal relationships.

III. THE BAYH-DOLE ACT

Much of the dispute in *Stanford* centers on the proper interpretation of the BD Act¹⁰² because Stanford chose to forgo other legal issues and focus its final appeal entirely on the BD issue. This Part describes the history and policy objectives of the BD Act and how the Act operates to maximize the social impact of federal research funding. BD provides a framework for answering the basic question of who owns what invention and when. In effect, BD provides a consistent, predictable ownership framework that gives contractors the role of promoting government funded inventions to the private sector.

99. The university can sue to enforce that equitable right. But legal right remains with the inventor until a court grants an equitable remedy such as injunction or specific performance. *Stanford*, 131 S. Ct. at 2194.

100. Mimura, *supra* note 35, at 273–84 (discussing industry-university collaborations and partnerships).

101. See O'Connor, *supra* note 27.

102. *Stanford*, 131 S. Ct. at 2192.

A. BEFORE THE BAYH-DOLE ACT

The BD Act did not spring out of ether. It is the product of negotiated compromises based on years of experience on knowledge of what policies worked well and what did not.¹⁰³ Prior to enactment of BD in 1980, the federal government lacked a uniform policy for IP ownership.¹⁰⁴ In many instances, the government retained ownership of patents developed using federal funding but failed to commercialize the inventions that it owned.¹⁰⁵ Proponents of BD often cite the debatable statistic that in 1980, about ninety-five percent of federally owned patents were languishing in a vast bureaucracy, not generating licensing fees or royalties.¹⁰⁶ Also, while promises of monopoly in the form of exclusive licenses are often necessary to attract private investors, the federal government granted mostly non-exclusive licenses.¹⁰⁷

What eventually became BD started as agency-specific procedures for contractor institutions to obtain patent rights if the federal government chose not to retain patent ownership.¹⁰⁸ The National Institutes of Health (“NIH”) were one such funding agency that followed case-by-case procedures that worked much like the eventual provisions of BD.¹⁰⁹ So BD’s general mechanism of encouraging technology transfer by giving ownership of

103. Mowery, *supra* note 8, at 85–98 (discussing the political history of BD).

104. Hutt & Mays, *supra* note 109, at 5; Mowery, *infra* note 8, at 35–98 (discussing pre-BD university patenting and licensing and the political history of BD).

105. Dov Greenbaum, *National technology transfer mechanism*, in HANDBOOK ON LAW, INNOVATION, AND GROWTH 245, 248–52 (Robert E. Litan ed., 2011); Mowery, *supra* note 8, at 35–98.

106. While arguing that there was little technology transfer of government funded inventions before BD, the BD proponents noted that “[t]he General Accounting Office (GAO) reported in 1978 that fewer than 5% of approximately 28,000 government-held patents were licensed for commercial use.” BayDole25, Inc., *The Bayh-Dole Act at 25*, at 13. (Apr. 2006) (whitepaper). “Mowery et al. have criticized this widely-cited figure, rightfully pointing out that it may overstate the problem in that it includes defense contracts, and national security considerations would preclude technological innovations that result from such contracts from being licensed.” *Id.* (citing Mowery, *supra* note 8, at 90–91).

107. *Id.* at 2.

108. Mowery, *supra* note 8, at 89.

109. *Id.* at 87–88 (The NIH is part of Department of Health and Human Services (DHHS), which was formerly known as HEW (Department of Health, Education, and Welfare); Greenbaum, *supra* note 105, at 247; Peter B. Hutt & Thomas Mays, *Historical Perspectives on Government Technology Transfer Policy and Pharmaceutical Industry*, in GOVERNMENT AND INDUSTRY COLLABORATION IN AIDS DRUG DEVELOPMENT 3, 3–7 (Leslie M. Hardy ed., 1994), available at http://www.nap.edu/catalog.php?record_id=9196.

inventions to universities was not novel in 1980. What was novel was the unification of disparate agency policies on technology transfer.¹¹⁰

B. LEGISLATIVE HISTORY

At the time Congress introduced the bill that became BD, nearly everyone agreed that default government ownership of inventions failed to maximize the potential social benefits that could be extracted from federally funded research.¹¹¹ Debates on an early draft of the Act indicate that Congress simply “presumed” that universities have legal ownership of their researcher’s inventions.¹¹² Hence, much of the debate revolved around why a uniform policy would be important and why universities are in a better position to manage patents than the federal government. The final version of the Act does not explicitly require that an inventor assign his invention to the university.¹¹³

C. ENACTMENT AND POLICY OBJECTIVES

Congress conveniently lays out the many objectives of BD in the Act itself:

to use the patent system to promote the utilization of inventions arising from federally supported research or development; to encourage maximum participation of small business firms in federally supported research and development efforts; to promote collaboration between commercial concerns and nonprofit organizations, including universities; to ensure that inventions made by nonprofit organizations and small business firms are used in a manner to promote free competition and enterprise without unduly encumbering future research and discovery; to promote the commercialization and public availability of inventions made in the United States by United States industry and labor; to ensure that

110. Greenbaum, *supra* note 105, at 248 (stating that BD was introduced to “harmonize the government’s policies towards patenting of federally funded research”); Hutt & Mays, *supra* note 109 at 4–6 (noting that prior to BD, “[b]y the late 1970s, there were approximately 22 different administrative policies regarding patent rights to government-sponsored inventions”).

111. Edward C. Walterscheid, *The Need for a Uniform Government Patent Policy: The D.O.E. Example*, 3 HARV. J.L. & TECH. 103, 130 (1990).

112. H.R. Rep. No. 96-1307, pt. 1, at 5 (1980) (“The legislation [BD] establishes a presumption that ownership of all patent rights in government sponsored research will vest in any contractor who is a non-profit research institution or a small business.”).

113. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc. et al.*, 131 S. Ct. 2188, 2196 (2011) (noting that “[n]owhere in the [BD] Act is title expressly vested in contractors or anyone else; nowhere in the Act are inventors expressly deprived of their interest in federally funded inventions”).

the Government obtains sufficient rights in federally supported inventions to meet the needs of the Government and protect the public against nonuse or unreasonable use of inventions; and to minimize the costs of administering policies in this area.¹¹⁴

As a policy matter, Congress essentially declared with BD that federal contractors such as universities are in a better position than the government to advance the social policy goals of public research. Empirical evidence over the last thirty years shows that the BD Act has probably played some role, (though perhaps a more limited role than proponents of BD have argued) in encouraging a surge of commercialization in federal funded inventions.¹¹⁵ Thus Congress may have been correct, at least partially, in its view that contractors are effective owners of federally funded inventions.

D. PROLIFERATION OF TECHNOLOGY LICENSING OFFICES

Following the enactment of the BD Act, many universities established technology transfer or licensing offices (“TLOs”) or expanded their existing offices.¹¹⁶ These offices act as central clearinghouses for university generated inventions and provide an administrative mechanism for ensuring compliance with BD.¹¹⁷ The possibility of generating “unencumbered” payout from inventions provides strong impetus for most universities and their TLOs to diligently monetize the inventions that they own.¹¹⁸

So the question becomes this: if the potential payout incentive to the universities were removed, giving that payout instead to the inventors, would innovation suffer as a result? Part of the answer may be found in BD itself. The Act requires that federal contractors share with their employee-inventors proceeds derived from the contractor’s ownership of the inventor’s work product,¹¹⁹ though BD does not specify how much of a share ought to be given to inventors.¹²⁰ The reason Congress explicitly provides that inventors share in the licensing fees is possibly the recognition that the inventor is at the root of the invention, so the most direct way to stimulate innovation is to

114. 35 U.S.C. § 200 (2006).

115. *See, e.g.*, Kenney, *supra* note 8; Mowery, *supra* note 8 and references therein.

116. For a detailed discussion of TLO’s and their relationships with inventors, see Kenney, *supra* note 8, at 1409–13.

117. *Id.*; Mowery, *supra* note 8, at 146–47.

118. Kenney, *supra* note 8, at 1410 (“TLO income is attractive to administrators because the funds are, in fact, largely unencumbered, thereby providing wide discretion on how they are spent.”).

119. 35 U.S.C. § 202(c)(7)(B) (2006) (stating the “requirement that the non-profit contractors share royalties with their inventors”).

120. *Id.*

reward the source of inventive genius. But by that logic, the inventor ought to receive all of the licensing revenue to maximize the incentive to invent. That is simply not the scheme under BD, which merely requires that the contractors share some revenue with the inventors.¹²¹ Indeed, the most plausible reason for revenue sharing with the inventors is likely that increased sharing is the “best way to encourage disclosure.”¹²² And without disclosure of inventions by their employee-inventors, the university TLOs would be irrelevant.¹²³

For university inventors who have little entrepreneurial bent or interest in the business world, TLOs are critical to helping them commercialize valuable inventions by taking a proactive approach to marketing and managing inventions, thus preventing inventions from languishing in academic anonymity. On the other hand, some inventors who are eager to commercialize their inventions do not necessarily want or need TLOs to get in their way. There are examples of professors who are serial entrepreneurs with a track record of translating their academic research into commercialized products.¹²⁴ For some of these individuals, success in the business world seemingly would occur without the cooperation of TLOs at their respective universities.¹²⁵

Stanford represents one scenario where the TLO was not needed for or helpful to innovation. There, Roche took ownership of the PCR invention in 1989 by virtue of the VCA assignment from the visiting Stanford

121. *Id.* Perhaps university inventors already have plenty of other incentives to invent, such as promise of a reasonable salary, so any additional income from BD’s mandatory payout sharing is simply a nice bonus without much motivating effect.

122. Kenney, *supra* note 8, at 1413.

123. Absent voluntary disclosure, a TLO would likely have trouble finding out about employee inventions. It would be impractical for TLOs to audit laboratory notebooks to find potentially valuable inventions.

124. For example, Peter G. Schultz of The Scripps Research Institute founded several biotechnology companies including Symyx, Syrrx, Kalypsys, Phenomix, Ilypsa, and Ambrx. Peter G. Schultz, THE PETER G. SCHULTZ LABORATORY, <http://schultz.scripps.edu/schultz.php> (last visited Feb. 5, 2012). Likewise Robert S. Langer of Massachusetts Institute of Technology has been involved in numerous companies including Acusphere, AIR, Arsenal, Bind Biosciences, Blend Therapeutics, Kala, Living Proof, Microchips, Moderna, Momenta, Pervasis, Pulmatrix, Selecta Biosciences, Seventh Sense, Taris, Transform, and T2. Gregory T. Huang, *The Bob Langer and Polaris Family Tree: From Acusphere to Momenta to Visterra*, XCONOMY (Apr. 19, 2011), <http://www.xconomy.com/boston/2011/04/19/the-bob-langer-and-polaris-company-tree-from-acusphere-to-momenta-to-visterra/>.

125. This sentence by no means implies that entrepreneurial professors find TLOs cumbersome and unhelpful. To the contrary, many of these professors probably find the legal, business, and organizational skills and experience of TLOs helpful to their commercial ventures.

researcher.¹²⁶ Meanwhile, Roche independently developed the invention into a commercial product and received FDA approval in March 1999, six years before the *Stanford* lawsuit began.¹²⁷ Involvement of Stanford's TLO before 1999 probably would not have made much, if any, difference to whether Roche commercialized the PCR test product. In hindsight, it seems like the only role that Stanford's TLO would have played with its involvement was to extract licensing fees from Roche before the product came to market and royalties thereafter.¹²⁸

E. OPERATION OF BAYH-DOLE AND PRESUMPTIONS UNDERLYING BAYH-DOLE

BD applies to “any invention of the contractor conceived or first actually reduced to practice in the performance of work under a [federal] funding agreement”¹²⁹ Once BD applies, it sets into motion an ownership hierarchy that first gives the contractor power to “elect to retain title” of the invention. As the Supreme Court explained, this first step presumes that the contractor already has title in hand and therefore something to “retain.”¹³⁰ Next on the hierarchy is the government, which has the option of taking title from the contractor in a variety of circumstances, such as when the contractor elects to not retain title, or if a foreign government controls the contractor.¹³¹ Finally, the inventor may obtain title if the contractor “does not elect to retain title” and the government likewise declines to take title and approves of the title transfer to the inventor.¹³²

Importantly, BD does not consider the government taking title directly from the inventor, nor does BD discuss the inventor retaining title himself. BD is structured with the contractor as the initial title holder in mind.¹³³ And that is the trouble with the BD Act: it presumes that the contractor has legal ownership of its employee's inventions.¹³⁴ This is a good assumption most of the time because contractors usually do properly gain legal ownership of their

126. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2192 (2011).

127. *Id.*

128. *See infra* note 145 on transaction cost of TLOs.

129. 35 U.S.C. § 201(e) (2006).

130. *Stanford*, 131 S. Ct. at 2197.

131. 35 U.S.C. § 202 (2006); *Stanford*, 131 S. Ct. at 2193.

132. 35 U.S.C. § 202; *Stanford*, 131 S. Ct. at 2193.

133. H.R. REP. NO. 96-1307, pt. 1, at 5 (“The legislation [BD] establishes a presumption that ownership of all patent rights in government sponsored research will vest in any contractor who is a non-profit research institution or a small business.”).

134. *Id.*

employees' inventions. But as the Supreme Court pointed out in *Stanford*, the BD statute itself does not give contractors ab initio legal title to their employees' inventions.¹³⁵ Instead, patent law, ancillary contract law, and common law, dictate legal title.¹³⁶ A contractor therefore has to somehow obtain legal title in the invention. Otherwise BD's legal framework is simply irrelevant because legal title is a prerequisite to the operation of BD.¹³⁷ Most of all, BD's proper operation does not require that the contractor has initial ownership, but merely that the contractor has legal ownership at some point after invention has occurred.¹³⁸

F. THE IMPACT OF BAYH-DOLE

Commercialization of university inventions has increased significantly and steadily since the 1980s.¹³⁹ Empirical studies of BD in practice over the past thirty years disagree on BD's contribution to the surge of university innovation.¹⁴⁰ While some proponents of the Act argue that dramatic increases in patent filings and licensing by universities are a direct result of the BD Act, other scholarly research show that the BD Act is merely one contributor among myriad factors that led to an innovation surge starting in the 1980s.¹⁴¹ What is clear though is that BD created a predictable framework of IP ownership that provides private parties with a reliable basis on which to form contracts.¹⁴² Legal disputes centered around interpretation of BD have been few and far between.¹⁴³

The heaviest criticism of BD is that the Act assumes TLOs are intrinsically better than inventors at attracting and dealing with licensees, collaborators, and venture capitalists. Various commentators have questioned this assumption on the basis of comparative studies that show that inventor

135. *Stanford*, 131 S. Ct. at 2194.

136. *Id.*

137. *Id.* at 2197.

138. *See id.*

139. Mowery, *supra* note 8, at 1–2.

140. *See generally* Jensen & Thursby, *supra* note 84 and references therein (discussing case studies of university technology transfer in the post-BD era); Kenney, *supra* note 8 and references therein (discussing current and alternative invention ownership models under the BD Act while citing various empirical studies on the BD Act's impacts); Mowery, *supra* note 8 (discussing university-industry technology transfer before and after the BD Act).

141. *See* Kenney, *supra* note 8.

142. Greenbaum, *supra* note 105.

143. *Infra* note 147.

ownership of inventions can be quite effective at advancing innovation.¹⁴⁴ Perhaps BD adds a layer of unnecessary transaction cost by requiring TLOs as middlemen.¹⁴⁵ Some have argued that the public policy goals of commercializing the fruits of federally funded research could instead be better achieved by streamlining the transfer of patent rights away from the federal government, without requiring that the rights always go to the contractors.¹⁴⁶

IV. THE *STANFORD V. ROCHE* LITIGATION

While the effectiveness of BD might be hotly debated as to how it might encourage innovation, rarely has the Act been a focus in legal disputes.¹⁴⁷ But the Act managed to take center stage in the *Stanford* litigation, where the Supreme Court took its first look at the invention ownership structure under the BD Act. Though the Supreme Court confined its holding in *Stanford* to the question of whether BD trumps the default rule in patent law that inventors own their inventions, the decision could have broader implications for innovation.¹⁴⁸

144. See Kenney, *supra* note 8, at 1416 n.33. University of Waterloo in Canada has an inventor as initial owner system that seems to work well. Research in Motion (RIM), the maker of Blackberry®, is a technology company that came out of University of Waterloo.

145. See, e.g., Lorelei Ritchie de Larena, *The Price of Progress: Are Universities Adding to the Cost?*, 43 HOUS. L. REV. 1373, 1402–25 (discussing mismanagement and misuse of federal research funds, and “questionable licensing practices” that enrich the university’s general funds at the public’s expense).

146. See, e.g., Kenney, *supra* note 8 and references therein, at 1414–18 (discussing the “inventor ownership model” and “weaker ownership rights model[s]”); de Larena, *supra* note 145, at 1439–44 (proposing a “unified, national technology-transfer center”).

147. A search of the ALLFEDS database on Westlaw® (all federal courts including the Supreme Court, Circuit Courts of Appeals, and district courts in all states and territories) reveals that over 30 years of the BD Act’s existence, only 51 judicial opinions, encompassing 26 separate lawsuits, contain the term “Bayh-Dole” more than once in the opinion. Indeed, BD wasn’t the central issue in *Stanford* until the case reached the Supreme Court. The BD argument was one of several legal theories (bona fide purchaser, statute of limitations, standing, etc.) disputed at the Federal Circuit. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 583 F.3d 832, 842–44, 846–49 (2009), *aff’d*, 131 S. Ct. 2188 (2011) (affirming solely on the issue of whether BD trumps private ordering arrangements and gives ownership automatically to the contractor).

148. See *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2196–98 (2011) (most of the discussion relates to statutory interpretation). The *Stanford* decision’s importance to the university innovation community is reflected in the participation of dozens of *amici curiae*, representing the academic community, technology transfer professionals, venture capitalists, private industries, the federal government, among others, representing the full spectrum of participants in the innovation process. See, e.g., *infra* Section IV.E, IV.F.

The Court held that consistent with over 300 years of patent law, the BD Act does not displace the norm that “rights in an invention belong to the inventor.”¹⁴⁹ That is, initial title in an invention vests in the inventor, and not the federal contractor. At first glance, this decision seems to upend the basic premise on which BD is built—that a contractor has title to inventions and uses that ownership to advance innovation.¹⁵⁰ On closer examination however, the decision still allows BD to fully do its job of promoting innovation, so long as assignment contracts are properly drafted. But it leaves open the possibility of bypassing BD in those rare circumstances where doing so might be efficient in terms of maximizing the social welfare objective of federally funded research through private ordering arrangements.¹⁵¹

A. THE PARTIES

The petitioner-plaintiff Stanford University is a research university that receives considerable research funding from the federal government. As a federal contractor, Stanford is required to comply with the BD Act, in addition to any obligations imposed by individual federal funding agencies. For example, the NIH require that Stanford has in place a mechanism to take title in inventions from its employees.¹⁵² Stanford employees, including professors, students, research staff and fellows, are the inventors. They are not the parties contracting with the federal government; Stanford is the contractor. Interestingly, failure of a contractor to comply with NIH’s grants policy is supposed to result in penalties such as forfeiture of the grant.¹⁵³ But here, despite Stanford’s apparent violation of NIH policy, it is unclear if NIH levied sanctions against Stanford.¹⁵⁴

149. *Id.* at 2192.

150. The legislative history shows a presumption of initial contractor ownership. *See supra* note 133.

151. The Court’s interpretation of BD also leaves open the possibility of bypassing BD to the pecuniary detriment of the contractor. Such is what happened in *Stanford*.

152. NIH GRANTS POLICY STATEMENT, *supra* note 83, at IIA-89-93.

153. *Id.* at IIA-93.

154. Here, violation of the Grants Policy only became apparent to Stanford and NIH several years after any grant that could have resulted in the invention had already been used up and expired. Moreover, it was unclear if Holodniy’s research was covered by any NIH grant at all. Brief of Respondents (Roche) at *6–7, *Stanford*, 131 S. Ct. 2188 (No. 09-1159), 2010 WL 288882 (“Stanford failed to produce the two NIH grant agreements on which it relies, and it is undisputed that Holodniy’s salary at Cetus was paid not by either grant, but by a National Research Service Award of the kind expressly exempted from the Bayh-Dole Act.”).

The respondent-defendant Roche Molecular Systems, Inc. is a medical diagnostics company that produces, among other products, a PCR tool for quantifying HIV viral load in patients.¹⁵⁵ Roche acquired Cetus Corporation's PCR assets in 1991.¹⁵⁶ Cetus Corporation ("Cetus") was a California biotechnology company that pioneered PCR techniques for medical diagnostics.¹⁵⁷ One of its scientists, Kary Mullis, received a Nobel Prize in chemistry for the invention of the PCR method while at Cetus.¹⁵⁸ Around the late 1980s, Cetus was at the pinnacle of PCR research and many research institutions, including Stanford, sought PCR know-how from Cetus on what was then a groundbreaking technology.¹⁵⁹

B. BACKGROUND OF THE DISPUTE

The ownership of three patents was in dispute. All three patents shared a common parent application and claimed a method for quantifying HIV in human blood samples using PCR.¹⁶⁰ In 1988, Mark Holodniy, one of the listed inventors on the patents, began developing the disputed inventions at Stanford University as a Research Fellow.¹⁶¹ Upon joining Stanford, Holodniy executed an agreement where he "agreed to assign" his future inventions to Stanford.¹⁶²

In early 1989, Holodniy visited Cetus daily to learn about the PCR technology.¹⁶³ Before beginning his visits at Cetus, Holodniy executed a visitor confidentiality agreement ("VCA") that immediately assigned all of Holodniy's inchoate PCR inventions to Cetus.¹⁶⁴ In due course, Holodniy returned to Stanford and produced a PCR assay that could quantify HIV in humans.¹⁶⁵ He and his Stanford supervisors were listed as co-inventors when Stanford filed the patent applications that would become the focus of the *Stanford* lawsuit.¹⁶⁶ Because NIH funded at least part of the HIV research at

155. *Stanford*, 131 S.Ct. at 2192.

156. *Id.*

157. *Id.*

158. *The Nobel Prize in Chemistry 1993*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/chemistry/laureates/1993/ (last visited Feb. 6, 2012).

159. *The History of PCR (RU9577)*, SMITHSONIAN INSTITUTION ARCHIVES, http://siarchives.si.edu/research/videohistory_catalog9577.html (last visited Feb. 6, 2012).

160. *Stanford*, 131 S. Ct. at 2192.

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.* ("Over the next few years [after Holodniy's Cetus visit], Stanford obtained written assignments of rights from the Stanford employees involved in refinement of the

Stanford, Stanford “formally notified the Government that it elected to retain title to the inventions under the Bayh-Dole Act” during prosecution of the patents-in-suit.¹⁶⁷

Meanwhile, Roche acquired Cetus’ PCR business, developed a PCR assay for HIV and commercialized it.¹⁶⁸ When the commercial success of Roche’s PCR assay became evident, Stanford, armed with the issued patents-in-suit, demanded royalty payments.¹⁶⁹ Having failed to reach an amicable licensing agreement, Stanford filed suit in 2005 against Roche for patent infringement.¹⁷⁰ Roche answered and counterclaimed that Stanford lacked standing to bring suit because Roche “possesses ownership, licenses, and/or shop rights to the patents through Roche’s acquisition of Cetus’s PCR assets.”¹⁷¹ Roche also answered that the asserted patent claims were invalid for obviousness.¹⁷²

C. LOWER COURT DECISIONS

Before the district court, Stanford argued *inter alia* that BD “negated” Holodniy’s assignment to Cetus, thus giving the government and Stanford “the right to take complete title to the inventions as a ‘right of second refusal.’”¹⁷³ The district court granted Stanford’s motion in part, holding that Roche’s ownership claims on the patents were barred by the BD Act. Interestingly, the district court held for Roche in finding the asserted patent claims invalid for obviousness.¹⁷⁴

The Federal Circuit reversed the district court on the BD issue.¹⁷⁵ It held that BD did not “automatically void . . . prior contractual transfer of rights” to a third party by the Stanford inventor.¹⁷⁶ The Federal Circuit found that Holodniy’s initial assignment contract with Stanford was only an agreement

technique, including Holodniy, and filed several patent applications related to the procedure. Stanford secured three patents to the HIV measurement process.”).

167. *Id.* at 2193.

168. *Id.*

169. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 583 F.3d 832, 838 (Fed. Cir. 2009).

170. *Id.*

171. *Id.*

172. *Id.* at 836.

173. *Id.* at 844 (discussing the district court’s ruling at 563 F. Supp. 2d 1016 (N.D. Cal. 2008)).

174. *Stanford*, 563 F. Supp. 2d 1016, 1037–48 (N.D. Cal. 2008), *aff’d-in-part, vacated-in-part*, 583 F.3d 832, 838 (Fed. Cir. 2009) (vacating lower court’s finding of Stanford patent’s invalidity for obviousness).

175. *Stanford*, 583 F.3d at 844–45.

176. *Id.* at 844.

to assign, whereas his assignment contract with Cetus was a valid present assignment of future inventions.¹⁷⁷ Therefore when Holodniy executed a second assignment agreement with Stanford to transfer to Stanford his invention *after* his visits to Cetus, he was left with nothing to assign because by that time Cetus had gained legal title to the invention.¹⁷⁸

Furthermore, the Federal Circuit stated that “the primary purpose of BD is to regulate relationships of small businesses and nonprofit grantees with the Government, not between contractors and the inventors who work for them.”¹⁷⁹ In other words, the court held that a patent ownership assignment controversy between a third party assignee (Roche) and the contractor (Stanford) falls outside of BD’s purview.¹⁸⁰ The Federal Circuit emphasized the consistency between its reading of BD and its own precedent *Central Admixture*, as well as with several recent district court opinions.¹⁸¹ Finally, because the Federal Circuit held that Stanford lacked ownership in the patents, and thus standing to sue, it vacated the invalidity judgment.¹⁸²

D. THE SUPREME COURT OPINION

Stanford petitioned the Supreme Court for certiorari in March 2010.¹⁸³ M.I.T., the Wisconsin Alumni Research Foundation (“WARF”), and various other universities and research organizations filed amicus briefs in support of Stanford’s petition, arguing that the Federal Circuit’s decision renders BD virtually irrelevant.¹⁸⁴ At the Supreme Court’s invitation, the Solicitor General (“SG”) filed an amicus brief ostensibly in support of neither party, but

177. *Id.*

178. *Id.*

179. *Id.* at 845 (quoting *Fenn v. Yale Univ.*, 393 F. Supp. 2d 133, 141–42 (D. Conn. 2004)).

180. *Id.*

181. *Id.* at 844–45 (citing *Cent. Admixture Pharm. Servs., Inc. v. Advanced Cardiac Solutions, P.C.*, 482 F.3d 1347, 1352–53 (Fed. Cir. 2007); *Univ. of Pittsburgh v. Townsend*, 2007 U.S. Dist. LEXIS 56860 (E.D. TN. 2008), *aff’d* 2008 FED App. 342P (6th Cir. 2008); *Fenn v. Yale Univ.*, 393 F. Supp. 2d 133, 141–42 (D. Conn. 2004)).

182. *Stanford*, 583 F.3d at 848–49 (“[t]he case is remanded with instructions to dismiss Stanford’s claim for lack of standing”).

183. *See* Petition for a Writ of Certiorari, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (filed Mar. 22, 2010).

184. *See, e.g.*, Brief of Amici Curiae Association of American Universities et al., *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (filed Apr. 26, 2010); Brief of Amicus Massachusetts Institute of Technology, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (filed Apr. 26, 2010); Brief of Wisconsin Alumni Research Foundation et al. in Support of Stanford’s Petition for Certiorari, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (filed Apr. 23, 2010).

actually strongly in favor of Stanford's position in urging the Supreme Court to grant the petition.¹⁸⁵ The Court granted certiorari soon after.¹⁸⁶

At the Supreme Court, Stanford argued that BD "automatically vests title to federally funded inventions in federal contractors"—i.e., the universities themselves.¹⁸⁷ The Court, in an opinion delivered by Chief Justice Roberts, held that consistent with over 300 years of patent law, the Bayh-Dole Act does not displace the norm that "rights in an invention belong to the inventor."¹⁸⁸ Thus, BD does not change the legal recognition that initial ownership of an invention under patent law belongs to the inventor.¹⁸⁹ The majority opinion focused on statutory interpretation and discussed potential negative implications if the Court had reached the opposite decision.¹⁹⁰ The Court pointed out that such a sea change in invention ownership regime, by taking away inventor ownership, should not occur over a huge swath of inventive enterprise unless Congress explicitly said so in the statute.¹⁹¹

Justice Breyer, joined by Justice Ginsburg, dissented.¹⁹² The dissenting Justices focused on the validity of present assignments of future inchoate inventions and what language such an assignment requires, a matter that they found neither parties fully briefed before the Court.¹⁹³ They would have remanded the case for further argument on this contract interpretation issue.¹⁹⁴ They also questioned the arbitrary restrictiveness of the Federal Circuit's *FilmTec* line of cases, which specifically require "hereby assign" or "hereby do assign" phrasing to effect immediate transfer of inchoate inventions.¹⁹⁵ Justice Sotomayor concurred with the majority despite her

185. Brief for the United States as Amicus Curiae, *Stanford*, 131 S. Ct. 2188 (2011) (No.09-1159) (filed Sep. 28, 2010).

186. *Stanford*, 131 S. Ct. 502 (2010) (granting Stanford's Writ of Certiorari).

187. *Id.* at 2198.

188. *Id.* at 2192.

189. *See id.*

190. *Id.* at 2198–99 (noting that BD lacks protection for third party ownership rights, thus bolstering the Court's conclusion that BD is only intended to govern the rights between contractors and the government).

191. *Id.*

192. *Id.* at 2199.

193. *Id.* at 2204 (stating that the dissenting opinion's views on contractual language interpretation matters are tentative "because the parties have not fully argued these matters").

194. *Id.* at 2200.

195. *Id.* at 2202–03 (quoting *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568 (Fed. Cir. 1991)).

agreement with the dissent's concerns with *FilmTec*, pointing out that "Stanford failed to challenge the decision below on these grounds."¹⁹⁶

In hindsight, it would appear that to prevail on the argument that BD ought to be a vesting statute, an attorney would want to find a set of facts involving an invention that had failed to become commercialized because it languished in the hands of an inventor who did not assign it to his highly competent university TLO. The ideal set of facts would unambiguously show that university-contractor ownership is the best way to move an invention forward in the innovation process, and that inventor ownership caused a failure to commercialize. Here, the unusual circumstances in *Stanford* do not come close to this ideal scenario, precisely because Roche successfully commercialized the PCR-HIV test invention without the Stanford TLO's involvement.

E. VIEWS OF AMICI IN SUPPORT OF STANFORD UNIVERSITY

After the Supreme Court granted certiorari, academic and industry groups filed a flood of amicus briefs.¹⁹⁷ The arguments of the amici merit attention and analysis because they represent various interests of the innovation community and highlight practical concerns over the outcome of this case. Notable amici in support of Stanford University include the U.S. Solicitor General, former Senator Bayh who had co-sponsored BD, the Association of University Technology Managers, the American Association for the Advancement of Science, the Association of American Universities, and somewhat surprisingly, the National Venture Capital Association ("NVCA").¹⁹⁸ Their policy arguments fall into the following three categories.

1. *Simplicity, Predictability, and Certainty in Ownership*

The amici in support of Stanford University argued that BD should automatically vest invention ownership in the universities because doing so would be procedurally efficient and would encourage investment.¹⁹⁹ They argued that statutory conveyance of title would make title determination simple and predictable without the uncertainty of unauthorized assignment,

196. *Id.* at 2199.

197. In all, the Supreme Court received thirteen *amicus* briefs on the merits of this case, and four *amicus* briefs in support of the Petition for Certiorari. See docket, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159).

198. *Id.*

199. See, e.g., Brief of Amicus Curiae BayhDole25, Inc. in Support of Petitioner at 7–10, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159); Brief of National Venture Capital Association as Amicus Curiae in Support of Petitioner at 2–17, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159).

conflicting contracts, or botched assignment documents.²⁰⁰ Basically, the universities would no longer have to ensure that they had assignment agreements in place with their employees.²⁰¹ And in the absence of an airtight assignment agreement, an inventor would not be able to bypass the TLO, notwithstanding that failure by an inventor to assign inventions to the university violates most federal funding policies.²⁰² Likewise, the NVCA emphasized that certainty in invention ownership is crucial to investment decisions.²⁰³ Uncertainty would lead to higher due diligence costs and a lower willingness to invest in promising inventions.²⁰⁴ Of course, it would be hard to imagine a venture capital firm doing away with due diligence searches and title assurances on intellectual property even if BD were to become a vesting statute.

Although efficiency and certainty are policy arguments in favor of automatic title vesting, the fact of the matter is that BD's plain language simply does not support such a reading of the statute. The Supreme Court reached its decision largely via straightforward statutory interpretation; the Court did not speculate on whether BD ought to be an automatic vesting statute as a matter of policy.²⁰⁵ While automatic vesting might be reasonable as a policy, what is clear from the Court's opinion is that BD is not an automatic vesting statute.²⁰⁶

200. Brief of Amici Curiae Association of American Universities et al. in Support of Petitioner at 27–30, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (This is Association of American Universities' second amicus brief. Its first amicus brief was filed in support of Stanford's Writ for Certiorari. *Supra* note 184); Brief of Amicus Curiae BayhDole25, *supra* note 199, at 7–10; Brief of National Venture Capital Association as Amicus Curiae in Support of Petitioner, *supra* note 199, at 2–17.

201. *See, e.g.*, Brief of Amici Curiae Association of American Universities et al. in Support of Petitioner at 27–30, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159) (arguing that “Congress enacted Bayh-Dole with the specific purpose of providing universities and other nonprofits with certainty that they would own their federally funded inventions”).

202. Brief of Amici Curiae Association of American Universities et al. in Support of Petitioner, *supra* note 200, at 9. *See also supra* note 87 and accompanying text.

203. Brief of the National Venture Capital Association as Amicus Curiae in Support of Petitioner, *supra* note 199, at 3 (“[U]ncertainty [in ownership] would discourage the commitment of the risk capital.”).

204. Brief Amicus Curiae of Birch Bayh in Support of Petitioner at 21, 24, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159).

205. *See Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2192 (2011).

206. *Id.*

2. *Protection of the Government's Interests*

The United States argued as amicus curiae in Stanford University's favor to protect the government's interest in federally funded inventions.²⁰⁷ The Solicitor General suggested that if universities were not granted title automatically, the government would lose control over valuable products of federal research funding because the government would not be able to make use of its BD prescribed rights.²⁰⁸ But as the Court noted, the Solicitor General's arguments were unavailing. First, BD puts the government second in line after the university-contractors for ownership of inventions; only if a university declines to retain ownership in the invention can the government choose to take ownership.²⁰⁹ Second, BD gives the government march-in rights.²¹⁰ The government can exercise this right to take possession of a license (either exclusive or non-exclusive) in the invention for a variety of reasons, such as if it deems that the owner of the invention is not making reasonable efforts to commercialize or develop the invention, or if there is a public health and safety reason for government action.²¹¹ The Solicitor General stressed in his brief that the government's march-in rights would evaporate if the university-contractor loses ownership of the invention to either the inventor or a third party.²¹² While the Solicitor General is technically correct, in the thirty years since BD was enacted, the government has never once exercised its march-in rights on its own initiative, and legal challenges petitioning for court orders to force the government to exercise its march-in-rights have uniformly failed.²¹³

207. See Brief for the United States as Amicus Curiae Supporting Petitioner, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159). This is the United States' second amicus brief in this case. The first amicus brief was filed in support of grant of Write for Certiorari. *Supra* note 185.

208. *Id.* at 31 ("The decision below also impairs the government's ability to protect taxpayers' substantial investment in scientific research and development.").

209. *Stanford*, 131 S. Ct. 2195–96.

210. 35 U.S.C. § 203 (2006).

211. *Id.*

212. See Brief for the United States as Amicus Curiae Supporting Petitioner, *supra* note 207, at 32–33.

213. See NAT'L RESEARCH COUNCIL OF THE NAT'L ACADEMIES, MANAGING UNIVERSITY INTELLECTUAL PROPERTY IN THE PUBLIC INTEREST 54–55 (Stephen A. Merrill & Anne-Marie Mazza, eds., The National Academy Press 2010), available at http://www.nap.edu/catalog.php?record_id=13001; John Conley, *Government Refuses to March-In Under Bayh-Dole—Again*, GENOMICS LAW REPORT (Jan. 11, 2011), <http://www.genomiclawreport.com/index.php/2011/01/18/government-refuses-to-march-in-under-bayh-dole-again/>.

3. *Threat of Reversion to the Pre-Bayh-Dole Ways*

Some amici in support of Stanford argued that a ruling against automatic vesting under BD would undermine the statute's function and purpose. But as the Supreme Court pointed out, university ownership of inventions is merely a presumption, not a certainty.²¹⁴ Over the past thirty years, universities, inventors, funding agencies, and private industry have generally interacted with each other on the premise that university ownership is not an absolute certainty: doubts about ownership explain why licensing agreements tend to include warranties on title and why parties to the agreements conduct due diligence searches.²¹⁵ Moreover, the assignment agreements that universities require their employees to execute would be completely superfluous, at least with respect to government funded inventions, unless there was some doubt over whether BD automatically gave ownership to the contractor.

The group BayhDole25²¹⁶ went so far as to say that the university innovation microcosm would revert back to pre-BD ways.²¹⁷ But this argument fails because the vast majority of university inventors faithfully assign their inventions to their employer-universities, and BD governs every one of those inventions.²¹⁸ So at most only a small handful of inventions

214. *See* Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc., 131 S.Ct. 2188, 2195–96 (2011).

215. *See, e.g.*, Brief of Amicus Curiae Intellectual Property Owners Association in Support of Respondents, *infra* note 220, at 17 (noting that “in the commercial world, private companies that engage in research routinely obtain assignment agreements from their employees, and prospective licensees routinely take measures to ensure that the licensor has clean title to the invention.” (citing MARK S. HOLMES, PATENT LICENSING: STRATEGY, NEGOTIATIONS, AND FORMS § 11:3.5, at 11-6 (Practicing L. Inst. 2010))).

216. A group dedicated to promoting BD on the 25th anniversary of the Bayh-Dole Act. The group has a website. *See About*, BAYHDOLE25.ORG, <http://www.bayhdole25.org> (last visited Feb. 9, 2012).

217. Brief of Amicus Curiae BayhDole25, Inc. in Support of Petitioner, *supra* note 199, at 6.

218. *See* Long, *infra* note 227. Also, *see supra* note 147 for support of the proposition that since very few lawsuits involve BD, and even fewer still involve failure of inventors to assign to contractors inventions that would be covered by BD, failure to assign and circumvention of BD must not be a common problem. Indeed, Roche argued in its brief that “Stanford attempts to read the Act against an ‘established practice of taking Government title to most federally funded inventions’, but in fact such practices were decidedly the *exception*.” Brief of Respondents (Roche) at *31, *Stanford*, 131 S. Ct. 2188 (No. 09-1159). Moreover, government granting agencies typically require that contractors have in place a mechanism for getting assignment for employee-inventors as a condition of receiving grant money. *E.g.*, NIH GRANTS POLICY STATEMENT, *supra* note 83. Hence failure to assign inventions would violate both granting agency regulations and the BD Act itself.

would fall outside of BD's purview because the university-contractor fails to gain ownership because of invalid or conflicting assignment agreements, or an inventor's refusal to assign.²¹⁹

F. VIEWS OF AMICI IN SUPPORT OF ROCHE MOLECULAR SYSTEMS

Industry players, ranging from major corporations (such as Intel, Pfizer, and Lilly) to small biotechnology companies, suggested that if Stanford prevailed, an innovation drought would ensue as private businesses would avoid collaborating with universities lest BD gives universities full ownership in any collaboration that is touched, however briefly, by federal funding.²²⁰ Many of the amici in support of Roche made statutory interpretation arguments mirroring those made by Roche, saying that industry has always assumed that patent law gives the inventor *ab initio* legal ownership.²²¹

In their joint brief, the Institute of Electrical and Electronics Engineers ("IEEE") and the American Association of University Professors wrote of the worry that inventors' control over the fruits of their own ingenuity would be diminished if ownership automatically defaulted to the contractor-universities.²²² Their concern highlights the tension in the symbiotic relationship between contractors and their employees. On one hand, the researchers rely on their employers' infrastructure and resources to do the inventing; on the other, the employers rely on the professors' ingenuity and skills to come up with inventions. These groups argued that BD ought not

219. *Id.*

220. *See, e.g.*, Brief of American Association of University Professors et al. as Amici Curiae in Support of Affirmance at 8–9, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159); Brief of Amici Curiae Biotechnology Industry Organization in Support of Respondent at 9–19, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159); Brief of Intel Corporation et al. as Amici Curiae in Support of Respondents at 12–18, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159); Brief of Amicus Curiae Intellectual Property Owners Association in Support of Respondents at 6–10, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159); Brief for the Pharmaceutical Research And Manufacturers of America as Amicus Curiae Supporting Respondent at 6–9, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159).

221. *See, e.g.*, Brief of American Association of University Professors et al. as Amici Curiae in Support of Affirmance, *supra* note 220, at 19–21; Brief of Biotechnology Industry Organization in Support of Respondent, *supra* note 220, at 20–28; Brief of Intel Corporation et al. as Amici Curiae in Support of Respondents, *supra* note 220, at 18–22; Brief for the Pharmaceutical Research And Manufacturers of America as Amicus Curiae Supporting Respondent, *supra* note 220, at 22–26; Brief of Amicus Curiae Intellectual Property Owners Association in Support of Respondents, *supra* note 220, at 11–18.

222. Brief of American Association of University Professors et al. as Amici Curiae in Support of Affirmance, *supra* note 220, at 11–19.

hand all rights to inventions to the employers without consideration for the inventors' interests.²²³

Meanwhile, the American Intellectual Property Law Association ("AIPLA") filed a brief officially supporting neither party.²²⁴ Nevertheless it argued, relying in part on observations of current practices and reliance expectations, that the innovation community operates on the premise that BD does not automatically vest ownership in the contractor.²²⁵ Indeed, over the past three decades, academic and industry players have filled in BD's silence on this issue using contract law.²²⁶ Hence AIPLA's brief largely favored Roche.

V. IMPLICATIONS OF THE *STANFORD* DECISION

The vigorous argument in *Stanford* about who has initial invention ownership rights underscores that those rights can have important downstream consequences.²²⁷ If the Supreme Court had held that BD trumps private contracts, the Court would have, in effect, endorsed a policy favoring special treatment for universities by giving statutorily conveyed ownership to contractors. Instead, the Court's holding reveals that what might be considered "faulty" assignment provisions, either by accident or through deliberate negotiation, are in fact one way that inventors can bypass the BD framework and avoid setting the BD ownership chain in motion.

Stanford may prompt lawmakers to amend the Act by giving universities ab initio ownership to ensure that BD automatically applies to publicly funded contractor research. Notably in 2007, Congress held a hearing on the

223. *Id.* at 4 (stating that inventors "must have the ability to contract, assign for consideration, or license their inventions." (emphasis added)).

224. Brief of Amicus Curiae, American Intellectual Property Law Association in Support of Neither Party, *Stanford*, 131 S. Ct. 2188 (2011) (No. 09-1159).

225. *Id.* at 11–12 (noting that "reliance on contractors' existing practice to secure invention assignments from inventors, and the corollary that Federal policy need only then concern itself with the allocation of title as between Federal agencies and the contractor entity, became a fundamental assumption of Government contracting and procurement policy that continues to this day").

226. *Id.*; Brief for the Pharmaceutical Research And Manufacturers of America as Amicus Curiae Supporting Respondent, *supra* note 220, at 10–17 (arguing that "federal agencies recognize that contractors cannot retain title under the Bayh-Dole act without assignments from inventors," that "universities do not assume that The Bayh-Dole Act automatically confers title on Contractors," and that "universities entering into technology transfer agreements frequently provide warranties that they have secured assignments from inventors"); see Sean O'Connor, *supra* note 27, at 281–84.

227. Clarisa Long, *Proprietary Rights and Why Initial Allocations Matter*, 49 EMORY L.J. 823, 823 (2000).

twenty fifth anniversary of BD with the purpose of “assess[ing] the current implementation of Bayh-Dole . . . and to hear recommendations that may be appropriate to improve the current implementation.”²²⁸ The main thrust of the congressional hearing was definitely not whether BD is an automatic vesting statute, and Congress did not make substantive amendments following that hearing.²²⁹

Under one view, one could say that the underlying situation in *Stanford* is indeed a success story for innovation. It is a story of a useful invention that has been commercialized and is accessible to the public—which arguably is the ultimate objective of the BD Act, and not the ownership by a university contractor of a new patent.²³⁰ There may have been a breach of employment contract between Holodniy and Stanford. There may have been a breach of a collaboration agreement between Stanford and Cetus. There may have been a breach of the VCA between Holodniy and Cetus. There may have even been a breach of the funding contract between the government and Stanford. But under any of these legal angles—contract law, property law, common law, and patent law—the end human result is that millions of HIV patients have access to HIV viral load test kits.²³¹ So somehow, despite bungled invention ownership assignments and a legal quagmire over initial ownership, the end result seems pretty good for society as a whole.

228. *The Bayh-Dole Act (P.L. 96-517, Amendments to the Patent And Trademark Act of 1980)—The Next 25 Years: Hearing Before the Subcommittee on Tech. And Innovation Committee on Science and Tech., H. Of Representatives, 110th Cong. 3, 6–7 (2007)* (statement of Chairman David Wu) (describing the purpose of the hearing).

229. *Id.*; see 35 U.S.C. §§ 200–212 (2006) and amendments since 2006.

230. See Letter from Jay S. Epstein, Director, Office of Blood Research and Review, Center for Biologics Evaluation and Research, to Alex Wesolowski, Roche Molecular Systems, Inc. (Mar. 2, 1999) (informing Roche that the U.S. Food and Drug Administration has approved Roche’s AMPLICOR® HIV-1 MONITOR Test kit for commercial distribution); *Timeline of PCR and Roche*, ROCHE, <http://molecular.roche.com/About/pcr/Pages/PCRTimeline.aspx> (last visited Feb. 20, 2012) (stating that the world’s first quantitative PCR test kit for HIV (Roche’s AMPLICOR® HIV-1 MONITOR Test) was launched outside the U.S. in 1995).

231. As of 2010, there are approximately 34 million people living with HIV. *HIV/AIDS*, WORLD HEALTH ORG., <http://www.who.int/mediacentre/factsheets/fs360/en/index.html> (last visited Feb. 20, 2012). Access to HIV viral load test is important for monitoring disease progression. *Id.* In 2010, a single contract in South Africa enabled Roche to supply over half a million HIV viral load test kits per year. F. Hoffmann-La Roche Ltd, *Roche Annual Report*, ROCHE 67 (2010), <http://www.roche.com/gb10e.pdf>. Roche also supplies HIV viral load tests at reduced price to many sub-Saharan African countries as well as many others countries in South America and Asia. F. Hoffmann-La Roche Ltd, *Roche Annual Report*, ROCHE 69 (2011), <http://www.roche.com/gb11e.pdf>.

Importantly, this Note is not advocating that bypassing BD is necessary or helpful to innovation, nor is it saying that the set of facts in the *Stanford* case is commonplace and ought to be encouraged. Rather, this Note is merely pointing out that the ultimate goals of publicly funded research can in some circumstances be realized even when parties bypass BD. And BD as it currently stands allows those perhaps rare success stories. The truth is, dueling contracts that cloud title ownership deter potential licensees and collaborators from participating in the innovation process, so contractors have strong incentive to ensure they have clear title to their employees' inventions. Stanford only resorted to arguing at the Supreme Court that BD is an automatic vesting statute because it failed to secure ownership using clear contractual devices.²³² Logically post-*Stanford*, university-contractors are more aware than ever of the importance of properly securing unambiguous invention ownership rights from their employees.

A. SHORT-TERM CONSEQUENCES

Two obvious measures that universities could take to ensure that legal ownership disputes such as *Stanford* would not occur in the future are: (1) require university employees to make present assignment of all future inventions using the "hereby assign" or "hereby do assign" language; and (2) require as university policy that university employees obtain prior TLO approval before entering into any contract or agreement with any outside party.

Within a few months of the *Stanford* decision, many universities modified their employee invention assignment agreements to make sure that they contained the "hereby assign" or "hereby do assign" language that was held essential for immediate assignment of future inchoate inventions by the Federal Circuit.²³³ One concern could be that, post *Stanford*, universities will always get legal ownership from the get-go via iron-clad present assignment contracts, thus forever preventing university researchers from signing away ownership rights to third parties as happened in *Stanford*. But this concern does not take into account the possibility that researchers may choose universities based on their innovation policies, and that some enterprising researchers have sufficient clout to negotiate the terms of their employment, including invention ownership rights. A university may also want to seem

232. *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2198 (noting that whether BD trumped private contracts was the only issue Stanford raised on appeal).

233. *See, e.g., supra* note 93.

inventor friendly and leave ownership to the inventor as a recruiting tool.²³⁴ A university may also leave ownership to inventors to generate goodwill, which could someday pay off in the form of generous alumni donations.²³⁵

Moreover, we can assume that in the short term, all universities that wish to use the “hereby assign” or “hereby do assign” language are able to do so, and most employees will sign the modified agreements without first consulting their attorneys.²³⁶ However, for existing professors and graduate students, a new assignment contract would require new consideration from the university under basic contract law principles. Even supposing that a nominal amount of salary increase is sufficient consideration for a new assignment contract to be deemed valid, some professors, particularly those with sophistication in patents and startup company experience, may refuse to execute present assignments of future inventions, so universities may not completely succeed in having all of their employees sign onto the modified, post-*Stanford* agreements.²³⁷

B. SECONDARY EFFECTS

1. *Inventor Ownership of Inventions Can Be Conducive to Innovation*²³⁸

There are at least five reasons why an inventor would retain ownership of his or her inventions: (1) the inventor does not recognize the commercial potential or cannot be bothered to disclose the invention; (2) the inventor

234. See Sean M. O’Connor, *supra* note 49, at 4.

235. See Mimura, *supra* note 35, at 274 (“We encourage gift relationships whenever an industry partner does not require contractual terms and conditions.”). Famous examples of gracious alumni donating to their alma mater include Jim Clark’s \$150 million donation to Stanford University in 1999. Kenney, *supra* note 8, at 1413. Clark was formerly a Stanford professor and started Silicon Graphics in the 1980s in part using technology that he and his students developed while at Stanford. James Robinson, *Entrepreneur Jim Clark to donate \$150 million to Stanford to fund biomedical engineering initiative*, STANFORD NEWS SERVICE (Oct. 27, 1999), <http://news.stanford.edu/pr/99/991027Clark.html>. See JIM CLARK, NETSCAPE TIME: THE MAKING OF THE BILLION-DOLLAR START-UP THAT TOOK ON MICROSOFT (1999) for a story on University of Illinois at Urbana Champaign’s (UIUC) less than amicable treatment of former student Marc Andreessen and his IP on the original web browser Mosaic. Andreessen went on to cofound Netscape with Jim Clark. Needless to say, UIUC did not receive generous donations from Andreessen. This story was also mentioned in Kenney, *supra* note 8, at 1413.

236. Both Stanford and UC did so soon after the Court handed down the *Stanford* decision. See *supra* Section II.C.

237. This sentence is consistent with the statement in Section II.C that says inventors are often the least legally sophisticated party within the innovation microcosm. Some employee-inventors may have sufficient legal sophistication and negotiating leverage to ask for more favorable assignment and revenue sharing terms. But most do not.

238. See Kenney, *supra* note 144 and accompanying text.

wants to give the community free access; (3) the inventor thinks that he can do a better job of commercializing his invention than the TLO; (4) the inventor deliberately attempts to profit from the invention without sharing the proceeds with his employer; or (5) the inventor inadvertently assigns the invention to a third party without the inventor realizing what he is signing.

For reasons one and two, statutorily mandated ownership by the university-contractor could conceivably lead to commercialization of inventions that otherwise would never enter the public domain as commercial products. But for reasons three and four, the inventor is already motivated to commercialize his inventions, and given that the strongest proponents of inventions are often the inventors themselves,²³⁹ perhaps statutorily mandated contractor ownership would not make much difference as to whether innovation happens. Likewise for reason five, a third party who would coerce an inventor into divesting his ownership rights likely has a pecuniary interest in commercializing the invention. So if the ultimate goal of the statute is to encourage innovation and fulfill the broader policy goals of federally funded research, an ownership regime that allows occasional deviation from contractor ownership, be it intentional or inadvertent, does not appear to be detrimental.

2. *Statutorily-mandated Contractor Ownership May Not Be Efficient*

Studies on whether contractor ownership is the best way to promote innovation show mixed results.²⁴⁰ A 2010 study by the National Research Council (“NRC”) concluded that there is insufficient evidence to support the notion that an inventor ownership scheme would be superior to a contractor ownership system.²⁴¹ Besides citing administrative and practical difficulties, the NRC study committee voiced “strong public policy reservations about any proposal to assign IP to inventors,” such policy reservations being difficulties with monitoring BD compliance, ensuring good licensing practices, and avoiding conflicts of interest between inventors and contractors.²⁴² So if government ownership has been tried and failed, and the benefits of contractor and inventor ownership seem unclear, perhaps a

239. See Ajay Agrawal, *Engaging the Inventor: Exploring Licensing Strategies for University Inventions and the Role of Latent Knowledge*, 27 STRATEGIC MGMT. J. 63, 77 (2006) (studying how “engaging the inventor favorably influence the likelihood and degree of commercialization success”).

240. See *supra* Section III.F and references therein.

241. Merrill, *supra* note 213, at 61–66.

242. *Id.*

flexible approach that allows alternative contractual arrangements would be best.

Proponents of BD would argue that as it currently stands, BD does include a mechanism that allows an inventor to eventually regain ownership of his invention.²⁴³ But that mechanism is by no means a guaranteed method for the inventor to gain ownership. It requires the inventor to enter into the rigmarole of (1) transferring ownership to the contractor; (2) convincing the contractor to forgo ownership; (3) standing by and hoping that the government also shows no interest in the invention; and then (4) finally getting back his invention as the third-in-line.²⁴⁴ To be clear, this procedure may not be as arduous as it sounds, but could still take many months or years. Inventions, however, are often time sensitive, and potential licensees and collaborators could lose interest because of bureaucratic delay. The *Stanford* decision leaves open the possibility of direct inventor ownership without the BD rigmarole, but only through either faulty employment contracts which are now very unlikely, or deliberate negotiations between researchers and their prospective employers. And even if bypassing BD might violate terms of the government-contractor funding agreement, such contract breach may be economically efficient and inconsequential.²⁴⁵ Again, this Note is not advocating contract breaches and violation of BD, but merely acknowledges that *Stanford* leaves that possibility, however remote, open.

C. HYPOTHETICAL SCENARIOS

In this Section, four reasonable hypothetical scenarios demonstrate differing outcomes that might result under current law versus automatic

243. See 35 U.S.C. § 202 (2006).

244. See *id.*

245. NIH requires contractors, as a condition to receiving grants, to acquire title to inventions from employees, and failing that, to suffer loss of grants and other penalties. U.S. DEPT. OF HEALTH AND HUMAN SERVS., NAT'L INSTS. OF HEALTH, NIH GRANTS POLICY STATEMENT IIA-89-93 (Oct. 2011), available at http://grants.nih.gov/grants/policy/nihgps_2011/nihgps_2011.pdf. In *Stanford*, Stanford University likely violated terms of its NIH funding agreements with respect to any grants that lead to the invention-in-suit, yet it is unclear from the parties' briefs if NIH terminated grants to Holodniy's supervisor or any Stanford researchers because of the possible violations that precipitated in *Stanford*. See, e.g., Brief of Respondents (Roche) at *20, Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc, 131 S. Ct. 2188 (No. 09-1159), 2010 WL 288882 ("Despite numerous requests, Stanford has never produced the actual funding agreement with the federal government that allegedly bears upon the inventions at issue in this case. Nor has Stanford demonstrated how Dr. Holodniy's work at Cetus or the contributions of Cetus and its scientists are connected to research grants awarded to Stanford.").

statutorily mandated contractor ownership of inventions. In each of the four scenarios, statutorily mandated vesting would foreclose the possibility of certain efficient private ordering arrangements. Mandatory vesting in the contractor would not only lead to different ownership structures and paths forward for the inventors and the contractors, but also different legal liabilities and potential remedies. That is not to say that contracts cannot be formed that could undo some of the undesirable consequences of statutorily mandated vesting. And obviously, discussions of these hypothetical scenarios do not and cannot explore every possible action that the parties involved could take.

1. *An entrepreneurial professor wants to start her own company to commercialize an invention that she conceived using federal funding. She thinks that her invention is brilliant. The university TLO thinks that the invention is a dud.*

Under the holding in *Stanford*, this professor's conduct going forward would depend on the exact wording of the invention assignment agreement between the professor and her employer-university. If as in *Stanford*, this professor only has a contractual obligation to assign her invention instead of a present assignment of inchoate inventions, then she may choose to breach her assignment contract and retain legal ownership. The question then becomes whether the university pursues its equitable rights to the inventions.

One of two things might happen at that point. Knowing that the professor has an equitable obligation to assign the invention, the university might promptly sue the professor in a contract action. A court may order specific performance requiring assignment and the professor could end up losing ownership of the invention. But if the university sees little value in the invention while the professor sees immense potential as the hypothetical suggests, then such a suit would be unlikely and the university may contently allow the professor to retain ownership with a wait-and-see attitude.²⁴⁶ In due course, the professor might go on to develop the invention further at her own startup company and reap profits from the invention. The university might then take notice of the professor's success and decide to file a lawsuit for contract breach and disgorgement of profits. The university might succeed, or it might be barred by statute of limitations. But the professor has at least a chance, albeit violative of funding agency regulations and her initial assignment contract with the university, of retaining ownership and thus

246. Meanwhile, the university-contractor violates BD so long as it does not have ownership of the invention.

commercializing the invention on her own. Moreover, if her startup venture were successful, the public would gain access and benefit. Once that happens, the university's subsequent intervention might do more harm than good.

A contrary decision in *Stanford*, or its functional equivalent via the "hereby do assign" language in the pre-invention assignment contract, would totally foreclose the possibility that the professor retains ownership because the university would have legal ownership from moment the invention comes to life. It is true that if the university had ownership of the invention in this hypothetical scenario, it would likely agree to license the invention back to the professor for a nominal sum. And the professor could still practice the invention at her startup company. But as success of the invention becomes evident, the university might demand higher and higher licensing fees and royalties. The point is that this toll on the invention by the contractor-university may not be helpful to innovation in a scenario where the inventor is highly motivated, while the TLO is not interested until commercial viability becomes certain.

Alternatively, if the university had ownership of the invention, it could also transfer ownership back to the inventor via operation of BD's cumbersome mechanism described above for the inventor to obtain third-in-line ownership. This process requires the university to first give the government the option of owning the invention, and only if the government declines to take ownership would the inventor receive ownership.²⁴⁷ Though the professor could potentially receive ownership of the invention by this route, she would have to endure the possibility that the university and the government might decide to keep the invention, and there would inevitably be bureaucratic delay. The uncertainty and delay therefore make this an unattractive scenario for innovation. Besides, this hypothetical assumes a highly motivated inventor and lackluster interest on the part of the TLO, so the benefit of requiring that title pass through the TLO before going back to the inventor is questionable.

Notably, some of the courses of action described above would likely violate terms of the university's federal research contracts, which in most cases mandates university ownership and compliance with BD as a precondition. But federal funding agencies have limited remedies against the universities in case of breach.²⁴⁸ They could sue the universities for breach of

247. See 35 U.S.C. § 202 (2006).

248. See NIH GRANTS POLICY STATEMENT, *supra* note 83, at IIA-93.

contract, void or take ownership of the disputed patents, and terminate ongoing grants to the nefarious professor.²⁴⁹ Beyond those remedies however, the funding agencies are unlikely to cut off grants that cover other professors at the university. And for this particular professor who is leaving academia to work at her startup company, a ban on federal grants may not be a huge deterrence.

2. *A famous professor invents widget X at University A using federal funding. He later invents widget Y at University B also using federal funding. The two inventions are commercially useful only when practiced together. The professor is well connected to a company that is interested in producing widget X-Y.*

First, the famous professor could have significant leverage when negotiating his employment contract with the second university by virtue of his fame and inventive proclivity. To get him on their faculty, the second university may agree to give him a higher share of licensing income than his peers. Under *Stanford*, the famous professor and his employer-university could conceivably craft an employment contract that leaves ownership of the professor's inventions with him, despite possible negative consequences with federal funding agencies. Statutorily mandated vesting would foreclose the use of inventor friendly contracts as recruiting tools.

Second, greater transactional efficiency could be achieved if the two related inventions are owned by one entity rather than two separate entities. If BD mandates automatic university ownership, a famous professor who migrates from school to school would leave a trail of inventions owned by separate entities. The Court's holding in *Stanford* leaves open the possibility that a professor who moves from school to school could retain ownership and consolidate all of his inventions under one roof, without having to negotiate ex post with each university and go through the BD rigmarole to gain consolidated ownership at each school.

249. *Id.*

3. *An engineer was hired to invent a widget at a corporation. He conceived of an invention and the corporation filed a patent application naming itself as the sole assignee. Three years later, the engineer became fed up with the corporation's office politics. He decided to become a professor at a local university. Using federal funding, he produced the first ever working prototype of the widget that he invented three years prior at the corporation.*

This hypothetical highlights inconsistencies between the definitions of a patentable invention and a subject invention. A patentable invention is an invention that accords with the patentability requirements of 35 U.S.C. §§ 101–103, 112, whereas a subject invention is an invention to which BD applies.²⁵⁰ BD's two prong standard for what constitutes "subject invention" conflicts with patent law's reduction to practice standard for patentability.²⁵¹ An invention falls under BD's purview if it is either "conceived" or "actually reduced to practice" using federal funding.²⁵² Whereas for patentability purposes, conception alone is insufficient; the inventor has to reduce the invention to practice either actually by building a prototype, or constructively by filing a patent application.²⁵³ Thus, the conception prong of BD's subject invention standard falls short of patentability requirements while BD's actual reduction to practice prong exceeds patentability requirement, where constructive rather than actual reduction to practice suffices.

Here, the professor's construction of the prototype at the university likely qualifies as an "actual reduction to practice" event that triggered BD. Meanwhile, earlier filing of the patent application by the corporation had no bearing on whether BD would be implicated because it was merely a constructive reduction to practice (even assuming for the moment that the

250. 35 U.S.C. §§ 101–103, 112 (2006).

251. J. Jonas Anderson, *Secret Inventions*, 26 BERKELEY TECH. L.J. 917, 923 (2011) ("An invention is eligible for patenting at the moment it is 'reduced to practice' or when an inventor produces descriptions of the invention that enable a skilled artisan to practice the invention."). Compare 35 U.S.C. 201(e) (2006) (defining "subject invention" in the BD Act: "the term 'subject invention' means any invention of the contractor conceived or first actually reduced to practice in the performance of work under a funding agreement"), with U.S. PATENT & TRADEMARK OFFICE, U.S. DEPT' OF COMMERCE, MANUAL OF PATENT EXAMINING PROCEDURE ("MPEP") § 2138.05 (8th ed. Rev. 8, July 2010) ("Reduction to practice may be an actual reduction or a constructive reduction to practice which occurs when a patent application on the claimed invention is filed. The filing of a patent application serves as conception and constructive reduction to practice of the subject matter described in the application.").

252. 35 USC § 201(e) (2006) (defining "subject invention" in the BD Act).

253. *Pfaff v. Wells Elecs., Inc.*, 525 U.S. 55, 67 (1998); MPEP, *supra* note 251, at § 2138.05.

work was performed under a federal research contract). So under *Stanford*, if the engineer never explicitly assigned the prototyped invention to the university, the university would not have title in the invention and the corporation would retain exclusive ownership of the invention, and interest in the pending patent application even after the prototype was subsequently built using federal resources.²⁵⁴

But if the Supreme Court had held that BD statutorily vested ownership in the university, then ownership of the invention would automatically transfer to the university the moment the professor finished building the prototype, even though there is no reasonable dispute that the corporation has initial title to the invention by virtue of the hired to invent doctrine. Now, suppose 95% of the cost of invention can be traced to the corporation, and the prototype was relatively inexpensive to build. Would it be fair for the university to take entire ownership by virtue of statutorily mandated vesting? What about 50% private funding? Without question, in this scenario, the corporation owned the entire interest in the patent application when it first filed the application. Mandatory vesting under BD would divest the corporation's interest simply because a prototype was later built using federal funding, and all this despite that the prototype made zero contribution to patentability. Maybe the corporation could argue that the contractor-university's ownership of the invention is an unconstitutional taking.²⁵⁵ And the contractor-university could argue that it has to take the invention from the corporation or it would be in violation of federal grants that require compliance with BD. The *Stanford* holding avoids this potentially bizarre result.

4. *A graduate student worked on two related projects simultaneously. The federal government funded one project while a startup pharmaceutical company funded the other project. The graduate student made an invention and actually reduced it to practice by combining elements from both research projects.*

This is a typical scenario involving comingled funds where enforceability of contracts that govern the private funder's ownership becomes critical to investment decisions. Assume here that the student validly executed a

254. See *Bd. of Trs. of the Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc.*, 131 S. Ct. 2188, 2192 (2011).

255. Roche also made unconstitutional takings argument in its brief. Brief of Respondents (Roche) at *43–44, *Stanford*, 131 S. Ct. 2188 (No. 09-1159), 2010 WL 288882 (arguing that Stanford's interpretation of BD "raises serious constitutional questions" in the form of the "takings problem").

present assignment agreement with the university when she started her degree program, and at precisely the same moment, she also executed a present assignment agreement with the startup company that partially funds her research. Also assume that this graduate student's invention qualified as a "subject invention" under BD because part of conception can be attributed to federal funding.²⁵⁶ Now, supposing that 50% of the student's invention can be traced to private funding, would it be reasonable to award the university entire ownership in the invention by statutory fiat, and ignore the agreement that the student signed with the startup company? If BD automatically vests ownership of the invention in the university, there would be nothing left for the startup pharmaceutical company. Certainly if the Supreme Court had reached a contrary holding in *Stanford*, private parties would become reluctant to fund projects that might be "polluted" by federal funding, because outright university ownership would become a non-negotiable term. *Stanford* leaves open the possibility that the private funders could become co-owners of inventions by *a priori* negotiation with the university and the inventors. Though co-ownership of patents is generally not a good business practice,²⁵⁷ the private funder could at least use the threat of co-ownership as a bargaining chip in negotiating a grant back of exclusivity from the university.

VI. CONCLUSION

From the perspective of a HIV/AIDS patient, the set of facts in *Stanford* presents a success story of innovation that provides real tangible health consequences. Ultimately, whether Stanford loses out on a few tens of millions of dollars in licensing fees and royalties, and whether Roche's shareholders makes a few pennies more per share, matters far less to a HIV-positive patient than the fact that Roche's HIV viral load test is an effective life-saving diagnostic tool that is available. And therein lies the conundrum. For certain inventions such as this one, innovation can and does happen despite a tangle of disputed contracts and statutes between the inventor (Dr. Holodniy), the contractor (Stanford), the funding agency (NIH), and the

256. 35 USC § 201 (2006) (defining "subject invention").

257. See generally Robert P. Merges & Lawrence A. Locke, *Co-Ownership of Patents: A Comparative and Economic Perspective*, 72 J. PAT. & TRADEMARK OFF. SOC'Y 586, 586-99 (1990) (discussing rules of patent co-ownership and "how to protect clients from the vicissitudes of the current U.S. rules"). The U.S. rule on patent co-ownership permits the co-owner of a patent to practice, license, and transfer in whole or in part that co-owner's interest in the patent without consent from, or compensation to, the other co-owner(s). *Id.* at 586. As a result, a patent owner's right to exclude others is eroded when there are co-owners, and with that erosion the economic value of the patent is diminished. See *id.*

private collaborator-innovator (Roche). Here, BD's statutory provisions, though crafted to encourage innovation, seem completely pointless.

In *Stanford*, the Supreme Court finally weighed in on this tangle of contracts and statutory provisions and clarified that contractors and inventors can indeed still have a variety of possible arrangements and contractual relationships, even if those arrangements were not part of the purpose of the BD Act. Despite relying mostly on statutory interpretation arguments, the Court managed to also reach the correct economic and policy result. The Court's affirmance of the status quo leaves reliance expectations of the innovation community relatively undisturbed and leaves room at the periphery for experimentation in private ordering arrangements, which is ultimately good for innovation even as some homogeneity among contractor/inventor relationships is sacrificed.²⁵⁸ A contrary decision in *Stanford* would have foreclosed certain efficient contractual ownership arrangements that remain theoretically possible after *Stanford*. The bottom line is that while the university-contractor ownership model might be a good one in the vast majority of cases, why foreclose the possibility of alternative arrangements by statutory fiat when private ordering using settled contractual language can achieve equivalent function, while allowing some degree of flexibility to persist in creative arrangements.

258. *Stanford*, 131 S. Ct. at 2192 (“Since 1790, the patent law has operated on the premise that rights in an invention belong to the inventor. The question here is whether the University and Small Business Patent Procedures Act of 1980—commonly referred to as the Bayh-Dole Act—displaces that norm and automatically vests title to federally funded inventions in federal contractors. We hold that it does not.”).

THE NEXUS ANALYSIS: LICENSE ENFORCEMENT IN THE WAKE OF *MDY V. BLIZZARD*

Erik Bauman[†]

Upon installing iTunes, you click “I agree.” When you update your Adobe reader, you do the same. You might have even diligently read and understood the terms you were agreeing to. But what could happen if you did not follow one of the terms you agreed to—if you breached your license? The worst outcome, criminal acts aside, would be that you committed copyright infringement, which can carry severe statutory penalties. Should it make a difference if you breached by making extra copies the license didn’t allow, by purchasing a competitor’s product that the license forbade, or by giving them a bad review on your blog after the license explicitly told you not to? The intuition that copyright law should not treat each of these license breaches the same is the subject of recent Ninth Circuit attention, and in an increasingly technological society the implications of breaching a license will only become more important.¹

It has become a standard industry practice for producers of digital goods to include an End User License Agreement that a consumer must agree to in order to use the item. These licenses, known as “click wrap” agreements, frequently take the form of a window that opens upon downloading the product, laying out the terms and conditions of the license and requiring the user to click “accept” or “agree” before the digital purchase can be used.² These licenses often include terms defining the number of copies a user may make and whether the user can transfer copies. The terms also frequently include restrictions on how the user may use the software, where legal disputes will be heard, and affirmative actions the user is obligated to take.³

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1. See *MDY Indus., LLC v. Blizzard Entm’t, Inc.*, 629 F.3d 928 (9th Cir. 2010).

2. Kevin W. Grierson, *Enforceability of “Clickwrap” or “Shrinkwrap” Agreements Common in Computer Software, Hardware, and Internet Transactions*, 106 A.L.R. 5TH 309, 317 n.1 (2003).

3. See, e.g., *iTunes Terms and Conditions*, APPLE, <http://www.apple.com/legal/itunes/us/terms.html> (last updated Oct. 12, 2011) (“You shall be authorized to burn an audio playlist up to seven times.”); *ADOBE Software License Agreement*, ADOBE, http://www.adobe.com/products/eulas/pdfs/Gen_WWCombined-20080205_1329.pdf (last visited Feb. 7 2012) (“This agreement will be governed by and construed in accordance with the

The terms of licenses are unilaterally drafted by producers for the purpose of limiting and preventing undesirable actions by consumers. These agreements have been consistently upheld by the courts.⁴

MDY Industries, LLC v. Blizzard Entertainment, Inc., a recent Ninth Circuit decision, held that breaking the terms of such an agreement can be considered copyright infringement only when the violated term is a condition precedent and is related to an exclusive right of copyright; otherwise, a violation is merely breach of contract.⁵ In that case, Blizzard's online game World of Warcraft had a license term banning various types of cheating in the game, including the use of "bots" that play the game without user input.⁶ MDY had created and distributed a program called Glider, which was widely used, that plays the game for the user while they are away from the computer.⁷ This automation gave an unfair advantage to players who used it and was considered cheating.⁸ Blizzard argued that Glider should be held liable for contributory copyright infringement since they encouraged users to violate the anti-cheating term in the license.⁹ The outcome hinged on whether the user violated copyright by using Glider, or whether they only breached their contract with Blizzard. This distinction was important because it determined both the extent of monetary damages available to the copyright holder and whether there can be contributory infringement by non-parties to the contract, such as MDY.¹⁰ The test presented in *Blizzard* to determine this legal fact restricts copyright liability to conditions for which there is "a nexus between the condition and the licensor's exclusive rights of copyright."¹¹ The purpose of the test was explicitly to prevent copyright holders from expanding their rights in ways not intended by the copyright act.¹² However, the Ninth Circuit's description of what constitutes a nexus with copyright is

substantive laws in force in: (a) the State of California, if a license to the Software is obtained when you are in the United States, Canada, or Mexico. . . . If a verification discloses that your use is not in conformity with a valid license, you shall immediately obtain valid licenses to bring your use into conformity.").

4. Nathan J. Davis, *Presumed Assent: The Judicial Acceptance of Clickwrap*, 22 BERKELEY TECH. L.J. 577, 583 (2007).

5. *Blizzard*, 629 F.3d at 940–41.

6. *Id.* at 938.

7. *Id.* at 928.

8. *See id.* at 936.

9. *Id.* at 937–38.

10. *Id.* at 938.

11. *Id.* at 941.

12. *Id.*

not specific enough to evaluate the outcome of many cases.¹³ This creates uncertainty for both consumers and producers of copyrighted material. A specific rule for applying the nexus test should be established to clarify the scope and ramifications of license agreements.

This Note argues that a nexus should be found only where federal copyright law would find infringement if the allegedly violated term was not in the license at all. This would result in a clearly defined nexus that would prevent producers from using license agreements to expand the intended scope of copyright protections. Part I will give background on the copyright law, licensing, and *Vernor v. Autodesk, Inc.*—the case that in many ways set the stage for *MDY Industries, LLC v. Blizzard Entertainment, Inc.* Part II will explicate the decision in *Blizzard* and the policy implications of that court’s nexus test. Part III will describe the Nexus Test advocated for by this Note and its basis in the reasoning and examples in *Blizzard*. Part IV will apply the Nexus Test to various license terms whose status may be unclear following *Blizzard*. Part V presents the conclusion and reiterates policy considerations.

I. BACKGROUND

This Part first explains the statutory basis of copyright law and how Congress sought to strike a balance between social benefit from creative works and incentives to authors by incorporating the doctrines of first sale and essential steps into the statutory framework. This Part then explains the way that licensing has developed within this statutory framework. Finally, this Part presents the recent Ninth Circuit case of *Verner v. Autodesk, Inc.*, the most recent development in this area, which explains the legal context in which *Blizzard* was decided.

A. PURPOSE AND SCOPE OF EXCLUSIVE RIGHTS OF COPYRIGHT

Congress is empowered to govern copyright by Article 1 Section 8 of the Constitution. This section states that Congress may enact laws “to promote the Progress of Science and the useful Arts, by securing for limited times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.”¹⁴ This establishes the underlying rationale for copyright: that society benefits from creative works, and authors of such works should be incentivized so that society as a whole will benefit from increased

13. Molly Shaffer Van Houweling, *Touching and Concerning Copyright: Real Property Reasoning in MDY Industries, Inc. v. Blizzard Entertainment, Inc.*, 51 SANTA CLARA L. REV. 1063, 1084 (2011).

14. U.S. CONST. art. I, § 8.

productivity.¹⁵ Those authors are granted exclusive rights for a period of time so that they can monetize their creativity, and society enjoys more creative works as a result.¹⁶ The particular rights that current copyright holders possess, defined in 17 USC § 106, include: (1) reproduction; (2) creating derivative works; (3) distribution; (4) public performance; and (5) display.¹⁷ These rights can be either exercised by the creator of a work or sold to another person or corporation for their use.¹⁸ The reproduction right permits its holder to create copies of an original work, such as making a duplicate of a photograph from the negatives.¹⁹ A derivative work is created when an original copy is used to create another work, such as a melody from one song being used to make a different song.²⁰ In addition to controlling the creation of new copies and derivative works, the distribution right allows copyright holders to control how any copies are distributed.²¹ For works like songs, the rights holder also controls the conditions under which the work can be performed in public, and also how a work like a painting can be displayed in public.²² Together, these rights allow copyright holders to use their works to generate revenue through almost any use of their intellectual property.²³

However, in order to strike an appropriate balance between producer incentives and consumer benefit, these exclusive rights are limited by several doctrines, most notably fair use,²⁴ first sale,²⁵ and essential steps.²⁶ These doctrines allow the use of copyrighted works in particular ways regardless of whether the copyright holder has given permission.²⁷ For this Note, the first sale and essential steps doctrines are particularly relevant. The first sale doctrine allows consumers who own a copy of some copyrighted work to transfer, resell, or alter that copy regardless of the copyright holder's

15. Bill Hinsee, *Wrath of the EULA: Can the Use of Bots Lead to Copyright Infringement?*, 17 B.U.J. SCI. & TECH. L. 160, 161–62 (2011).

16. *Id.*

17. 17 U.S.C. § 106 (2006).

18. See 3 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 10.02 (Matthew Bender, rev. ed. 2010).

19. See 2 *id.* § 8.02.

20. See 2 *id.* § 8.09.

21. See 2 *id.* § 8.11.

22. See 2 *id.* § 8.14.

23. See 2 *id.* §§ 8.02–8.22.

24. 17 U.S.C. § 107 (2006).

25. *Id.* § 109.

26. *Id.* § 117.

27. Brian W. Carver, *Why License Agreements Do Not Control Copy Ownership: First Sales and Essential Copies*, 25 BERKELEY TECH. L.J. 1887, 1891 (2010); Raymond T. Nimmer, *Copyright First Sale And The Over-Riding Role Of Contract*, 51 SANTA CLARA L. REV. 1311, 1314 (2011).

desires.²⁸ The essential steps doctrine allows owners of a copy of a computer program to the copies necessary to run the program, such as RAM copies, without violating copyright.²⁹ While these rights for consumers are firmly established, they only apply to those who actually *own* the copy they are using. Any copyrighted item that is rented, leased, or licensed does not grant these rights to the recipients of the copyrighted works because they are not owners.³⁰ This provides an incentive for copyright holders to license their products instead of selling them.

B. THE RISE OF LICENSING AND ITS RELATION TO COPYRIGHT LAW

Modern digital goods, especially software and digitally downloaded music, books and movies, are usually subject to an End User License Agreement (“EULA”) or a Terms Of Use (“TOU”) policy.³¹ EULAs and TOU licenses are contracts that generally set forth the conditions on which the digital good may be used³² and explicitly state that the recipient does not own their particular copy.³³ Such contracts are presented to the user in a pop-up window before the digital good can be used and require the consumer to agree to their terms before using the product.³⁴ These contracts are binding once agreed to, even if the person who clicked “I agree” did not really agree, did not read, or misunderstood the terms.³⁵ The terms contained in these agreements specify that the good is being licensed and not sold, meaning the consumer is not an owner and the first sale and essential steps doctrines do not apply.³⁶ Licenses can also specify how the recipient is allowed to use the product, how many copies they may make, and various actions that they are not allowed to take. A variety of specific examples will be addressed in Part III of this Note, *infra*.

This control over how a product is used and distributed can create benefits for both the producer and the consumer. Producers, or the copyright holders, are better able to control the uses and transfer of their

28. See Nimmer, *supra* note 27, at 1311.

29. Carver, *supra* note 27, at 1892; 2 NIMMER & NIMMER, *supra* note 18, § 8.08.

30. David A. Costa, *Vernor v. Autodesk: An Erosion of First Sale Rights*, 38 RUTGERS L. REC. 1, 4 (2011).

31. See, e.g., *iTunes Terms and Conditions*, *supra* note 3; *ADOBE Software License Agreement*, *supra* note 3.

32. See MDY Indus., LLC v. Blizzard Entm’t, Inc., 629 F.3d 928, 935 (9th Cir. 2010).

33. See Vernor v. Autodesk, 621 F.3d 1102, 1111 (9th Cir. 2010).

34. Kevin W. Grierson, *Enforceability of “Clickwrap” or “Shrinkwrap” Agreements Common in Computer Software, Hardware, and Internet Transactions*, 106 A.L.R. 5th 309, 317 n.1 (2003).

35. See Nathan J. Davis, *Presumed Assent: The Judicial Acceptance of Clickwrap*, 22 BERKELEY TECH L.J. 577, 579 (2007).

36. Nimmer, *supra* note 27.

products and can also gain access to consumer information to improve both their product and marketing.³⁷ Perhaps most importantly for copyright holders, licensing prevents consumers from reselling their product, which eliminates secondary “used” markets. Apart from copyright holder benefits, licensing allows flexibility in pricing structures by restricting resale, which can benefit consumers. For example, companies may distribute software at a very low price for students and non-profits because they are able to charge corporate clients much larger sums without worry of such clients resorting to secondary markets saturated by student and non-profit copies.³⁸ Producers of digital goods may also be able to offer discounted upgrading to current customers because they know that the old copies will not go to another party who would otherwise buy a new copy from them.³⁹ These aspects of licensing alter markets in ways that are both desirable for copyright holders and beneficial to consumers.

While there are notable benefits of licensing, there have been many critics of such practices. Brian Carver argues that denying ownership of a product when a user has perpetual possession of and control over it, such as a song that is downloaded, conflates intangible copyrights with tangible copies.⁴⁰ He argues that if a license grants perpetual possession, it should be viewed as a sale, creating first sale and essential step rights for the user that allow them to resell their copy and create a secondary market despite licensing terms that purport to restrict such activity.⁴¹ Currently, these rights do not attach under license agreements of any kind.⁴² Others also argue that licensing has been used as a tool to circumvent consumer protections in ways that are contrary to congressional intent.⁴³ This argument presents the presence of secondary markets and their benefits, such as availability of out of print works and a competing market, as a desired outcome that Congress intended when balancing producer and consumer rights.⁴⁴ The erosion of this market is then

37. See Jonathan C. Tobin, *Licensing As A Means Of Providing Affordability and Accessibility In Digital Markets: Alternatives To A Digital First Sale Doctrine*, 93 J. PAT. & TRADEMARK OFF. SOC'Y 167, 180–81 (2011) (arguing that copyright holders are better able to tailor digital rights management and differentiate products to suit different consumers with stronger rights).

38. See *Vernor*, 621 F.3d at 1114.

39. See *id.* at 1104.

40. Carver, *supra* note 27, at 1896–97.

41. See *id.* at 1953–54.

42. See *Vernor*, 621 F.3d at 1112 (citing 17 U.S.C. § 109(a) (2006)).

43. See, e.g., Jim Graves, *Who Owns A Copy?: The Ninth Circuit Misses An Opportunity To Reaffirm The Right To Use And Resell Digital Works*, 2 CYBARIS AN INTELL. PROP. L. REV. 45, 67–68 (2011); Costa, *supra* note 30, at 13.

44. Costa, *supra* note 30, at 5.

a departure from a status quo that has been effective at promoting the arts, and should be rectified by either Congress changing the wording of the statute⁴⁵ or courts adopting an “economic realities” test that would consider some licenses to be sales.⁴⁶ The common theme of these objections to licensing practices is that they erode established consumer rights for the benefit of copyright holders.⁴⁷

Regardless of one’s position on the policy impact of using license agreements to distribute digital goods, EULAs and TOUs create an intersection between copyright and contract law that can create difficulties when the two conflict. The primary conflicts arise when the copyright holder or good distributor seeks to enforce the terms of the license. They can either file a suit for breach of contract or for copyright infringement, which have different standards of liability and different available remedies.⁴⁸ Specifically, in a breach of contract action there is no third party liability possible, but under copyright law vicarious and contributory infringement are viable claims.⁴⁹ This is an especially important distinction for digital goods that are distributed on a large scale since suing individual users would be an extremely inefficient enforcement mechanism. In addition, damages for breach of contract actions are typically limited to expectation damages, whereas copyright claims can create an opportunity for much higher statutory damages.⁵⁰ Rights holders are therefore incentivized to seek copyright claims and damages and modify their licenses in ways that allow them to pursue copyright claims so that the licenses can be feasibly enforced.

C. RECENT NINTH CIRCUIT ANALYSIS

In 2010, the Ninth Circuit decided several cases directly addressing licensing practices. The trio of *Vernor v. Autodesk, Inc.*,⁵¹ *MDY Industries, LLC v. Blizzard Entertainment, Inc.*,⁵² and *UMG Recordings, Inc. v. Augusto*⁵³ were heard on the same day. The opinions for these cases were released sequentially, *Vernor* in September 2010, *Blizzard* in December 2010, and *UMG* in January 2011. These cases have received a great deal of attention and analysis from

45. *Id.* at 14.

46. Graves, *supra* note 43, at 72.

47. See Carver, *supra* note 27, at 1891; Costa, *supra* note 30, at 13–14; Graves, *supra* note 43, at 72.

48. Justin Van Etten, *Copyright Enforcement of Non-Copyright Terms: MDY v. Blizzard and Krause v. Titleserve*, 2011 DUKE L. & TECH. REV. 7, 11–13 (2011).

49. *Id.*

50. See 17 U.S.C. § 504 (2006); Van Etten, *supra* note 48, at 11.

51. *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010).

52. *MDY Industries, LLC v. Blizzard, Entm’t, Inc.*, 629 F.3d 928 (9th Cir. 2010).

53. *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2010).

commentators, and have effectively redefined the landscape of licensing law in the Ninth Circuit.⁵⁴ *Vernor* presented a test to determine whether a sale or license has been created by a transaction that makes it easy for producers to create a license.⁵⁵ *Blizzard* and *UMG* then apply this test and limit the copyright liability implications of licenses.⁵⁶ This Section will describe the holding and reasoning in *Vernor*, which provides the context necessary to understand the role of *Blizzard* in Part II.⁵⁷

In *Vernor v. Autodesk, Inc.*, Vernor sought declarative relief stating that he had not violated Autodesk's copyright when he bought used copies of AutoCAD software from a third party and sold them on eBay.⁵⁸ The software was subject to a license agreement that stated the software was licensed and not sold, and that transferring copies was not allowed.⁵⁹ The third party had upgraded from version 14 to 15 at a discounted price, and was obligated by the license to destroy previous versions or return them, but instead they sold the old versions to Vernor.⁶⁰

The court held that a copy is licensed and not sold if a EULA or TOU agreement (1) specifies the user is granted a license; (2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions.⁶¹ This case also re-established that a license precludes application of the first sale and essential steps doctrines.⁶² Applying this test to the facts, the court found that the license did specify it was a license; restricted the user from transferring the software at all; and limited the things a consumer was permitted from doing with the software such as modifying or reverse engineering it.⁶³ This met all three prongs of the test, meaning that the original purchaser of the software never owned it in the first place, and thus could not legitimately sell it to Vernor to resell on eBay.⁶⁴ The case was remanded for reconsideration with the understanding that Vernor could not invoke the first sale and essential steps doctrines.⁶⁵

54. See Nimmer, *supra* note 27; Robert H. Rotstein et al, *The First Sale Doctrine In The Digital Age*, 22 No. 3 INTELL. PROP. & TECH. L.J. 23 (2010).

55. *Vernor*, 621 F.3d at 1111.

56. Hinsee, *supra* note 15, at 169–70; Nimmer, *supra* note 27, at 1343.

57. This Note will not significantly address *UMG Recordings, Inc. v. Augusto*.

58. *Vernor*, 621 F.3d at 1103.

59. *Id.* at 1104.

60. *Id.*

61. *Id.* at 1111.

62. *Id.*

63. *Id.* at 1111–12.

64. *Id.* at 1112.

65. *Id.* at 1115.

The test imposed in *Vernor* is very broad. It may be instructive to compare the language required by *Vernor* to the language that was unenforceable in *Bobbs-Merrill v. Straus*, the case which established the modern first sale doctrine.⁶⁶ In that case, Bobbs-Merrill Co. had printed a book and wanted to control the price at which it was distributed through copyright.⁶⁷ They include a warning printed immediately below the copyright notice that the defendant admitted reading, however the Court did not enforce the warning because a sale had occurred.⁶⁸ The language found to be unenforceable was: “The price of this book is one dollar net. No dealer is licensed to sell it at a less price, and a sale at a less price will be treated as infringement of the copyright.”⁶⁹

Based on *Vernor*, if the phrases “this is a license accepted by purchasing the book from the publisher” and “this copy is for personal entertainment uses only” were added, the license test in *Vernor* would be facially met.⁷⁰ This type of comparison with well-established examples of first sale language has led to substantial criticism. Opponents of the *Vernor* rule argue that it allows certain “magic words” to circumvent consumer protections incorporated into the Copyright Act.⁷¹ Since licenses can establish the basis for copyright claims with no first sale or essential steps defense, these defenses may effectively cease to exist for consumers if licenses are too easy for copyright holders to establish.⁷² Opponents of the *Vernor* rule assert that Congress implemented these doctrines in the statute for a reason, and such easy circumvention alters the balance of interests against consumers.⁷³

However, it is worth noting that these objections are less forceful under the facts in *Vernor* because Autodesk’s licensing structure did provide consumer benefits. The licensing structure of Autodesk allowed alternative low pricing for students and non-profits, which they could only implement if the student and non-profit copies couldn’t be resold to undercut their corporate prices.⁷⁴ Further, the company that sold their copy to Vernor had

66. Costa, *supra* note 30, at 3.

67. *Bobbs-Merrill Co. v. Straus*, 21 U.S. 339, 341 (1908).

68. *Id.* at 342.

69. *Id.* at 341.

70. *But see* UMG Recordings, Inc. v. Augusto, 628 F.3d 1175 (9th Cir. 2010) (finding that even though the language of a license may facially meet the *Vernor* test, other considerations, such as lack of assent, may preclude a license from being created).

71. *See, e.g.*, Carver, *supra* note 27 at 1913; Jim Graves, *Who Owns A Copy?: The Ninth Circuit Misses An Opportunity To Reaffirm The Right To Use And Resell Digital Works*, 2 CYBARIS AN INTELL. PROP. L. REV. 45 (2011).

72. Costa, *supra* note 30, at 10–14.

73. *See* Graves, *supra* note 43, at 72.

74. *Vernor v. Autodesk, Inc.*, 621 F.3d 1104 (9th Cir. 2010).

received over an 85% discount for upgrading to a new version before selling the older version.⁷⁵ Autodesk would not be encouraged to offer upgrade incentives like these if secondary markets undercut new sales whenever an upgrade occurred. While the outcome of *Vernor* may have struck a reasonable balance between consumer and producer benefits for that particular license, these facts were not incorporated into the rule enunciated by the court and consumer benefits are not considered when determining if a sale or license has occurred.

II. *MDY INDUSTRIES, LLC V. BLIZZARD ENTERTAINMENT, INC.*

While the rule in *Vernor* was broad, its implications for copyright liability were narrowed significantly in *MDY Industries, LLC v. Blizzard Entertainment, Inc.*, a case heard the same day as *Vernor* but whose opinion was released a few months later.⁷⁶ In this case, Blizzard produced and distributed a massively multiplayer online game called World of Warcraft.⁷⁷ In order to use this software and access the online service required to play, users were required to agree to Blizzard's EULA and TOU.⁷⁸ One of the terms included in those licenses prohibited cheating in the game.⁷⁹ MDY created a program called Glider that played the game for the player.⁸⁰ A player could start up Glider, go to work for the day, and come back to an in-game character that had much more items and experience than before.⁸¹ This was a form of cheating explicitly prohibited by the license that a user had already agreed to.⁸² While the facts were clear that players who used Glider violated their license, Blizzard wanted the court to grant an injunction against MDY, not the players.⁸³ This remedy would only be available for contributory copyright infringement and not breach of contract, because MDY was not a party to the contract.⁸⁴ Therefore the case hinged on whether this particular violation

75. *Id.* at 1105.

76. *MDY Indus., LLC v. Blizzard Entm't, Inc.*, 629 F.3d 928 (9th Cir. 2010).

77. *Id.* at 934.

78. *Id.* at 935.

79. *Id.* at 938 (“You agree that you will not . . . (ii) create or use cheats, bots, ‘mods,’ and/or hacks, or any other third-party software designed to modify the World of Warcraft experience; or (iii) use any third-party software that intercepts, ‘mines,’ or otherwise collects information from or through the Program or Service.”).

80. *Id.* at 935.

81. *Id.*

82. *Id.* at 938.

83. *Id.* at 942.

84. *Id.* at 937–38.

of the license by players was copyright infringement or merely a breach of contract.⁸⁵

The court recognized that if any violation of a EULA or TOU constituted copyright infringement, then a company could include conditions wholly unrelated to their copyrights and enforce them through threat of a copyright action.⁸⁶ Based on this worry, the court held that terms within a license must be (1) a condition precedent to the license, as opposed to a mere covenant, and (2) have “a nexus between the condition and the licensor’s exclusive rights of copyright” in order to be enforced as a violation of copyright.⁸⁷ Any breach of EULA or TOU that falls short of these two conditions is only a breach of contract and does not open a consumer, or third parties contributing to the consumer’s actions, to copyright liability.⁸⁸ The court very clearly defined the difference between a condition and a covenant for the first prong, but the nature of the “nexus” was not clearly delineated.⁸⁹

The court in *Blizzard* distinguished two different types of provisions that might be in a license agreement: license conditions and contractual covenants.⁹⁰ A covenant is a contractual promise, while a license condition is an act or event that must occur before a duty to perform a promise arises.⁹¹ For example, a covenant might read “the end user is forbidden from installing this software on an Apple computer.” However, a condition would need to be phrased in a manner such as “you are granted this license only if you meet the condition that you do not install this software on an Apple computer; failure to meet this condition rescinds any grant of license.”⁹² As seen with this example, any covenant in a contract could be made into a condition with language indicating that the license as a whole is contingent upon fulfilling that clause. However, the language must be explicit because ambiguous contract provisions are interpreted as covenants.⁹³

85. *Id.*

86. *Id.* at 941.

87. *Id.*

88. *Id.*

89. *Id.* at 939–40; Van Houwelling, *supra* note 13, at 1084–85 (2011) (“suffice it to say that the Ninth Circuit’s specific articulation of the nexus test does not provide a satisfactory answer in this and in other difficult cases”).

90. *Blizzard*, 629 F.3d at 939.

91. *Id.*

92. This language was created merely as exemplary of the difference in question, based on the description in *Blizzard*. *Id.* at 939.

93. *Id.*

In *Blizzard*, the license provisions at issue⁹⁴ did not explicitly condition the license on adherence to the relevant provisions and therefore were mere covenants, enforceable under contract law but not copyright law. The covenant/condition distinction alone could have determined the outcome in *Blizzard* since both prongs of the test must be met for copyright liability to attach.⁹⁵ However, the court also addressed what would be required for a valid condition to have a nexus with exclusive rights of copyright.⁹⁶

In addition to requiring that the subject clause is a condition and not a covenant, the court in *Blizzard* ruled that the condition must also “be grounded in an exclusive right of copyright.”⁹⁷ The court reasoned that if this were not the rule, any software copyright holder could “designate any disfavored conduct during software use as copyright infringement by purporting to condition the license” on a user’s adherence to that term in the license.⁹⁸ If a copyright holder could successfully enforce such provisions under the copyright act, they would be afforded “far greater rights than Congress has generally conferred on copyright owners.”⁹⁹ Therefore, the court held that in order for a condition of a license to open a user to a claim of copyright infringement, there “must be a nexus between the condition and the licensor’s exclusive rights of copyright.”¹⁰⁰

This court did not explain what a nexus would entail, or what test should be applied to determine if a nexus exists.¹⁰¹ The only guidance the court gave regarding the scope of a potential nexus is that the condition should not expand the rights of copyright holders beyond what Congress has generally conferred.¹⁰² The court also delineated certain provisions that would create a

94. *Id.* at 938 (“You agree that you will not . . . (ii) create or use cheats, bots, ‘mods,’ and/or hacks, or any other third-party software designed to modify the World of Warcraft experience; or (iii) use any third-party software that intercepts, ‘mines,’ or otherwise collects information from or through the Program or Service.”).

95. *Id.* at 939.

96. *Id.* at 940.

97. *Id.*

98. *Id.* at 941.

99. *Id.*

100. *Id.*

101. *See id.*

102. *Id.*

nexus with an exclusive right of copyright¹⁰³ and others that would not.¹⁰⁴

III. NEXUS TEST ANALYSIS

This Note aims to fill in the details left out of the *Blizzard* court's nexus test. An appropriate test can be developed using the principle of not expanding copyright powers beyond congressional intent, combined with the examples given by the court. Any rule that would find copyright liability solely because a clause was included in the EULA or TOU would inherently allow copyright holders to expand their rights by including such a clause.

At least commentator,¹⁰⁵ Molly Van Houwelling, has considered a rule that is similar in structure to the test this Note proposes but much broader in application. That formulation states that violation of a license term is infringing if that action would violate copyright if there were no license at all.¹⁰⁶ The shortcomings of this test are most apparent in the software context. The use of any software creates RAM copies, which violate copyright if the person using the software is not licensed to do so.¹⁰⁷ If the test for infringement asks whether an act infringes if there is no license at all, and any use of software infringes via RAM copies without a license, then such a rule would find infringement for violating any term in a software license. This runs contrary to the desire to prevent copyright holders from expanding their rights through licenses. Van Houwelling comes to this same conclusion and rejects such a test.¹⁰⁸ Moreover, the violated license provisions in *Blizzard* violated copyright under this broader test, yet the court found no nexus.¹⁰⁹ An alternative, narrower test is necessary.

The test for whether a nexus exists with an exclusive right of copyright should be: if an act that allegedly violates a term in a license would violate copyright law if the *violated term* were not in the license at all, then the term

103. *Id.* at 940–41 (“For instance, ToU § 4(D) forbids creation of derivative works based on WoW without Blizzard’s consent. A player who violates this prohibition would exceed the scope of her license and violate one of Blizzard’s exclusive rights under the Copyright Act.”).

104. *Id.* at 941 (“ToU § 4(C)(ii) prohibits a player’s disruption of another player’s game experience. [. . .] Although this conduct may violate the contractual covenants with Blizzard, it would not violate any of Blizzard’s exclusive rights of copyright.”).

105. Van Houwelling, *supra* note 13, at 1083.

106. *Storage Tech*, 421 F.3d at 1316; Van Houwelling, *supra* note 13, at 1083.

107. *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 519 n.5 (9th Cir. 1993); Carver, *supra* note 27, at 1893.

108. *See* Van Houwelling *supra* note 13, at 1084.

109. *Blizzard*, 629 F.3d at 941.

has a nexus with an exclusive right of copyright. I will call this the “Nexus Test” throughout this Note. The Nexus Test differs from the formulation considered and rejected by Van Houweling because it does not consider whether there would be infringement without any license at all, but whether there would be infringement if the license as a whole were intact but the sole violated provision were excised. The Nexus Test determines if violation of a license term results in copyright liability, which does not preclude copyright liability established on separate grounds.¹¹⁰ This particular formulation has not been considered by a court. The Nexus Test accounts for the conditions in *Blizzard* explicitly found to create a nexus as well as those that do not, and also provides a reliable method of deciding borderline cases without granting additional rights to copyright holders beyond those intended by Congress.¹¹¹

IV. APPLYING THE NEXUS TEST

This Part will first apply the Nexus Test to conditions that are clearly determined within the *Blizzard* decision in order to establish that the Nexus Test is consistent with the goals of the court. Then this Part will apply the Nexus Test to a variety of conditions that are not clear under *Blizzard*, showing the results of the Nexus Test and arguing that these outcomes reflect the reasoning of the court. In order to facilitate a deeper analysis of the nexus prong of the *Blizzard* test, all examples will be considered conditions even if they are not phrased that way in their current form. This is practical as a policy matter since any covenant could be rephrased in a way that makes it a condition.¹¹²

A. TERMS WHOSE NEXUS STATUS IS CLEAR UNDER *BLIZZARD*

1. *Terms That Do Create a Nexus*

The terms laid out by *Blizzard* as creating a nexus with an exclusive copyright would also establish a nexus under the Nexus Test. The court in *Blizzard* explicitly held that a condition limiting the number of copies a licensee is able to produce or restricting the licensee from making derivative works without permission would create an appropriate nexus.¹¹³ Each of these conditions directly invokes an exclusive right of copyright by name.¹¹⁴ Further, each of these conditions would clearly be considered a nexus under

110. For instance, if a licensee created derivative works without permission, then the presence or absence of a license term prohibiting such conduct would be moot.

111. *See infra* Part IV.

112. *Blizzard*, 629 F.3d at 941.

113. *Id.* at 940–41.

114. *See* 17 U.S.C. § 106 (2006).

the Nexus Test this Note proposes, because making a copy or derivative work would violate copyright if that particular term were not in the license. While this principle does not shed light on grey areas, it is an important baseline that any viable test must meet.

2. *Terms that Do Not Create a Nexus*

The Nexus Test is consistent with the court's description of conditions that fail to form a nexus. The *Blizzard* court held that the covenants at issue in the case would not have established a nexus even if they were conditions.¹¹⁵ In particular, the provisions barring users from installing and using third party software as well as restrictions on conduct while using the licensed software were held to not have a nexus with any exclusive copyright.¹¹⁶ The court reasoned that restrictions on third party software or restricting other conduct while using a copyrighted work could be used to discourage competing products or make arbitrary demands of consumers.¹¹⁷ The court held that these are not within the powers granted to copyright holders by Congress, and should only be enforceable through contract law.¹¹⁸ The Nexus Test reaches the same conclusion. Since a consumer would be allowed to use any third party software without violating copyright if the restricting term were not in the license, the Nexus Test would not find copyright liability for violating that term.

Another type of license provision that would almost certainly fail to establish a nexus with copyrights are restrictions of legal rights. For example, a provision dictating choice of law, mandating arbitration, or preventing the user from entering a class action lawsuit, would likely be held not to implicate any exclusive right of copyright. This is a very clear application of the Nexus Test, since any legal right a licensee would exercise without a restriction in the license would be allowed without any copyright considerations. Creating copyright liability for violating legal right restrictions in a contract would be a dramatic expansion of copyright powers of exactly the type the court in *Blizzard* sought to avoid.¹¹⁹ The Nexus Test accurately traces the court's determination of conditions that are excluded from forming a nexus.

115. *Blizzard*, 629 F.3d at 941.

116. *Id.*

117. *Id.*

118. *Id.*

119. *See id.*

B. TERMS WHOSE NEXUS STATUS IS UNCLEAR UNDER BLIZZARD

Conditions in licenses that seem to have some connection to an exclusive right but do not directly invoke that right are likely to be the subject of future lawsuits. This Section will apply the previously described Nexus Test to various EULA and TOS licenses that are required for a variety of mediums. The goal of this section is to explore what kinds of considerations are likely to arise when implementing the Nexus Test in real world contexts. Towards that end, the examples used are from mainstream companies that have established considerable market shares in their respective industries. These are the rights holders who are likely to be most influential in changing license language. For the sake of analysis, each provision at issue will be considered a condition whether or not it is phrased as one.

1. *Preconditions for Installation*

License terms that establish preconditions for installation may be ambiguous upon initial examination, but are meaningfully analyzed by the Nexus Test. Certain types of software licenses, particularly operating system licenses, often prohibit installation of the product if certain conditions won't be met after the product is installed. For example, Windows 7 OEM discs prohibit installation if the installer does not distribute the computer the software is installed on and provide technical support to the recipient,¹²⁰ and Apple's Mac OS X license agreement prohibits installation of the operating system on any non-Apple computer.¹²¹ Under the Nexus Test, these types of conditions would not implicate an exclusive right under the copyright act. This is not to say that all preconditions for installation wouldn't invoke an exclusive right, but that such conditions do not inherently do so.

In the case of the Windows 7 OEM agreement, if the condition requiring the installer to sell the machine and provide service was not in the license at all, failure to perform those actions could not be construed as a copyright violation. This coincides with the court's desire expressed in *Blizzard* to prevent expansion of powers under copyright.¹²² Requiring a consumer to transfer the machine and provide services is not a restriction but an affirmative duty, and the copyright act permits rights holders "to do and to authorize" actions, not mandate them.¹²³ Allowing such provisions to be

120. *Microsoft OEM System Builder License*, MICROSOFT, http://oem.microsoft.com/public/sblicense/2008_sb_licenses/fy08_sb_license_english.pdf (last visited Feb. 7 2012).

121. *Apple Inc. v. Psystar Corp.*, 658 F.3d 1150, 1153 (9th Cir. 2011).

122. *See Blizzard*, 629 F.3d at 941.

123. 17 U.S.C. § 106 (2006).

enforced through copyright would expand the powers of rights holders to include creating affirmative duties.

The Apple case is tougher because the prohibition on installing MAC OS X on non-Apple computers has an effect on the means of distribution of MAC OS X.¹²⁴ This could be read to implicate the distribution right since copyright does aim to let rights holders control the manner in which copies are distributed. However, if the condition were not included in the license, then the particular branding of the pieces of hardware surrounding the hard drive the OS is installed on would have no copyright implications so long as the user would be authorized to make that copy elsewhere in the license. Although installing Mac OS X on a non-Apple computer has the effect of using the software in a way contrary to Apple's desired usage, it does not produce or distribute an unauthorized copy of the software, and does not create any derivative work.¹²⁵

This same license provision was at issue in the Ninth Circuit case *Apple v. Psystar*,¹²⁶ and the Nexus Test outcome is consistent with the outcome of that case. There, Psystar was mass producing non-Apple computers equipped with Mac OS X.¹²⁷ They did this by using one copy of the software to create a digital image, and then copied this exact same image onto each of the computers they sold.¹²⁸ Apple brought suit for copyright infringement, arguing in part that the violation of their license agreement provided grounds for copyright liability.¹²⁹ The license issue was not specifically analyzed in *Apple v. Psystar* because the primary issue on appeal was copyright misuse.¹³⁰ However, the district court held that Psystar had created a derivative work by producing the image they cloned onto each computer, and had thus violated copyright in that manner, which the Ninth Circuit affirmed.¹³¹ The Nexus test, as noted in the preceding paragraph, would not find infringement on the basis of the license—the license provision does not implicate Apple's exclusive rights under copyright. Of course, the result of the Nexus Test here would not preclude a finding that Psystar infringed Apple's copyrights

124. *Software License Agreement For Mac OS X*, APPLE, <http://images.apple.com/legal/sla/docs/macosx106.pdf> (last updated July 15, 2009).

125. RAM copies would need to be otherwise authorized in another section of the license, which is necessary for the software to be installed and used in any manner without violating copyright.

126. *Apple*, 658 F.3d at 1153.

127. *Id.*

128. *Id.*

129. *Id.*

130. *See id.*

131. *Id.* at 1154, 1162.

regardless of the statement in the license agreement.¹³² The *Pystar* court found infringement on the independent grounds of unauthorized derivative works, and is entirely consistent with the Nexus Test. This example demonstrates that the Nexus Test only determines if a *license violation* in itself creates copyright infringement liability, it is silent on whether any other activity can create liability separately.

Conditions for installation of operating system software should not be viewed as inherently having a nexus with an exclusive right, although a particular condition could have a nexus.¹³³ Whether a nexus is found should be decided by determining if the action is infringing without that condition in the contract. Otherwise software distributors can obtain greater rights, such as imposing affirmative obligations and hardware restrictions, through the Copyright Act than were intended.

2. *Digital Media*

Forms of traditional media, books, music, and videos, are now widely available in digital formats. Digital music over the past year had a \$4.6 billion market value¹³⁴ and e-readers are becoming increasingly more popular.¹³⁵ iTunes was responsible for more than half of all digital music downloads in 2010,¹³⁶ and Amazon accomplished the same feat in the eBook market with their Kindle.¹³⁷ Given the prodigious market share of these two companies, their license agreements will likely be models for the industry and deserve analysis. Determining whether certain provisions can be enforced using copyright will be important as the law develops following *Blizzard*. This Section analyzes two such licenses, Apple's iTunes license and Amazon's Kindle license, under the Nexus Test.

The iTunes Store, which contains all of Apple's digital music downloads, is governed by a Terms of Use agreement.¹³⁸ Certain usage rules in this

132. *Id.*

133. For example, a restriction prohibiting backup copies from being made.

134. *IFPI Digital Music Report 2011*, INT'L FED'N OF THE PHONOGRAPHIC INDUS., <http://www.ifpi.org/content/library/DMR2011.pdf> (last visited Feb. 23, 2012).

135. Kristen Purcell, *E-reader Ownership Doubles in Six Months*, PEW INTERNET AND AMERICAN LIFE PROJECT (June 27, 2011), <http://pewresearch.org/pubs/2039/e-reader-ownership-doubles-tablet-adoption-grows-more-slowly>.

136. Eric Slivka, *iTunes Store Reaches 28% Overall Share, 70% Download Share of US Music Sales*, MACRUMORS (May 26, 2010, 2:07 PM), <http://www.macrumors.com/2010/05/26/itunes-store-reaches-28-overall-share-70-digital-share-of-u-s-music-sales>.

137. David Carnoy, *Amazon: We have 70–80 percent of e-book market*, CNET REVIEWS (Aug. 2, 2010, 1:08 PM), http://reviews.cnet.com/8301-18438_7-20012381-82.html.

138. *iTunes Terms and Conditions*, APPLE, <http://www.apple.com/legal/itunes/us/terms.html> (last updated Oct. 12, 2011).

agreement clearly have a nexus with an exclusive right of copyright, such as “you shall be authorized to burn an audio playlist up to seven times” or “you shall not be entitled to burn video iTunes Products or tone iTunes Products.”¹³⁹ These are restrictions on the right to reproduce the copyrighted work, and such actions would clearly be infringing if these terms were not included in the agreement at all.

However, there are other provisions where the presence of a nexus is less clear. One such section states “you shall be authorized to use iTunes Products on five iTunes-authorized devices at any time.”¹⁴⁰ If a user was to use their downloaded songs on six devices at a time, would they face copyright liability? Would a third party who sold software explicitly to facilitate exceeding this device limit be subject to contributory infringement liability? In this case, the Nexus Test would indicate that there is no nexus and copyright liability does not attach. If the provision were not in the agreement at all, assuming that other parts of the agreement permitted copies to be placed on six devices in the first place, their simultaneous use by itself would not implicate any exclusive right. Essentially this is a restriction on how a consumer may use otherwise authorized copies, and would thus be analogous to the restrictions against using cheats while playing that Blizzard included in its license.¹⁴¹ Both restrictions are on the manner in which a copy is used for personal enjoyment, not on how it is reproduced, transferred, or any other exclusive right of copyright. Because of this, a third party enabling this kind of violation would not face liability, and Apple would only be able to sue the iTunes user for expectation damages caused by the breach of contract.

A similar provision raises a slightly different set of considerations. “You shall be able to store iTunes Products from up to five different Accounts at a time on compatible devices.”¹⁴² Here, the analysis differs because the usage of the products is not at issue, but the location of materials attached to particular accounts. In this case there could be two different types of license violations. One could be a situation where five people have accounts on the same computer, and they each store all of the music on the computer on their personal MP3 players. Under the Nexus Test, this would be infringing because if this clause were not in the contract unauthorized copies would be made to non-licensees. However, if the same person owned over five

139. *Id.*

140. *Id.*

141. *See* MDY Indus., LLC v. Blizzard Entm’t, Inc., 629 F.3d 928, 938 (9th Cir. 2010).

142. *iTunes Terms and Conditions*, APPLE, <http://www.apple.com/legal/itunes/us/terms.html> (last updated Oct. 12, 2011).

accounts, copyright liability would not attach under the Nexus Test because absent this provision, an individual with six or more accounts would be permitted to store all of their music on one device from any number of accounts without violating copyright.¹⁴³ Thus for media provisions like this one, the facts at issue will determine whether or not the clause was breached in a way that creates a nexus.

Amazon's Kindle has a EULA and TOU that raises different nexus issues. One provision states that digital content can be used "solely on the Kindle or a Reading Application," where a Reading Application is the Kindle App for a smartphone or tablet.¹⁴⁴ This TOU is similar to the wording of the Mac OS X EULA, discussed in section IV.B.1, *supra*, and the analysis follows the same path. Since the purchase of the ebook for a non-Kindle device without such a clause does not implicate an exclusive right, there is no nexus formed upon violation of this provision.

Ultimately, the specific facts of each case will be important in determining if there is a nexus regarding terms that define a user's ability to store and transfer digital media, but generally terms that restrict the manner in which media is used on a device will fail to create a nexus.

3. *Software*

There is such a wide variety of software with accompanying license agreements that a fully representative survey is impossible. However, there are some pieces of software that are commonly used in both business and home computing where the question of contributory liability and statutory damages under copyright infringement would be especially salient, since contract remedies against individual users would be impractical to pursue on a large scale.

One commonly used type of software is a Portable Document Format program. Free versions of these programs allow users to read PDF files, and priced versions allow further capabilities such as file conversion and editing. The Adobe Acrobat software suite is by far the leading PDF software program.¹⁴⁵ This Section will analyze the license agreement of this software suite.

143. As before, this assumes that the copies are authorized initially elsewhere in the license.

144. *Amazon.com Kindle License Agreement and Terms of Use*, AMAZON, http://www.amazon.com/gp/help/customer/display.html/ref=hp_left_cn?ie=UTF8&nodeId=200506200 (last updated Sept. 28, 2011).

145. See Abhishek Baxi, *The Underdogs In Adobe vs. Foxit PDF World*, THE WINDOWS CLUB (Aug. 1, 2010), <http://www.thewindowsclub.com/the-underdogs-in-adobe-vs-foxit-world>; see also FOXIT, http://www.foxitsoftware.com/pdf/rd_eula.htm (last visited Feb. 4,

Adobe has a section in their license designed to allow the software distributor to check if companies are following the terms of the license. Adobe's policy reads:

If you are a business, company or organization, you agree that, no more than once every 12 months, Adobe or its authorized representative shall, upon 10 days' prior notice to you, have the right to inspect your records, systems, and facilities to verify that your use of any and all Adobe Software is in conformity with your valid licenses from Adobe. If a verification discloses that your use is not in conformity with a valid license, you shall immediately obtain valid licenses to bring your use into conformity.¹⁴⁶

In this case the Nexus Test would determine that there is not a nexus to any exclusive right of copyright. If the term were not in the license, the affirmative action not taken by the licensee could not implicate copyright, similarly to the affirmative obligations imposed by Microsoft's OEM Windows license discussed in Part IV.B.1, *supra*. While the purpose of clauses like these may be to check for copyright violations, failure to comply with such inspections would not in and of itself be a violation of copyright. In the case of Adobe's license, the additional requirement that a violation be remedied by purchasing the necessary licenses could also fail to satisfy a nexus analysis. It is possible that the company violated a non-copyright related portion of the contract. Therefore, breaching this clause alone wouldn't inherently implicate a copyright nexus, although it might be likely.

Adobe also has a provision that raises the question of how the term that is hypothetically excised from the license during the Nexus Test analysis should be defined. The interpretive problem is determining how much of a clause should hypothetically be excluded when performing a nexus analysis. The relevant language states that a primary user:

may install a second copy of the Software for his or her exclusive use on either a portable Computer or a Computer located at his or her home, provided that the Software on the portable or home Computer is not used at the same time as the Software on the primary Computer.¹⁴⁷

If the entire sentence is hypothetically excluded from the license, then the creation of a second copy clearly meets the nexus requirement by implicating

2012) (Foxit is another relatively popular PDF program, and its license agreement contains provisions similar to those discussed in the Adobe license).

146. *ADOBE Software License Agreement*, ADOBE, http://www.adobe.com/products/eulas/pdfs/Gen_WWCombined-20080205_1329.pdf (last visited Feb. 7 2012).

147. *Id.*

the right of reproduction. However, since a violation would be triggered by simultaneous use, one could interpret the test to only exclude the grammatical clause beginning at “provided.” In that scenario, the Nexus Test would determine that because usage restrictions do not inherently implicate an exclusive right, there is no nexus.

It is likely that similar interpretive problems will arise in future litigation, and courts should establish a principled rule to clearly define exactly what language within any particular term is being hypothetically excluded for the purpose of the Nexus Test. The rule should be that the language hypothetically excluded is limited to the language defining the alleged conduct that violated the license. In this case, since the violation could only be triggered by simultaneous usage and not merely by simultaneous installation, only the clause beginning at “provided” should be at issue for the nexus analysis and therefore a nexus should not be found. This provision is a conditional right to make a copy granted by the license, and in order to implicate copyright would need to be embedded in language that conditions the entirety of the license on satisfaction of this condition.¹⁴⁸

While the court in *Blizzard* only addressed conditions in the context of distinguishing them from covenants, it is logically consistent that embedded conditions be treated the same as conditions to the license as a whole. To do otherwise would open the door for licenses to be worded in such a way that copyrights are conditionally tied to use restrictions, which would expand copyright holders’ rights in exactly the way the court in *Blizzard* sought to avoid.¹⁴⁹ For example, a license from Blizzard could state “you may make RAM copies of this program only if you do not use third party software while playing the game” and included the necessary language to condition the license as a whole on this clause. Assuming RAM copies are not allowed elsewhere in the license, removing that term in its entirety in the course of the Nexus Test would make use of the software infringing. Blizzard would be able to circumvent the explicit determination that restrictions on third party programs did not have a nexus to copyright if the Nexus Test is interpreted this way. While this would involve a fair deal of textual acrobatics to meaningfully incorporate into a license, the Nexus Test should be interpreted in the way most logically consistent with the reasoning in *Blizzard*. In the case of dependent conditions as seen in the Adobe license, only the prohibition on behavior should be hypothetically excluded from the license during the Nexus Test, and not the privilege that is conditioned upon it.

148. See the discussion of how covenants can be rephrased as conditions in *supra* Part II.

149. See *MDY Indus., LLC v. Blizzard Entm’t, Inc.*, 629 F.3d 928, 941 (9th Cir. 2010).

A reasonable objection to this interpretation is that it creates a disincentive for Adobe and others to grant conditional rights to users. In the example in question, it seems likely that many consumers would not violate the term and gain substantial benefit from having a copy on both a desktop and laptop. While it is true that this construction would create some level of disincentive for such terms, it is important to note that contract remedies are still available if a violation is detected. Moreover, the cost benefit analysis of including such terms likely already presumes few enforcement efforts. The apparent primary benefit of including the term is improving consumer satisfaction, with little harm to the licensor even if the term were violated. While it is possible that there could be unanticipated market effects of this Nexus Test interpretation, the types of terms currently included in licenses such as Adobe's do not create reasonable anticipation of any seriously deleterious effects towards either licensees or licensors.¹⁵⁰

4. *Video Games*

While technically a subset of software, video games also incorporate media elements and are available on both consoles and personal computers. Regardless of the exact status of video games as a medium, the license agreements pertaining to PC games tend to take the same clickwrap form as other software licenses.

A game called *Call of Duty: Modern Warfare 3* set records by grossing \$775 million globally in the first five days after it was released, selling 6.5 million units in the US and UK in the first 24 hours it was available.¹⁵¹ The license agreement for the PC version of the game includes provisions very similar to those in *Blizzard*, restricting the use of hacking and cheats.¹⁵² However, there are other provisions that might be subject to litigation following the ruling in *Blizzard*.

One such condition states that “you shall not exploit this Program or any of its parts commercially, including but not limited to use at a cyber café, computer gaming center or any other location-based site.”¹⁵³ In order to run

150. See *ADOBE Software License Agreement*, *supra* note 146.

151. *Call of Duty: Modern Warfare 3 Sets All-Time Record*, ACTIVISION (Nov. 11, 2011), <http://investor.activision.com/releasedetail.cfm?ReleaseID=623056>.

152. Compare *MDY Indus., LLC v. Blizzard Entm't, Inc.*, 629 F.3d 928, 938 (9th Cir. 2010) (“You agree that you will not . . . (ii) create or use cheats, bots, ‘mods,’ and/or hacks, or any other third-party software designed to modify the World of Warcraft experience”), with *ACTIVISION BLIZZARD INC., CALL OF DUTY MW3 INSTRUCTION BOOKLET 8* (2011) (“You shall not hack or modify (or attempt to modify or hack) the Program, or create, develop, modify, distribute or use any software programs in order to gain . . . advantage”).

153. *ACTIVISION*, *supra* note 152.

the program in a cyber café, you would need a separate, and likely more expensive, license.¹⁵⁴ If this term were not in the license, these actions would form a nexus with the exclusive right to public performance. Since all the locations mentioned were in public places with open access to the game, a nexus should be found under the Nexus Test. This is especially the case for video games since the e-sports industry has begun developing in the US, where games are played competitively on a public stage for cash prizes.¹⁵⁵ Terms like this one are necessary for software developers to ensure that they receive additional compensation for such commercial uses. Nevertheless, the exact terms of such licenses would need to be evaluated in each case to ensure that the restricted activity constitutes a public performance.

V. CONCLUSION

This Note proposes that a nexus between a condition in a license and an exclusive right afforded to copyright holders should be found only if the activity would be infringing if the allegedly violated term were not in the license at all. While the Nexus Test would still require a case by case analysis of both the nature of the allegedly infringing action and the license condition in question, it would provide a stable and reliable framework to judge those factors with. It would also inherently prevent copyright holders from expanding the rights granted by federal law through the wording of their licenses. This potential expansion of the powers that copyright holders possess is especially worrisome in the context of *Vernor*, since first sale and essential steps defenses will not be available to the consumers of many digital goods. Any method that relies on the particular language of the condition would be subject to abuse at the expense of consumers and contrary to the holding in *Blizzard*.

154. *Id.*

155. See, e.g., *Intel Extreme Masters: New York*, ELECTRONIC SPORTS LEAGUE, <http://www.esl-world.net/masters/season6/newyork/> (last visited Feb. 23, 2011).

COPYRIGHT DAMAGES: INCORPORATING REASONABLE ROYALTY FROM PATENT LAW

Kevin Bendix[†]

On November 23, 2010, a jury in the Northern District of California awarded Oracle \$1.3 billion in copyright infringement damages in light of industry rival SAP's admitted copying of Oracle's software.¹ These compensatory damages were mandated under a hypothetical license theory and are claimed to be the largest award ever for copyright infringement.² On September 1, 2011, the district court granted SAP's motion for judgment as a matter of law, finding insufficient evidence for a reasonable jury to conclude that Oracle was entitled to a hypothetical license award.³ The court also granted SAP's motion for a new trial, conditional upon Oracle's rejection of a remittitur to \$272 million.⁴ Despite the court's skepticism of the hypothetical license theory, the jury's immoderate damage award raises complex doctrinal issues involving the proper method of calculating the fair market value of copyrights. This unresolved issue is important, as it may have far-reaching implications for mergers and acquisitions involving technology companies, for valuation of software products and services, and for third-party software support and add-on businesses—all beyond the seemingly simple notion of copyright infringement that triggered the case.

Copyright owners are often compensated in the form of a license. In such cases, the plaintiff's actual damages should take the form of lost license fees. While precision is not required,⁵ a copyright owner should be entitled to receive an award that represents the licensing fees she would have recognized but for the infringement. However, courts have struggled to determine the fair market value of such a license. One method looks to the reasonable

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1. Oracle Corporation v. SAP AG, 49 Trials Digest 13th 10.

2. Karen Gullo, *Oracle Wins \$1.3 Billion Verdict for Closed SAP Unit's Illegal Downloading*, BLOOMBERG (Nov. 24, 2010, 3:26AM), <http://www.bloomberg.com/news/2010-11-23/sap-must-pay-oracle-1-3-billion-over-unit-s-downloads.html>.

3. Oracle USA, Inc. v. SAP AG, C 07-1658 PJH, 2011 WL 3862074, at *13 (N.D. Cal. Sept. 1, 2011).

4. *Id.*

5. On Davis v. The Gap, Inc., 246 F.3d 152, 163 (2d Cir. 2001).

royalty scheme used in patent law, which contemplates a hypothetical negotiation between a willing buyer and willing seller for the licensed work.⁶ Courts and scholars have oscillated on the adoption of such a hypothetical license theory into copyright law.⁷ After a thorough analysis of the Copyright Act and its policies, this Note proposes that adopting a hypothetical license scheme into copyright law is not only proper, but helpful in determining adequate compensation resulting from infringement.

The goals of this Note are to: (1) provide a coherent understanding of how the reasonable royalty award developed in the patent context; (2) clarify why copyright law's adoption of reasonable royalty principles does not run afoul of the Copyright Act; and (3) explain how the reasonable royalty concept should be tailored to copyright damages. Part I begins with a comprehensive background of actual damages in the Copyright Act. It then outlines conventional valuation techniques and explains the rationale of the hypothetical license technique in copyright law. Part II reviews the development of the hypothetical negotiation tests in both patent and copyright law. Part III tests the hypothetical license premise against the statutory construction of the Copyright Act, finding that its adoption does not run afoul of the statutory language or legislative intent. It then reviews the "historic kinship" rationale, set out by the Supreme Court to analyze analogous issues between patent and copyright law, as a potential justification for adopting the reasonable royalty technique into copyright law. It confirms that rationale, finding historic kinship in damage remedies by looking to the constitutional origins of patent and copyright law, their initiation under tort law, and their parallel evolution in more accurately assessing the value of use of the underlying asset. Part IV proposes key factors to guide courts in accurately and consistently determining a hypothetical license by conforming the *Georgia-Pacific* factors to address copyright issues. Part V concludes.

6. See *infra* Part II.A.

7. Compare *Bus. Trends Analysts, Inc. v. Freedonia Group, Inc.*, 887 F.2d 399, 405 (2d Cir. 1989) (declining to adopt a "reasonable royalty rule" based on the "entirely hypothetical sales" between the parties), and 4 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 14.02[A] (2011) (opining that a reasonable royalty measure of actual damages should not be regarded as authorized by § 504(b)), with *Getaped.Com, Inc. v. Cangemi*, 188 F. Supp. 2d 398, 405 (S.D.N.Y. 2002) ("[A] reasonable license fee is appropriate even where plaintiff cannot show that defendant would have been willing to negotiate a license to use plaintiff's copyrighted work, or where the plaintiff cannot plausibly argue that it would have been willing to use defendant's use."), and PAUL GOLDSTEIN, GOLDSTEIN ON COPYRIGHT § 14.1.1, at 14:13 (2005) (arguing that "the reasonable royalty measure is not inconsistent with the 1976 Act's . . . stated purpose of compensating copyright owners for their actual damages").

I. BACKGROUND

The Copyright Act allows for recovery of “actual damages suffered by [the copyright owner] as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages.”⁸ These actual damages are awarded to compensate for demonstrable harm caused by infringement.⁹ When proof of actual damages or infringer’s profits is insufficient, the copyright owner may elect to receive statutory damages, subject to having met other statutory requirements.¹⁰

Actual damages are generally determined by the loss in the fair market value of the copyright, “measured by the profits lost due to the infringement or the value of the use of the copyrighted work to the infringer.”¹¹ Finance experts use traditional valuation methodologies to value the use of a copyrighted work. The cost approach, for example, measures value by analyzing the expenditures necessary to replace the asset in question.¹² The historical cost to develop the intellectual property, or its cost basis, is generally used to determine value under this theory.¹³ This approach, however, is more often used to value assets for which no specific market application can be identified, as it does not reflect the earning potential of the assets.¹⁴ The market approach values intangible assets by comparing recent sales or other transactions involving similar assets in similar markets.¹⁵ This technique depends on an active market providing several examples of recent arm’s-length transactions within that market of similar assets.¹⁶ This method, however, requires a high level of similarity between the copyright and the market asset, as well as between the comparable market and market at issue, in order to serve as an accurate model. Lastly, the income approach values assets by determining future income streams expected from that asset.¹⁷ This technique considers a projection of future income attributable to the asset, an

8. 17 U.S.C. § 504(b) (2010).

9. *Polar Bear Prods., Inc. v. Timex Corp.*, 384 F.3d 700, 708 (9th Cir. 2004).

10. *See* 17 U.S.C. §§ 412(2), 504(c).

11. *McRoberts Software, Inc. v. Media 100, Inc.*, 329 F.3d 557, 566 (7th Cir. 2003); *see also Mackie v. Rieser*, 296 F.3d 909, 914 (9th Cir. 2002) (approving the recovery of a reasonable license fee).

12. WESTON ANSON, *FUNDAMENTALS OF INTELLECTUAL PROPERTY VALUATION* 33 (2005).

13. *Id.*

14. *Id.*

15. *Id.* at 34.

16. *Id.*

17. *Id.*

estimate of the likely duration of the income stream, and an estimate of the risk associated with generating the projected income stream.¹⁸ Under this theory, the asset is worth the present value of the future economic benefits that will accrue to its owner.¹⁹ Because the information available is seldom perfect or adaptable to one particular methodology, a more accurate valuation technique considers all available methodologies.²⁰

Although some district courts hesitate to conform, the Ninth Circuit has endorsed a retroactive license fee as another measure of the loss in fair market value of the copyright, which does in fact consider all available methodologies.²¹ Originally based on the “value of use” theory, the hypothetical license approach calculates actual damages based on what a willing buyer would have reasonably been required to pay a willing seller for the work. As a threshold matter, the plaintiff must establish that she in fact lost the opportunity to license the copyright at issue.²² The court is then given considerable leeway to reconstruct a hypothetical negotiation, envisioning the fair market value of the infringed copyright in order to adequately compensate its owner. This flexible approach is superior to any one valuation method because courts are able to weigh a wide range of considerations on a case-by-case basis. This ensures a more realistic valuation because parties negotiating a copyright license are likely to consider the effects of the cost, market, and income approach, among others, to reach a final price.²³

The hypothetical license award envisioned by copyright law is similar to the patent law reasonable royalty scheme.²⁴ Both methodologies seek to calculate adequate compensation for infringement based on a flexibly applied hypothetical negotiation. These inquiries require a detailed review of the asset at issue, the bargaining positions of the parties, and past licensing practices, ultimately resulting in a license fee awarded to the owner.

The hypothetical negotiation techniques found in patent and copyright law differ in two respects. First, copyright law requires, as a threshold matter,

18. *Id.*

19. *Id.*

20. WESTON ANSON, IP VALUATION AND MANAGEMENT 48 (2010).

21. *See, e.g.*, *Jarvis v. K2, Inc.*, 486 F.3d 526, 533 (9th Cir. 2007).

22. *See Oracle USA, Inc. v. SAP AG*, C 07-1658 PJH, 2011 WL 3862074, at *7 (N.D. Cal. Sept. 1, 2011) (“[I]n order to recover hypothetical license damages, Oracle was required to show that, but for infringement, the parties would have agreed to license the use of the copyrighted works at issue.”).

23. WESTON ANSON, IP VALUATION AND MANAGEMENT 48 (2010).

24. *See generally* PAUL GOLDSTEIN, GOLDSTEIN ON COPYRIGHT § 14.1 (2005).

that the copyright owner prove that she lost an opportunity to license the copyright because of the infringement.²⁵ Once this threshold is satisfied, courts are then free to determine the value of the hypothetical license. Patent law requires no such threshold; a court will simply engage in a reasonable royalty analysis if it is required to adequately compensate the patent owner. Second, the reasonable royalty scheme is the statutory minimum for patent damage awards.²⁶ In effect, this allows courts to cipher an award regardless of the speculative nature of the inquiry, giving it considerable leeway to make assumptions. Statutory damages serve this function in copyright law, requiring more reliable evidence to tether the hypothetical license to each case under an actual damages theory.

Putting aside these minor differences, the process of determining a reasonable royalty under the more established patent scheme can provide helpful guidance as copyright law continues to develop its damages structure. Indeed, the two inquiries are nearly identical once a copyright owner satisfies the “but for” threshold for proving actual damages.

II. DEVELOPMENT OF THE HYPOTHETICAL NEGOTIATION

A. DEVELOPMENT OF THE REASONABLE ROYALTY IN PATENT LAW

Despite the broad and often ambiguous language of 18th and 19th century patent acts, early Supreme Court jurisprudence consistently held that royalties established from previous licenses constitute the correct criterion for determining damages in a patent infringement suit.²⁷ However, these license fee awards were strictly tethered to the amount previously licensed as opposed to a “value of use” analysis.²⁸ Case law during this period oscillated on the question of allowing general damages for use or sale of the invention

25. *See supra* note 22 and accompanying text.

26. *See* 35 U.S.C. § 284 (2000) (“[I]n no event [shall damages be] less than a reasonable royalty for the use made of the invention . . .”).

27. *See* *Clark v. Wooster*, 119 U.S. 322, 326 (1886) (“It is a general rule in patent causes, that established license fees are the best measure of damages that can be used.”); *Burdell v. Denig*, 92 U.S. 716, 720 (1876) (“We have repeatedly held that sales of licenses of machines, or of a royalty established; constitute the primary and true criterion of damages in the action at law.”).

28. *See, e.g., Packet v. Sickles*, 86 U.S. (19 Wall.) 611, 616–17 (1873) (holding that the trial court erred in instructing the jury to consider the value of use of the patented invention because the price of previous licenses of that same product should be taken as the measure of damages).

where specific license rates or lost profits could not be proven.²⁹ The Sixth Circuit was the first to confirm the efficacy of a reasonable royalty recovery and initiated the development of the modern damage theory.

In *United States Frumentum Co. v. Laubhoff*,³⁰ the Sixth Circuit confirmed the recoverability of a reasonable royalty, relying on patent law's origin in tort law to analogize infringement to a taking of property. The court emphasized that the key inquiry was to determine the actual value of the patent, most often evidenced by its market value.³¹ Judge Denison of the Sixth Circuit established the first multi-factor test for determining a reasonable royalty: the court held that the patent's usefulness, commercial value, customary industry profit sharing, and expert opinion should all be considered in valuing the invention.³² The Supreme Court approved the *Laubhoff* analysis and its reasonable royalty test in *Dowagiac Manufacturing Co. v. Minnesota Moline Plow Co.*³³ After finding insufficient evidence to prove lost sales and an actual royalty rate, the Court permitted a reasonable royalty award "considering the nature of the invention, its utility and advantages, and the extent of the use involved."³⁴

Congress incorporated the judicially-created reasonable royalty award into statutory law with the Patent Act of 1922.³⁵ However, the statute remained less than satisfactory, referring to a "reasonable sum as profits or general damages" where the damages "are not susceptible of . . . determination with reasonable certainty" rather than to the "reasonable royalty" recognized in *Laubhoff* and *Dowagiac*.³⁶ With the Patent Act of 1946, Congress eliminated recovery for infringer's profits, instead intending such profits to be considered as evidence establishing a reasonable royalty.³⁷ Congress also added the phrase "reasonable royalty" as a minimum measure of general damages.³⁸

29. Compare *Suffolk v. Hayden*, 70 U.S. (3 Wall.) 315 (1865) (holding that damages should be calculated by looking at the value of the thing used by analyzing the patent's character, operation, and effect), with *Coupe v. Royer*, 155 U.S. 565 (1895) (holding that the trial judge erred in instructing the jury to award damages based on the value gained from the use of the patented invention).

30. 216 F. 610, 615 (6th Cir. 1914).

31. *Id.*

32. *Id.* at 616–17.

33. 235 U.S. 641, 650 (1915).

34. *Id.* at 648–50.

35. DONALD S. CHISM, 7 CHISM ON PATENTS § 20.02[2][d] (2011).

36. Act of Feb. 21, 1922, Ch. 58, 42 Stat. 392.

37. CHISM, *supra* note 35, § 20.02[4].

38. Act of August 1, 1946, Ch. 726, § 1, 60 Stat. 778.

Valuation of a reasonable royalty using a willing buyer-willing seller rule dates back at least to *Austin-Western Road Machinery Co. v. Disc Grader & Plow Co.*³⁹ In *Austin-Western Road*, the Sixth Circuit noted that there is no mathematical formula for valuing a reasonable royalty, but courts should look to the “amount a person desiring to manufacture and sell the patented article would, as a business proposition, be willing to pay as a royalty”⁴⁰ In *Horvath v. McCord Radiator & Manufacturing Co.*,⁴¹ the Sixth Circuit defined a reasonable royalty as the sum that “would be accepted by a prudent licensee who wished to obtain a license but was not so compelled and a prudent patentee, who wished to grant a license but was not so compelled.”

Modern case law emphasizes the limited utility of the willing buyer-willing seller rule due to its oversimplified approach.⁴² To more accurately reenact a hypothetical negotiation, the seminal *Georgia-Pacific* case stressed a consideration of “economic factor[s] that normally prudent businessmen would, under similar circumstances, take into consideration in negotiating the hypothetical license.”⁴³ *Georgia-Pacific* set forth a comprehensive list of such evidentiary facts later approved by the Federal Circuit to determine a reasonable royalty.⁴⁴ However, Federal Circuit decisions warn that these factors are not the exclusive means of assessing a reasonable royalty and that some or all of the factors may not be pertinent in a given case.⁴⁵

Recent decisions suggest that courts are now more diligent in requiring litigants to narrowly tailor the reasonable royalty analysis to the facts of each case. For instance, the Federal Circuit cut down on generous royalties by limiting the application of the entire market value rule, which gives damages

39. 291 F. 301, 304 (8th Cir. 1923).

40. *Id.* at 304.

41. 100 F.2d 326, 335 (6th Cir. 1938).

42. *See, e.g.*, *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970) (noting that the willing buyer-willing seller rule “is more a statement of approach than a tool of analysis”).

43. *Id.*

44. *See id.* at 1120; *see, e.g.*, *Rite-Hite Corp. v. Kelley Co., Inc.*, 56 F.3d 1538, 1555 (Fed. Cir. 1995) (citing *Georgia-Pacific* for the proposition that a “wide range of factors [are] relevant to hypothetical negotiation”); *Dow Chemical Co. v. Mee Industries, Inc.*, 341 F.3d 1370, 1382 (Fed. Cir. 2003) (“Should [the patent owner] prove infringement of [the patent’s] claims . . . the district court should consider the so-called *Georgia-Pacific* factors . . . in detail, and award such reasonable royalties as the record evidence will support.”).

45. *See ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869–73 (Fed. Cir. 2010) (holding that the *Georgia-Pacific* factors are “often overlapping” and some factors “have no real impact” depending on the circumstances of each case).

based on a product of which the patented invention is only a part.⁴⁶ Such cases now require the patented invention to serve as the basis for customer demand for the product.⁴⁷ As a result, litigants are forced to apportion damages, enabling courts to more accurately determine what portion of the product fairly belongs to the patentee. Similarly, the Federal Circuit abolished the “25% rule,” which used 25% of the profits as a baseline royalty rate in a hypothetical negotiation.⁴⁸ Faced with concerns of arbitrariness of the valuation, the Federal Circuit ruled that the 25% rule was fundamentally flawed, and now requires patentees to carefully tie damages to the claimed invention’s footprint in the marketplace.⁴⁹ Thus, the continued evolution of the reasonable royalty scheme, a scheme that is still inherently speculative, has resulted in damage awards more strictly tethered to the facts of each case.⁵⁰

B. DEVELOPMENT OF THE HYPOTHETICAL LICENSE IN COPYRIGHT LAW

The hypothetical license fee is a judicially-created doctrine used to determine the fair market value of a copyright for the purpose of awarding infringement damages. Based on the “value of use” theory, it was first developed to fill a perceived gap in the remedies provided by Congress.⁵¹ These circumstances arise when the copyright owner is unable to win any recovery, even if the infringer acted willfully. The events that must coalesce are threefold.⁵² First, the loss to the copyright owner must be difficult to quantify, thus precluding recovery of lost profits.⁵³ Second, the infringement must produce no gain to the infringer, rendering disgorgement unavailable.⁵⁴ Lastly, the copyright owner must fail to timely register the work, thus sacrificing the ability to recover the fallback remedy of statutory damages.⁵⁵

46. *See* *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011); *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).

47. *Uniloc*, 632 F.3d at 1318.

48. *Id.*

49. *Id.*

50. *See id.* (“[E]vidence . . . must be tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time.”); *ResQNet.com*, 594 F.3d at 869 (“[T]he trial court must carefully tie proof of damages to the claimed invention’s footprint in the market place.”).

51. WILLIAM F. PATRY, PATRY ON COPYRIGHT § 22:124 (2011).

52. NIMMER & NIMMER, *supra* note 7, § 14.02[B].

53. *Id.*

54. *Id.*

55. *Id.*

Facing these triple circumstances, a series of cases developed the value of use doctrine to effectuate congressional policy, allowing copyright owners to recover a license fee for their work when they would otherwise be left uncompensated.⁵⁶

In *Deltak, Inc. v. Advanced Systems, Inc.*,⁵⁷ the Seventh Circuit established the “value of use” method of calculating damages by strictly analyzing past licenses. Expanding upon an older line of cases which set the royalty at the previously negotiated price between the parties for the same or similar product, the *Deltak* court reasoned that the fair market value of producing fifteen infringing pamphlets can be determined by showing what a willing buyer would have been reasonably required to pay a willing seller for the work.⁵⁸ By holding that an infringer’s saved acquisition costs count as a copyright owner’s actual damages, *Deltak* avoids the anomaly of affording the copyright owner a right without a remedy.⁵⁹ Indeed, if recovery were denied, *Deltak*’s property could be taken risk-free.⁶⁰ The Supreme Court has held that “a rule of liability which merely takes away the profits from an infringement would offer little discouragement to infringers Even for uninjurious and unprofitable invasions of copyright the court may, if it deems it just, impose a liability within statutory limits to sanction and vindicate the statutory policy.”⁶¹ Relying on this rationale, *Deltak* appropriately balances copyright ownership rights while serving the congressional purpose of discouraging infringement.

The “value of use” theory gained momentum after *On Davis v. The Gap, Inc.*,⁶² which rejected both Second Circuit precedent and the treatise *Nimmer on Copyright*⁶³ in holding that a general rule denying the availability of a “reasonable royalty” was improper. In reviewing *Deltak*, *Nimmer* argued that

56. For cases demonstrating these triple circumstances, see *Deltak, Inc. v. Advanced Systems, Inc.*, 767 F.2d 357, 363–64 (7th Cir. 1985); *On Davis v. The Gap, Inc.*, 246 F.3d 152, 163 (2001); *Bus. Trends Analysts, Inc. v. Freedom Group, Inc.*, 887 F.2d 399, 404–06 (2nd Cir. 1989).

57. 767 F.2d 357, 363–64 (7th Cir. 1985).

58. *Id.* at 362.

59. *Bus. Trends*, 887 F.2d at 406.

60. If use of the infringing pamphlet fails to generate revenue by gaining customers, then there is no cost to ASI. However, if it succeeds, ASI only risks disgorging its lost profits. See John Tehranian, *The Emperor Has No Copyright: Registration, Cultural Hierarchy, and the Myth of American Copyright Militancy*, 24 BERKELEY TECH. L.J. 1399, 1416–28 (2009) (discussing the “one-way risk” that results when a copyright holder fails to register in a timely manner).

61. *F.W. Woolworth Co. v. Contemporary Arts, Inc.*, 344 U.S. 228, 233 (1952).

62. *On Davis v. The Gap, Inc.*, 246 F.3d 152, 163, 170–72 (2d Cir. 2001).

63. NIMMER & NIMMER, *supra* note 7, § 14.02[B][1].

a royalty estimate based on a negotiation “relies on the most transparent of fictions” because the infringer would have never willingly negotiated.⁶⁴ While conceding that Nimmer’s argument might hold true in some cases, the *On Davis* court held that a per se rejection is not universally applicable. Instead, the court noted that whether the infringer would have negotiated with the copyright owner is immaterial.⁶⁵ The court explained that the purpose of the test “seeks to determine the fair market value of a valuable right that the infringer has illegally taken from the owner.”⁶⁶ While mathematical precision is not required, the *On Davis* decision confirmed the efficacy of the hypothetical license theory, so long as the award is based on a factual basis rather than undue speculation.⁶⁷ Because the proper measure of damages is often difficult to ascertain, indirect evidence may be used to fix the amount of the damages.⁶⁸

Other circuits followed the Second Circuit’s affirmance of a hypothetical license fee, and began applying the same method in calculating actual damages under 17 U.S.C. § 504(b).⁶⁹ Although the Supreme Court has not directly addressed the question, it has suggested in a fair use context that the critical question is “whether the user stands to profit from exploitation of the copyrighted material without paying the customary price.”⁷⁰

III. ANALYSIS OF ACTUAL DAMAGES UNDER THE COPYRIGHT ACT

A. STATUTORY CONSTRUCTION OF 17. U.S.C. § 504

Traditional principles of statutory construction require a careful reading of the statute, consideration of its legislative history, and systematic review of copyright jurisprudence.⁷¹ Indeed, scholars have repeatedly warned against

64. *Id.* at 171.

65. *On Davis*, 246 F.3d at 172.

66. *Id.*

67. *Id.* at 163.

68. *Fitzgerald Pub. Co., Inc. v. Baylor Pub. Co., Inc.*, 807 F.2d 1110, 1118 (2d Cir. 1986).

69. *See, e.g.*, *Thoroughbred Software Intern., Inc. v. Dice Corp.*, 488 F.3d 352, 359–60 (6th Cir. 2007); *Polar Bear Prods., Inc. v. Timex Corp.*, 384 F.3d 700, 708–09 (9th Cir. 2004); *McRoberts Software, Inc. v. Media 100, Inc.*, 329 F.3d 557, 566–67 (7th Cir. 2003); *Bruce v. Weekly World News, Inc.*, 310 F.3d 25, 28–30 (1st Cir. 2002); *Kleier Adver., Inc. v. Premier Pontiac, Inc.*, 921 F.2d 1036, 1040 (10th Cir. 1990).

70. *Harper & Row Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 562 (1985).

71. *See Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176 (1980) (determining legislative intent regarding indirect patent liability by parsing text, legislative history, and jurisprudence of patent law).

substituting legislative judgment for judicial reasoning.⁷² Therefore, a proper analysis must start with the language of 17 U.S.C. § 504(b).

1. *Text and Legislative Intent*

On its face, the Copyright Act provides no guidance as to the proper calculation of actual damages. Under 17 U.S.C. § 504(b), “[t]he copyright owner is entitled to recover the actual damages suffered by him or her as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages.” Because the plain language is unclear,⁷³ an endeavor into legislative intent is required.

Generally, it is helpful for courts to look to other statutes with similar objectives as an interpretive tool to clarify ambiguous language.⁷⁴ Given the identical goals of patent and copyright law,⁷⁵ as well as the similarity of the underlying assets,⁷⁶ it seems proper to look to judicial interpretations of the Patent Act when interpreting the Copyright Act.

However, it could be argued that Congress’ inclusion of the term “reasonable royalty” in the Patent Act, and subsequent exclusion from the Copyright Act, precludes such an inference. Some scholars argue that courts should presume that Congress intended to omit particular language from one

72. See, e.g., Peter S. Menell & David Nimmer, *Unwinding Sony*, 95 CAL. L. REV. 941, 993 (2007) (questioning the analysis of the Copyright Act when the Supreme Court “substituted a legislative judgment for judicial reasoning”).

73. Although surrounding language is typically helpful in elucidating the plain language of the statute, the Copyright Act provides no such language to clarify “actual damages.” See 17 U.S.C. §§ 101–1332 (2010).

74. See *United States v. Johnson Controls, Inc.*, 457 F.3d 1009, 1021 (9th Cir. 2006) (“Where the wording and objectives . . . are similar to the wording and objectives of a federal statute, California courts look to interpretations of the federal statute for guidance in interpreting the state statute.”); *Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd.*, 269 F. Supp. 2d 1213, 1224 (C.D. Cal. 2003) (holding that when interpreting the Cartwright Act, it is proper to look to federal antitrust laws for guidance because of their similar objectives).

75. See *infra* Part III.B.2.

76. See Menell & Nimmer, *supra* note 72, at 986 (“Given that insofar as they constitute an ‘asset’ in a proprietor’s portfolio there is little to separate copyrights from patents, it is not surprising that the Court would look to analogous assets in resolving these cases.”); see also *United States v. Paramount Pictures*, 334 U.S. 131, 158 (1948) (holding that insofar as antitrust law is concerned with leveraging one asset to extend control into other markets, copyrights and patents stand on the same footing); *Fox Film Corp. v. Doyal*, 286 U.S. 123, 131 (1932) (holding that “royalties from copyrights stand in the same position as royalties from the use of patent rights” for purposes of tax law).

statute when it appears in another closely related statute.⁷⁷ Professor Justin Hughes warns that the “Congress-knew-how-to-draft reasoning” precludes reading a phrase from the Patent Act into the Copyright Act when Congress has left it out.⁷⁸ Hughes followed this reasoning in arguing that an exception to indirect liability in the Patent Act should not be read into the Copyright Act, which is silent on the subject.⁷⁹ Such a reading would infer that Congress deliberately chose to exclude reasonable royalty from copyright damages.

The Congress-knew-how-to-draft rationale, while founded on sound principles, cannot apply to the present interpretation of 17 U.S.C. § 504(b) because Congress specifically considered the possibility of utilizing a patent reasonable royalty scheme, among others, to evaluate damage caused by the infringer.⁸⁰ Instead of adopting a particular method, Congress concluded that the fact-intensive inquiry of copyright damages is best decided by the courts.⁸¹ Thus, the omission, while intentional, should not be seen as limiting remedies, but as allowing courts flexibility, including the flexibility to assess reasonable royalty damages.

Copyright damages attracted little attention during early 20th century congressional deliberations. Though the topic was discussed, Congress never specified a preferred method of calculating actual damages resulting from copyright infringement. Instead, Congress clearly left courts free to mold the contours of copyright law on a case-by-case basis to fill statutory gaps. Indeed, the House Report explains that one of the basic aims of copyright damages is “to provide courts with reasonable latitude to adjust recovery to the circumstances of the case, thus avoiding some of the artificial or overly

77. See, e.g., Menell & Nimmer, *supra* note 72, at 981; Justin Hughes, *On the Logic of Suing One's Customers and the Dilemma of Infringement-Based Business Models*, 22 CARDOZO ARTS & ENT. L.J. 725, 754–56 (2005); see also *Chicago v. Envtl. Def. Fund*, 511 U.S. 328, 338 (1994) (holding that where there is evidence that Congress knew how to draft an exemption, one should not be read into a statute).

78. Hughes, *supra* note 77, at 754–56.

79. *Id.*

80. William S. Strauss, *Study No. 22: The Damage Provisions of the Copyright Law* 37 (1956) (comments of George E. Frost), in STAFF OF S. COMM. ON THE JUDICIARY, 86TH CONG., COPYRIGHT LAW REVISION: STUDIES PREPARED FOR THE SUBCOMM. ON PATENTS, TRADEMARKS, AND COPYRIGHTS OF THE S. COMM. ON THE JUDICIARY PURSUANT TO S. RES 240: STUDIES 22–25, at 37 (Comm. Print 1960), reprinted in 2 OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY (George S. Grossman ed., 2001)) (“Since 1946 the statute has provided for damages only, and then only in the amount ‘not less than a reasonable royalty.’ My present reaction is that we ought to face up to the fact that there can be no positively correct way to handle this matter and that the matter can best be handled by giving the court ample discretion in one way or another.”).

81. *Id.*

technical awards resulting from the language of the [previous] statute.”⁸² This shows legislative intent to defer to the judicially-created standards for actual damages calculations. Moreover, scholars and courts have generally agreed that 17 U.S.C. § 504(b) should be broadly construed to favor victims of copyright infringement.⁸³

It is clear that congressional intent not to impose unduly restrictive valuation methods is not tantamount to a decision to withhold the reasonable royalty award from copyright law. Instead, legislative history proves that Congress actually endorsed this technique, or at least a court’s “ample discretion” to use this technique if it deems appropriate.⁸⁴ Based on first principles of statutory analysis, it is therefore safe to conclude that granting a reasonable license fee does not run afoul of the statutory text or its broad intended scope determined by legislative history.

2. *Copyright Policy Stemming from Its Origin in Tort Law*

Copyright infringement, like patent infringement, is a tort.⁸⁵ Both are predicated on the same basic *ex ante* compensation principle by determining the fair market value of the asset.⁸⁶ Courts consistently look to tort law for

82. H.R. REP. NO. 94-1476, at 161 (1976).

83. *See* *Syigma Photo News, Inc. v. High Society Magazine*, 778 F.2d 89, 95 (2d. Cir. 1985) (holding that when courts are confronted with imprecision in calculating damages, they should “err on the side of guaranteeing the plaintiff a full recovery”); NIMMER & NIMMER, *supra* note 7, § 14.02[A] (“[U]ncertainty will not preclude a recovery of actual damages if the uncertainty is as to amount, but not as to the fact that actual damages are attributable to the infringement.”); WILLIAM F. PATRY, *COPYRIGHT LAW AND PRACTICE* 1167 (1994) (“Within reason, any ambiguities should be resolved in favor of the copyright owner.”).

84. *See* Strauss, *supra* note 80, at 37 (“Since 1946 the statute has provided for damages only, and then only in the amount ‘not less than a reasonable royalty.’ My present reaction is that we ought to face up to the fact that there can be no positively correct way to handle this matter and that the matter can best be handled by giving the court ample discretion in one way or another.”).

85. *See* *United States Frumentum Co. v. Lauhoff*, 216 F. 610, 617 (6th Cir. 1914) (noting that patent infringement is in effect a tort and a taking of property, drawing a “perfect analogy between the rules of damages as to general property and as to patent property”); REPORT OF THE REGISTER OF COPYRIGHTS ON THE GENERAL REVISION OF THE U.S. COPYRIGHT LAW, 87TH CONG., 1ST SESS. (House Comm. Print 1961) (“The remedies available against copyright infringers include those comparable to the remedies usually accorded for torts in general—namely . . . recovery of the actual damages suffered by the copyright owner.”); Menell & Nimmer, *supra* note 72, at 995 (“[T]ort doctrine furnishes the background law for determining what circumstances render someone liable for infringement and, if liable, the scope of remedies.”).

86. RESTATEMENT (SECOND) OF TORTS § 906 (1979); DAN B. DOBBS, 2 *THE LAW OF TORTS* 207 (2011) (“The normal remedy for conversion is an award of

guidance in establishing a damage award.⁸⁷ Indeed, courts are hesitant to construe the copyright statute as to overthrow normal tort damage principles.⁸⁸ Given its clear foundation in tort law, it is proper to analyze copyright damages against this background.

According to tort law, the fact that property does not have an established market value will not necessarily restrict the owner of the property to an award of nominal damages.⁸⁹ Instead, tort law has long imposed “value of use” damages upon tortfeasors relating to land and chattel.⁹⁰ In determining the measure of recovery, it is proper to consider to extent to which the “assets of the injured person have been affected by the tort, including his capacity to make profitable use of [them]”⁹¹ This principle can be analogized to the copyright damage threshold requiring plaintiffs to prove a lost opportunity to license, or make use of, the copyright at issue.⁹² Just as tort victims can be compensated for the destruction of the earning potential of their property, copyright owners can similarly be compensated to the extent that they lost the opportunity to profit from their copyright via a license sale.

Not surprisingly, tort law contemplates a hypothetical negotiation structure to value particular assets. With the benefit of an established market, tort law looks to the “amount paid in actual transactions involving a similar

damages . . . [measured by] the market value of the chattel at the time and place of conversion”); H.R. REP. NO. 94-1476, at 161 (1976) (“Damages are awarded to compensate the copyright owner for losses from the infringement.”).

87. *See, e.g.*, *Mackie v. Rieser*, 296 F.3d 909, 915 (9th Cir. 2002) (requiring a threshold inquiry into whether there is a legally sufficient causal link between the infringement and subsequent profits because “[t]o do otherwise would be inconsistent with . . . rudimentary principles of tort law, to which copyright law is often analogized”); *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1170 (1st Cir. 1994) (noting in actual damages context that “it is useful to borrow familiar tort principles of causation and damages”).

88. *See Deltak, Inc. v. Advanced Sys., Inc.*, 574 F. Supp. 400, 403 (N.D. Ill. 1983) (Posner, J., sitting by designation) (referring to “normal tort damages principles” in discussion of copyright damages), *vacated on other grounds*, 767 F.2d 357 (7th Cir.1985).

89. 4-37 DAMAGES IN TORT ACTIONS § 37.03.

90. RESTATEMENT (SECOND) OF TORTS § 904 (1979) (“[A] claim for damages caused by the detention of land or chattels includes a claim for the loss of value of the use”); *see also Dowagiac Mfg. Co. v. Minnesota Moline Plow Co.*, 235 U.S. 641, 648–49 (1915) (“As the exclusive right conferred by the patent was property, and the infringement was a tortious taking of a part of that property, the normal measure of damages was the value of what was taken.”).

91. RESTATEMENT (SECOND) OF TORTS § 906 (1979).

92. *See supra* note 22 and accompanying text.

subject matter” in determining the value of the asset.⁹³ This is tantamount to copyright law’s inquiry into past licensing practices to establish a royalty. Absent an established market, tort law determines the value of the asset by analyzing its potential exchange value, determined by the amount a willing buyer would agree to pay.⁹⁴ In determining the asset’s value, courts look to factors typically considered when negotiating a price, such as the scarcity or abundance of the asset, comparable sales, potential rental value or value of its use, the cost of securing a functional substitute, and risks of loss and chances of gain.⁹⁵ Expert opinion is also helpful for an ex post valuation.⁹⁶ Given that tort principles—as copyright law and patent law’s common wellspring—envision a hypothetical negotiation damage remedy, it seems proper for copyright law to incorporate the same.

3. *Copyright Policy Pursuant to Its Utilitarian Goal*

Some scholars reject the fundamental premise that intellectual property remedies should always look to tort law for guidance. Instead, they argue that remedies should look to the original purpose of intellectual property law—the promotion of innovation and creative works. Though advocating in the patent context, Professor Ted Sichelman argues that “patent law should be tailored simply to promote the types and levels of innovation that most benefit society,” instead of vindicating individual rights.⁹⁷ Although this argument means that judicial reliance on tort law since the early 20th century has been misplaced, it seems proper that copyright remedies should look to its constitutional origins for guidance.

The ultimate goal of copyright law is to stimulate artistic creativity for the general public good.⁹⁸ Because copyright law should be strictly tethered to its

93. *Id.* at 911; *see also* *United States v. 2,635.04 Acres of Land, More or Less, in Allen & Barren Counties, State of Ky.*, 336 F.2d 646, 649 (6th Cir. 1964) (looking to previous sales of comparable property in determining fair market value).

94. RESTATEMENT (SECOND) OF TORTS § 911; DAN B. DOBBS, 1 DOBBS LAW OF REMEDIES § 5.16(1) (2nd ed. 1993) (stating that “courts have tended to construct a hypothetical market value out of the same factors that would influence buyers in the market if there had been a market”); DAN B. DOBBS, 2 THE LAW OF TORTS § 3.5 (2001) (“[F]air market value is the amount which a willing buyer would pay and for which a willing seller would sell, neither being under any special compulsion.”).

95. DAN B. DOBBS, 2 THE LAW OF TORTS 325, (2001); RESTATEMENT (SECOND) OF TORTS § 911 (1979).

96. RESTATEMENT (SECOND) OF TORTS § 911 (1979).

97. Ted Sichelman, *Purging Patent Law of ‘Private Law’ Remedies* (San Diego Legal Studies, Paper No. 11-077, 2011).

98. *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975); *see also* *Fogerty v. Fantasy, Inc.*, 510 U.S. 517, 526–27 (1994) (stating that the Copyright Act seeks to

constitutional enabling language,⁹⁹ its remedies should focus on this utilitarian function by fostering creation. Our current system optimizes such incentives through a compensation scheme founded in tort law, both to compensate owners and to deter potential infringers. Compensation is necessary to incentivize investment in the development of the creation.¹⁰⁰ Protection is needed to encourage the development of creative works because authors will not be incentivized to invest their time without appropriate remedies for infringement. A proper deterrence mechanism is also necessary to discourage infringement. However, strong policies exist against excessive protection; exclusivity creates a form of monopoly in the protected materials. Society values both free competition and freedom of ideas, and a strong public domain has the potential to make important contributions to a nation's cultural and scientific health.¹⁰¹ Copyright law, therefore, must provide a delicate balance with society's material welfare as a priority. Professor Sichelman argues that private law remedies, such as compensatory damages, may thwart optimal creation incentives in some cases.¹⁰² However, tort law principles and the incentive-based model are not necessarily mutually exclusive. Indeed, the Supreme Court has noted that personal gain is the best way to encourage creation of intellectual property to advance the public welfare.¹⁰³ Moreover, protection is important in some cases regardless of encouragement; "natural law" permits the artist to reap the rewards of his work and have it attributed to him rather than to others.¹⁰⁴

stimulate artistic creativity for the general public good and to discourage infringement); *Fox Film v. Doyal*, 286 U.S. 123, 127 (1932) ("The sole interest of the United States . . . in conferring [copyrights] lie[s] in the general benefits derived by the public from the Labors of authors.").

99. See U.S. CONST. art. I, § 8, cl. 8 ("To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries . . .").

100. For a discussion of the "encouragement theory," see Wendy J. Gordon, *An Inquiry into the Merits of Copyright: The Challenges of Consistency, Consent, and Encouragement Theory*, 41 STAN. L. REV. 1343, 1459 (1989).

101. *Id.*

102. Sichelman, *supra* note 97, at 15.

103. *Mazer v. Stein*, 347 U.S. 201, 219 (1954) ("The economic philosophy behind the clause empowering Congress to grant . . . copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors . . . in 'Science and useful Arts.'").

104. For a discussion on natural law theory applied to intellectual property, see Wendy J. Gordon, *A Property Right in Self-Expression: Equality and Individualism in the Natural Law of Intellectual Property*, 102 YALE L.J. 1533 (1993).

Adopting exclusionary rights via copyrights and attendant liability for infringement makes copying costly. However, like an efficient breach in contract law, efficient infringement will occur when transaction costs of negotiation outweigh the value of the copyright at issue.¹⁰⁵ Third party infringers will “gauge the financial value of infringing based upon the expected damages they will pay in court.”¹⁰⁶ Without a substantial reward to the copyright owner, and thus a substantial penalty for infringement, potential infringers could, after considering all options, conclude that copyright infringement is optimal. This clearly disincentivizes creation because such opportunities transform creative thought to focus on the cheaper and less time consuming task of misappropriating the work from others. These actions lead to fewer independently created works, and in turn, deprives the public of potential progress in the arts and sciences.

Without a “value of use” doctrine, which attempts to fill a void in copyright recovery, such efficient infringements would occur often. One can imagine a potential infringer weighing the options of independent creation against infringing a copyright falling into the “triple circumstances,” which allows no recovery for the copyright owner.¹⁰⁷ In this situation, the infringer has nothing to lose except potential lost profits, if provable. Thus, to properly deter infringement, and advance the current public domain of intellectual property, this gap must be filled. To ignore it would leave copyright holders a right without a remedy, and infringers an opportunity without liability. By filling this gap, the exclusionary rights afforded by copyright law under a reasonable royalty scheme promote a more optimal level of creation by providing incentives to invest in creation, as well as deterrence in an otherwise forgiving damages scheme.

B. HISTORIC KINSHIP

1. *Origin of the Rationale*

The Supreme Court has held that patent and copyright laws are connected by a “historic kinship,” a rationale which the Court relies upon to analyze analogous issues.¹⁰⁸ Most recently, in *Sony Corp. of America v. Universal*

105. See Sichelman, *supra* note 97, at 31 (“[E]fficient infringement occurs when the transaction costs of negotiation dwarf the value of the innovation-at-issue”); see also Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 950–53 (1982) (positing that an efficient breach is optimal when transaction costs of renegotiations outweigh the transaction costs from the breach).

106. Sichelman, *supra* note 97, at 18.

107. See *supra* Part II.B.

108. *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 439 (1984).

City Studios, Inc., the Court imposed an indirect liability safe harbor upon copyright law based on patent law's "staple article of commerce" doctrine.¹⁰⁹ Justice Stevens, writing for the majority, noted that "[t]here is no precedent in the law of copyright for the imposition of vicarious liability on such a theory. The closest analogy is provided by the patent law cases to which it is appropriate to refer because of the historic kinship between patent law and copyright law."¹¹⁰ Based solely on this rationale, the Supreme Court engrafted an express provision from the Patent Act into the Copyright Act.

Importing the patent reasonable royalty scheme into copyright law based on their historic kinship seems to comport with the Supreme Court's rationale in *Sony*. However, scholars have criticized the Supreme Court for blindly transplanting principles of patent law into the Copyright Act based solely on this connection.¹¹¹ It is important to address these grievances here, and to explain why copyright law's adoption of a reasonable royalty scheme alleviates these concerns.

2. *Historic Kinship in Damages*

Professors Peter Menell and David Nimmer argue that *Sony* improperly construed the Copyright Act by ignoring its legislative history.¹¹² Indeed, the legislative history would have revealed Congress's intention to look to tort principles in determining the contours of copyright liability.¹¹³ In rejecting the Court's sole reliance on historic kinship, Menell and Nimmer note that there are instances in which importation based on historic kinship might be appropriate.¹¹⁴ Such instances must prove that Congress drew explicitly on patent law in its deliberations.¹¹⁵ Therefore, 17 U.S.C. § 504(b) must be evaluated against the backdrop in which it was developed.¹¹⁶

Construction by analogy to patent law in the context of damages is proper because Congress drew upon provisions founded in patent law in creating the current 17 U.S.C. § 504(b). In *Sheldon v. Metro-Goldwyn Pictures Corp.*, the Supreme Court held that, "[i]n passing the Copyright Act, the

109. *Id.* at 442.

110. *Id.* at 439.

111. *See, e.g.*, Menell & Nimmer, *supra* note 72, at 944, 983; Hughes, *supra* note 77, at 754–55.

112. *See* Menell & Nimmer, *supra* note 72, at 943–44 (“[T]he legislative history of the Copyright Act reveals that Congress rooted its considerations regarding contributory infringement elsewhere.”).

113. *Id.* at 995.

114. *Id.* at 985.

115. *Id.* at 992.

116. *Id.* at 991.

apparent intention of Congress was to assimilate the remedy with respect to the recovery of profits to that already recognized in patent cases.”¹¹⁷ Although the adoption pertained to the aggregation of actual damages and profits, Congress clearly imported Patent Act damage principles into the Copyright Act of 1909. Indeed, the House Committee concluded that

[t]he provision that the copyright proprietor may have such damages . . . is substantially the same provision found in section 4921 of the Revised Statutes relating to remedies for the infringement of patents As such provision was found both in the trade-mark and patent laws, the committee felt that it might be properly included in the copyright laws.¹¹⁸

Historic kinship is found in patent and copyright damages based on their parallel development. Copyright and patent laws are governed by the same constitutional mandate.¹¹⁹ As such, they share the same utilitarian principle— incentivizing innovation and creation for the progress of science and the useful arts. Throughout history, Congress and courts have carried out this mandate in both the patent and copyright context by consistently applying the private law of torts.¹²⁰ Thus, intellectual property law has developed under the premise that remedies are best given in the form of compensation analogous to those that result from misappropriation of property. Although this development may be built upon faulty ground,¹²¹ the reasoning raises empirical questions beyond our ability to resolve here. Instead, a proper analysis focuses on the parallel evolution of common law patent and copyright damages.

Based on the foundational principles of tort law,¹²² patent and copyright laws share the goal of compensation for the value of the asset lost.¹²³ Both patent and copyright hypothetical negotiation schemes were judicially created to avoid a nonrecourse cause of action absent substantial proof of lost profits. The “value of use” theory was developed to bridge a gap in the

117. *Sheldon v. Metro Goldwyn Pictures Corp.*, 309 U.S. 390, 400 (1940).

118. H.R. REP. NO. 2222, 60th Cong., 2d sess., at 15; S. REP. NO. 1108, 60th Cong., 2d sess., at 15.

119. U.S. CONST. art. I, § 8, cl. 8.

120. *See supra* Part III.A.2.

121. *See supra* Part III.A.3.

122. *See supra* note 85 and accompanying text.

123. S. Rep. No. 94-473, at 157 (1976) (“Damages are awarded to compensate the copyright owner from his losses from the infringement”); CHISM, *supra* note 35, § 20.02[2] (“Early Supreme Court decisions stressed the compensatory nature of the monetary damages recoverable in an action at law for patent infringement.”).

Copyright Act under circumstances in which the copyright owner cannot sufficiently prove lost profits and has not met the requirements for statutory damages.¹²⁴ Similarly, a reasonable royalty was a judicially-created, and later codified, remedy in response to the difficulty in finding an appropriate measure of damages when a patent owner could prove neither lost profits nor an established royalty rate.¹²⁵

Facing similar issues of a potential remediless infringement and speculative valuation techniques, both patent and copyright law looked to a hypothetical negotiation scheme to determine the fair market value of the asset at issue. In copyright law, “actual damages” represents the extent to which infringement has destroyed the market value of the infringed work.¹²⁶ In *Deltak, Inc. v. Advanced Systems, Inc.*, the Seventh Circuit defined actual damages to include the “value of use” to the infringer, which was calculated under a hypothetical negotiation theory.¹²⁷ Looking to Supreme Court precedent,¹²⁸ the Second Circuit found that “a reasonable license fee for the use of [the plaintiff’s work] best approximates the market injury sustained by [the plaintiff] as a result of [the defendant’s] misappropriation.”¹²⁹ Likewise, the patent law reasonable royalty scheme initiated based on the need to accurately calculate the value of the infringing use of the patent. In *Suffolk v. Hayden*,¹³⁰ the Supreme Court approved an instruction that the jury consider the value of the improvement to the defendant, and consider “the value of the thing used and ascertain that value by all the evidence as to its character, operation, and effect.”¹³¹ The Sixth Circuit confirmed this by adding that “[t]he real value—the actual value—of what has been taken is always the ultimate question. Proof of market value is one way to show this actual loss”¹³²

The hypothetical negotiation technique is useful to calculate the value of use across both patent and copyright law because copyrights and patents are analogous assets.¹³³ Though not “identical twins,”¹³⁴ patent law principles can

124. See *supra* Part II.B.

125. See *supra* Part II.A; CHISM, *supra* note 35, § 20.02[2][a].

126. NIMMER & NIMMER, *supra* note 7, § 14.02[A].

127. *Deltak, Inc. v. Advanced Systems, Inc.*, 767 F.2d 357, 361–62 (7th Cir. 1985).

128. *Harper & Row Publishers, Inc. v. Nat’l Enter.*, 471 U.S. at 562 (“[A]ny such exploitation must at least entail ‘paying the customary price.’”).

129. *Rogers v. Koons*, 960 F.2d 301, 313 (2d Cir. 1992).

130. 70 U.S. (30 Wall.) 315 (1865).

131. *Id.* at 320.

132. *United States Frumentum Co. v. Lauhoff*, 216 F. 610, 616–17 (6th Cir. 1914).

133. See *Menell & Nimmer*, *supra* note 72, at 986 (“Given that insofar as they constitute an ‘asset’ in a proprietor’s portfolio there is little to separate copyrights from patents, it is not

be helpful guidance in developing a framework for determining the contours of copyright liability based on their historic kinship in damages. The historic kinship connecting patent and copyright damages, however, cannot justify mere blind transplantation. Instead, courts must be sensitive to distinctions in their requirements and enforcement aspects by tailoring the reasonable royalty inquiry to the facts of each case.

IV. HOW COURTS SHOULD IMPLEMENT A REASONABLE ROYALTY SCHEME

Calculating a reasonable royalty requires courts to consider a broad range of factors to determine what type of agreement hypothetical negotiators would reach in each case. Patent law looks to the seminal *Georgia-Pacific*¹³⁵ case, which outlines fifteen factors used to carefully construct the inquiry.¹³⁶ The Federal Circuit adopted these factors as a method for determining the amount of a hypothetically negotiated royalty for a patent license based on the flexibility to properly tie the calculation to the facts of each case. However, blind adoption of patent law principles will not always yield correct results in the copyright context. Using the *Georgia-Pacific* factors as a baseline, the hypothetical license factors applied to copyrights (“Copyright Factors”) are as follows:

1. *Whether the Parties Would Have Entered into a Negotiation for the Copyright at Issue.*¹³⁷

Recovering actual damages requires the establishment of a “but for” nexus to the infringement.¹³⁸ This causal link must prove that but for the infringement, the copyright owner would have been able to license the

surprising that the Court would look to analogous assets”); *see also* United States v. Paramount Pictures, 334 U.S. 131, 158 (1948) (holding that insofar as antitrust law is concerned with leveraging one asset to extend control into other markets, copyrights and patents stand on the same footing); Fox Film Corp. v. Doyal, 286 U.S. 123, 131 (1932) (holding that “royalties from copyrights stand in the same position as royalties from the use of patent rights” for purposes of tax law).

134. *Sony*, 464 U.S. at 439 n.19 (1984).

135. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).

136. *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1317 (Fed. Cir. 2011). However, it is less clear whether and to what extent these factors apply to a determination of a hypothetical license fee in copyright cases.

137. *See Georgia-Pacific*, 318 F. Supp. 1116 at 1121 (considering “[t]he commercial relationship between the licensor and licensee, such as, whether they are competitors in the same territory in the same line of business; or whether they are inventor and promoter”).

138. WILLIAM F. PATRY, *COPYRIGHT LAW AND PRACTICE* 22:111 (1994).

infringer's use.¹³⁹ As such, this first factor acts as a threshold requirement, precluding any hypothetical license recovery absent evidence of a lost opportunity to license. In *Encyclopedia Brown Productions, Ltd. v. Home Box Office, Inc.*,¹⁴⁰ the Southern District of New York provided three factors tending to suggest that such a license would have occurred: (1) a lack of ill motive of the defendant in infringing; (2) a pre-existing sale or licensing arrangement between the parties for the same or different copyrighted works; and (3) other aspects of the parties' relationship, such as their status as non-competitors.¹⁴¹ For instance, repeated refusal to purchase a license, along with evidence of a good faith basis for believing that no license was required, has been held to fall short of the threshold requirement.¹⁴² However, evidence of licensing discussions,¹⁴³ or proof that the infringer considered entering into a license agreement,¹⁴⁴ will rebut this presumption.

Most courts focus on the third factor, finding direct competition to have significant probative value because it tends to disprove the fact that the parties would have consummated the sale or license.¹⁴⁵ In *Business Trends*

139. *Oracle USA, Inc. v. SAP AG*, C 07-1658 PJH, 2011 WL 3862074, at *7 (N.D. Cal. Sept. 1, 2011) (“[T]o recover hypothetical license damages, Oracle was required to show that, but for infringement, the parties would have agreed to license the use of the copyrighted works at issue.”); *see* *On Davis v. The Gap, Inc.*, 246 F.3d 152, 164 (2d Cir. 2001) (upholding a hypothetical license after finding that, had the oversight not occurred, either the parties would have negotiated a reasonable licensing fee or The Gap would have eliminated the eyewear from its photograph); *Big Seven Music Corp. v. Lennon*, 554 F.2d 504, 509 (2d Cir. 1977) (holding that actual damages must bear a “necessary, immediate and direct causal connection” to the defendant’s infringement); *see also* *Harper & Row, Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 567 (1985) (holding that once plaintiff shows a causal connection, “the burden properly shifts to the infringer to show that this damage would have occurred had there been no taking of the copyrighted expression”).

140. 25 F. Supp. 2d 395 (S.D.N.Y. 1998).

141. *Id.* at 401–02.

142. *Polygram Intern. Pub., Inc. v. Nevada/TIG, Inc.*, 855 F. Supp. 1314, 1334–35 (1994) (holding that lost license fees are not an appropriate award where Interface refused to purchase a license from ASCAP based on a good faith belief that, under existing law, no license was required).

143. *Thoroughbred Software Intern., Inc. v. Dice Corp.*, 488 F.3d 352, 359–60 (6th Cir. 2007) (upholding a reasonable license fee based on the causal connection due to the parties’ “dealer agreement”).

144. *Marshall & Swift v. BS & A Software*, 871 F. Supp. 952, 964 (1994) (awarding Marshall a lost license fee based on evidence that “defendants at least at one point before their infringing activity considered entering into a license agreement with Marshall”).

145. *See* *Encyclopedia Brown Prods., Ltd. V. Home Box Office, Inc.*, 25 F. Supp. 2d 395, 401–02 (S.D.N.Y. 1998) (finding that the fact that the parties “are not direct competitors supports a reasonable inference that licensing of the [copyright] would have been a viable alternative”); *Bus. Trends Analysts, Inc. v. Freedomia Group, Inc.*, 887 F.2d 399, 405 (2d Cir. 1989) (emphasizing the parties’ status as direct competitors in finding that

Analysts, Inc. v. Freedomia Group, Inc.,¹⁴⁶ the Second Circuit held that there was no possibility of future negotiations due to the parties' direct competition in the marketplace. However, the *On Davis* court warned against a per se rule precluding a hypothetical negotiation involving direct competitors.¹⁴⁷ In restricting *Business Trends* to the facts of the case, *On Davis* explained that the "competitive relationship" prong should look more to the larcenous intentions of the infringer than to mere direct competition in establishing the threshold.¹⁴⁸ The court noted that *Business Trends* was motivated by the perception of an unrealistic negotiation because "the defendant before it was no more inclined to negotiate a purchase price than a 'purse snatcher'"¹⁴⁹ On the contrary, the parties involved in *On Davis* "could have happily discussed the payment of a fee" despite their competitive relationship. A court may also determine that direct competitors would have freely negotiated when honest users infringe by reason of oversight or good faith mistake.¹⁵⁰

If the copyright owner proves the lost opportunity to license the copyright, the hypothetical license inquiry still accounts for factors that may or may not bring the negotiators to the bargaining table. For instance, although a competing commercial relationship might not be enough to bar the plaintiff from recovery under this Copyright Factor, the parties' status as competitors will likely result in a higher price for a license, as the copyright owner will be reluctant to license a work to companies targeting the same customers. While it is true that there is no formula by which these factors can be rated in the order of their relative importance, this first Copyright Factor should take priority, as a reasonable royalty will not be granted absent its satisfaction.

"[t]he last thing the infringers wanted to buy and to sell was the actual material produced under their competitor's name").

146. 887 F.2d 399, 405 (2d Cir. 1989).

147. *On Davis v. The Gap, Inc.*, 246 F.3d 152, 163 (2d Cir. 2001).

148. *Id.* (holding that *Business Trends* did "not lay[] down an absolute rule, but rather ma[de] a ruling that was heavily influenced by the particular facts of that case").

149. *Id.* at 163–64.

150. *Id.* at 172 (holding that declining a hypothetical license fee in all cases would be improper because "[t]he infringer may have mistakenly believed in good faith that the work was in the public domain, that his licensor was duly licensed, or that his use was protected by fair use").

2. *The Royalties Received by the Copyright Owner for Licensing the Copyright at Issue, Tending to Prove an Established Royalty.*¹⁵¹

Perhaps the best evidence of the value of a license is proof that the copyright owner previously licensed the same copyright for a certain price. This established royalty is the primary evidence analyzed in copyright hypothetical license cases.¹⁵² Previous negotiations between the parties for the copyright at issue, even if unsuccessful, are also instructive.¹⁵³ For example, in *Polar Bear Productions, Inc. v. Timex Corp.*, the Ninth Circuit accepted the value of a hypothetical license based on an amount previously quoted to the infringer for the same copyright.¹⁵⁴ In *McRoberts Software, Inc. v. Media 100, Inc.*, the Seventh Circuit upheld the value of a hypothetical license fee based on past agreements between Media 100 and MSI under previous versions of the copyright at issue.¹⁵⁵ However, even if the copyright owner establishes such royalties, it is important to continue to consider the realities of the bargaining position of the hypothetical buyer. Particular buyers and sellers might value the copyright differently than in previous negotiations, or perhaps possess more leverage, depending on their financial position as it changes over time. Thus, it is incorrect to look solely to this Copyright Factor in establishing a reasonable royalty for a copyright.

3. *Royalties Received by Licensors of Other Comparable Copyrighted Works in Similar Markets.*¹⁵⁶

Proof of industry practice is crucial to the calculation of actual damages.¹⁵⁷ Such evidence might assist the court in determining the scope of

151. *See Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970) (holding that the first factor considers “[t]he royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty”).

152. *See Oracle USA, Inc. v. SAP AG*, C 07-1658 PJH, 2011 WL 3862074, at *10–11 (N.D. Cal. Sept. 1, 2011) (denying hypothetical license damages because “Oracle offered no evidence of the type on which plaintiffs ordinarily rely to prove that they would have entered into such a license, such as past licensing history or a plaintiff’s previous licensing practices”).

153. *See id.* at 14 (“[T]he court expected to see objective evidence showing some licensing activity . . . from Oracle/SAP’s prior dealings . . .”).

154. *Polar Bear Prods., Inc. v. Timex Corp.*, 384 F.3d 700, 709 (2004).

155. *McRoberts Software, Inc. v. Media 100, Inc.*, 329 F.3d 557, 567 (7th Cir. 2003).

156. *See Georgia-Pacific*, 318 F. Supp. at 1121 (holding that the second factor considers “[t]he rates paid by the licensee for the use of other patents comparable to the patent in suit”).

the license at issue,¹⁵⁸ or even prove that the parties rarely negotiate using a license fee,¹⁵⁹ tending to weigh against Copyright Factor #1. License prices paid in similar markets are also instructive.¹⁶⁰ Indeed, a court's determination of the fair market value of a license is often facilitated by the use of benchmark agreements between similar parties in similar industries.¹⁶¹ However, courts must be mindful of the differences between these

157. *Bruce v. Weekly World News, Inc.*, 310 F.3d 25, 29 (1st Cir. 2002); *see also* *Mills Music, Inc. v. Snyder*, 469 U.S. 153, 170–71 (1985) (assuming that Congress intended to incorporate prevailing industry practices when it enacted the Copyright Act).

158. *See* *Straus v. DVC Worldwide*, 484 F. Supp. 2d 620, 648–49 (2007) (looking to industry practice to award a higher retroactive license fee for unauthorized or infringing uses); *see also* *Bruce*, 310 F.3d at 30 (“[U]nder the prevailing industry practice, Bruce almost surely would not have been able to negotiate with World News for anything other than a single, lump-sum, up-front licensing fee”); *Fournier v. Erickson*, 242 F. Supp. 2d 318, 337 (2003) (finding that “whether a general fee standard prevailed in the industry” provides objective evidence of fair market value); *United States v. Am. Soc’y of Composers, Authors, Publishers*, 627 F.3d 64, 76, 81–82 (2d Cir. 2010) (looking to other licenses in the music industry to determine fee structures); *On Davis v. The Gap, Inc.*, 246 F.3d 152, 163 (2d Cir. 2001) (finding sufficiently concrete evidence that \$50 was the fair market value of the license at issue based on previous licenses of \$50 for similar use).

159. *See* *Bruce*, 310 F.3d at 29–30 (“[T]here was no realistic prospect whatsoever that Bruce could negotiate a per-use licensing fee with World News.”).

160. *Am. Soc’y*, 627 F.3d at 76 (2d Cir. 2010) (finding that fundamental to the reasonableness of the royalty “is a determination of what an applicant would pay in a competitive market . . .”).

161. *Oracle USA, Inc. v. SAP AG*, C 07-1658 PJH, 2011 WL 3862074, at *7 (N.D. Cal. Sept. 1, 2011) (“An objective, non-speculative license price is established through objective evidence of benchmark transactions, such as licenses previously negotiated for comparable use of the infringed work, and benchmark licenses for comparable uses of comparable works.”); *id.* at 14 (“[T]he court expected to see objective evidence showing some licensing activity . . . by Oracle or by some other company in the related industry”); *Am. Soc’y*, 627 F.3d at 76 (2d Cir. 2010) (quoting *United States v. Broad. Music, Inc.*, 426 F.3d 91, 94 (2d Cir. 2005) (“‘A rate court’s determination of the fair market value of the music is often facilitated by the use of benchmarks-agreements reached after arms’ length negotiation between other similar parties in the industry.’”)); *Fournier*, 242 F. Supp. at 337 (S.D.N.Y. 2003) (finding that “what Fournier received from other customers for similar work” was objective evidence tending to prove the fair market value of the license); *Kleier Adver., Inc. v. John Deery Motors, Inc.*, 834 F. Supp. 311, 314 (N.D. Iowa 1993) (using the same licensing fee for each of the three infringing markets, although two of the markets were unknown); *see, e.g.*, *McRoberts Software, Inc. v. Media 100, Inc.*, 329 F.3d 557, 566–67 (7th Cir. 2003) (upholding hypothetical license award based on evidence of the value of other licenses purchased by Media 100 for similar services in the software industry based on the relative size of the Macintosh market as compared to the Windows market for such products).

industries, comparing only those substantially similar to the industry at issue.¹⁶²

This Copyright Factor is identical to the second *Georgia-Pacific* factor.¹⁶³ However, this factor will weigh considerably less in the copyright context due to the corroboration requirement in Copyright Factor #1. Because copyright law places the burden of proof on the owner to prove that she would have actually licensed the copyrighted work, it is likely that the owner will be required to present proof that she previously licensed the product. With evidence of the exact market at issue, this factor will become important only if the previous licenses vary in price. To establish a fair price in each case, courts would then be required to analyze other copyrights of comparable value in similar markets to determine a reasonable price.

4. *The Established Profitability of the Copyrighted Item, its Commercial Success, and its Current Popularity.*¹⁶⁴

It is acknowledged in the patent context that one of the most important factors in ascertaining the value of a patent for royalty purposes is the ability of the invention to make money.¹⁶⁵ This Copyright Factor will be instructive as to how much the infringer would actually pay for the copyright, considering her expected profits arising from the asset. In a hypothetical negotiation, the owner would be reasonable in taking the position that she will not accept a royalty amount significantly less than the profit she is currently making from that product. On the other hand, the hypothetical buyer would likely examine this information in considering how valuable the copyright would be to her business.

162. GOLDSTEIN, *supra* note 7, § 12.1.1 (2005) (“The market value measure of damages will be correct so long as the court takes care to capture the value of the work in the specific market in which the infringer used it.”); *see Am. Soc’y*, 627 F.3d at 84–85 (comparing royalty rates from different online music platforms, but refusing to compare them to television networks based on the companies’ music use).

163. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970) (considering “[t]he rates paid by the licensee for the use of other patents comparable to the patent in suit”).

164. *Id.* at 1120 (considering “[t]he established profitability of the product made under the patent; its commercial success; and its current popularity”).

165. *Id.* at 1127.

5. *Economic Benefit of the Copyright at Issue.*

The amount of a hypothetical license should be based in part on the current value of the underlying asset.¹⁶⁶ This factor is a combination of (1) *Georgia-Pacific* factor #9, accounting for the utility and advantages of the patent;¹⁶⁷ (2) *Georgia-Pacific* factor #6, accounting for the value of the invention as a generator of sales for other items;¹⁶⁸ (3) *Georgia-Pacific* factor #7, accounting for the duration of the patent and the term of the license;¹⁶⁹ (4) *Georgia-Pacific* factor #10, considering the nature and character of the invention, and the benefits to those who have used it;¹⁷⁰ and (5) *Georgia-Pacific* factor #13, distinguishing the profit credited to the patent from the non-patentable elements and business risks involved in attaining the expected profit.¹⁷¹ This Copyright Factor should be considered from the perspective of both the licensee and licensor.

Using information from Copyright Factor #4, the hypothetical buyer will consider her expected economic profit. Such a consideration requires analyzing the size of the market and the possibility of capturing a given share of that market.¹⁷² She will also consider the duration of the license and the risk involved, such as competing products. The hypothetical buyer might also consider the amount of investment that would be required to commercialize the intellectual property, such as marketing and manufacturing costs. These economic considerations assume that the hypothetical buyer comes to the negotiating table looking to pay less for a license than her expected profit.

166. *Oracle USA*, 2011 WL 3862074 at *11 (“The amount of the hypothetical license must be based on the actual use the defendant made of the work . . .”).

167. *Georgia-Pacific*, 318 F. Supp. at 1120 (considering “[t]he utility and advantages of the patent property over the old modes or devices, if any, that had been used for working out similar results”).

168. *Id.* at 1120 (considering “[t]he effect of selling the patented specialty in promoting sales of other products of the licensee; that existing value of the invention to the licensor as a generator of sales of his non-patented items; and the extent of such derivative or convolved sales”).

169. *Id.* at 1120 (considering “[t]he duration of the patent and the term of the license”).

170. *Id.* at 1120 (considering “[t]he nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention”).

171. *Id.* at 1120 (considering “[t]he portion of the realizable profit that should be credited to the invention as distinguished from non-patented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer”).

172. *See Kleier Adver., Inc. v. John Deery Motors, Inc.*, 834 F. Supp. 311, 314 (1993) (“Kleier’s licensing fee depends on the size of the exclusive geographical market in which the licensee does business.”).

On the other hand, a hypothetical licensor would consider the same effects to her company as a result of the license. She would consider to what extent the license will take away her share of the market,¹⁷³ as well as what other risks she might bear with a competing product on the market. She might also consider the existing value of the copyright as a generator of sales of other items not at issue. These factors provide more realistic, business-based criteria that more accurately reflect a true arm's-length negotiation.¹⁷⁴

6. *The Portion of the Realizable Profit That Should Be Credited to the Expression at Issue as Distinguished from Non-Copyrighted Items and Other Significant Features or Improvements Added by the Infringer.*¹⁷⁵

This Copyright Factor addresses the apportionment issue when analyzing the value of the copyright to the infringer. It reflects the notion that an infringer may add value to the copyrighted item, which should be extracted from the calculation of its fair market value. However, apportionment is improper where the “copyrighted portions are so intermingled with the rest of the piratical work” that they cannot be distinguished.¹⁷⁶ The purpose is thus to provide just compensation for the value of the license, not to impose an extra penalty for the infringer’s additional expression.

Though seemingly aimed at preventing an entire market value rule violation in patent law, the Supreme Court has recognized the usefulness of apportionment in the copyright context.¹⁷⁷ Thus, courts should consider whether the infringer created profits by the addition of non-infringing and valuable improvements, and should narrowly tailor the calculation of profits to features attributable to the infringement.¹⁷⁸ For example, where a motion

173. *See, e.g.,* Cream Records, Inc. v. Jos. Schlitz Brewing Co., 754 F.2d 826 (1985) (considering licensor’s loss of opportunity to license to another in determining the value of the license at issue).

174. *See* WESTON ANSON, IP VALUATION AND MANAGEMENT, 206–07 (2010) (providing a list of updated *Georgia-Pacific* factors more truly reflecting negotiation and business realities).

175. *See Georgia-Pacific*, 318 F. Supp. at 1121 (considering “[t]he portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions”).

176. *Sheldon v. Metro-Goldwyn Pictures Corp.*, 309 U.S. 390, 401–02 (1940).

177. *Id.* at 405 (“We see no reason why these principles should not be applied to copyright cases.”); *see also* NIMMER & NIMMER, *supra* note 7, § 14.03(c) (“*Sheldon*’s result has now won express adoption in the 1976 Act,” which allows the court to exclude from recovery elements of profit attributable to factors other than the copyrighted work.).

178. *Sheldon*, 309 U.S. 390, 402–08 (1940); *see also* MGE UPS Systems, Inc. v. GE Consumer and Indus., Inc. 622 F.3d 361, 369 (5th Cir. 2010) (“MGE needed to present a more narrowly tailored calculation of PMI’s profits in order to cognize a claim for damages

picture infringes upon a copyrighted play, courts should utilize expert testimony to analyze the extent to which the use of the copyrighted material contributed to the profits in question.¹⁷⁹ Indeed, apportionment is almost always available in the context of infringing derivative works because original expression added by the infringer is itself entitled to copyright protection.¹⁸⁰ It is also used when only a small portion of a copyrighted song is infringed¹⁸¹ and when the parties are large companies involved in different markets.¹⁸²

7. *The Relative Strength of the Parties at the Time of the Negotiation.*

This Copyright Factor essentially considers the realities of the bargaining table.¹⁸³ However, it is important to revert to the parties' pre-infringement state of mind in determining their bargaining positions, as this would otherwise create an unfair advantage for the copyright owner. The patent context, for example, considers "a prudent licensee who wished to obtain a license but was not so compelled and a prudent patentee, who wished to grant a license but was not so compelled."¹⁸⁴

Courts may consider the licensor's notoriety and related ability to demand high prices for the work. The hypothetical licensor will likely assess her leverage by considering the market position of each party, including the risk that the licensee will explore alternatives to enter into the marketplace.

'attributable to infringement.'"); *United States v. Am. Soc'y of Composers, Authors, Publishers*, 627 F.3d 64, 80 (2d Cir. 2010) (requiring "a more precise way . . . to account for the value of the music use . . . in light of the fact that some components of the subscription do not involve the streaming of content . . ."); *Orgel v. Clark Boardman Co.*, 301 F.2d 119, 121 (2d Cir. 1962) ("In cases . . . where an infringer's profits are not entirely due to the infringement, and the evidence suggests some division . . . it is the duty of the court to make some apportionment.").

179. *Sheldon*, 309 U.S. at 407.

180. *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1176 (1st Cir. 1994).

181. *See, e.g., Cream Records, Inc. v. Jos. Schlitz Brewing Co.*, 754 F.2d 826, 827–29 (9th Cir. 1985).

182. *See, e.g., Am. Soc'y*, 627 F.3d at 80 (requiring superior calculations to apportion music use revenue in light of the fact that some components of the subscription do not involve streaming the copyrighted work); *Data Gen.*, 36 F.3d at 1176 ("[A]pportionment is almost always available in the context of infringing derivative works, perhaps in part because original expression added by the infringer is itself entitled to copyright protection.").

183. *See Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970) ("Where a willing licensor and a willing licensee are negotiating for a royalty, the hypothetical negotiations would not occur in a vacuum of pure logic. They would involve a market place confrontation of the parties, the outcome of which would depend upon . . . their relative bargaining strength . . .").

184. *Horvath v. McCord Radiator & Mfg. Co.*, 100 F.2d 326, 335 (6th Cir. 1938).

She will also consider the novelty of the copyright at issue. The hypothetical licensee will consider the possibility of exploring other markets, design around alternatives, and the cost of noninfringing alternatives. Essentially, this considers the licensee's best alternative to a negotiated agreement ("BATNA"), meaning that she will not purchase a license if it is less attractive than her next best alternative.

8. *The Licensor's Established Policy and Marketing Program to Maintain Her Monopoly by Not Licensing Others or by Granting Licenses Under Special Conditions Designed to Preserve That Monopoly.*¹⁸⁵

This factor is important because it establishes the hypothetical licensor's likelihood of achieving a higher price due to her resistance in negotiating. For example, the Second Circuit has held that ASCAP's monopolistic tendencies and disproportionate power over the market for music rights must be considered by rate-setting courts to reasonably determine the rate it requires from licensees.¹⁸⁶ Courts should also consider special conditions typically required by the licensor.¹⁸⁷ However, in situations where a license from the copyright owner is unprecedented due to her preservation of a monopoly, courts may find that a license would never have been reached.¹⁸⁸ Therefore, this analysis requires a delicate balance with Copyright Factor #1.

9. *The Opinion Testimony of Qualified Experts.*¹⁸⁹

Expert testimony is an important aspect of a reasonable royalty determination even in cases relying on past licenses of the copyrighted

185. See *Georgia-Pacific*, 318 F. Supp. at 1120 (considering "[t]he licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly").

186. *Am. Soc'y*, 627 F.3d at 76 (citing *United States v. Broad. Music, Inc.*, 426 F.3d 91, 96 (2d Cir. 2005) ("Fundamental to the concept of 'reasonableness' [in calculating a rate] is a determination of what an applicant would pay in a competitive market, taking into account the fact that ASCAP, as a monopolist, 'exercise[s] disproportionate power over the market for music rights.'").

187. See, e.g., *Cream Records, Inc. v. Jos. Schlitz Brewing Co.*, 754 F.2d 826, 827 (1985) ("There was no evidence that . . . Cream was willing to grant[] a license for use of less than the entire copyrighted work . . .").

188. See, e.g., *Oracle USA, Inc. v. SAP AG*, 2011 WL 3862074 at *7 (finding that Oracle cannot receive hypothetical license damages because "Oracle has never granted a comparable license that would permit a competitor to use Oracle software to compete for Oracle's customers . . . such a license would be 'unique' and 'unprecedented'").

189. See *Georgia-Pacific*, 318 F. Supp. at 1121 (considering "[t]he opinion testimony of qualified experts").

work.¹⁹⁰ In these cases, expert opinion is required to confirm the similarity of the licenses and the markets at issue. As long as it is relevant and reliable, expert testimony can also be used to prove prevailing industry practice,¹⁹¹ the similarity of markets or copyrighted works,¹⁹² to apportion copyrightable subject matter and to determine the extent to which the copyrighted material contributed to profits,¹⁹³ and to calculate fair market value.¹⁹⁴

V. CONCLUSION

Congress has implicitly blessed the reasonable royalty technique in copyright law. The Copyright Act is a statute that deserves flexible judicial interpretation based on congressional intent to defer to courts to develop in a common law fashion. A first principles analysis shows that Congress left courts free to mold the contours of copyright law on a case-by-case basis to fill statutory gaps based on tort law principles. Moreover, in contemplating amendments to the Copyright Act, Congress actually discussed the possibility that courts would engage in a reasonable royalty analysis to calculate copyright damages. The historic kinship that exists in the co-evolution of copyright and patent damages provides further justification for the incorporation of a reasonable royalty scheme. Courts, however, must be sensitive to the distinctions in their requirements and enforcement aspects to avoid mere blind transplantation across regimes.

Patent law's robust reasonable royalty scheme will provide helpful guidance for courts to determine the true value of a copyright license. Adapting the *Georgia-Pacific* factors to fit the requirements unique to copyright law will allow courts to more closely tether the hypothetical negotiation award to the facts of each case. This will enable courts to adhere to congressional intent by affording copyright owners adequate compensatory

190. PAUL GOLDSTEIN, COPYRIGHT PRINCIPLES, LAW AND PRACTICE 317 (1989) (“Courts admit expert testimony . . . to prove market value.”).

191. *See, e.g.*, *Bruce v. Weekly World News, Inc.*, 310 F.3d 25, 29–30 (1st Cir. 2002) (relying on expert testimony that, given the prevailing industry practice, there was no realistic prospect that Bruce could negotiate a per-se licensing fee with World News).

192. *See, e.g.*, *Semerdjian v. McDougal Littell*, 641 F. Supp. 2d 233 (S.D.N.Y. 2009) (confirming the relevancy of expert testimony regarding a market for images in textbooks in calculating a reasonable license fee).

193. *See, e.g.*, *Sheldon v. Metro-Goldwyn Pictures Corporation*, 309 U.S. 390 (1940) (relying on expert witness testimony in finding that, for apportionment purposes, the portion of the profits attributable to the use of a copyrighted play was small).

194. *See, e.g.*, *Polar Bear Prods., Inc. v. Timex Corp.*, 384 F.3d 700, 709 (9th Cir. 2004) (finding substantial evidence for a license fee award based on the testimony of a certified accountant, who calculated a reasonable license fee by determining fair market value).

damages when they would otherwise have no remedy.¹⁹⁵ Indeed, adopting a reasonable royalty scheme will help achieve copyright's utilitarian goals by promoting creation to benefit society.

195. *See* H.R. REP. NO. 94-1476, at 161 (1976) ("Damages are awarded to compensate the copyright owner for losses from the infringement.").

GRADUATED RESPONSE SYSTEMS AND THE MARKET FOR COPYRIGHTED WORKS

John M. Owen[†]

Over the last two decades, technological developments have disrupted the ability of copyright holders to monetize their creations by limiting their ability to exercise exclusive control of the reproduction and distribution of their works. The digitization of media has made the copying and distribution of copyrighted content ubiquitous. Data storage costs are dropping rapidly, download speeds are increasing, and internet accessibility is proliferating thanks to broadband, Wi-Fi, and mobile devices. Streaming technologies, peer-to-peer (“P2P”) file exchanges, and social media sites allow consumers to become active, if unknowing, copyright infringers. As a result of these technological developments, the scope of copyright infringement has grown, which in turn, has increased enforcement costs. Content owners seek mechanisms to deter infringement and restore lost profits in their copyrighted works.

Content owners hope that a new copyright enforcement model—so-called “graduated response systems” (“GRS”)—will help stem infringement of copyrighted works and encourage consumers to return to legal markets.¹ GRS are an approach to copyright enforcement that prescribes a series of escalating consequences for an individual accused of infringing copyrighted works.² The consequences for infringement can include automatic redirection to a different homepage and reduction in internet download speeds.³ Both public and private entities can administer GRS.⁴ Privately ordered GRS are systems that are administered by private entities rather than government

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1. See Kristen Hainen, *Music, Movie, TV and Broadband Leaders Team to Curb Online Content Theft*, COPYRIGHT INFORMATION CENTER (July 7, 2011), <http://www.copyrightinformation.org/node/704>.

2. See Annemarie Bridy, *Graduated Response and the Turn to Private Ordering in Online Copyright Enforcement*, 89 OR. L. REV. 81, 128 (2010).

3. See Memorandum of Understanding Between ISPs (SBC Internet Services, Inc. et al) and Content Owners (RIAA et al.) (July 6, 2011), [http://www.copyrightinformation.org/sites/default/files/Memorandum of Understanding.pdf](http://www.copyrightinformation.org/sites/default/files/Memorandum%20of%20Understanding.pdf) [hereinafter 2011 MOU Agreement].

4. See Annemarie Bridy, *ACTA and the Specter of Graduated Response*, 26 AM. U. INT’L L. REV. 559, 569–73 (2011).

bodies.⁵ The framework of any privately ordered GRS is defined, at least in part, by contract rather than exclusively by statute, regulation, and case law.⁶

As more consumers turn to the Internet for entertainment, news, and media, content owners believe that business models that seek to capitalize on collaborations between copyright owners and internet service providers (“ISPs”) have created a market climate that makes GRS implementation by ISPs the most efficient and fair mechanism for enforcing their copyrights.⁷ Furthermore, advancements in the software technologies used to identify and filter infringing works have improved the ability of copyright owners and ISPs to effectively implement GRS.⁸

In 2011, a consortium of major ISPs and content owners adopted a Memorandum of Understanding (“MOU”) that will create industry standards for implementing uniform GRS.⁹ The signatories to the MOU hope that privately ordered GRS can help create an internet landscape where the difficulty of accessing infringing material outweighs the benefits of acquiring content without paying for it.¹⁰ But many critics argue that the MOU represents another step in a troubling trend of overbroad expansion of the scope of copyright protection given to rightsholders, citing threats to the general benefits of the Internet, free speech, innovation, and fair use of copyright works.¹¹

This Note argues that the 2011 MOU between content owners and ISPs, which sets up privately ordered GRS, is a crucial step in copyright holders’ efforts to reduce widespread online copyright infringement and to attract consumers into legal digital markets to access their works. Given the changes in the internet landscape over the last decade, the time has come to implement privately ordered enforcement mechanisms that fairly allocate the burden of enforcement between ISPs and content owners. As broadband access and mobile networks have proliferated, people increasingly consume copyrighted content over the Internet, and ISPs now play a greater role than

5. See Bridy, *supra* note 2 at 81.

6. See *id.*

7. See Bridy, *supra* note 4 at 572.

8. See Rob Frieden, *Internet Packet Sniffing and Its Impact on the Network Neutrality Debate and the Balance of Power Between Intellectual Property Creators and Consumers*, 18 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 633, 645 (2008) (stating that many ISPs will likely adopt “smart” technologies to monitor and direct traffic on their networks).

9. See 2011 MOU Agreement, *supra* note 3.

10. See Part II, *infra*, for a discussion of the motivations underlying the adoption of the 2011 MOU.

11. See Part IV, *infra*, for a discussion of criticisms of GRS and the 2011 MOU Agreement, *supra* note 3.

ever before in the distribution of creative content.¹² Furthermore, ISPs have an additional financial incentive to curb online piracy because the unauthorized distribution of creative content creates a significant burden on their data pipelines.¹³ Private ordering of copyright enforcement offers greater speed, flexibility, and adaptability to deal with the rapidly changing landscape of the Internet than publicly ordered enforcement regimes, which rely on the slow, expensive, and unpredictable processes of legislation and litigation.¹⁴

Furthermore, the “graduated responses” prescribed by the MOU are less severe and more closely tailored to a user’s infringing offense than the statutory consequences an infringer faces through litigation.¹⁵ Likewise, an enforcement system based on ubiquitous filtering of all users’ activities is fairer—and likely more effective—than a system that depends on “making an example” out of a few individual users through selective policing and litigating.¹⁶ While the MOU will improve copyright protection for creators and the creative industries, the parties to the MOU should include procedural safeguards that allow consumers to fairly defend against infringement claims. Ultimately, parties to the MOU should seek to design a copyright enforcement regime that is transparent, predictable, and narrowly tailored. If all parties’ interests are correctly balanced and consumers are offered convenient, attractively priced options for digital works, content owners may be able to bring many consumers back into the legal market.

Part I of this Note provides a historical background of the enforcement mechanisms that rightsholders have employed in response to advancements in digital technology—especially the rise of P2P networks—that led to dramatic increases in copyright infringement. Part II examines the factors that led to the development and adoption of GRS and the 2011 MOU. Part III explores the procedures, mechanisms, and protections established by the terms of the 2011 MOU. Part IV discusses the potential benefits of implementing privately ordered copyright enforcement mechanisms and GRS. Part IV also outlines many of the criticisms of the MOU and GRS. Finally, Part V weighs the benefits GRS offer to creators, content owners, consumers, and ISPs, and suggests that the parties to the 2011 MOU should

12. See Preserving the Open Internet, Broadband Industry Practices, 76 Fed. Reg. 59,192, 59,194 (Sept. 23, 2011).

13. See *id.* at 59,209.

14. See Alain Strowel, *Internet Piracy as a Wake-up Call for Copyright Law Makers—Is the “Graduated Response” a Good Reply?*, 1 WIPO J. 75, 77–79 (2009).

15. See discussion in Section IV.A.4.

16. See *id.*

implement procedures to safeguard consumers' interests in privacy, fair use, and free speech.

I. BACKGROUND: A HISTORY OF COPYRIGHT ENFORCEMENT IN THE DIGITAL AGE

Despite widespread piracy, the absolute value of copyrights to U.S. gross domestic product has continued to expand as the United States transitions increasingly to an information-based economy. One study stated that copyrights added \$932 billion to the U.S. economy in 2010 alone and that almost 5.1 million Americans are employed by core copyright industries.¹⁷ An increasing percentage of the population of developed nations earn a living in fields affected by copyright law.¹⁸ Moreover, the global economy produces exponentially more copyrightable content than it did prior to digitalization and the expansion of the Internet.¹⁹ This growth is partially attributable to the rise in global population, the increase in per capita wealth, and the decrease in production and distribution costs.²⁰ Furthermore, rises in per capita income have also increased the leisure time and money available to people to consume entertainment and expressive content.²¹

The digitization of copyrighted works and the growth of the Internet facilitated a widespread rise in online infringement of copyright works. This dematerialization of copyrighted works has weakened the creative industries' ability to exclusively control the copying and distributing of their works, and content owners have struggled to find an adequate deterrent to digital piracy. Although estimates of the economic loss caused by online infringement vary depending on the methodologies and underlying assumptions used in

17. STEPHEN E. SIWEK, INT'L INTELLECTUAL PROP. ALLIANCE, COPYRIGHT INDUSTRIES IN THE U.S. ECONOMY: THE 2011 REPORT 4, (2011), <http://www.ipa.com/pdf/2011CopyrightIndustriesReport.PDF>.

18. See Justin Hughes, *Copyright and Incomplete Historiographies: Of Piracy, Propertization, and Thomas Jefferson*, 79 S. CAL. L. REV. 993, 1078–79 (2006) (quoting the research of Richard Florida, which categorizes scientists, engineers, artists, musicians, lawyers, physicians, and teachers as “the creative class,” Florida found that 30% of the American workforce were members of this ‘class’—38 million people—whereas only 10% of the workforce was so categorized in 1900, 15% in 1945, and 20% in 1980).

19. See United Nations Conference on Trade and Development, Sao Paulo, Braz., June 13–18, 2004, *Creative Industries and Development*, ¶ 11–30, U.N. Doc. TD(XI)/BP/1, (June 4, 2004).

20. See *id.*

21. See *id.* ¶ 13.

calculations, the losses are substantial.²² The Recording Industry Association of America (“RIAA”) claims that sound recordings sales in the United States dropped by 40% from 1999 to 2008, representing a loss in revenue of almost \$6.1 billion.²³ Although exact figures on consumers’ listening habits are difficult to calculate, the RIAA’s decrease in sales would not seem to reflect a decrease in the amount of time spent listening to music by consumers given the ubiquitous use of iPods, smartphones, and laptops.²⁴ Assessing the effects of online file-sharing is also made difficult by the fact that for those copyright owners who lack the resources to pursue legal action, the cost of enforcement frequently outweighs the commercial value of their copyrights, and thus, those owners rarely even pursue litigation against infringing users.²⁵

Part I of this Note recounts a history of some of the biggest issues in copyright enforcement since the onset of the digital age. Section I.A defines the competing interests of content owners, ISPs, and users that have given rise to the heated debates about the role that copyright should play in light of recent technological advances. Section I.B discusses the enforcement mechanisms that content owners have employed in attempting to protect their copyrighted works over the last two decades.

A. DEFINING THE COMPETING INTERESTS OF CONTENT OWNERS, ISPS, AND USERS

This Note frames much of its discussion about copyright enforcement around the interests of three main groups: content owners, ISPs, and users. Each of these groups has been affected very differently by the digitization of media and the growth of the Internet and, frequently, the interests of these groups have stood in conflict and competition.²⁶ This Section attempts to define each group’s interests and to discuss these groups’ divergent views of what should constitute an ideal copyright enforcement system.

22. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-10-423, INTELLECTUAL PROPERTY: OBSERVATIONS TO QUANTIFY THE ECONOMIC EFFECTS OF COUNTERFEIT AND PIRATED GOODS 9–15 (Apr. 2010).

23. 2008 *Consumer Profile*, RECORDING INDUSTRY ASS’N OF AM., (2008), <http://76.74.24.142/CA052A55-9910-2DAC-925F-27663DCFFFF3.pdf>.

24. See U.S. *Music Consumption: How Many Are Buying & Who’s Listening?*, BRIDGE RATINGS (Aug. 29, 2007) http://www.bridgeratings.com/press_08.29.2007-MusicConsumption.htm.

25. See *Remedies for Small Copyright Claims: Hearing Before the Subcomm, on Courts, the Internet, and Intellectual Property of the H. Comm on the Judiciary*, 109th Cong. 1 (2006) (statement of the U.S. Copyright Office), available at <http://www.copyright.gov/docs/regstat032906.html>.

26. See S. REP. NO. 105-190, at 7, 10 (1998).

1. *Content Owners*

The term “content owners,” as discussed in this Note, includes creators—such as writers, directors, and musicians—as well as those parties whose economic interests are associated with the creative industries—such as record labels, distributors, and studios. Content owners’ interests are often represented through major industry groups such as the Motion Picture Association of America (“MPAA”),²⁷ the Recording Industry Association of America (“RIAA”),²⁸ and the American Society of Composers, Authors, and Publishers (“ASCAP”).²⁹ Generally speaking, content owners’ economic goal is to maximize their revenue from the sale and licensing of their copyrighted works.³⁰ Additionally, for some content owners, the right to control the production of derivative works based on their original creations is important for economic reasons as well as reasons of maintaining artistic integrity.³¹ It should be noted that such a discussion of parties’ interests is obviously a simplification of a complex problem. Persons working in the creative fields may differ greatly in their views about the ideal scope of copyright law and in their perceptions of the effects of online file-sharing. ISPs and users are likely similarly diverse in their viewpoints.

Content owners believe that the growth of the Internet and file-sharing technologies have given rise to an unprecedented level of piracy that has cut into their revenue streams and weakened their ability to exclusively control the use of their works.³² Furthermore, many content owners worry that file-sharing has become so commonplace that many consumers now believe that music, news, and movies should rightfully be available for free.³³ Some

27. *See About Us*, MOTION PICTURE ASSOCIATION OF AMERICA, <http://www.mpa.org/about> (last visited Feb. 2, 2012).

28. *See id.*

29. *See About ASCAP*, AMERICAN SOCIETY OF COMPOSERS, AUTHORS, AND PUBLISHERS, <http://www.ascap.com/about/> (last visited Feb. 2, 2012).

30. *See* Olivier Bomsel & Heritiana Ranaivoson, *Decreasing Copyright Enforcement Costs: The Scope Of A Graduated Response*, 6 REV. OF ECON. RES. ON COPYRIGHT ISSUES 13, 13–16 (2009).

31. *Cf.* 17 U.S.C. § 103 (2006) (protecting a copyright holder’s exclusive right to create derivative works); 17 U.S.C. § 106(a) (giving visual artists the exclusive right to prevent the “intentional distortion, mutilation, or other modification” of their works).

32. *See generally* ROBERT LEVINE, *FREE RIDE: HOW DIGITAL PARASITES ARE DESTROYING THE CULTURE BUSINESS, AND HOW THE CULTURE BUSINESS CAN FIGHT BACK* (2011) (arguing that online distributors of media, such as YouTube, are “parasites” that reap all of the profits and benefits from the distribution of the creative works without compensation to artists while simultaneously driving down the price that those artists can demand for their works).

33. *See id.*

content owners believe that these changes threaten to discourage future artists from creating new works.³⁴

For content owners, one of the most important goals of any copyright enforcement system is to maximize revenue streams by discouraging unauthorized uses of their copyrighted works.³⁵ To effectively accomplish this goal, a copyright enforcement regime must efficiently identify infringing uses and prevent or punish infringement so as to deter piracy.³⁶ Furthermore, content owners must be able to keep the cost of enforcement lower than the amount of potentially recoupable lost revenues.³⁷ Finally, under any copyright enforcement regime, content owners must also offer users attractive means for accessing works legally.³⁸ To do so, content owners must make works available at a price that consumers perceive as fair, and furthermore, those content owners must provide convenient means for distributing and storing those works. For content owners, successful copyright enforcement regimes ideally incorporate normative measures, such as educational tools, to legitimize the paid market for copyrighted works.³⁹

2. ISPs

The term “ISPs,” as used in this Note, refers to two different types of internet service providers: network providers such as Comcast, Verizon, and AT&T—whose cables and towers make up the physical infrastructure of the Internet—and application providers such as Facebook, Google, and Twitter—whose services are provided over the Internet. For network providers, access to creative content is important as a means of encouraging users to subscribe to their services in order to download, stream, and share copyrighted works.⁴⁰ Given the large file size of movies, TV shows, and music, access to creative content further attracts users to pay for high-speed broadband services.⁴¹ For application ISPs, creative content serves as a means to attract and maintain users looking to access and share entertainment and media through their websites.

For both types of ISPs, a copyright enforcement regime should provide clear and predictable guidelines about which uses of copyrighted content on

34. *See id.*

35. *See* Bomsel & Ranaivoson, *supra* note 30, at 13–18.

36. *Id.*

37. *Id.*

38. *See* INT’L FED’N PHONOGRAPHIC INDUS., DIGITAL MUSIC REPORT 2009: NEW BUSINESS MODELS FOR A CHANGING ENVIRONMENT 4 (2009).

39. *See id.* at 26.

40. *Id.* at 19–24.

41. *Id.*

their networks and websites are acceptable and which uses might subject an ISP to secondary liability for infringement.⁴² If an ISP's potential liability is difficult to assess, the cost associated with defensive litigation strategies increases and affects its profitability.⁴³ Accordingly, most ISPs favor an enforcement regime that limits their liability for the actions of their users.⁴⁴

Relatedly, ISPs prefer an enforcement regime that allows them to negotiate with content owners for licenses granting broad authorized access to copyrighted works at competitive prices in order to attract users to their sites.⁴⁵ This is especially true for application ISPs—such as Spotify, Netflix, and Amazon—who compete with one another to attract users with the breadth of their entertainment offerings and the convenience of access to that content.⁴⁶

Likewise, ISPs seek enforcement mechanisms that are cheap to implement and maintain. Network ISPs may have an interest in limiting the trafficking of pirated works on their networks because some studies suggest that such trafficking creates a disproportionate strain on their networks' bandwidth.⁴⁷ Thus, for ISPs, automated filtering and takedown systems are preferable to mechanisms for detecting and resolving infringement incidents that rely on costly individualized human review.⁴⁸

42. Cf. Peter K. Yu, *The Graduated Response*, 62 FLA. L. REV. 1373, 1384–87 (2010) (stating that the uncertainty of liability for the infringing acts of their subscribers forces ISPs to devote financial resources to be prepared to respond to the threat of lawsuits).

43. *Id.*

44. *Id.*

45. Cf. TIMOTHY WU, *THE MASTER SWITCH* 294 (2010) (suggesting that Apple's ability to successfully negotiate with record labels led in part to the rapid success of the online iTunes store).

46. See Parmy Olson, *Spotify Loses \$42 Million On Licensing Costs*, FORBES (Oct. 11, 2011), <http://www.forbes.com/sites/parmyolson/2011/10/11/spotify-loses-42-million-on-licensing-costs>; Julianne Pepitone, *Netflix's Vanished Sony Films Are An Ominous Sign*, CNNMONEY (July 11, 2011), http://money.cnn.com/2011/07/08/technology/netflix_starz_contract/index.htm.

47. See Preserving the Open Internet, Broadband Industry Practices, 76 Fed. Reg. 59,192, 59,206–10 (Sept. 23, 2011) (stating that broadband providers may implement reasonable practices to prevent the unlawful transfer of content to manage their networks and “to ensure that heavy users do not crowd out others”); cf. Christopher S. Yoo, *Network Neutrality After Comcast: Toward a Case-by-Case Approach to Reasonable Network Management*, in NEW DIRECTIONS IN COMMUNICATIONS POLICY 55 (Randolph J. May ed., 2009) (“The economics of two-sided markets indicate that it may be socially beneficial for content and application providers to subsidize the prices paid by end users. The fact that the Internet has become increasingly dominated by advertising revenue paid to content and application providers rather than network providers makes this particularly likely to be true.”).

48. See Yu, *supra* note 42, at 1384–87.

Furthermore, in order to ensure users' continued use of their services, ISPs also favor a copyright regime that does not require enforcement measures that users might perceive as violating their privacy or as being unfair or unduly burdensome.⁴⁹ For application ISPs, attempting to maximize the profitability of their business while respecting their users' privacy creates a tenuous balance of interests. Unlike network ISPs, who derive most of their revenue from paid subscriptions, most application ISPs rely on advertisement revenues to fund their services. An application ISP's ability to demand higher prices from advertisers is directly related to how well that ISP is able to individually target a given user's tastes and interests through data tracking. Yet, in order to maintain subscribers, an application ISP must convince its users that its terms of service are not overly invasive of privacy.

3. Users

The term "users," in this Note, is used to refer to all persons who access creative content via the Internet. This includes subscribers to network ISPs' broadband and wireless services, as well as users of application ISPs' websites and services. Users' interests are often articulated and advocated for by public interests groups, such as the Electronic Frontier Foundation⁵⁰ and the Center for Democracy and Technology.⁵¹ It should be noted that users have widely divergent preferences in the way they choose to access content. Some users may weigh the convenience of access more heavily than price, whereas other users may look at price alone.⁵² For those concerned primarily with price, free access to media serves as a motivation for seeking out unauthorized, pirated content.⁵³

An ideal copyright enforcement regime for many users allows for wide access to copyrighted works at the lowest price possible. Furthermore, users disfavor any copyright enforcement mechanisms that they perceive as intruding on their privacy or as creating an unfair, harsh, or burdensome

49. *Id.*

50. *See About EFF*, ELECTRONIC FRONTIER FOUNDATION, <https://www.eff.org/about> (last visited Feb. 23, 2012).

51. *See CDT Mission and Principles*, CENTER FOR DEMOCRACY AND TECHNOLOGY, <https://www.cdt.org/mission> (last visited Feb. 22, 2012).

52. *See* Courtney Boyd Myers, *Showdown: Spotify vs Rdio vs Grooveshark vs Pandora*, THE NEXT WEB (July 14, 2011), <http://thenextweb.com/apps/2011/07/14/showdown-spotify-vs-rdio-vs-grooveshark-vs-pandora>.

53. *See* INT'L FED'N PHONOGRAPHIC INDUS., *supra* note 38, at 23 (citing statistics that 7 out of 10 downloaders of unauthorized file-sharing are driven primarily by the availability of free content).

process for adjudicating suspected infringement incidents.⁵⁴ Likewise, many users favor an enforcement regime that allows for a broad and permissive interpretation of fair uses.⁵⁵ User-generated content (“UGC”), which often involves the creation of derivative works of copyrighted content, represents a large portion of the material accessed on popular content sharing websites, such as YouTube.⁵⁶ Furthermore, the increasing role of the Internet as an outlet for free speech and for organizing democratic movements has increased users’ concerns that an overly strict enforcement regime could censor protected speech and stifle political participation.⁵⁷

Thus, an ideal copyright enforcement regime must seek to balance the various interests of content owners, ISPs, and users.

B. A BRIEF HISTORY OF COPYRIGHT ENFORCEMENT STRATEGIES

Section I.B summarizes the various copyright enforcement mechanisms that content owners have employed to try to protect their works in the digital age. Section I.B.1 discusses content owners’ efforts to prevent unauthorized copying through technological measures, such as digital rights management software. Section I.B.2 looks at how the competing interests of content owners and ISPs led to the passage of the Digital Millennium Copyright Act (“DMCA”). It also discusses the DMCA’s framework for enforcing copyright protections and its shortcomings given the evolving landscape of the Internet. Section I.B.3 recounts content owners’ efforts to enforce their copyrights through litigation. Section I.B.4 examines how the federal government is expanding its efforts to protect the content owning industries. Finally, Section I.B.5 summarizes the current viability of various copyright enforcement mechanisms available to content owners and argues that the strategies employed thus far have largely proven unsuccessful.

1. *Digital Rights Management*

The first major tactic employed by content owners to prevent unauthorized reproduction and distribution was the development of digital

54. See PRINCIPLES FOR USER GENERATED CONTENT SERVICES, <http://www.ugcprinciples.com> (last visited Feb. 23, 2012).

55. See *id.*

56. See Edward Lee, *Warming Up to User-Generated Content*, 2008 U. ILL. L. REV. 1459, 1508 (2008).

57. See Letter from Access to Rep. Lamar Smith, Chairman, Comm. on the Judiciary (Nov. 15, 2011), available at https://s3.amazonaws.com/access.3cdn.net/bee9ca8d08d08c45c7_rvm6bx96w.pdf (stating that H.R. 3261, the Stop Online Piracy Act, “sends an unequivocal message to other nations that it is acceptable to censor speech on the global Internet”).

rights management (“DRM”) technologies.⁵⁸ DRM acted as a software lock to restrict consumers’ ability to copy and distribute purchased media.⁵⁹ However, savvy computer users quickly showed that they were capable of circumventing most DRM technologies through hacking.⁶⁰ Less savvy users were annoyed that the content industries had placed inconvenient restrictions on their legally acquired copies.⁶¹ Furthermore, many critics also felt that companies had unfairly employed DRM technologies to lock buyers into a single distribution platform or device and that DRM had also obstructed legitimate fair uses.⁶² Although many content owners continue to view DRM technologies as an important means for protecting their works, most copyright owners now recognize that DRM technologies alone cannot effectively deter copyright infringement.⁶³

2. *The Digital Millennium Copyright Act: Its Origins and Inadequacies*

As the Internet and proprietary online networks grew in scope and popularity during the late 1980s and early 1990s, policy makers struggled to

58. See Daniel J. Gervais, *Electronic Rights Management and Digital Identifier Systems*, J. ELECTRONIC PUBLISHING (March 1999), available at <http://quod.lib.umich.edu/cgi/t/text/text-idx?c=jep;view=text;rgn=main;idno=3336451.0004.303> (summarizing the policies and legal issues involved in the use of DRM to protect copyright); *The Decade in DRM (and announcing Day Against DRM, 2010)*, DEFECTIVE BY DESIGN (Feb. 25, 2010, 12:19 PM) <http://www.defectivebydesign.org/decade-in-drm> (providing a timeline of developments in the use of DRM technologies).

59. See Damian Kulash, Jr., *Buy, Play, Trade, Repeat*, N.Y. TIMES, Dec. 6, 2005, at A27 (discussing how Sony BMG had installed software on its audio CDs that limited how many copies users could make of its discs).

60. See generally Bruce Schneier, *The Futility of Digital Copy Prevention*, CRYPTO-GRAM NEWSLETTER (May 15, 2001), <http://www.schneier.com/crypto-gram-0105.html#3> (arguing that technological means for encrypting copyrighted material are inherently capable of being circumvented); Ruth Suehle, *The DRM Graveyard: A Brief History of Digital Rights Management in Music*, OPENSOURCE.COM (Nov. 3, 2011), <http://opensource.com/life/11/11/drm-graveyard-brief-history-digital-rights-management-music> (describing failed efforts by content owners and technology companies to use DRM to enforce copyright).

61. See *The Pros, Cons and Future of DRM*, CBC NEWS (Aug. 7, 2009, 4:12 PM), <http://www.cbc.ca/news/technology/story/2009/08/06/tech-digital-locks-drm-tpm-rights-management-protection-measures-copyright-copy-protection.html>.

62. See, e.g., Dan L. Burk & Julie E. Cohen, *Fair Use Infrastructure for Copyright Management Systems*, 15 HARV. J.L. & TECH 41, 83, (2001); see also Fred von Lohmann, *Fair Use and Digital Rights Management: Preliminary Thoughts on the (Irreconcilable?) Tension between Them*, ELECTRONIC FRONTIER FOUNDATION (Apr. 16, 2002), http://w2.eff.org/IP/DRM/fair_use_and_drm.html (discussing how DRM prevents consumers from fair uses of material they have purchased, such as converting files into newer formats for their own private use).

63. See, e.g., Marcus Yam, *RIAA: We Didn't Say 'DRM is Dead'*, TOM'S GUIDE (July 22, 2009, 1:00 PM), <http://www.tomsguide.com/us/riaa-drm-dead-mp3-music,news-4281.html> (discussing the RIAA's statements that DRM usage by content owners continues, but is in decline).

define the role that ISPs should play in policing copyright infringement on their networks.⁶⁴ Moreover, ISPs, content owners, scholars, and politicians debated the scope of liability that ISPs should face for the infringing activities of their online users.

In 1996, the member states of the World Intellectual Property Organization (“WIPO”) adopted the WIPO Copyright Treaty to address the inadequacies of contemporary legal regimes and deal with developments in information technologies. In 1998, the treaty was incorporated into U.S. law through passage of the DMCA.⁶⁵ In crafting the DMCA, Congress attempted to balance the competing interests of ISPs and content owners.⁶⁶ Content owners had successfully advocated for the inclusion of anti-circumvention provisions in the DMCA, which made it illegal for anyone to knowingly bypass technological barriers for protecting a copyrighted work, such as DRM mechanisms.⁶⁷ Similarly, the DMCA prohibited tampering with copyright management information.⁶⁸ On the other hand, ISPs won broad “safe harbor” provisions to limit their liability for the infringing activities of their users. Section 512 of the DMCA created new liability limitations based on four categories of activity by an ISP: (1) transitory communications; (2) system caching; (3) storage of information on systems or networks at the direction of users; and (4) information location tools.⁶⁹ ISPs that persistently

64. See Bruce A. Lehman, U.S. Patent and Trademark Office, Intellectual Property and the National Information Infrastructure: The Report of the Working Group on Intellectual Property Rights, 114–24 (1995), <http://www.uspto.gov/web/offices/com/doc/ipnii/ipnii.pdf>. In 1993, President Clinton created the Information Infrastructure Task Force (“IITF”) in order to develop his Administration’s vision for a comprehensive information and telecommunications policy framework. *Id.* at 1. In its 1995 white paper on the National Information Infrastructure, the IITF rejected arguments that the Internet’s potential for growth would be jeopardized by a copyright regime under which ISPs could be liable for the infringing activities of their users. *Id.* at 117–24. The IITF believed that ISPs were best positioned “to know the identity and activities of their subscribers and to stop unlawful activities.” *Id.* at 117. The IITF also believed that because ISPs benefitted from infringing activities through increased usage and added subscribers, they should also bear some of the enforcement costs and be liable for infringement. *Id.* at 117–18.

65. See The Digital Millennium Copyright Act Of 1998, Pub. L. No. 105-304, 112 Stat. 2860 (codified in scattered sections of 17 U.S.C.).

66. See Cassandra Imfeld & Victoria Smith Ekstrand, *The Music Industry and the Legislative Development of the Digital Millennium Copyright Act’s Online Service Provider Provision*, 10 COMM. L. & POL’Y 291, 299–301 (2005).

67. See S. REP. NO. 105-190, at 7, 10 (1998); see also 17 U.S.C. § 1201(a)(1) (2006).

68. 17 U.S.C. § 1201.

69. 17 U.S.C. § 512 (2011).

store information at the direction of their users must comply with a “notice and takedown” regime to remain immune from liability.⁷⁰

All ISPs claiming safe harbor protection under the DMCA must meet the conditions for eligibility listed in Section 512(i), which requires that ISPs (1) adopt a policy that provides for the termination of access for repeat infringers in appropriate circumstances and (2) accommodate technical measures used by copyright holders to identify and protect their works.⁷¹ However, Section 512(m) expressly precludes courts from construing any provision in Section 512 to mean that ISPs have an affirmative duty to monitor their services to actively seek out infringing activities in order to qualify for safe harbor protections.⁷²

Some critics argue that the DMCA is ill-equipped to address many issues arising from the technological developments of the last decade.⁷³ When the DMCA was drafted, ISPs’ technical capacity to monitor and police the content flowing through their networks was more limited than that of today.⁷⁴ Placing the policing burden on copyright holders under a notice-and-takedown regime no longer makes sense given the availability of powerful and cheap technologies for monitoring and filtering infringing uses.⁷⁵ To strengthen their ability to claim safe harbor under the DMCA, many operators of P2P networks have designed their networks in ways that limit their knowledge of their users’ activities.⁷⁶ Yet these operators of such networks still profit from the trafficking of pirated content via advertisement sales.⁷⁷ However, many courts have been reluctant to hold that constructive knowledge of general infringement should cause an ISP to lose its safe

70. See 17 U.S.C. § 512(c) (providing that ISPs that merely serve as temporary conduits for information transfer fall under the scope of 512(a)’s protections and are not subject to the notice-and-takedown framework).

71. See 17 U.S.C. § 512(i).

72. See 17 U.S.C. § 512(m).

73. See, e.g., Annemarie Bridy, *Is Online Copyright Enforcement Scalable?*, 13 VAND. J. ENT. & TECH. L. 695, 717 (2011); Jennifer M. Urban & Laura Quilter, *Efficient Process or “Chilling Effects”? Takedown Notices Under Section 512 of the Digital Millennium Copyright Act*, 22 SANTA CLARA COMPUTER & HIGH TECH. L.J. 621, 638 (2006).

74. See Lital Helman & Gideon Parchomovsky, *The Best Available Technology Standard*, 111 COLUM. L. REV. 1194, 1203 (2011) (discussing the superior ability of ISPs relative to content owners to implement technological filters to screen for copyrighted works).

75. Cf. Frieden, *supra* note 8, at 645 (stating that many ISPs will likely adopt “smart” technologies to monitor and direct traffic on their networks and that by choosing “to operate [as] a non-neutral conduit, the ISP, internationally or not, should incur greater responsibility for the content it carries”).

76. Peter S. Menell & David Nimmer, *Legal Realism in Action: Indirect Copyright Liability’s Continuing Tort Framework and Sony’s De Facto Demise*, 55 UCLA L. REV. 143, 187 (2007).

77. See *id.*

harbor protection.⁷⁸ Nonetheless, the legal uncertainty of what constitutes actual knowledge of infringement increases the risks faced by ISPs and slows innovation,⁷⁹ while also driving up the costs of enforcement for content owners.

Most recently, the Internet has become host to far more generative and interactive content, further making application of the DMCA problematic.⁸⁰ Courts addressing liability under the DMCA in cases involving P2P networks and websites with UGC have struggled to reach consistent outcomes.⁸¹ UGC frequently transforms, criticizes, or parodies copyrighted works, and therefore, may constitute fair use of copyrighted material.⁸² Since a fair use analysis is often quite difficult even for trained lawyers and judges, some argue that current filtering technologies are inadequate to protect fair uses of copyrighted materials.⁸³ Furthermore, as the business models of ISPs move beyond that of mere information relays towards that of hosts of interactive content and social media, ISPs and content owners now have incentives to explore private agreements in order to reduce infringement, avoid liability, monetize the consumption of media, and gain a possible economic advantage over their competitors.⁸⁴

78. See, e.g., *Viacom Int'l Inc. v. YouTube, Inc.*, 718 F. Supp. 2d 514, 525 (S.D.N.Y. 2010) (stating that “[g]eneral knowledge that infringement is ‘ubiquitous’ does not impose a duty on the service provider to monitor or search its service for infringements”); *UMG Recordings, Inc. v. Veoh Networks Inc.*, 665 F. Supp. 2d 1099, 1112 (C.D. Cal. 2009) *aff’d sub nom.* *UMG Recordings, Inc. v. Shelter Capital Partners LLC*, 09-55902, 2011 WL 6357788 (9th Cir. Dec. 20, 2011) (finding that actual awareness must include knowledge of “red flags,” regardless of whether the defendant had knowledge of the “general proposition that infringing material is often uploaded”).

79. See Mitchell P. Goldstein, *Service Provider Liability for Acts Committed By Users: What You Don't Know Can Hurt You*, 18 J. MARSHALL J. COMPUTER & INFO. L. 591, 641 (2000).

80. See Michael Sawyer, *Filters, Fair Use, and Feedback: Generated Content Principles and the DMCA*, 24 BERKELEY TECH. L.J. 363, 371, 402 (2009).

81. See *id.* at 367.

82. See *Harper & Row, Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 560 (1985).

83. See *Burk & Cohen*, *supra* note 62, at 55 (stating that “an algorithm-based approach to fair use is unlikely to accommodate even the shadow of fair use as formulated in current copyright law”).

84. See Bridy, *supra* note 2, at 81–84. Bridy notes that “[t]he policy underlying § 512(a)—that providers acting as passive conduits and automatically transmitting material chosen by others should not be held liable if that material turns out to be infringing—was not without antecedent in copyright law when the DMCA was enacted in 1998,” yet “[c]ontroversially, ISPs—including cable, DSL, and wireless broadband providers—have not been subject to the common carrier requirements that define the regulatory space for wire-based telephony.” *Id.*

3. *Litigation as Enforcement: Limitations and Criticisms*

Copyright holders have two main litigation options to enforce their rights under current U.S. law.⁸⁵ Rightsholders can bring suits against individual infringers or against the companies whose technologies facilitate unauthorized distribution of their copyrighted works.⁸⁶ The DMCA places the burden of online copyright enforcement on the copyright owner to identify infringers under a notice-and-takedown framework.⁸⁷ Furthermore, infringement suits are often expensive, lengthy, and uncertain.⁸⁸ The stratospheric damages sought (and occasionally won) by copyright owners have virtually guaranteed that many if not most individual infringers are judgment proof.⁸⁹ Lawsuits against individual users have often turned public opinion against content owners, as many people see such suits as a contest between an innocent David and a greedy Goliath.⁹⁰ Thus, content owners have generally preferred to target organizations that enable illegal file-sharing because of the potential for greater damages awards and lower litigation costs.⁹¹

85. See Christopher M. Swartout, *Toward A Regulatory Model of Internet Intermediary Liability: File-Sharing and Copyright Enforcement*, 31 NW. J. INT'L L. & BUS. 499, 504 (2011).

86. See *id.*

87. See *Perfect 10, Inc. v. CCBill LLC*, 488 F.3d 1102, 1113 (9th Cir. 2007) (“The DMCA notification procedures place the burden of policing copyright infringement—identifying the potentially infringing material and adequately documenting infringement—squarely on the owners of the copyright. We decline to shift a substantial burden from the copyright owner to the provider.”).

88. See Bridy, *supra* note 73, at 720; see, e.g., Lisa Lerer, *Viacom’s Expensive Suit*, FORBES.COM (March 28, 2007) http://www.forbes.com/2007/03/27/youtube-viacom-google-tech-cx_ll_0328google.html (stating that the lawsuit between YouTube and Viacom could generate \$350 million or more in legal fees).

89. See *Sony BMG Music Ent. v. Tenenbaum*, 672 F. Supp. 2d 217 (D. Mass. 2009) (awarding initially \$675,000 in damages); *Capitol Records, Inc. v. Thomas-Rasset*, 799 F. Supp. 2d 999 (D. Minn. 2009) (awarding \$1.5 million in damages).

90. See Justin Hughes, *On the Logic of Suing One’s Customers and the Dilemma of Infringement-Based Business Models*, 22 CARDOZO ARTS & ENT. L.J. 725, 735 (2005).

91. *In re Aimster Copyright Litig.*, 334 F.3d 643, 645 (7th Cir. 2003) (“The swappers [of infringing files], who are ignorant or more commonly disdainful of copyright and in any event discount the likelihood of being sued or prosecuted for copyright infringement, are the direct infringers. But firms that facilitate their infringement, even if they are not themselves infringers because they are not making copies of the music that is shared, may be liable to the copyright owners as contributory infringers. Recognizing the impracticability or futility of a copyright owner’s suing a multitude of individual infringers (‘chasing individual consumers is time consuming and is a teaspoon solution to an ocean problem,’), the law allows a copyright holder to sue a contributor to the infringement instead, in effect as an aider and abettor.”).

Shortly after the DMCA was drafted, Napster transformed the way people used and perceived the Internet.⁹² File-sharing of copyrighted content skyrocketed and the record industry soon took notice.⁹³ After negotiations broke down between the RIAA and Napster, the RIAA's member labels filed suit against Napster in late 1999.⁹⁴ The district court granted a preliminary injunction against Napster's unauthorized distribution of copyrighted content, which was later upheld by the Ninth Circuit.⁹⁵

However, even where content owners have successfully been able to shut down one file-sharing site, similar sites sprouted up almost immediately to take their place.⁹⁶ The RIAA's member labels brought suits against many of the companies that introduced new P2P file-sharing networks.⁹⁷ However, the decentralization of P2P software employing bit torrent technology has complicated the RIAA's ability to clamp down on these companies through injunctions.⁹⁸ Given the vast number of content sharing sites, actively pursuing all cases of infringement would require a virtually unlimited amount of time and financial resources. Thus, while content owners still bring lawsuits against the operators of P2P networks, court-ordered injunctions appear unlikely to ever fully stop online piracy.

Following the RIAA's consistent failure to shut down file-sharing sites, the RIAA embarked in 2003 on a campaign of infringement suits against

92. See Menell & Nimmer, *supra* note 76, at 178.

93. See Susan Stellan, *Technology Briefing: Internet; Napster Use Quadrupled In 5 Months*, N.Y. TIMES, Sept. 12, 2000, at C6.

94. A&M Records, Inc. v. Napster, Inc., 114 F. Supp. 2d 896, 925–27 (N.D. Cal. 2000) *rev'd on other grounds*, 239 F.3d 1004, 1014–19, 1024–27 (9th Cir. 2001).

95. *Id.*; A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004, 1014–19, 1024–27 (9th Cir. 2001).

96. See *Napster Eclipsed by Newcomers*, WIRED (Sept. 6, 2001), <http://www.wired.com/techbiz/media/news/2001/09/46596>.

97. See *RIAA v. The People: Four Years Later*, ELECTRONIC FRONTIER FOUNDATION (2007), http://w2.eff.org/IP/P2P/riaa_at_four.pdf (listing RIAA member's lawsuits against other operators of P2P networks); see also *MGM Studios Inc. v. Grokster, Ltd.*, 545 U.S. 913, 933–37 (2005) (holding that one who distributes file-sharing software while affirmatively promoting its copyright-infringing use could be held liable for secondary infringement, even if the device has substantial non-infringing uses). The Court distinguished *Grokster* from the “staple article of commerce” safe harbor from *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 442 (1984), stating that it did not apply where there was evidence of intentional promotion of copyright-infringing use. *Grokster*, 545 U.S. at 933–37.

98. See Swartout, *supra* note 85, at 518–19; see also Eric Bangeman, *Study: BitTorrent Sees Big Growth, LimeWire Still #1 P2P App*, ARS TECHNICA (Apr. 21, 2008), <http://ars.technica.com/old/content/2008/04/study-bittorrent-sees-big-growth-limewire-still-1-p2p-app.ars> (reporting that bit torrent platforms account for the vast majority of P2P file-sharing).

individual infringers.⁹⁹ The campaign's purpose was to deter the public from engaging in infringing conduct through the threat of costly lawsuits.¹⁰⁰ While some of the individual users in these cases faced massive statutory damages for their illegal file-sharing activities,¹⁰¹ copyright infringement remained widespread.¹⁰² Furthermore, judges have not been inclined to let massive statutory damages awards stand in cases involving individual downloaders.¹⁰³ In some of the most closely followed cases, judges reduced damages on remittitur or struck down damage awards as violations of the Due Process Clause because they were seen as grossly disproportionate to any demonstrated actual harm.¹⁰⁴

Critics debate whether the lawsuits against individuals have succeeded in discouraging infringement.¹⁰⁵ Some critics contend that these lawsuits succeeded only in triggering a consumer backlash against the record industry.¹⁰⁶ Dramatic increases in the penetration of broadband access both

99. See David Kravets, *File Sharing Lawsuits at a Crossroads, After 5 Years of RIAA Litigation*, WIRED (Sept. 4, 2008, 2:55 PM), <http://www.wired.com/threatlevel/2008/09/proving-file-sh/>.

100. See *id.* (quoting an RIAA spokesperson as stating that the goal of the litigation campaign was “simply to get peer-to-peer users to stop offering music that does not belong to them”).

101. See, e.g., *Sony BMG Music Ent. v. Tenenbaum*, 672 F. Supp. 2d 217 (D. Mass. 2009) (initially awarding \$675,000 in damages); *Capitol Records, Inc. v. Thomas-Rasset*, 799 F. Supp. 2d 999 (D. Minn. 2009) (awarding \$1.5 million in damages).

102. Swartout, *supra* note 85, at 504.

103. *Id.*

104. See *Capitol Records, Inc. v. Thomas-Rasset*, 680 F. Supp. 2d 1045 (D. Minn. 2010); *Sony BMG Music Entm't v. Tenenbaum*, 721 F. Supp. 2d 85, 89 (D. Mass. 2010). *But see* *Sony BMG Music Entm't v. Tenenbaum*, 660 F.3d 487 (1st Cir. 2011) (rejecting the district court's Due Process argument and holding that the judge should have first consider remittitur and non-constitutional grounds for lowering the damages award).

105. See Sarah McBride & Ethan Smith, *Music Industry to Abandon Mass Suits*, WALL ST. J., Dec. 19, 2008, at B1, available at <http://online.wsj.com/article/SB122966038836021137.html> (stating that one report commissioned by the RIAA indicated that while the percentage of Internet users illegally downloading music had stayed constant for a number of years, the volume of shared music had increased); *cf.* INT'L FED'N PHONOGRAPHIC INDUS., *supra* note 38, at 22 (finding that “globally around 95% of music tracks are downloaded without payment to the artist”); *IFPI's Mission*, INT'L FED'N PHONOGRAPHIC INDUS., http://www.ifpi.org/content/section_about/index.html (last visited Oct. 31, 2011) (stating that the IFPI “represents the recording industry worldwide with some 1400 members in 66 countries and affiliated industry associations in 45 countries”).

106. See Jacob Ganz, *The Decade in Music: The Way We Listen Now*, NATIONAL PUBLIC RADIO (Dec. 2, 2009), <http://www.npr.org/templates/story/story.php?storyId=121023882>; Joseph Palenchar, *Music Habits Continue to Shift*, TWICE (Mar. 17, 2009), http://www.twice.com/article/258446-Music_Consumption_Habits_Continue_To_Shift_NPD.php (stating that “[a]lthough the number of paid downloads is up, music purchasing overall—including CD sales—is down”).

domestically and abroad complicate any attempt to measure the RIAA's litigation campaign's effect on stemming piracy.¹⁰⁷ However, surveys indicate that the campaign successfully raised consumer awareness of the potential for lawsuits for file-sharing activities.¹⁰⁸

By late 2008, the RIAA had abandoned its campaign after having filed complaints against almost 35,000 people—many of whom settled rather than face the risk of massive statutory damages.¹⁰⁹ The reasons behind the RIAA's decision are not entirely clear.¹¹⁰ The RIAA indicated that the move away from litigation was a strategic shift towards cooperative relationships with ISPs.¹¹¹ However, many claim that the litigation campaign had backfired, causing resentment among consumers while doing little to stifle rampant infringement.¹¹²

The last few years have also witnessed the emergence of a new form of business based upon copyright litigation.¹¹³ Some companies have employed a business model mirroring that of the non-practicing entities in patent law—so-called “patent trolls.” These businesses acquire a portfolio of IP rights either directly or through representation agreements with rightsholders, identify potential infringers (often through subpoenas to ISPs), send out demand letters, and negotiate settlements by leveraging the threat of expensive litigation and high statutory damages.¹¹⁴

107. See Rep. of the Broadband Comm'n for Digital Dev., *Broadband: A Platform for Progress*, in U.N. EDUC., SCIENTIFIC AND CULTURAL ORG. 3 (June 2011), http://www.broadbandcommission.org/Reports/Report_2.pdf (finding that the number of fixed broadband subscribers per 100 people in the developing world increased from 10% to 25% from 2005 to 2010); see also Hughes, *supra* note 90, at 725 (analyzing the success of lawsuits in removing infringing content from the Internet).

108. David A. McGill, *New Year, New Catch-22: Why the RIAA's Proposed Partnership with ISPs Will Not Significantly Decrease the Prevalence of P2P Music File Sharing*, 27 ENT. & SPORTS LAW 7, 9 (2009) (suggesting that, according to an RIAA spokesperson, the proportion of consumers who thought that file-sharing was illegal increased from thirty-seven percent in 2003 to seventy-three percent in 2008).

109. See McBride et al, *supra* note 105.

110. See *id.* (stating that critics believe the RIAA abandon the suits because they were ineffective and expensive while RIAA spokespersons claim that the recording industry instead decided to focus its efforts on collaborations with ISPs).

111. See *id.*

112. See *id.*

113. See Nate Anderson, *US Anti-P2P Law Firms Sue More in 2010 than RIAA Ever Did*, ARS TECHNICA (Oct. 7, 2010), <http://arstechnica.com/tech-policy/news/2010/10/us-anti-p2p-law-firms-sue-more-in-2010-than-riaa-ever-did.ars>.

114. See, e.g., Josh Halliday, *ACS: Law Gets More of Copyright Fines than Rights Holders*, GUARDIAN (Oct. 5, 2010, 7:10 PM), <http://www.guardian.co.uk/technology/2010/oct/05/acs-law-filesharing-copyright-claims>; see also *Sample Settlement Agreement*, DIGITAL RIGHTS CORPORATION, http://digitalrightscorp.com/joomla/index.php?option=com_content&

Some copyright litigation businesses represent creators, including independent film makers who have seen their works shared widely on P2P networks long before official release.¹¹⁵ Other litigation groups have actually brought suit on their own behalf after signing assignment agreements with the original rightsholders. Most notorious of these so-called “copyright trolls” is Righthaven, which reportedly sought out cases of copyright infringement, then bought the rights to the infringed work in order to pursue settlements and statutory damages.¹¹⁶ In a handful of tersely worded decisions, judges found that Righthaven had no standing to sue because it had never truly been assigned the copyrights that it was litigating.¹¹⁷ Righthaven now is on the verge of bankruptcy after a number of its cases have been dismissed and attorneys’ fees were awarded to defendants.¹¹⁸

4. *A More Active Government Role in Copyright Enforcement*

Because of the vast amount of money and labor involved in copyright-related industries, the United States and other nations have sought to establish trade protections for their intellectual property assets.¹¹⁹ In 2010, copyright-related industries accounted for nearly a trillion dollars of the U.S. economy.¹²⁰ Over 5 million Americans are employed in copyright-related

view=article&id=71&Itemid=278 (explaining that Digital Rights Corporation, one of the copyright litigation companies, operates by sending out blanket notice-of-infringement letters to users accused of possessing unauthorized copyrighted works with offers to release the users from liability in exchange for a small predetermined settlement fee agreement of \$10 per infringing work).

115. See Eriq Gardner, “Hurt Locker” Suits Target Pirates, REUTERS (May 11, 2010), <http://www.reuters.com/article/2010/05/12/us-hurtlocker-idUSTRE64B0AU20100512>.

116. See Steve Green, *Legal Attack Dog Sicked On Websites Accused of Violating R-J Copyrights*, LAS VEGAS SUN (Aug. 4, 2010, 2:00 AM), <http://www.lasvegassun.com/news/2010/aug/04/unlikely-targets-emerging-war-media-content/>.

117. See, e.g., *Righthaven LLC v. Newsblaze LLC*, 2:11-CV-720-RCJ-GWF, 2011 WL 5373785 (D. Nev. Nov. 4, 2011) (stating that “[c]ourts in this district have found that the [Righthaven’s assignment agreement] does not confer Righthaven standing to sue for copyright infringement because the [agreement] deprives Righthaven of any of the rights normally associated with ownership of an exclusive right and only leaves Righthaven the bare right to sue”).

118. See *Righthaven Says It May Have To File For Bankruptcy*, VEGAS INC. (Sept. 9, 2011, 9:53 AM), <http://www.vegasin.com/news/2011/sep/09/righthaven-says-it-might-have-file-bankruptcy/>.

119. See *Intellectual Property*, OFFICE OF THE U.S. TRADE REPRESENTATIVE, <http://www.ustr.gov/trade-topics/intellectual-property> (last visited Feb. 25, 2012) (stating that the U.S. Trade Representative “uses a wide range of bilateral and multilateral trade tools to promote strong intellectual property laws and effective enforcement worldwide, reflecting the importance of intellectual property and innovation to the future growth of the U.S. economy”).

120. See SIWEK, *supra* note 17, at 4.

industries.¹²¹ Furthermore, domestic and international lobbying by the major content industries has pressured governments to assume a more active role in copyright enforcement. The U.S. Advisory Committee for Trade Negotiations (“ACTN”), a committee in the Office of the U.S. Trade Representative, and the International Intellectual Property Association (“IIPA”), an industry association, spearheaded efforts to integrate intellectual property enforcement standards into international trade agreements.¹²² The ACTN has worked to include the major players in the American intellectual property private sector in shaping U.S. trade policy.¹²³ The TRIPS agreement, which required member states to create criminal penalties for counterfeiting and piracy, represented one of the first major steps in an evolving trend among developed nations to coordinate their efforts to rigorously safeguard the intellectual property assets of domestic industries in global markets.¹²⁴

Reflecting the United States’ growing interest in protecting its intellectual property assets, the 2008 Pro-IP Act created a federal intellectual property enforcement coordinator position in order to align U.S. copyright enforcement efforts.¹²⁵ As part of these coordinated efforts, the U.S. Immigration and Customs Enforcement and the Department of Homeland Security have taken down more than 120 domain names of websites that were trafficking in unauthorized copyright content and counterfeit goods.¹²⁶ This campaign, dubbed “Operation in Our Sites,” has drawn sharp criticism from some who argue that the takedowns sidestep due process rights by taking away a suspect’s assets before that person can defend himself in a

121. *Id.*

122. See Peter Drahos, *Global Property Rights in Information: The Story of TRIPS at the GATT*, 13 PROMETHEUS 6, 10 (1995), available at http://www.anu.edu.au/fellows/pdrahos/articles/pdfs/1995globalproprightsinfo_drahos.pdf.

123. *See id.*

124. See Agreement on Trade-Related Aspects of Intellectual Property Rights, Art. 61, Apr. 15, 1994, 1869 U.N.T.S. 299.

125. See 15 U.S.C. §8111(a) (2006) (stating “[t]he President shall appoint . . . an Intellectual Property Enforcement Coordinator . . . to serve within the Executive Office of the President”).

126. See *ICE Declares ‘Mission Accomplished’ On Domain Seizures*, TECHDIRT (June 10, 2011), <http://www.techdirt.com/articles/20110608/20310614626/ice-wants-european-countries-to-join-domain-seizure-party.shtml>.

judicial proceeding.¹²⁷ Supporters of the campaign argue that foreign-based websites present a growing threat to American intellectual property assets.¹²⁸

A number of bills have been recently proposed in Congress that would create new mechanisms for the federal government to shutdown sites that appear to be distributing unauthorized copies of copyrighted works. In 2010, Senator Leahy introduced the Combating Online Infringement and Counterfeits Act (“COICA”) that would have given increased authority to federal law enforcement agencies to seize the domain names of sites accused of being “dedicated to infringing activity,”¹²⁹ but the bill never made it to a floor vote after intense pressure from internet companies, online pundits, and public campaigns.¹³⁰ In early 2012, two similar bills, the Stop Online Piracy Act (“SOPA”), in the House, and the Protect IP Act (“PIPA”), in the Senate, attracted even greater public attention to the issue of intellectual property enforcement on the Internet.¹³¹ On January 18, 2012, a large number of internet companies, including Wikipedia and Google, voiced their opposition to the bills in unison, warning visitors to their sites that the two pieces of legislation threatened freedom of expression on the Internet.¹³² Although many in the content-owning industries had hoped that the bills would create new tools for copyright enforcement, both pieces of legislation were quickly abandoned after millions of individuals signed online petitions calling for their halt.¹³³

127. See Andrew McDiarmid, *Mozilla Questions Takedown Demand*, CENTER FOR DEMOCRACY & TECHNOLOGY (May 6, 2011) <http://www.cdt.org/blogs/andrew-mcdiarmid/mozilla-questions-takedown-demand>; James Temple, *Don't Be Overzealous in Copyright*, SF GATE (June 15, 2011), http://articles.sfgate.com/2011-06-15/business/29659679_1_internet-copyright-legal-challenge-sports-sites.

128. See *Piracy of Intellectual Property: Hearing Before the Subcomm. on Intellectual Property of the S. Comm. on the Judiciary*, 109th Cong. 1 (2005) (statement of Marybeth Peters, U.S. Register of Copyrights) (stating that “piracy, and especially global piracy, is probably the most enduring problem [she has] encountered”).

129. See Combating Online Infringement and Counterfeits Act of 2010, S. 3804, 111th Cong. (2010), available at <http://www.govtrack.us/congress/bill.xpd?bill=s111-3804>.

130. See Nate Anderson, *Revised Net Censorship Bill Requires Search Engines To Block Sites, Too*, ARS TECHNICA (May 11, 2011), <http://www.wired.com/epicenter/2011/05/revised-net-censorship-bill/2/>.

131. See Stephanie Condon, *PIPA, SOPA Put on Hold in Wake of Protests*, CBS NEWS (Jan. 20, 2012), http://www.cbsnews.com/8301-503544_162-57362675-503544/pipa-sopa-put-on-hold-in-wake-of-protests/.

132. See *id.*

133. See *id.*

5. *Where Copyright Enforcement Efforts Stand Today*

Content owners continue to rely on a hodgepodge of enforcement mechanisms to protect their copyrighted works. Although DRM technologies have proven vulnerable to hacking and are widely disliked by consumers, content owners continue to develop new technological means to prevent unauthorized copying.¹³⁴ The DMCA's notice-and-takedown framework is still widely used by content owners to remove allegedly infringing works from their networks.¹³⁵ However, as lawsuits such as *YouTube v. Viacom* demonstrate,¹³⁶ the conditions for safe harbor protections are still widely disputed and millions of dollars worth of copyrighted materials are contested in incredibly expensive litigation.¹³⁷ Likewise, content owners continue to pursue litigation against the operators of P2P networks, but few rightsholders hold on to any hope that lawsuits alone will curb online piracy.¹³⁸ Given the shortcomings of current enforcement mechanisms, content owners continue to look for new tools to fight online piracy and to attract users to revenue-generating distribution models.¹³⁹

II. EVENTS LEADING TO THE 2011 MEMORANDUM OF UNDERSTANDING

Most content owners believe that litigation measures and legislation have done little so far to stop the hemorrhaging of their profits.¹⁴⁰ After witnessing the disruption of the music business due to the digitization of media and the growth of the Internet, other creative content industries, including the television and movie industries, began to look for alternative models to control and capitalize on their works. Many content owners are now considering collaborative relationships with ISPs to develop private enforcement mechanisms—often in the form of GRS—that rely on infringement detecting technologies, standardized terms of service (“TOS”), end user license agreements (“EULA”), and acceptable use policies.¹⁴¹ For content owners, GRS offer the obvious benefit of reducing the costs and

134. *See supra* Part I.B.1.

135. *See supra* Part I.B.2 & I.B.3.

136. *Viacom Int'l Inc. v. YouTube, Inc.*, 718 F. Supp. 2d 514, 525 (S.D.N.Y. 2010).

137. *See* Lisa Lerer, *Viacom's Expensive Suit*, FORBES.COM (March 28, 2007), http://www.forbes.com/2007/03/27/youtube-viacom-google-tech-cx_ll_0328google.html (suggesting that the lawsuit could generate \$350 million or more in legal fees).

138. *See supra* Part I.B.3.

139. *See infra* Part II.

140. *See* INT'L FED'N PHONOGRAPHIC INDUS., *supra* note 38, at 22.

141. *See* Bridy, *supra* note 2, at 2.

risks of litigating against accused infringers while shifting some of the cost burden onto ISPs. But the reasons why ISPs have been willing to assume a greater burden in copyright enforcement are more complicated. This Part will explore some of the factors that gave rise to the development and adoption of GRS domestically and abroad.

A. THE ORIGIN OF GRADUATED RESPONSE SYSTEMS

A number of foreign governments have adopted a “three strikes and you’re out” graduated response model, in which a user’s internet connection is temporarily downgraded, suspended, or terminated by the user’s ISP after three notices of copyright infringement.¹⁴² In a typical GRS, a content owner identifies an infringing use of its copyrighted work and notifies the appropriate ISP about that infringing activity.¹⁴³ The ISP then responds to the infringing activities of a given user with a series of prescribed consequences.¹⁴⁴ Subsequent accusations of infringement result in the administering of a stronger punishment—or a “graduated response.” Although some of these publicly ordered regimes rely on content owners to manually issue takedown notices similar to the requirements of the DMCA, other more automated—and controversial—systems depend upon filtering technologies to monitor infringement and police individual users’ “strikes.”¹⁴⁵ Systems relying on filtering technologies might be overly broad compared to systems relying on manual notices because filters are unlikely to be sufficiently sophisticated to recognize all fair uses.¹⁴⁶ However, technological filtering systems for monitoring online content can be more widely and evenly applied than manual systems, which are inherently restricted by human limitations given the vast scope and scale of the Internet.

Several countries, including France, the United Kingdom, and South Korea, have already adopted GRS through legislation into their copyright enforcement regimes.¹⁴⁷ The majority of these countries have designed their systems to be regulated by administrative bodies, rather than through traditional judicial channels.¹⁴⁸ However, there have been challenges to the

142. See Yu, *supra* note 42, at 1376.

143. See Bridy, *supra* note 2, at 84.

144. See *id.*

145. See *id.*

146. See Sawyer, *supra* note 80, at 383.

147. See DIGITAL ECONOMY ACT, 2010, c.24 §§ 3–18 (U.K.) (creating legal duties to prevent online copyright infringement); see also Jeremy de Beer & Christopher D. Clemmer, *Global Trends in Online Copyright Enforcement: A Non-Neutral Role for Network Intermediaries?*, 49 JURIMETRICS J. 375, 393–96 (2009) (describing France’s graduated response regime, HADOPI, as well as South Korea’s preventative obligation scheme).

148. See DIGITAL ECONOMY ACT, c.24 §§ 3–18; de Beer, *supra* note 147, at 393–96.

legality of certain “responses” such as denials of service in the absence of judicial proceedings and due process protections.¹⁴⁹ France’s laws are among the toughest of the GRS and create fines of €1,500 for individuals identified as an infringer for a third time.¹⁵⁰ However, France’s GRS framework ostensibly strives to create a regime for handling claims of online copyright infringement that is efficient and fair.¹⁵¹ After vocal criticism of the initial procedural framework, accused users under HADOPI have gained a significant degree of procedural protections.¹⁵²

The idea of an administrative system for enforcing copyrights is not new. In 2005, Mark Lemley and Anthony Reese suggested creating a copyright dispute resolution system modeled on the Internet Corporation for Assigned Names and Numbers (“ICANN”) Uniform Dispute Resolution Policy, which had been successfully used to resolve domain name disputes involving trademarks.¹⁵³ Lemley and Reese hoped that a special administrative system for resolving copyright enforcement issues would reduce the burdens and inefficiencies associated with litigation.¹⁵⁴ Although such a system has yet to be adopted domestically, the 2010 Joint Strategic Plan on Intellectual Property Enforcement described a similar system—albeit without any real enforcement means beyond educational mechanisms.¹⁵⁵

In the United States, GRS has thus far been implemented solely by contractual agreements between private entities rather than through public administration.¹⁵⁶ Compared to publicly administered systems, privately ordered GRS can quickly and flexibly be adapted to respond to changes in the Internet landscape. Publicly ordered enforcement regimes tend to rely on the slow and expensive processes of formal adjudication or litigation. Furthermore, privately administered systems are funded by the parties to the agreement, whereas publicly administered systems are paid for by public taxes and fees. However, public systems established by the state are more transparent and democratically accountable than privately ordered regimes,

149. See de Beer, *supra* note 147, at 393–96.

150. See *FAQ*, L’HADOPI, <http://www.hadopi.fr/faq.html> (last visited Dec. 9, 2010).

151. See Bridy, *supra* note 73, at 735–36.

152. See *id.*

153. See Mark A. Lemley & R. Anthony Reese, *A Quick and Inexpensive System for Resolving Peer-to-Peer Copyright Disputes*, 23 CARDOZO ARTS & ENT. L.J. 1 (2005).

154. Bridy, *supra* note 73, at 735–36.

155. See Exec. Office of the President, *2010 Joint Strategic Plan on Intellectual Property Enforcement* 33, 44–45 (2010), available at http://www.whitehouse.gov/sites/default/files/omb/assets/intellectualproperty/intellectualproperty_strategic_plan.pdf.

156. See *id.*; see also Hainen, *supra* note 1.

thus making public systems more readily accepted by public interest advocates.

B. CHANGING BUSINESS MODELS AND ALIGNING ECONOMIC INTERESTS

Part of the reason for ISPs' willingness to partner with content owners may reflect changing business models wherein ISPs' and content owners' commercial interests overlap more now than when the DMCA was first passed. In the late 1990s, the drafters of the DMCA had attempted to satisfy the interests of ISPs, who felt that contributory liability and strict regulation threatened to curtail the expansion of broadband and the burgeoning potential of the Internet.¹⁵⁷ Most content owners, meanwhile, believed that online file-sharing amounted to nothing more than brazen piracy that threatened their ability to generate revenue from their copyrighted works.¹⁵⁸ Moreover, at that time, online commerce was still largely in its infancy, and few content owners fully recognized the Internet's potential as a legitimate market for copyrighted goods.¹⁵⁹

The division between content owners and ISPs is not as clearly defined as it was when the DMCA was originally passed. As broadband and Wi-Fi access has increased, people increasingly consume copyrighted content over the Internet, and ISPs now play a greater role than ever before in the distribution of creative content.¹⁶⁰ Furthermore, network ISPs have an additional financial incentive to curb online piracy because the unauthorized distribution of creative content creates a significant burden on their data pipelines.¹⁶¹ Many ISPs, especially application ISPs, are investing in licensing content to attract users.¹⁶² Likewise, the acquisition of content owning companies by ISPs, such as Comcast's recent purchase of NBC Universal, has given ISPs a vested interest in protecting their content holdings.¹⁶³

157. See Yu, *supra* note 42, at 1385–86.

158. See S. REP. NO. 105-190, at 5 (1998).

159. See Bomsel, *supra* note 30, at 24.

160. See Preserving the Open Internet, Broadband Industry Practices, 76 Fed. Reg. 59,192, 59,194 (Sept. 23, 2011).

161. See *Technical Report: An Estimate of Infringing Use of the Internet*, ENVISIONAL (Jan. 2011), http://documents.envisional.com/docs/Envisional-Internet_Usage-Jan2011.pdf (reporting that the transmission of infringing material accounts for about a quarter of all Internet traffic).

162. See Yu, *supra* note 42, at 1386 (describing Comcast's ten-year licensing deal with CBS to provide online access to CBS's content).

163. See Sam Gustin, *New Anti-Piracy Tactic Turns ISPs Into Copyright*, PAIDCONTENT.ORG (July 11, 2011, 3:31 PM) <http://paidcontent.org/article/419-no-more-lawsuits-isps-take-lead-in-policing-piracy-with-six-strikes-pla/>.

Similarly, some ISPs are developing their own content, such as Google's announcement in 2011 that it plans to create original programming on YouTube.¹⁶⁴

By licensing copyrighted works, these companies hope to offer consumers breadth of content and convenience of access without having to account for the risk of litigation costs associated with providing unauthorized access to content. Many companies, such as Hulu, Netflix, and Spotify, are now staking the competitiveness of their business models on licensing and collaboration with content owners.¹⁶⁵ While the record industry was still struggling to adapt after the emergence of P2P networks, Apple demonstrated that a convenient online pay-for-content system was commercially viable when it licensed songs from all five major record companies and offered them for sale via its iTunes store.¹⁶⁶

C. LOBBYING EFFORTS TO CREATE A COLLABORATIVE FRAMEWORK

The widespread rise of GRS has resulted at least in part from content owner industries that have lobbied internationally—often through governmental trade bodies—to create regulatory regimes around the globe.¹⁶⁷ Representative groups like the International Federation for the Phonographic Industry (“IFPI”) and the International Intellectual Property Alliance (“IIPA”) were at the forefront of these efforts to require ISPs to adopt measures to police copyrighted works.¹⁶⁸

The Anti-Counterfeiting Trade Agreement (“ACTA”) is an international treaty for establishing international standards on intellectual property rights enforcement.¹⁶⁹ The United States signed on to the ACTA in October of 2011, although the Administration has stated that the treaty does not require any changes to existing law to implement its provisions.¹⁷⁰ The ACTA

164. See Don Reisinger, *Google Gearing Up Original YouTube Programming*, CNET (Oct. 27, 2011) http://news.cnet.com/8301-13506_3-20126342-17/google-gearing-up-original-youtube-programming/.

165. See Olson, *supra* note 46; Pepitone, *supra* note 46.

166. John Markoff, *Apple Sells 70 Million Songs in First Year of iTunes Service*, N.Y. TIMES, Apr. 29, 2004, at C10.

167. See Bridy, *supra* note 4, at 559.

168. See *id.*

169. See Anti-Counterfeiting Trade Agreement, Oct. 1, 2011, *available at* http://www.mofa.go.jp/policy/economy/i_property/pdfs/acta1105_en.pdf.

170. See Press Release, Office of the U.S. Trade Representative, ACTA: Meeting U.S. Objectives, (Oct. 2011), *available at* <http://publicintelligence.net/anti-counterfeiting-trade-agreement-final-version-may-2011/> (stating that ACTA fulfills the Administration's goals of ensuring “enhanced international cooperation; promotion of sound enforcement practices; and a strengthened legal framework for IPR [Intellectual Property Rights] enforcement in

establishes an international legal framework that promotes, but does not require, the development of collaborative efforts between content owners and ISPs.¹⁷¹ Even though the ACTA does not mandate the development of GRS, the treaty reflects content owners' desire for ISPs to shoulder a greater part of the enforcement burden.¹⁷² However, many public interest organizations voiced concerns that the ACTA prioritizes content owners' interests over individual rights of free speech, privacy, fair use, and due process.¹⁷³

U.S. politicians have also pressured ISPs to work with content owners to develop new copyright enforcement strategies by threatening to make legislative changes to the copyright enforcement regime. In 2008, Andrew Cuomo, then New York's attorney general, convened leaders from the ISP and content owning industries in order to put pressure on the two industries to develop partnerships to address copyright infringement.¹⁷⁴ Cuomo stated that he believed that it was in the public interest to have two of the state's leading industries working together rather than in opposition.¹⁷⁵ According to a spokesperson, Cuomo felt that it was preferable that the two sides develop a privately ordered compromise, rather than create the potential for new lawsuits or require serious government intervention.¹⁷⁶

The White House has similarly put pressure on ISPs and content owners to develop industry-based, privately ordered mechanisms for copyright enforcement. In December 2009, Vice President Joe Biden hosted a roundtable on enforcing copyright infringement with some of the country's top officials, including Attorney General Eric Holder, Obama advisor Valeria Jarrett, Homeland Security Secretary Janet Napolitano, U.S. Intellectual Property Enforcement Coordinator Victoria Espinel, and the heads of the

the areas of criminal enforcement, enforcement at the border, civil and administrative actions, and distribution of copyrighted material on the Internet").

171. See Anti-Counterfeiting Trade Agreement, Oct. 1, 2011, available at http://www.mofa.go.jp/policy/economy/i_property/pdfs/acta1105_en.pdf.

172. See *id.*

173. See *Government Blocks Release of Documents on Secret IP Enforcement Treaty*, ELECTRONIC FRONTIER FOUNDATION (Jan. 29, 2009), <https://www EFF.org/press/archives/2009/01/29>.

174. See Greg Sandoval, *Should You Fear New ISP Copyright Enforcers?*, CNET (July 7, 2011), http://news.cnet.com/8301-31001_3-20077659-261/should-you-fear-new-isp-copyright-enforcers/; see also Bill Dedman & Bob Sullivan, *ISPs are Pressed to Become Child Porn Cops*, MSNBC.COM (Oct. 16, 2008), <http://www.msnbc.msn.com/id/27198621/#.TrMYoFYu6UM> (stating that Cuomo had previously used threats of lawsuits to put pressure on ISPs to voluntarily assist the attorney general's office in its efforts to fight the distribution of child pornography).

175. See *id.*

176. See *id.*

FBI and Secret Service.¹⁷⁷ The meeting also included many of the top executives of content industry leaders, such as Warner Music Group, Sony Pictures, NBC, Universal Music, HarperCollins, Walt Disney, News Corp., and Viacom as well as the heads of the MPAA and RIAA.¹⁷⁸ The White House has officially expressed its approval of collaborative efforts between ISPs and content owners as an important step in reducing infringement of American intellectual property.¹⁷⁹ However, Vice President Biden's meeting notably did not include representatives from ISPs, academia, or public interest groups.¹⁸⁰

The circumstances that led to the development and adoption of GRS represent an alignment of business interests between ISPs and content owners, as well as the belief among content owners that the current mechanisms for deterring widespread online piracy have proven inefficient, unpopular, and otherwise untenable. The widespread growth of GRS also arose directly out of content owning industries' concerted lobbying effort to establish a new mechanism for enforcing copyright protections.

III. A MEMORANDUM OF UNDERSTANDING BETWEEN U.S. CONTENT OWNERS AND INTERNET SERVICE PROVIDERS

In 2011, a consortium of U.S. ISPs and content owners signed a Memorandum of Understanding ("the MOU") that will create a common framework for developing a "copyright alert system"—in other words, a graduated response system—for privately regulating copyright enforcement.¹⁸¹ Many of the United States' largest ISPs and content owners, including major players in the music, television, and movie industries, have signed on to the MOU.¹⁸² The MOU is not the first attempt by U.S.

177. See Nate Anderson, *Biden's "IP Roundtable" Brings Together Big Content*, ARS TECHNICA (Dec. 15, 2009), <http://arstechnica.com/tech-policy/news/2009/12/bidens-ip-roundtable-brings-together-big-content-fbi.ars>.

178. See *id.*

179. See Victoria Espinel, *Working Together to Stop Internet Piracy*, THE WHITE HOUSE BLOG (July 07, 2011), <http://www.whitehouse.gov/blog/2011/07/07/working-together-stop-internet-piracy>.

180. See *id.*

181. See 2011 MOU Agreement, *supra* note 3.

182. See Hainen, *supra* note 1 (listing signatories to the Memorandum of Understanding to include Walt Disney Studios Motion Pictures, Paramount Pictures Corporation, Sony Pictures Entertainment Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLC, Warner Bros. Entertainment Inc., Universal Music Group Recordings, Sony Music Entertainment, Warner Music Group, EMI Music, AT&T, Cablevision Systems Corp., Comcast Corp., Time Warner Cable, Verizon, the IFTA which represents the

companies to establish privately ordered copyright enforcement mechanisms,¹⁸³ but the scope and scale of the agreement represents an unprecedented agreement by private entities to coordinate their efforts to curb online copyright infringement.¹⁸⁴ However, several key companies are noticeably absent from the list of signatories to the MOU, including Apple, and Google—the operator of the hotly contested user-generated content hosting site YouTube.¹⁸⁵

The stated purpose of the MOU is to strengthen protections of creative content by developing industry-wide best practices for notifying and educating users accused of copyright infringement about the legal basis and consequences of copyright law.¹⁸⁶ The MOU also seeks to encourage users to pursue legal means for acquiring content.¹⁸⁷ Under the MOU's graduated response framework, content owners and ISPs will work together to issue "copyright alerts" to subscribers accused of infringing activities.¹⁸⁸ Furthermore, the MOU outlines plans for a system of "mitigation measures" that ISPs will implement to respond to users after multiple accusations of infringement.¹⁸⁹

Additionally, the MOU establishes a Center for Copyright Information to develop public education programs about copyright laws.¹⁹⁰ The Center for Copyright Information will assist in developing, implementing, and administering each ISP's copyright alert program, as well as assessing the system's effectiveness.¹⁹¹ The agreement also creates an Independent Review Program to which subscribers can appeal and dispute accusations of infringement.¹⁹² The Independent Review Program and the Center for Copyright Information will be funded in equal part (50% each) by the participating ISPs and by the participating content owners.¹⁹³ The Center for

Independent Producers & Distributors of Film & Television Programming, and A2IM which represents 283 small and medium-sized music labels).

183. See Nate Anderson, *Verizon to Forward RIAA Warning Letters (But That's All)*, ARS TECHNICA (Nov. 13, 2009) <http://arstechnica.com/tech-policy/news/2009/11/verizon-to-forward-riaa-warning-letters-but-thats-all.ars> (suggesting that Verizon, Comcast, AT&T, and Cox all had agreements in place with various content owning studios or labels).

184. See Hainen, *supra* note 1.

185. See *id.*

186. See 2011 MOU Agreement, *supra* note 3.

187. *Id.*

188. See *id.* § 4(G), at 7.

189. *Id.*

190. *Id.* § 2(A), at 3.

191. *Id.*

192. *Id.* § 4(H), at 14.

193. *Id.* §§ 2(E), 4(H), at 4, 14.

Copyright Information will be governed by an executive committee, which will be made up of three members selected by the content owner members and three members chosen by the ISPs.¹⁹⁴

The MOU places the burden of identify infringing uses and giving notice to ISPs on content owners.¹⁹⁵ Each content owner is to develop a written description of the processes it uses to identify infringing uses on P2P networks.¹⁹⁶ A technical independent expert appointed by the executive committee of the Center for Copyright Information will evaluate the accuracy and effectiveness of the process used by each content owner to identify infringing works.¹⁹⁷ Although the independent expert will work in consultation with privacy experts to develop recommendations to improve the processes employed by each content owner, failure to adopt a recommendation will not constitute a breach of the agreement.¹⁹⁸

Currently, many ISPs email their subscribers when they receive notice from content owners that infringing use is taking place that is associated with that subscribers' account.¹⁹⁹ However, ISPs vary in their policies and procedures, which are currently designed to comply with the safe harbor requirements of the DMCA. A number of ISPs, including YouTube and Facebook, have already adopted policies that facilitate and standardize a process for copyright holders to file § 512(c) takedown notices for infringing activities on their sites.²⁰⁰ In some ways, these measures resemble the procedures outlined in the MOU. For example, if YouTube receives a copyright infringement notice from a content owner, that uploader of that video is required to complete "YouTube Copyright School," which involves watching an educational video on copyright law and YouTube's terms of service.²⁰¹ Google will remove "strikes" from a user's account if he successfully completes "copyright school" and refrains from further

194. *Id.* § 2(B), at 4.

195. *Id.* § 4(A), at 4.

196. *Id.*

197. *Id.* § 4(B), at 4.

198. *Id.*

199. See Nate Anderson, *Verizon to Forward RIAA Warning Letters (But That's All)*, ARS TECHNICA (Nov. 13, 2009), <http://arstechnica.com/tech-policy/news/2009/11/verizon-to-forward-riaa-warning-letters-but-thats-all.ars>.

200. See *Content Management*, YOUTUBE, http://www.youtube.com/t/dmca_policy (last visited Oct. 30, 2011); *DMCA Notice of Copyright Infringement*, FACEBOOK, http://www.facebook.com/legal/copyright.php?copyright_notice=1 (last visited Oct. 30, 2011).

201. See Jennifer Martinez, *Google to Sentence YouTube Users to "Copyright School"*, POLITICO (April 14, 2011), <http://www.politico.com/news/stories/0411/53035.html>.

infringing activities.²⁰² Google's general policy regarding multiple accusations of infringement is to suspend YouTube users after accumulating three copyright strikes.²⁰³

The MOU also presently bears resemblance to Section 512(i) which requires ISPs seeking safe harbor to "adopt and reasonably implement . . . a policy that provides for the termination in appropriate circumstances" of subscribers who are repeated infringers of copyrighted materials.²⁰⁴ However, under the MOU, ISPs are not just seeking safe harbor from liability. They are actively partnering with content owners to identify and address infringement outside of a litigation context.

A. TERMS OF THE MEMORANDUM OF UNDERSTANDING

1. *Copyright Alerts and Mitigation Measures*

Rather than adopting the "three strikes, you're out" model embraced by a number of foreign governments, ISPs who signed the MOU agreed to implement a graduated response system into their user policies that is "substantially similar" to the framework laid out in the terms of the MOU.²⁰⁵ The MOU's graduated response system framework includes four phases or steps: the Initial Educational Step, the Acknowledgement Step, the Mitigation Measures Step, and the Post Mitigation Measures Step. ISPs will issue up to six alerts through these steps to warn subscribers that they are infringing copyright material.²⁰⁶

As part of the Initial Educational Step, each participating ISP, upon receiving a first notice of infringing activity associated with an account, will send a subscriber an alert intended to educate the subscriber about the ISP's copyright policy.²⁰⁷ This alert will include information specifically identifying the subscriber's allegedly infringing activity as well as information about U.S. copyright law and the ISP's terms of service and/or acceptable use policies.²⁰⁸

After a subscriber has received one or two educational copyright alerts,²⁰⁹ additional notices of infringing activities will trigger the Acknowledgment Step. At this phase, an ISP will send two further copyright alerts that will

202. *Id.*

203. *Id.*

204. 17 U.S.C. § 512(i) (2006).

205. *See* 2011 MOU Agreement, *supra* note 3.

206. *Id.* § 4(G), at 8.

207. *Id.*

208. *Id.*

209. *See id.* (stating that under the MOU, ISPs may elect to send either one or two copyright alerts at the "educational step").

require a subscriber to acknowledge receipt of the notices by clicking through a landing page or pop-up window.²¹⁰

When a subscriber is accused of infringing activity, after already having received two acknowledgement alerts, the subscriber will then move to the Mitigation Measures Step. During this phase, the ISP will then send one “mitigation measure copyright alert” and will apply the prescribed mitigation measure.²¹¹ At the mitigation stage, ISPs have a range of mitigation measures available for users accused of multiple infringing activities including slowing internet connection speeds, downgrading the service tier to which a user is subscribed, temporarily redirecting a user to a different home page until the subscriber contacts the ISP for further action, and temporarily redirecting to a copyright education site or a landing page site informing the user that they must contact the ISP.²¹² Alternatively, ISPs have the discretion to skip straight to the step of disconnecting an accused user’s internet connection or restricting the user’s access to a given site.²¹³

In the event that a participating ISP receives notice of further infringing activities associated with a subscriber’s account after mitigation measures have been applied, the subscriber will move to the final phase—the Post Mitigation Measures Step. At this phase, the ISP will send one more mitigation measure alert and will apply a different mitigation measure, which may include termination of service and notice to the subscriber that he may be subject to a possible lawsuit for copyright infringement.²¹⁴ However, it should be noted that almost every ISP already includes a termination of service provision in its policies because the safe harbor provisions of the DMCA limit an ISP’s liability only when that ISP provides for the termination of service of repeat infringers.²¹⁵

2. *Dispute Resolution Mechanisms and the Independent Review Board*

The MOU also outlines the procedures by which a subscriber can dispute an accusation of infringement. Users will not be able to challenge any alert until the mitigation stage, after the fifth or sixth copyright alert.²¹⁶ However,

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. *Id.* § 4(G), at 8.

215. *See* 17 U.S.C. § 512(i) (2006) (stating that to be eligible for safe harbor protections, an ISP must adopt and inform users of a “policy that provides for the termination in appropriate circumstances of subscribers and account holders of the service provider’s system or network who are repeat infringers”).

216. *See* 2011 MOU Agreement, *supra* note 3 § 4(H), at 14.

at that point, a user may contest any previously issued copyright alert unless that user failed to properly raise an objection to that alert during a prior appeal.²¹⁷ In order to contest the finding of infringement, a user must pay \$35 and appeal to the Independent Review Program.²¹⁸ The executive committee of the Center for Copyright Information will appoint an Administering Organization to process all disputes.²¹⁹ Each dispute will be decided by a “neutral” individual reviewer, who must be a lawyer, but who need not be qualified to be an arbitrator.²²⁰ In reaching their decision, reviewers are to apply the relevant legal principles as determined by U.S. federal courts.

Because the MOU creates a privately ordered enforcement regime, an accused user cannot avail himself of the full range of defenses available under U.S. copyright law. The MOU instead lays out six possible defenses that will be considered:

- (i) Misidentification of Account—where a subscriber’s account has been misidentified as the account responsible for the infringing act.
- (ii) Unauthorized Use of Account—where another party is the actual infringer, and the infringing use was made without the subscriber’s knowledge and the subscriber could not have reasonably prevented the infringing use.
- (iii) Authorization—where the allegedly infringing use was in fact authorized by the copyright owner.
- (iv) Fair Use—where the subscriber’s use constitutes fair use.
- (vi) Misidentification of File—where the file alleged to contain an unauthorized copy of a work has been inappropriately identified as consisting primarily of the copyrighted work at issue.
- (vii) Work Published Before 1923—where the allegedly infringed work was published prior to 1923.²²¹

The MOU defines specific rules for each defense category.²²² Because the defenses here are created by contract, rather than by copyright law, the

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. See 2011 MOU Agreement, *supra* note 3, Attachment C, § 1; see also 2 MELLVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 9:11 (Matthew Bender, Rev. Ed. 2010) (stating that under U.S. copyright law, works published prior to 1923 were not granted an extension of protection by the 1976 Copyright Act, and as such, have now passed into the public domain).

222. *Id.*

defenses do not necessarily mirror the more familiar defenses available to a defendant in a court of law. For instance, to successfully defend under “misidentification of account” a subscriber must show that the ISP misidentified the IP address at which the allegedly infringing act took place, and/or that the ISP inaccurately linked the identified IP address to the subscriber’s account.²²³ According to the MOU, the reviewers will assume a rebuttable presumption that the automated systems for identifying and storing infringing IP addresses work accurately.²²⁴

Furthermore, the “unauthorized use of account” defense, likely to arise in cases involving unsecured Wi-Fi networks and hacked computers, can only be raised once. Moreover, the reviewer has the discretion to conclude that the “unauthorized use” occurred as a result of a subscriber’s failure to secure its internet connection.²²⁵ In making that determination, the reviewer will “consider the evidence in light of the educational messages previously provided by the Participating ISP.”²²⁶ After succeeding on this defense, a user will be required to show by clear and convincing evidence that any subsequent unauthorized use “occurred despite reasonable steps to secure the Internet account and that the breach of such security could not reasonably have been avoided.”²²⁷ Subscribers who successfully defend against the accused infringement will be refunded the \$35 fee and the alert leading to the mitigation phase will be removed from the subscriber’s account.²²⁸ However, the previous alerts given to the user will remain on the user’s account, such that any subsequent alert will trigger the mitigation process.²²⁹ If a user receives no further alerts within a twelve month period, his account will be cleared of all previous alerts.²³⁰

3. *Mechanisms for Identifying Infringing Works*

The MOU provides little information about how content owners will go about identifying infringing works on the ISPs’ networks.²³¹ The MOU, like the DMCA, places the burden on content owners to identify and notify ISPs about allegedly infringing works on their networks.²³² Content owners might

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *Cf. id.*

232. *Id.* § 4(a), at 4.

employ their own automated technologies to search sites for infringing works. Furthermore, some ISPs, such as Comcast, are also content owners and thus they may implement automated filtering in their own pipelines to identify infringing works.²³³

Many filtering technologies rely on digital tags and watermarks inserted into media files by content owners to identify content that is being distributed without authorization.²³⁴ A number of content owners will likely rely on newer video and audio monitoring software that utilizes “perceptual characteristics” of the sounds and images encoded in a file of a copyrighted work to create a unique digital “fingerprint.”²³⁵ The efficacy of fingerprinting technology remains disputed, especially when files have been converted, compressed, or separated into multiple files.²³⁶

It is unclear whether any parties to the agreement will utilize controversial deep-packet inspection (“DPI”) technology to identify infringing works.²³⁷ DPI looks beyond the routing information contained within a data packet’s header, and into the packet’s payload that contains the underlying transmitted information.²³⁸ DPI is appealing to ISPs for reasons beyond those related to copyright enforcement, because DPI can be used to detect viruses, malware, and spam, to manage network flow congestion, and to mine user’s data for advertising and marketing purposes.²³⁹ However, DPI is a controversial technology, especially among privacy and free speech advocacy groups, because it allows an organization to inspect—and thus control—all of the data flowing over its pipelines.²⁴⁰ The use of DPI as a copyright enforcement device may be appealing to companies that operate as both an ISP and a content owner, such as Comcast, so long as the costs of filtering is lower than the economic loss created by unauthorized use of that companies’ copyrighted works.

233. *Cf.* Bridy, *supra* note 2, at 112.

234. *See* Sawyer, *supra* note 80, at 383.

235. *See id.* at 384.

236. *See id.*

237. *Cf.* Bridy, *supra* note 2, at 105.

238. *See id.* at 112.

239. *Id.*

240. *See* Ralf Brendrath, *The End of the Net as We Know It? Deep Packet Inspection and Internet Governance*, SOCIAL SCIENCES RESEARCH NETWORK 24 (Aug. 4, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1653259#667993.

IV. BENEFITS AND DRAWBACKS OF PRIVATELY ORDERED ENFORCEMENT

Changes in the landscape of the Internet over the last decade have altered many of the premises on which the DMCA was based. Furthermore, legislation aimed at strengthening public enforcement of copyright has thus far been met with substantial opposition.²⁴¹ Thus, the time may be ripe for a shift towards private ordering. This Part identifies the benefits and drawbacks of private ordering. Privately ordered copyright enforcement regimes, such as that created by the 2011 MOU, present a number of advantages over publicly administered regimes, but critics are concerned that consumers' interests are neglected when content owners and ISPs collaboratively administer GRS.

A. HAS THE TIME COME FOR PRIVATE ORDERING?

1. *A Changed Landscape*

The way people use and conceive of the Internet has changed drastically since the time when the DMCA was first passed. At the turn of the century, ISPs were primarily concerned with increasing broadband penetration.²⁴² As broadband was being rolled out, the future shape of the Internet was still uncertain. Public policy favored expanding the physical infrastructure of the Internet and fostering the legitimacy and potential of online markets and communities.²⁴³ During this period, it was perhaps wise to relax copyright enforcement in exchange for encouraging and solidifying the Internet's potential to promote commerce, productivity, and information exchange.²⁴⁴ Internet commerce, in general, was still in its infancy.²⁴⁵ In the days of Napster—prior to the advent of iTunes and other online retailers—users had no real alternative to legally acquire music and other copyrighted content online.²⁴⁶ At that time, slower internet access speeds and smaller market penetration of broadband connectivity limited the scope of file-sharing.²⁴⁷ Prior to the development of P2P networks, most content was delivered from a centralized host located at a URL.

Scholars, such as Tim Wu, have stated that the anarchic state of the Internet over the last two decades created a chaotic creative environment

241. See discussion in Section I.B.4., *supra*.

242. See Bomsel & Ranaivoson, *supra* note 30, at 13–29.

243. See *id.* at 20.

244. See *id.* at 13–29.

245. See *id.*

246. See Markoff, *supra* note 166.

247. See Bomsel & Ranaivoson, *supra* note 30, at 20.

that was conducive to a remarkable period of innovation and technical expansion.²⁴⁸ The lack of copyright enforcement online probably helped many ISPs to grow and expand their physical and technical infrastructure without incurring the cost of paying for content access.²⁴⁹ Thus, the digitization of content and the concurrent rise in infringing activities encouraged innovation and the growth of ISPs, while passing the burden on to content owners via copyright enforcement costs.²⁵⁰

However, the Internet is no longer in its infancy. Broadband access is widespread. Wi-Fi is ubiquitous, and smart phones and mobile networks allow users to access the Internet from virtually anywhere. Online commerce, banking, and communication are well-established and, in some fields, have largely displaced their brick-and-mortar counterparts.²⁵¹ Likewise, consumers can choose from a dizzying array of models to legally access music, e-books, movies, and television on line. A huge variety of websites, including wildly popular social media sites, allow for the free exchange of information and ideas. In economic terms, the positive externalities of the expansion of broadband access are diminishing, while the negative externalities of widespread infringement are increasingly threatening the creative industries without producing a corresponding benefit to the public.²⁵² ISPs are no longer vulnerable companies that must be fostered and subsidized to ensure their continued success.²⁵³

Other recent technological advances have created new challenges in copyright enforcement. Smart phones and tablet computers give consumers constant access to music, video, and other media, including unauthorized copies. Furthermore, Web 2.0 created a culture that embraces sharing and remixing of copyrighted works.²⁵⁴ YouTube, Facebook, and other interactive sites allow users to easily share copyrighted materials including user-generated content. Similarly, with the growth of “cloud computing,” users now can store data—acquired legally or illegally—on remote servers. As the

248. See WU, *supra* note 45 (suggesting that centralized control of information networks stifles innovation as companies become invested in maintaining the status quo of technology).

249. See Bomsel & Ranaivoson, *supra* note 30, at 24.

250. See *id.*

251. See, e.g., Julie Bosman, *The Bookstore's Last Stand*, N.Y. TIMES (Jan. 28, 2012), <http://www.nytimes.com/2012/01/29/business/barnes-noble-taking-on-amazon-in-the-fight-of-its-life.html?pagewanted=all>; Katia Hetter, *Travel Agents Know Something You Don't*, CNN (Jan. 30, 2012, 11:47 AM), <http://www.cnn.com/2012/01/30/travel/travel-agent-evolution/index.html> (last visited Jan. 31, 2012).

252. See Bomsel & Ranaivoson, *supra* note 30, at 13–29.

253. See *id.*

254. See Edward Lee, *supra* note 56, at 1485.

cost of data storage becomes cheaper and the speed of transmission increases, users will likely turn increasingly to the cloud. The potential for liability for the operators of these remote servers remains an unsettled question, especially for those cloud-service providers, such as cyberlocker services, that create cloud-based copies without assuring that the original file was an authorized copy.²⁵⁵ Furthermore, as more people in developing countries gain broadband Internet access, piracy threatens copyright owners' ability to capitalize on their works in international markets.²⁵⁶

The technologies available to ISPs for managing their networks have also advanced greatly since the passage of the DMCA. Filtering technologies have become much more sophisticated and now offer ISPs the ability to monitor and control the data sent over their networks.²⁵⁷ Broadband providers are eager to employ "smart technologies" to improve the capacity and speed of their networks.²⁵⁸ More controversially, ISPs have lobbied against efforts to codify net neutrality into U.S. law because they prefer to be able to prioritize data transfers based on differential pricing and preferred content.²⁵⁹

Despite the huge volume of file-sharing that now occurs on the Internet, ISPs are arguably in a much better position than ever before to police their networks for infringing use given the vast technological improvements of the last fifteen years.²⁶⁰ Scholars such as Annemarie Bridy have pointed out that the improvement in ISPs' adoption of smart network technologies to monitor the data flowing over their networks has weakened the DMCA-era

255. See John Baumgarten, *First Looks at Copyright and the Cloud—Recent "Locker" Decisions Probe Infringement Liability and Safe Harbor Issues*, LEXIS NEXIS COMMUNITIES: LAW & TRADEMARK COMMUNITY (Sept. 21, 2011, 1:06 PM), <http://www.lexisnexis.com/community/copyright-trademarklaw/blogs/copyrightandtrademarklawblog/archive/2011/09/21/first-looks-at-copyright-and-the-cloud-recent-quot-locker-quot-decisions-probe-infringement-liability-and-safe-harbor-issues.aspx>; see also Murad Ahmed, *Megaupload Action Puts Cloud Services In Spotlight*, THE AUSTRALIAN (Jan. 23, 2012, 11:00 AM), <http://www.theaustralian.com.au/news/world/megaupload-action-puts-cloud-services-in-spotlight/story-fnb64oi6-1226251071259> (reporting that Megaupload.com, a hugely popular cloud locker service, had been shutdown because of alleged rampant copyright infringement on its website).

256. See Michael Cieply, *Digital Piracy Spreads, and Defies a Fix*, N.Y. TIMES, Apr. 6, 2009, at B3.

257. See Paul Ohm, *The Rise and Fall of Invasive ISP Surveillance*, 2009 U. ILL. L. REV. 1417, 1432 (2009).

258. *Id.*

259. See Suganya Sukumar, *Is Network Neutrality Affecting the Internet?*, BUZZLE.COM (Sept. 23, 2011) <http://www.buzzle.com/articles/is-network-neutrality-affecting-the-internet.html>.

260. See generally Bridy, *supra* note 2 (discussing how technological developments have altered the assumptions underlying the costs and feasibility of enforcing copyrights since the original drafting of the DMCA).

arguments that ISPs should be shielded from liability for copyright infringement because they serve as mere conduits of information exchange.²⁶¹

Further complicating the issue of allocating liability is the fact that many new smartphones and similar devices are tethered to specific software platforms. These devices are often subject to the centralized control of a single company, such as Apple's iPhone, which limits a user to installing only those applications that have been purchased through Apple's proprietary online application store.²⁶² The makers of these tethered devices have a greater ability than their PC making counterparts to control the content-accessing activities of their customers. Whether this increased control over the software available to a user might affect a company's copyright infringement liability under the DMCA's safe harbor provisions by increasing an ISP's actual knowledge of infringing activities remains untested.²⁶³ Critics who fear that GRS jeopardize free speech, privacy, and due process protections are also concerned that single platform devices are vulnerable to censorship and centralized control.²⁶⁴

2. *Consumer Options, Convenience, and Competition*

Through its highly successful iTunes store, Apple has already shown that customers are willing to pay for content through purchasing individual songs, albums, TV shows, and movies. Through licensing deals negotiated with the all of the major record labels, Apple was able to establish a pricing scheme that attracted many newcomers to purchase authorized content online.²⁶⁵ Part of iTunes's success likely stemmed from the popularity of Apple's iPod mp3 player, which provided a convenient single access point for a user's music collection. A number of newer businesses, such as Netflix and Spotify, have demonstrated that there may be a market for people who value convenience of access to content to the degree that they are willing to become paying

261. *See id.*

262. *See* Timothy B. Lee, *How I Learned To Stop Worrying And Love The App Store*, ARS TECHNICA (Oct. 16, 2011 8:00 PM), <http://arstechnica.com/tech-policy/news/2011/10/the-constitution-how-to-protect-user-freedom-in-an-app-store-world.ars/4>.

263. *See* Bridy, *supra* note 2, at 106.

264. *Cf.* Letter from Access to Rep. Lamar Smith, Chairman, Comm. on the Judiciary (Nov. 15, 2011), *available at* https://s3.amazonaws.com/access.3cdn.net/bea9ca8d08d08c45c7_rvm6bx96w.pdf (stating that aggressive copyright enforcement measures "sends an unequivocal message to other nations that it is acceptable to censor speech on the global Internet").

265. *See* WU, *supra* note 45, at 294 (speculating that Apple's ability to successfully negotiate with record labels may have been partially a result of the fact that then-CEO Steve Jobs had learned to operate in both Silicon Valley and Hollywood during his tenure as CEO of Pixar).

subscribers.²⁶⁶ Many of these new models offer tiered plans, where users can access content through a paid subscription—generally offering the greatest number of features and fewest ads—or through an advertisement-supported format that limits certain features or restricts catalog access.²⁶⁷

Many companies, such as Apple, Amazon, Google, and Dropbox, are investing heavily in cloud-based services that allow consumers to sync content between all of their devices, such as iPods, smart phones, and laptops. These companies believe that consumers value the ease of accessing content over the cost-savings of acquiring free unauthorized content. If this is proven true, the companies that succeed will be those which offer the best balance of breadth of content catalog and convenience of access. However, it remains unclear whether a purchase, subscription, or advertisement-supported model will come to dominate the authorized market for media.²⁶⁸

A recent Swedish survey found that convenience of access and breadth of licensed content contributed to the growing popularity of Spotify, an online music provider that offers unlimited access to licensed content through a subscription and advertisement-based business model.²⁶⁹ Looking at the motivations for why people switch to authorized music services, survey participants cited “the range of music that’s released” as the main reason (40%).²⁷⁰ Other reasons given were the increase in the volume of available music (30%).²⁷¹ The fact that legal services have become cheaper (24%) and simpler (24%) also significantly affected consumer’s decisions.²⁷² Notably, the survey indicated a temporary lapse in the consumer trend towards legal models during the second quarter of 2011, when Spotify announced new limits in its free ad-based service.²⁷³ This lapse suggests that the balance between the cost of convenience and the appeal of accessing free pirated content is still difficult to quantify.

266. See *What is Spotify*, SPOTIFY, <http://www.spotify.com/us/about/what> (last visited Feb. 21, 2012).

267. See Boyd Myers, *supra* note 52.

268. See John DeFore, *Spotify Music-Streaming Service’s Honeymoon May Soon Be Ending*, WASHINGTON POST (Oct. 7, 2011), <http://www.washingtonpost.com/entertainment/music/spotify-music-streaming-services-honeymoon-may-soon-be-ending/2011/09/27/gIQA5o39SL>.

269. See *Musiksverige Svenskarnas Internet Van Or Q2 2011*, SCRIBD, <http://www.scribd.com/doc/66658516/Musiksverige-Svenskarnas-Internet-Van-Or-Q2-2011> (last visited Mar. 27, 2012) (summarizing Swedish music consumers’ listening trends since the introduction of the Spotify music service).

270. See *id.*

271. See *id.*

272. See *id.*

273. See *id.*

3. *Equitable Cost Sharing in a Developed Market*

GRS, and private ordering generally, are market-driven mechanisms that internalize copyright piracy externalities by spreading the cost across all parties in the chain of content distribution.²⁷⁴ Economic principles state that without the ability to monetize a good, less of that good will be produced than would be optimal for the public good.²⁷⁵ In copyright, much of the cost of capitalizing a given work lies in enforcement costs to discourage free riders through identification and litigation of infringing uses.²⁷⁶ Enforcement costs “include the costs of setting up boundaries or erecting imaginary fences that separate protected and unprotected elements of a work” and “include the costs of excluding trespassers, proving infringement and sanctioning copyright violators.”²⁷⁷ By giving creators copyright protection, the law allows creators to build some of those costs of enforcement into the final price of their product.²⁷⁸ Digitization of content reduces certain production and distribution costs for creators, but it also makes piracy far easier and more widespread.²⁷⁹ Consumers who download unauthorized content without paying for it enjoy the benefit of a content creator’s labor without paying any of the accompanying costs of creation and production.²⁸⁰ Furthermore, those websites and companies that profit through advertisements while providing access to unauthorized access to content also enjoy the benefits of a creator’s work at no cost.²⁸¹

Scholars Olivier Bomsel and Heritiana Ranaivoson have argued that uncompensated content creators and distributors in effect end up subsidizing ISPs that are able to attract consumers by offering breadth of content (YouTube) at fast download speeds (broadband) without compensation to rightsholders.²⁸² Bomsel and Ranaivoson also argue that administering GRS will generate costs for ISPs to identify and notify infringing users²⁸³ and that the cost of implementing these systems will push ISPs to develop efficient

274. See Bomsel & Ranaivoson, *supra* note 30, at 16–17.

275. See generally Harold Demsetz, *Toward A Theory of Property Rights*, 57 AM. ECON. REV. PAPERS & PROC. 347 (1967) (discussing the costs associated with assigning and enforcing property rights and the need to assign ownership to internalize externalities).

276. See LANDES, W.M., “COPYRIGHT”, IN TOWSE, RUTH (ED.), *HANDBOOK OF CULTURAL ECONOMICS*, CHELTENHAM: EDWARD ELGAR 134 (2003).

277. See *id.*

278. See Bomsel & Ranaivoson, *supra* note 30, at 13–29.

279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.*

283. See *id.*

filtering technologies.²⁸⁴ However, without a concurrent cost assigned to content owners for falsely accusing or identifying a user for infringement, content owners may lack sufficient incentives to avoid overbroad enforcement.²⁸⁵ An ideal agreement between each party would balance the benefits of widespread, technically efficient enforcement with a mechanism for introducing costs for misidentification.

Properly constructed, graduated response mechanisms can increase the value of enforcement by reducing the costs of monitoring and applying appropriate measures to discourage or prevent further acts of infringement. Furthermore, if designed correctly, GRS can equitably share the costs of copyright enforcement such that all parties are encouraged to cooperate. Such mechanisms can help to compensate rightsholders for the use of their copyrighted works.

Privately ordered copyright enforcement regimes such as GRS may help resolve some of the major issues in copyright enforcement by reducing the costs, risks, and inefficiencies of litigation while contributing to more widespread and evenly applied enforcement. By encouraging a marketplace based on competition between companies offering different models for accessing authorized content, privately ordered enforcement can help equitably divide the costs of enforcement and the profits of distribution of copyright content. In contrast, public ordering based on legislation, litigation, and administration by public bodies places a significant cost of enforcement on the public through taxation. Furthermore, litigation and legislation are both relatively slow and static processes for defining copyright infringement liability. But by structuring an enforcement regime through private mechanisms, companies are better situated to innovate and adapt to changes in technology and markets.

4. *The Soft Hammer*

Privately ordered enforcement mechanisms constitute an improvement upon the current system based on lawsuits and statutory damages if they lead to more even and widespread enforcement. Currently the cost of litigation motivates plaintiffs to limit the number of lawsuits they pursue, which decreases the chance that an individual will be sued. However, these plaintiffs are also motivated by enforcement cost concerns to seek higher damages so as to deter other infringers.²⁸⁶ Litigation depends on an enforcement model that makes the consequences of infringement lawsuits severe enough for a

284. *See id.*

285. *Id.*

286. *See supra* Section I.B.3.

few individual infringers so that others are discouraged from future infringement. Over the last decade, this model of enforcement, based on low individual risk but very high cost if caught, has proven rather unsuccessful and unpalatable for all parties.²⁸⁷ Much of the public views these damages as unfair and disproportionate to the actual harm caused, perhaps because unauthorized downloading and streaming is so commonplace.²⁸⁸ Furthermore, because the risk to any one individual of being sued is exceedingly low, users may have not been deterred from using and distributing pirated content despite the high damages awards in individual cases.²⁸⁹

Filtering technologies and reduced barriers to adjudicating claims of infringement increases the probability of an infringer being caught, which in turn allows the enforcing party to decrease the penalty to each individual user. Furthermore, privately administered sanctions that are defined by private agreements in the form of end user license agreements and terms of service may not carry the same stigma associated with the exercise of the state's coercive power through public sanctions, and thus consumers may perceive those punishments to be less harsh or unfair. Many individuals feel that it is unfair to be punished for behavior, such as music downloading, that is perceived as commonplace.²⁹⁰ In their proposal for a copyright enforcement administrative body, Lemley and Reese argued that people will accept limited enforcement of a rule only so far as the response is seen as commensurate.²⁹¹ If GRS issue copyright alerts in a consistent manner, and if mitigation measures are applied equally to all accused infringers, then people may come to see private copyright enforcement as fair and acceptable.

B. CONCERNS WITH THE GRADUATED RESPONSE SYSTEM AND PRIVATE ORDERING

A number of significant concerns must be addressed in order to ensure that privately ordered enforcement mechanisms strike the appropriate balance between online copyright protection for rights holders and

287. See Mark Lemley & Anthony Reese, *Reducing Digital Copyright Enforcement Without Restricting Innovation*, 56 STAN. L. REV. 1345, 1405 (2004) (“[I]t seems unfair and disproportionate to impose the burden of enforcing copyright so heavily on a few unlucky defendants. This is particularly true if the sanction is severe—we put up with random enforcement of traffic offenses because the sanction is so minor, but we might feel differently if speeders had to spend a year in jail.”).

288. See *id.*

289. See *supra* Section I.B.3.

290. See Lemley & Reese, *supra* note 287, at 1405.

291. See *id.*

individuals' right to free speech, due process, privacy, and fair use. Many critics argue that it is dangerous to allow private entities to create a system wherein copyrights are presumed valid and accused infringers have the burden of proving their innocence²⁹² Furthermore, a privately ordered system, lacking the protections provided by public law, could more readily be used to censor media and suppress free speech.²⁹³ Many now argue that internet access has become an important right necessary for full participation in democracy and the marketplace that should not be abridged solely to protect the right of content owners to monetize their intellectual property assets.²⁹⁴ The failure of many of the post-Napster copyright enforcement efforts by the content owning industries, such as the lawsuit campaign against individual infringers, were at least in part a result of public perception that a given enforcement strategy was unfair.²⁹⁵ To be successfully implemented, GRS must account for these concerns and perceptions.

1. *Net Neutrality and Universal Access*

Some critics contend that internet connectivity should be a basic right, and that principles of network neutrality should be protected by statute.²⁹⁶ For these critics, internet disconnection is an inappropriate sanction for copyright infringement and undermines the neutrality of the Internet.²⁹⁷ Moreover, new technologies allow ISPs to monitor—and potentially control—with ever-greater detail exactly what information is flowing over their networks. Industry-wide adoption of GRS may present a slippery slope problem where such technologies could be used for censorship and propaganda purposes. Considering the recent use of social media and user-generated content in the revolutions of the Arab Spring and in other democratic movements,²⁹⁸ it may be dangerous to allow private entities to request that content be removed from websites without proof that the private party is the actual owner of the copyright and that the party is exercising a protected exclusive right. This is especially troublesome where filters could be used to prevent such material from ever being posted in the first place.

292. See Bridy, *supra* note 2, at 127.

293. See Brendrath, *supra* note 240, at 24.

294. See Yu, *supra* note 42, at 1398.

295. See *supra* Section I.B.3.

296. See Bridy, *supra* note 2, at 127.

297. *Id.*

298. See Michael Blackman, *Bullets Stall Youthful Push for Arab Spring*, N.Y. TIMES (March 17, 2011), <http://www.nytimes.com/2011/03/18/world/middleeast/18youth.html?pagewanted=all>.

Moreover, threats of disconnection may turn out to be an ineffective deterrent in the first place, given the variety of internet access points available to consumers today, including home, work, and mobile networks via smart phones. Furthermore, because many internet connections are shared by families and coworkers, disconnections could affect non-infringing users. Likewise, businesses such as cafes might be discouraged from providing internet access to customers because of the potential loss of internet connectivity.

Denials of internet service as an alternative to civil liability does not solve all of the challenges of creating an effective copyright enforcement regime. Many people already argue that universal access to internet connectivity should be a public policy goal, given the central role of the Internet in commerce and the public sphere.²⁹⁹ Thus any enforcement mechanisms that deny internet access could be criticized as a disproportionate response to a user's copyright-infringing activities.

2. *Fair Use and Free Speech*

The doctrine of fair use allows an individual to make use of copyrighted material without seeking right holders' permission when that use is made in the context of criticism, comment, news reporting, or educating.³⁰⁰ The doctrine of fair use stems from a recognition that overbroad copyright protection could chill free speech rights guaranteed by the First Amendment.³⁰¹ The Internet created a variety of new tools for creating, transforming, and distributing works. User-generated content in particular proliferated because of Internet sites such as YouTube. Overbroad copyright enforcement that discourages remixing and transformation is thus contrary to copyright's purpose as a means for encouraging the development of new creative works.³⁰²

Automated filter technologies in some ways shift the burden from content owners to affirmatively identify infringing works to uploaders, who must present evidence of fair use for posting user-generated content. Aggressive filtering technology might prevent users from uploading materials that would constitute fair use in a court of law. A proper fair use analysis, which is arguably quite difficult even for trained lawyers, may be far too

299. See WU, *supra* note 45.

300. 17 U.S.C. § 107 (2006).

301. See *Eldred v. Ashcroft*, 537 U.S. 186, 221 (2003) (stating that "the 'fair use' defense allows the public to use not only facts and ideas contained in a copyrighted work, but also expression itself in certain circumstances").

302. See Sawyer, *supra* note 80, at 403.

complicated to be automated using current technology.³⁰³ Many critics believe ISPs' users and subscribers must be given the right to dispute accusations of infringement based on automated filtering and that any appeal process should include a human reviewer given the complexities of fair use analysis.³⁰⁴

Some commentators propose the development of a public administrative body to facilitate fair use and other infringement defense disputes arising as a result of automated filters to ensure due process rights.³⁰⁵ Furthermore, technologies that have contributed to piracy also helped create the conditions for a huge expansion of user-generated creativity and innovation. GRS may threaten this growth by blocking remixes, fan fiction, and the like.

3. *Privacy and Procedural Due Process*

Graduated response regimes also implicate serious privacy concerns where ISPs intend to automatically monitor users' activities to identify infringers. This will be especially true where ISPs employ filtering technologies rather than rely on notifications by content owners.³⁰⁶ Furthermore, technological advances are increasing ISPs' ability to track the activities of their users.³⁰⁷ Technologies such as deep packet inspection allow ISPs to monitor—and potentially control—with ever-greater detail exactly what information is flowing over their networks.³⁰⁸ If GRS rely on stored information about a user's previous infringement allegations, then users may rightfully feel that ISPs have violated their privacy by tracking and recording their online activities.³⁰⁹ Furthermore, many critics are concerned with the length of time that ISPs may store a user's online browsing information and with whom such information might be shared.³¹⁰

Finally, many critics fear that users will not be afforded sufficient procedural safeguards in privately administered GRS, which are often largely automated.³¹¹ These critics insist that any graduated response system must

303. *See id.*

304. *See id.*

305. *See* Lemley & Reese, *supra* note 287, at 1471.

306. *See* Swartout, *supra* note 85, at 532.

307. *See* Ohm, *supra* note 257, at 1432.

308. *See* Ralf Brendrath, *The End of the Net as We Know it? Deep Packet Inspection and Internet Governance*, SOCIAL SCIENCES RESEARCH NETWORK (Aug. 4, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1653259#667993.

309. *See* Yu, *supra* note 42, at 1401.

310. *See id.*

311. *Id.*

include independent review, sufficient notice, and an opportunity for a user to defend against allegations of infringement.³¹²

V. AN ANALYSIS OF THE 2011 MOU

The 2011 MOU improves protections for the copyrighted works of content owners, may reduce litigation and associated costs for ISPs, and incorporates a number of protections for individual users' rights and interests. To respect users' interests, parties to the 2011 MOU should ensure that their GRS are transparent, predictable, and narrowly tailored to users infringing activities. As a privately ordered enforcement regime, the 2011 MOU has the potential to be modified throughout its implementation to further this balancing of interests more readily than a publicly ordered regime. To ensure that this balancing is done well, the GRS created by the 2011 MOU should be continually monitored and critiqued by all of the interested parties.

The 2011 MOU defines an efficient process to streamline and automate the process by which incidents of infringement are identified and adjudicated.³¹³ The GRS created by the 2011 MOU will provide for an enforcement process that may be cheaper than litigation for content owners and ISPs.³¹⁴ For content owners and ISPs, filtering technologies can reduce the costs of identifying and monitoring infringing works.³¹⁵

One goal of any copyright enforcement regime should be to make infringing means for acquiring content significantly less appealing to consumers than legal means while preserving free speech and privacy rights.³¹⁶ Although some users will certainly continue to find ways to access pirated content, a copyright enforcement regime should not be designed to completely wipe out piracy but rather to incentivize consumers to choose legal markets in order to access creative works.³¹⁷ Accessing creative works through pirated channels online fails to reward content owners for their creativity, and instead compensates application ISPs and advertisers who derive their revenue from the sale of advertisements and related purchases.

312. See Bridy, *supra* note 2, at 126.

313. See Strowel, *supra* note 14, at 75.

314. See Yu, *supra* note 42, at 1384.

315. See Justin Hughes, *Copyright Enforcement on the Internet—In Three Acts*, Fordham Conference at Cambridge working paper, 2009, available at http://fordhamipconference.com/wp-content/uploads/2010/08/JustinHughes_Copyright_Enforcement_on_the_Internet_in_Three_Acts.pdf.

316. See Strowel, *supra* note 14, at 86.

317. See *id.*

Effective deterrence of piracy thus pulls users towards markets wherein the creator of a work is more directly compensated for a user's access to that work. By partnering with ISPs to enforce their copyright protections, content owners can avoid the costs and risk of litigation while creating more widespread enforcement. Improved filtering technologies and more widespread employment of automated monitoring via ISPs' willing participation can more readily and cheaply identify infringing uses of content owners' copyrighted works. For content owners, reducing enforcement costs and improving revenues from the sale and licensing of their works can improve the profitability of creating and distributing artistic works. This in turn further incentivizes future creativity and innovation, which benefits users by leading to the development of new artistic works.

Network ISPs will benefit from the 2011 MOU if GRS leads to a reduction in unauthorized file-sharing because infringing activities often use up massive amounts of the bandwidth on ISPs' networks, which in turn affects other non-infringing users. Some network ISPs have already demonstrated a strong desire to throttle users' bandwidth and download speeds in order to better manage their networks.³¹⁸ However, filtering technologies may increase an ISP's awareness of the infringing activities of its users, which in turn could open the ISP up to liability by running afoul of the safe-harbor requirements of the DMCA that condition immunity from liability on an ISP's lack of knowledge of infringing activities.³¹⁹

Although the terms of the agreements between individual ISPs and content owners are unavailable, it may be that ISPs negotiated with content owners to contractually shield themselves from liability in exchange for participating in the 2011 MOU. Likewise, as many network ISPs, such as Comcast, have moved beyond the model of passive carrier into active arbiters of content,³²⁰ the 2011 MOU embodies through private agreement an alignment of the economic interests of content owners and ISPs. By employing contractual means to limit liability, both network and application ISPs can reduce their costs associated with litigation and devote those saved resources towards greater creativity and innovation, which in turns benefits users. Application ISPs who are party to the MOU also improve their position to negotiate profitable licensing deals from content owners relative to their competitors, which can in turn produce licensing agreements that

318. See Yoo, *supra* note 47.

319. See Bridy, *supra* note 2, at 120.

320. See *id.* at 86.

maximize the development of content for users.³²¹ If content owners continue to develop legal models that are convenient and efficiently priced by the market and the graduated steps of the 2011 MOU serve to deter many users from engaging in infringing activities by making it sufficiently difficult to access unauthorized content, then the 2011 MOU will accomplish the goal of pulling consumers back into legal markets.

The 2011 MOU creates a system for enforcing copyright that can be tested and defined by the dynamic, experimental forces of the market. As copyright scholar Jonathan Zittrain has noted, “reasonable copyright holders could disagree on whether it would be a good thing to prevent certain unauthorized distributions of their works.”³²² Companies are not homogenous entities: they have different ideas about tolerated uses of copyright content.³²³ ISPs who are party to the 2011 MOU that relax their filtering mechanisms to allow for a broad understanding of fair use may attract the greatest number of consumers for their content. It is conceivable that tolerant companies will out-compete those with the tightest restrictions. However, if competing ISPs differ in the degree to which they police their networks, customers may jump to the least restrictive companies and thus undermine the purpose of an industry-wide agreement for establishing a copyright enforcement framework. Thus, the terms of the 2011 MOU, though admirable, risk backfiring because of their flexibility. Nonetheless, one of the strengths of the 2011 MOU as a privately ordered framework is that signatories may choose to alter or abandon the agreement as soon as they feel that the framework does not satisfy their needs. A legal framework defined by statutes, such as the DMCA, has no such flexibility for voluntary participation and experimentation.

The 2011 MOU also addresses a number of critics’ concerns by establishing procedural mechanisms to protect users’ rights and interests.³²⁴ The 2011 MOU provides four alerts to users before any mitigation measure is implemented.³²⁵ Rather than a litigation-based model wherein a user is first notified of infringing activity in the form of a legal complaint, the 2011 MOU

321. See PETER S. MENELL & SUZANNE SCOTCHMER, INTELLECTUAL PROPERTY, IN HANDBOOK OF LAW AND ECONOMICS (A. Mitchell Polinsky & Steven Shavell eds., 2008) (discussing how licensing promotes creativity by allowing creators the flexibility necessary to optimize the capitalization of their intellectual property assets).

322. See ZITTRAIN, *supra* note 264, at 120.

323. *Cf. id.* (discussing how the internal diversity of ideas within a single company allows for fruitful discussions of how aggressive or lax a stance that company should take regarding copyright enforcement to maximize profit).

324. See Bridy, *supra* note 2, at 126.

325. See *supra* Section III.A.1.

provides a system that gives users early warning of suspected infringement. These early warnings include educational measures that provide a means for creating informed notice of the basis for an infringement claim.³²⁶ For users, these educational measures are implemented prior to administering any action to slow or disconnect a users' internet service.³²⁷ The alerts should be designed to ensure users understand the specific activity that is allegedly infringing as well as the rationale behind copyright protections. Likewise, ISPs and content owners should make these educational warnings user-friendly rather than legalistic to increase their effectiveness. While 'copyright school' may appear more like propaganda than a primer of legal doctrines,³²⁸ an enforcement system that is transparent about its policies and its rationale for those policies is more likely to be accepted by the public, which is critical for any successful enforcement regime.³²⁹

Under the 2011 MOU, ISPs are granted flexibility in choosing between the prescribed mitigation measures, all of which are arguably more narrowly tailored and less harsh than the remedies available at law.³³⁰ Giving users repeated, "graduated" warnings more fairly allows an opportunity to adjust their conduct or to contest the allegation of their infringing activities. The MOU provides for at least four warnings before even the first "mitigation measure" is taken.³³¹ The current agreement between ISPs and content owners in the U.S. does not include the more Draconian three-strikes model adopted in some countries,³³² likely because ISPs fear that such strict termination of service provisions for accused infringers threatens to drive away paying internet service subscribers.

The measures provided for in the 2011 MOU do not carry the same social stigma as lawsuits and criminal or civil penalties. This "soft hammer" approach of redirecting users to landing sites or temporarily reducing download speeds is likely to increase consumers' acceptance of the GRS because these remedies are not likely to be seen as overly harsh or disproportional to users' infringing acts.³³³ Likewise, because the GRS

326. *See supra* Section III.A.1.

327. *See id.*

328. *Cf.* Nate Anderson, *Back To School With RIAA-Funded Copyright Curriculum*, ARS TECHNICA (Sept. 17, 2009), <http://arstechnica.com/tech-policy/news/2009/09/back-to-school-with-riaa-funded-curriculum.ars> (discussing how various companies existing approaches to "copyright education" offer only the unilateral perspective of copyright owners).

329. *See* Yu, *supra* note 42, at 1421.

330. *See supra* Sections III.A.1 & IV.A.4.

331. *See id.*

332. *See* 2011 MOU Agreement, *supra* note 3.

333. *See* Yu, *supra* note 42, at 1421.

provided for in the 2011 MOU will rely partially on automation and filtering,³³⁴ enforcement is likely to be more widespread and less arbitrary than individual lawsuits, which also should improve users' perceptions of GRS. However, some ISPs may remain reluctant to downgrade or terminate their customers' access if doing so drives users towards ISPs who are less aggressive in their enforcement.³³⁵ But given the size and scope of the parties who signed on to the 2011 MOU, there should be a high degree of standardization between ISPs' GRS, which will help deter subscribers from simply moving to the ISP with the most lax enforcement.

Although the 2011 MOU does provide for termination of a user's internet access as a possible consequence for infringement, termination for repeated infringement is already required as part of the conditions for safe harbor under the DMCA.³³⁶ Furthermore, ISPs that seek to maintain their subscriber base have an economic incentive to provide the most narrowly tailored measure that will effectively discourage future infringement. Finally, compared to the current litigation-based model for enforcement, reducing a user's internet speed or terminating his broadband access is arguably a far more equitable response for illegal file-sharing than awarding statutory damages that can reach into the hundreds of thousands of dollars.³³⁷

Although critics are rightly concerned that policy reasons may favor universal internet access as a basic right,³³⁸ that goal should be addressed through legislation establishing such a right, rather than through policies that indirectly advocate for lax copyright enforcement in order to avoid internet service termination. Furthermore, given the ubiquity of internet access points, such as connections at work, libraries, and through mobile networks, few users are likely to be completely denied internet access. Inconvenience is not equivalent to complete denial of access. Nonetheless, ISPs should generally avoid termination as a consequence for infringement, especially in communities without multiple network ISPs, as a mitigation measure to avoid digitally ostracizing consumers.

The 2011 MOU also creates an independent review process to dispute infringement claims.³³⁹ The \$35 dollar fee for requesting a review of allegations of infringement is far less than what any user would have to spend

334. *See supra* Section III.A.3.

335. *See* Bridy, *supra* note 2, at 95.

336. *See* 17 U.S.C. § 512(i) (2006).

337. *See* Sony BMG Music Ent. v. Tenenbaum, 672 F. Supp. 2d 217 (D. Mass. 2009); Capitol Records, Inc. v. Thomas-Rasset, 799 F. Supp. 2d 999 (D. Minn. 2009) (awarding \$1.5 million in damages).

338. *See* WU, *supra* note 45.

339. *See supra* Part III.A.2.

to fight such allegations in a lawsuit. Users can avail themselves of a number of defenses that would be available in a court of law, and reviewers are instructed to adhere to established legal procedures and precedent in adjudicating claims.³⁴⁰ Improvements in filtering technologies over the last decade should allow parties to the 2011 MOU to more accurately identify actual cases of infringement and lower the number of false positives, which can unfairly burden users.³⁴¹ Furthermore, any allegation that is successfully defended against will be removed from a user's record. However, the 2011 MOU should be amended to require that users be informed of the right to appeal any finding of infringement at each phase, rather than only after a user is moved to the mitigation phase.

The Supreme Court, in *Eldred*, recognized that while the doctrine of fair use protects the free speech interests of individuals in the context of copyright law, that right is limited when an individual wholly appropriates another's speech.³⁴² Accordingly, the independent review program established by the 2011 MOU should allow for a robust and liberal understanding of fair use that maps on to the current legal understanding of the doctrine as established by relevant case law. In addition, ISPs that maintain records of their users' online activities should only maintain the minimum amount of information necessary to adjudicate infringement claims. User information should be kept confidential and not shared with content owners, other ISPs, or government agencies, except where required by law.

Because ISPs, as private entities, can limit the acceptable uses of their services through terms of service agreements, the 2011 MOU does not implicate critics' concerns about free speech as much as a publicly administered GRS, which would necessitate the coercive and unavoidable power of the state. Users who found an application ISP's enforcement policies to be overly strict can move to a different ISP, thus allowing the market to preserve their interests. Furthermore, there may be a danger in relying on private entities to maintain a publicly accessible Internet. If public policy favors treating ISPs as common carriers, then that goal should be accomplished through appropriate legislation establishing an official endorsement of net neutrality, rather than through a weakening of copyright enforcement.

340. See *supra* Part III.A.2.

341. See Hughes, *supra* note 315.

342. *Eldred v. Ashcroft*, 537 U.S. 186, 201 (2003) (stating that “[t]he First Amendment securely protects the freedom to make . . . one’s own speech; it bears less heavily when speakers assert the right to make other people’s speeches.”).

The 2011 MOU embodies a market-based approach to balancing the interests of content owners, ISPs, and users. The 2011 MOU establishes a clearinghouse to study and recommend best practices for administering GRS effectively and cheaply. Content owners, ISPs, and public interest groups should continually engage this clearinghouse to advocate for their competing interests via the clearinghouse mechanism. This private means for balancing interests should serve as a complement, rather than a replacement, to public means such as lobbying, litigation, and legislation to develop guidelines for copyright enforcement. The success of the 2011 MOU should be measured by whether it reduces piracy, provides users convenient and reasonably priced access to creative works, fairly and accurately identifies and adjudicates infringement claims, and creates efficient means for allocating the costs of copyright enforcement among those who benefit from access to creative works.

VI. CONCLUSION

Striking the correct balance between enforcement costs, individual free speech and due process rights, and the benefits of providing incentives to create new works, lies at the center of copyright protection policy concerns. GRS allocate the costs and burdens of copyright enforcement equally among content owners and ISPs, who both benefit from the consumption of copyrighted materials. Privately ordered copyright enforcement regimes can create more even and widespread enforcement, which can in turn reduce the consequences for any single infringer and usher in a return of fairness to the enforcement regime. As enforcement becomes more commonplace, consumers will likely be drawn to legal mechanisms for acquiring content, which will in turn help restore the legal market for creative works. Furthermore, privately ordered systems can be adapted and refined much more quickly than public legal regimes. Likewise, economic competition encourages efficiencies in enforcement processes and filtering technologies.

For consumers to accept GRS as a legitimate and fair means of enforcing copyright, which is the only way they will work as an effective regime over the long term, parties to the 2011 MOU should ensure that their GRS are transparent, predictable, and narrowly tailored to users' infringing activities. The independent review program should be truly independent and respectful of users' privacy, free speech, and due process rights. Moreover, content owners must continue to push for convenient models for legally acquiring copyrighted content that are structured and priced in such a way as to attract users.

The success of the 2011 MOU as a means for copyright enforcement will turn largely on how ISPs and content owners implement and administer the

GRS. Furthermore, although many of the key industry players have signed on to the MOU, the notable absence of tech giants, such as Google and Apple, may detract from the 2011 MOU's effort to establish industry-wide standards. Ultimately, consumers will determine the success of the 2011 MOU by how they choose to access copyrighted content. Unless users perceive GRS as fair, the public may come to see GRS as yet another overzealous approach of content owners that isolates modern consumers—similar to the RIAA's post-Napster litigation strategies. But if consumers find that the price of convenient legal access outweighs the costs of acquiring content illegally on the Internet, then the 2011 MOU's GRS may lead to a thriving and efficient market for copyrighted works.

BEYOND THE GAP: A PRACTICAL UNDERSTANDING OF COPYRIGHT'S TERMINATION OF TRANSFERS PROVISIONS

Kiley C. Wong[†]

Charlie Daniels, American country music legend, has been an active singer, songwriter, and multi-talented musician since the 1950s, but it wasn't until the 1970s that his career really started to take off. In 1974 his first hit single reached number nine on the Billboard Hot 100, the following year he had a Top 30 hit as a member of the Charlie Daniels Band, and in 1979 he won a Grammy for his number one hit "The Devil Went Down to Georgia."¹ The song was even featured in the popular 1980 film, "Urban Cowboy." Daniels released a total of nine studio albums between 1971 and 1977—his popularity was the kind most music publishers only dream of.² In recent years, Daniels, now seventy-three years old, has made it into the headlines again, though he is attracting a somewhat different crowd.³ Hoping to share in the commercial success "The Devil Went Down to Georgia" brought to Universal Music Publishing Group over the past three decades, Daniels attempted to exercise his right under the Copyright Act of 1976 to reclaim copyright ownership in his Grammy-winning song.⁴ Unfortunately for Daniels, he learned that his right to terminate his transfer to Universal might have slipped through the cracks because of a statutory gap, or more precisely, a gaping statutory ambiguity.⁵

One of the most acute examples of the competing interests of creators, distributors, and consumers of creative content in the copyright laws of the United States is the termination of transfers provisions.⁶ A complex statutory

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1. *Charlie Daniels*, CHARLIE DANIELS BAND, <http://www.charliedaniels.com/the-band/bio-charlie.htm> (last visited Feb. 24, 2012).

2. *Id.*

3. Brian Reisinger, *Charlie Daniels' Signature Song at the Heart of Copyright Dispute*, NASHVILLE BUS. J. (Mar. 28, 2010, 11:00 PM), <http://www.bizjournals.com/nashville/stories/2010/03/29/story2.html>.

4. *Id.*

5. *Id.*

6. During the general revision process, the decades leading up to the enactment of the Copyright Act of 1976, interested parties weighed in on the debates over the revision of

scheme allows authors to set aside contractual obligations and reclaim rights in their works decades after assigning them away. In the decades leading up to the 1976 overhaul of the U.S. copyright laws, Congress saw heated arguments on both sides of the debate over the novel right these provisions ultimately created. Now—just under thirty-five years since the 1976 Act’s effective date—the first transfers executed under the Act will soon be ripe for termination. As this happens, interpretive debates over how these provisions should operate have begun to echo the explosive debates out of which termination of transfer rights were born.

One prominent area of uncertainty surrounding the termination of transfer provisions concerns works, like “The Devil Went Down to Georgia,” where creators assigned the copyright to the publisher prior to the January 1, 1978 effective date of the Act but did not actually create the work until after this date. Though this may seem like an odd situation, it is a common industry practice.⁷ For example, Universal Music Publishing Group’s predecessor signed Daniels to an exclusive term deal in 1975; he then wrote and recorded this particular song in 1979.⁸ Works, like this one, that were assigned prior to but created after January 1, 1978 earned the name “Gap Works” because they are not explicitly referenced anywhere in the termination of transfers provisions. As a result, Gap Works have raised many questions about how the inalienable termination of transfers provisions will operate as the crucial date swiftly approaches for the first such transfers to be ripe for termination. Moreover, the language of the statute is facially confusing and allows for multiple and equally plausible interpretations.

various provisions, including the termination of transfers provisions. See, e.g., *Comment Received from American Book Publishers Council, Inc.* (Nov. 1963) [hereinafter *Book Publishers’ Comment*], in STAFF OF H. COMM. ON THE JUDICIARY, 88TH CONG., COPYRIGHT LAW REVISION PART 4: FURTHER DISCUSSIONS AND COMMENTS ON PRELIMINARY DRAFT FOR REVISED U.S. COPYRIGHT LAW 247–51 (Comm. Print 1964) [hereinafter *COPYRIGHT LAW REVISION PT. 4*], reprinted in 3 *OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY* (George S. Grossman ed., 2001); *Comment Received from American Book Publishers Council, Inc. and American Textbook Publishers Institute, Inc.* (June 12, 1964) [hereinafter *Joint Publishers’ Comment*], in *COPYRIGHT LAW REVISION PT. 4, supra*, at 267–71, reprinted in 3 *OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY, supra*; *Comment Received from Authors League of America, Inc.*, (June 19, 1964) [hereinafter *Authors League Comment*], in *COPYRIGHT LAW REVISION PT. 4, supra*, at 313–14, reprinted in 3 *OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY, supra*.

7. See DONALD S. PASSMAN, *ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS* 136–42 (7th ed. 2009); Letter from Michael Perlstein to Maria Pallante, Deputy Gen. Counsel, U.S. Copyright Office (Oct. 30, 2007), available at <http://www.copyright.gov/docs/termination/comments/2010/perlstein-et-al.pdf>.

8. Reisinger, *supra* note 3.

The Songwriters Guild of America predicts that the Gap Works issue will affect hundreds if not thousands of songwriters,⁹ and the Author's Guild estimates as many as 100,000 works—the majority of books published in 1978, 1979, and 1980—fall into this “gap”.¹⁰ However, the final interpretation of the statute in resolution of the Gap Works problem will incidentally affect a much larger number of authors moving forward. Thus both authors and producers in all relevant industries seek clarity on this issue in the hopes of avoiding costly delays and litigation or “a state of play where termination rights are left unexercised.”¹¹

This Note cautions that there is danger in hasty resolution of the Gap Works problem and argues that more time and thought must be given to the problem given the broad impact such resolution will have on the operation of the statute moving forward. Given the explosive debates that have surrounded the termination of transfers provisions from their inception, courts must be careful to engage in practical statutory interpretation, both heeding the conventions of textual and historical analysis and also considering the practical effects of their interpretation. As the date approaches when the first § 203 transfers will be ripe for termination, scholars and various interested parties have posited two convincing readings of the statute: one uses the date of creation of the copyrighted work as the date from which the termination window is calculated, while the other uses the date of the assignment contract that transferred the copyright. The implications of the interpretation stretch far beyond the classification of Gap Works—i.e., those works that straddle the effective date of the Act—since early decisions will set an interpretive precedent for the operation of the statute with respect to all subsequent creative works. This Note asserts that while a textual analysis of § 203 and a historical analysis of the Congressional intent behind the provision may support both opposing interpretations, practical reasoning exposes the superiority of the date-of-the-agreement interpretation.¹² Though the repercussions of this interpretation for authors of non-Gap-Works seem less severe since such authors will still have a termination interest regardless, determining the superior basis for calculating

9. U.S. COPYRIGHT OFFICE, ANALYSIS OF GAP GRANTS UNDER THE TERMINATION PROVISIONS OF TITLE 17, at 7 (2010), available at <http://www.copyright.gov/reports/gap-grant%20analysis.pdf> [hereinafter COPYRIGHT OFFICE, GAP GRANTS].

10. *Id.*

11. *Id.*

12. This term refers to the statutory interpretation model espoused in William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990).

the termination window is fundamental to ensuring successful operation of the statute in the industries in which it will have the greatest impact.

Part I of this Note provides background and context on the termination of transfers provisions of the Copyright Act of 1976. Part II exposes ambiguity in the statute, including one particular fact pattern that the statute does not explicitly reference, discusses the nature of contracting for creative works, and explains why certain entertainment industry practices make this statutory ambiguity significantly broader than the gap works problem. Part III then engages in careful statutory interpretation, examines two convincing but divergent interpretations, and shows how practical reasoning exposes one as superior to the other. The final Sections of Part III demonstrate the specific practical superiority of one interpretation in several of the industries that will feel the greatest impact of the termination of transfers provisions.

I. BACKGROUND

The very existence of a gap in the termination of transfers scheme of the Copyright Act of 1976 arises out of ambiguity in certain statutory provisions. This Part contextualizes this ambiguity by outlining the statutory definitions of copyright authorship, ownership, transfer of ownership, and termination of transfers.

A. AUTHORSHIP AND OWNERSHIP

U.S. copyright law, in fulfillment of Congress's authority to "promote the Progress of Science and the useful Arts,"¹³ provides protection to "original works of authorship."¹⁴ Copyright "vests initially in the author or authors of a work."¹⁵ The exception to this is where the work is created as a work for hire. In these cases, the employer will be deemed the statutory author of a work and own "all of the rights comprised in copyright."¹⁶

Section 106 of the Act sets forth the exclusive rights of a copyright owner: (1) reproduction, (2) preparation of derivative works, (3) distribution, (4) public performance, (5) public display, and (6) public performance by means of a digital audio transmission.¹⁷ Not all § 106 rights may be applicable

13. U.S. CONST. art. I, § 8, cl. 8.

14. 17 U.S.C. § 102 (2010); *see* U.S. CONST. art. I, § 8, cl. 8 ("To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.").

15. 17 U.S.C. § 201(a).

16. *Id.* § 201(b).

17. *Id.* § 106.

to every type of copyrighted work.¹⁸ Additionally, certain statutory exceptions authorize an act that would otherwise infringe one of these exclusive rights.¹⁹

Subsequent to initial vesting of a copyright in the “author” of a work, an author may transfer some or all of her rights.²⁰ Section 101 defines a “transfer of ownership” as “an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license.”²¹ However, such a transfer of ownership in the copyright, either by assignment or license, does not affect the creator’s status as the author of her work.

B. TERMINATION OF TRANSFERS

The difference between owning rights as an author and owning rights as an assignee is crucial in U.S. copyright law because of the novel statutory right of authors to terminate assignments or licenses of their copyrights decades after signing them away, irrespective of their contractual obligations.²² These termination rights are found in two separate provisions: § 203 applies to transfers executed on or after January 1, 1978 and § 304(c) to transfers made prior to 1978. Perhaps the most important and novel aspect of these rights is that they are inalienable: an author can invoke them “notwithstanding any agreement to the contrary.”²³

18. *Id.*

19. *E.g., id.* § 107 (excepting fair use); *id.* § 108 (excepting reproduction by libraries and archives); *id.* § 109 (excepting effect of transfer of a particular copy or phonorecord); *id.* § 110 (excepting exemption of certain performances and displays); *id.* § 111 (excepting secondary transmissions of broadcast programming by cable); *id.* § 112 (Limitations excepting ephemeral recordings).

20. *Id.* § 201(d).

21. *Id.* § 101. Section 204 articulates a statute of frauds requirement, that has been interpreted as requiring not just complete assignments, but also exclusive licenses of some or all of the § 106 rights to be stated in some form of a writing signed by the owner. *Id.* § 204; *see Effects Assocs., Inc. v. Cohen*, 908 F.2d 555, 557 (9th Cir. 1990) (“Section 204’s writing requirement is not unduly burdensome; it necessitates neither protracted negotiations nor substantial expense. The rule is really quite simple: If the copyright holder agrees to transfer ownership to another party, that party must get the copyright holder to sign a piece of paper saying so. It does not have to be the Magna Charta; a one-line pro forma statement will do.”). This requirement does not apply to non-exclusive licenses, though there are benefits to the written memorialization of any contract, like clarity and evidentiary concerns. Section 205 provides procedures for recording transfers with the Copyright Office, though such recordation is not required for any type of copyright transfer. 17 U.S.C. § 205.

22. *See* 17 U.S.C. §§ 203, 304(c).

23. *Id.* §§ 203(a)(5), 304(c)(5).

Section 203 permits an author to terminate any transfers of rights he had made in a copyrighted work.²⁴ Neither transfers made by subsequent owners, like transferees or the author's heirs, nor transfers by will are subject to termination under § 203.²⁵ On the other hand, works made for hire are not considered transfers because original authorship vests in the employer; thus, they are not terminable by the creator.²⁶ Such terminations may be made by the author or, if she is dead, those who own at least fifty-one percent of the termination interest.²⁷

Section 203 terminations may be made during a five-year period starting at the end of thirty-five years from the execution of the grant.²⁸ There is an exception to this timeline for grants that include the right of publication, in which case the five-year window begins at the earlier of thirty-five years after publication or forty years after the grant.²⁹ Terminations can be made by serving written notice to the transferee no fewer than two and no more than ten years before the termination is to occur.³⁰ Such notice must comply with formalities set forth in the Copyright Office regulations. In addition, a copy of such notice must be recorded in the Copyright Office before the effective date of termination.³¹ A § 203 termination reverts all rights to the terminating party.³² The important exception to this is that a transferee may continue to exploit *existing* derivative works after termination if they were prepared under the authority of the grant.³³

Section 304(c) applies to transfers made before January 1, 1978. Since such transfers involve works where duration is governed by the 1909 Act, there is an added layer of complexity. The prior regime granted authors a dual term in which rights-holders had to affirmatively seek renewal in order to receive protection for the second term.³⁴ Section 304(c) allows authors or their heirs to terminate transfers that conveyed interest in the renewal term, because they, and not the transferee, were the statutorily designed beneficiaries of the extended renewal term and thus get the first opportunity

24. *Id.* § 203(a).

25. *Id.*

26. *Id.*

27. *Id.* § 203(a)(2) (detailing the transfer of an author's termination interest at death).

28. *Id.* § 203(a)(3).

29. *Id.*

30. *Id.* § 203(a)(4).

31. *Id.*

32. *Id.* § 203(b).

33. *Id.* § 203(b)(1).

34. *Id.* § 304(a)–(b). The 1976 Act, incorporating language of 17 U.S.C. § 24 (1976 ed.), retains the dual-term system with respect to works in their original or renewal term as of January 1, 1978.

to benefit from the term extension.³⁵ So, terminations under § 304(c) can only apply to grants of the renewal term, not the initial term.³⁶ Furthermore, works made for hire and transfers made by will are not terminable under § 304(c).³⁷ Though § 304(c) allows for both authors and their successors in interest to terminate transfers, when someone other than the author seeks to terminate a grant of rights, only the surviving person or persons who actually executed the grant can terminate it.³⁸

Termination under § 304(c) can be effected during a five-year window that begins fifty-six years from the date statutory copyright protection was initially secured.³⁹ The person seeking to terminate must serve advance notice of termination on the transferee or his successor in title not less than two and no more than ten years before the desired effective date of termination, and she must record the termination with the Copyright Office before the effective date arrives. The effect of termination is the reversion of all rights under copyright to the person or persons who exercised § 304(c) rights. However, the transferee may continue to exploit existing derivative works prepared under the authority of the grant.⁴⁰

Sections 203 and 304(c) provide substantively similar rights for grants executed before and after the effective date of the 1976 Act. They are identical in their procedures for serving notice, the effect of termination, and their applicability to exclusive and nonexclusive licenses, as well as outright transfers of ownership. Both provisions also clarify their inapplicability to works for hire and the exception for the continued exploitation of derivative works. Moreover, both § 203 and § 304(c) contain the unique feature that terminations may be effected “notwithstanding any agreement to the contrary.”

In spite of these similarities, the two provisions differ in (1) the party who may effect the termination; (2) the scope of grants covered; and (3) the timeline for effecting termination. While § 304(c) allows both an author and

35. *Id.* § 304(c).

36. *Id.* Subsequent to the enactment of this dual-term regime, Congress further extended copyright duration. Section 304(d) concerns the additional twenty years provided by the 1998 Copyright Term Extension Act (“CTEA”). It states that the termination rights provided in subsection (c) which have expired on or before the effective date of the CTEA may be exercised under the same conditions as subsection (c) and that such terminations may be effected during a period of five years from the date the copyright was originally secured. *Id.* § 304(d).

37. *Id.*

38. *Id.*

39. *Id.* § 304(c)(3).

40. *Id.* § 304(c).

her successors in interest to terminate grants, § 203 allows only the author herself to terminate. Additionally, § 203 applies to grants of any or all interest in copyright, where § 304(c) only applies to grants of the renewal interest. Moreover, § 304(c) calculates the five-year window in which termination can be effected from the date the copyright was originally secured, but § 203 calculates it from the date of execution of the grant. These differences, however, are mostly rooted in practical considerations, as both termination of transfers provisions promote the same public policy goals. The Appendix illustrates the principal differences between the two sections.

C. HISTORY, POLICY, AND PURPOSE

The policy goals that underlie the inalienable right to terminate transfers derive from the practical situations in which copyright transfers arise. A common justification of the termination provisions looks to basic fairness concerns. The provisions allow the author to recapture rights from a transferee because between the two parties, society finds it “more fair” for *the author* to reap the benefits of the lasting commercial success of her work than for a producer or distributor to do so. Moreover, “the constitutional prescription is to accord copyright to authors and their beneficiaries,” and is not meant to privilege the rights of subsequent transferees.⁴¹ Many, however, find this policy goal to be paternalistic and controversial. The more accepted articulation of the policy goal roots these fairness concerns in the utilitarian notion of distributive justice.⁴² The House and Senate Reports state plainly: “A provision of this sort is needed because of the unequal bargaining position of authors, resulting in part from the impossibility of determining a work’s value until it has been exploited.”⁴³ Such an articulation both accounts for the precarious position of authors who are often at the mercy of producers and distributors in negotiating initial transfers since they have no way of predicting the work’s commercial viability, but also acknowledges the valuable role of producers and distributors in taking on this economic risk and thus fostering the commercial success of a work.

Professor Loren articulates the prevailing concern: “Why does federal copyright policy dictate that freedom and sanctity of contract must give way

41. *Transcript of Meeting* (Sept. 14, 1961), in STAFF OF H. COMM. ON THE JUDICIARY, 88TH CONG., COPYRIGHT LAW REVISION PART 2, DISCUSSIONS AND COMMENTS ON REPORT OF THE REGISTER OF COPYRIGHTS ON THE GENERAL REVISION OF THE U.S. COPYRIGHT LAW 38–39 (Comm. Print 1963), reprinted in 3 OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY, *supra* note 6.

42. Lydia Pallas Loren, *Renegotiating the Copyright Deal in the Shadow of the ‘Inalienable’ Right To Terminate*, 62 FLA. L. REV. 1329, 1330 (2010).

43. S. REP. NO. 94-473, at 65 (1975).

to the rights of authors and their families to negate otherwise valid assignments and licenses?”⁴⁴ The fundamental conflict between freedom of contract and constitutional protection for authorial works led to an uneasy compromise when Congress enacted the termination of transfers provisions of the 1976 Act.⁴⁵ Sections 203 and 304 codify compromises on what had been “the most explosive and difficult issue” throughout much of the mid-twentieth century revision of U.S. Copyright law.⁴⁶

During the omnibus revision of the U.S. copyright laws that culminated in the Copyright Act of 1976, the competing interests of authors and publishers came to a head when it came time to design a statutory scheme to succeed the “reversion rights” of the 1909 Act.⁴⁷ The publishers (and other

44. Loren, *supra* note 42, at 1329.

45. See STAFF OF H. COMM. ON THE JUDICIARY, 89TH CONG., SUPPLEMENTARY REGISTER'S REPORT ON THE GENERAL REVISION OF THE U.S. COPYRIGHT LAW 1965 REVISION BILL 71 (Comm. Print 1965) [hereinafter SUPPLEMENTARY REPORT], reprinted in 2 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 9-15 (Matthew Bender Rev. ed. 2010) (“Throughout the drafting phase of the revision program the most explosive and difficult issue has been the problem that the *Report* in 1961 called ‘protection of authors against unremunerative transfers,’ and that section 203 of the 1965 bill calls ‘termination of transfers and license by the author,’ but that has come to be known generally as the ‘reversion problem.’”).

46. The strength of competing interests surrounding the “reversion right” was evident early on as illustrated by a comment in a 1960 study about Copyright “Renewal as a reversion or reservation of author’s rights,” commissioned by Congress and conducted by Barbara Ringer, who would subsequently become the Register of Copyrights and hold the position a decade and a half later when the revision was finally passed into law. In the 1960 Study, Ringer commented that the problems surrounding the reversion right “promise to be among the most troublesome the legislative drafters will have to face.” Barbara Ringer & Julius A Culp, *Renewal of Copyright, Study No. 31*, June 1960, reprinted in 2 OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY, *supra* note 6, at 190; see also SUPPLEMENTARY REPORT, *supra* note 45, at 1. Discussions that gave rise to the novel termination of transfers provisions may have taken place as early as the decades preceding World War II, but appear concretely in the legislative history as early as 1960, in Ringer’s study. See Ringer & Culp, *supra*, at 188, 201; see also H.R. REP. NO. 94-1476, at 124 (1976) (“The final ‘Shotwell Committee’ bill was introduced by Senator Thomas on January 1, 1940” and contained a reversion term that read “no grant by an author who was a natural person would be valid for more than 25 years.”); SUPPLEMENTARY REPORT, *supra* note 45, at 72 (“[The Copyright Office sought] actively and persistently to find a basis for agreement that would be a practical benefit to authors and their families without being unfair to publishers, film producers, and other users.”).

47. See *Transcript of Meeting*, *supra* note 41. In 1955 Congress provided funds for “a comprehensive program of research and studies by the Copyright Office as the groundwork for such a revision.” Accordingly, the Copyright Office commissioned thirty-five studies focusing on the major substantive issues that were the subject of revision, the results of which were ultimately published in 1961 in the “Report of the Register of Copyrights on the General Revision of the U.S. Copyright Law.” See JOSEPH C. O’MAHONEY, 86TH CONG., COPYRIGHT REVISION STUDIES 29–30 iii (Comm. Print 1961) (“This committee print is the

transferees) voiced concerns that the reversion right would place an undue burden on them and hinder their successful performance of a necessary intermediary function between creators and consumers.⁴⁸ But authors championed the importance of keeping a reversion right, to ensure the protection of authors in their dealings with transferees, who were often more sophisticated.⁴⁹

A complicated back-and-forth during the revision process in the 1970s reflects the fundamental divide between the rights of authors and the rights of publishers. The Authors League argued that authors are in an inferior bargaining position when negotiating with publishers and that therefore some version of a reversion clause was needed to equalize the playing field over time and protect authors from unknowingly acting contrary to their best interests.⁵⁰ The publishers retorted that despite the existence of the reversion right in the 1909 Act renewal scheme, which aimed to address this concern but did not strictly limit transfer or waiver, “[t]he author can, and usually does, contract with his publisher to assign to him his rights in the renewal term.”⁵¹ The authors, in turn, insisted that “[t]hey do not have the economic bargaining power to resist the inclusion of [unfavorable clauses] in publishing contracts . . .” just as they struggle under the current regime to “resist the demand . . . that they tie-in an assignment of their renewal rights, when they grant publishing rights under the original copyright.”⁵² But the publishers filed multiple comments explicitly rejecting all of the early proposals that revised the reversion scheme, grounding their resistance in the changed commercial landscape:

The whole idea of reversion rests on a theory that authors as a class are improvident or are not in a position to bargain equally with copyright users and hence should not be allowed to contract freely for their works as may appear to them to be in their best interest. It would appear that at best this is a highly questionable theory, and that authors and publishers would both benefit from a freedom to make such contracts as seem to them naturally advantageous . . .

tenth of a series of such prints of studies on Copyright Law Revision published by the Committee on the Judiciary Subcommittee on Patents, Trademarks, and Copyrights. The studies have been prepared under the supervision of the Copyright Office of the Library of Congress with a view to considering a general revision of the copyright law (title 17, U.S. Code).”).

48. *Book Publishers' Comment*, *supra* note 6, at 248–51; *Joint Publishers' Comment*, *supra* note 6, at 274.

49. *Authors League Comment*, *supra* note 6, at 313–14.

50. *Id.* at 313–14 (internal quotations omitted).

51. *Book Publishers' Comment*, *supra* note 6, at 248.

52. *Authors League Comment*, *supra* note 6, at 313–14.

the antiquated concept that an author requires protection against his own improvidence in bargaining with a publisher is not true today if it ever was. Today an author is generally represented by a literary agent, by an attorney trained in the field of literary property and by tax counsel.⁵³

This argument, which may hold even more truth today than it did during the revision process, suggests that the “unequal bargaining power” justification appears unnecessarily paternalistic at best under current conditions of creation.

However, Congress took a different tack in justifying the provisions, noting that, contrary to what the authors’ and publishers’ exchanges suggest, the disadvantaged bargaining position arises out of the inherent difficulty of determining a work’s value before its commercial exploitation, and not out of the difference in the parties’ sophistication.⁵⁴ Furthermore, the provisions that ultimately made it into the 1976 Act arguably achieve a delicate balance in the following way.⁵⁵ While the termination of transfer provisions generally favor the authors’ interests, the Act mitigates the harsh effect on publishers and distributors in two important ways: (1) the reversion is not automatic but instead places the burden on authors to actively seek termination, and (2) termination has no effect on an assignee’s ability to exploit derivative works prepared under the grant.⁵⁶ In spite of these compromises, the unusual nature

53. *Joint Publishers’ Comment, supra* note 6, at 274–75 (“It is the position of the Council and the Institute that, as under the British Copyright Law, there should be no reversion; that the author is competent to bargain freely in transferring his copyrighted work, just as if he were selling his house. He should not be a ward of society and should not be entitled to any greater protection than is afforded inventors who are free to deal with their patent rights as they see fit.”); *Book Publishers’ Comment, supra* note 6, at 250 (“The net effect of the proposed provisions with respect to reversion, collective works, and works for hire would seriously curtail publishers’ rights and it is probably that book publishers would be better off under the present law than under a new statute with those provisions. However, other interests, notably motion pictures, are even more seriously affected and have joined in protesting these proposals.”). The 1961 Report had recommended two alternatives to the existing reversion right: either (1) an unwaivable twenty-five year limit on transfers effective automatically upon expiration of the term, thus placing burden on transferee, but with a specific exception for continued rights in derivative works like motion pictures; or (2) a three-year window beginning twenty years after grant where an author or her representatives can terminate or reform the contract if “the profits received by the transferee or his successors in title are strikingly disproportionate to the compensation, consideration, or share received by the author or his successors.” *Book Publishers’ Comment, supra* note 6 at 250.

54. H.R. REP. NO. 94-1476, at 124 (1976); S. REP. NO. 94-473, at 65 (1975).

55. *See* S. REP. NO. 94-473, at 65 (“Section 203 reflects a practical compromise that will further the objectives of the copyright law while recognizing the problems and legitimate needs of all interests involved.”).

56. *See supra* Part I.B.

of the provisions made their existence controversial even as Congress passed the final Act. The House and Senate reports on the final bill echo many of the concerns that plagued the revision process and the historical context of the conception and evolution of the termination of transfers provisions.⁵⁷

II. DEFINING THE GAP

The policies underlying the termination provisions are far less controversial than the 1976 Act's novel method of executing the policies through an inalienable, unwaivable right. Moreover, before creators can make reliable use of the provisions, the law must resolve substantial ambiguities in the statutory provisions that compound the difficulties with the novel right.⁵⁸ Discussion in recent years about how the statute will treat Gap Works, like "The Devil Went Down to Georgia," has illuminated the fundamental necessity of addressing this uncertainty in advance of the first wave of § 203 terminations.

A. THE "GAP WORKS" PROBLEM

The undefined word "executed" in the statute almost singlehandedly creates the Gap Works problem. Section 203 clearly provides for termination of grants "executed . . . on or after January 1, 1978" for works created on or after January 1, 1978.⁵⁹ There are two perhaps equally plausible interpretations of what Congress meant by requiring execution of a grant on or after this date. The Copyright Office has promulgated the first interpretation: in order for the actual assignment of a copyright in a work to be "executed," the copyright, and thus the work, must actually exist.⁶⁰ Under this interpretation, the date of grant execution can be no earlier than the date of creation of the work. The second interpretation uses the plain-language meaning to find that execution means the actual signing of the assignment contract, which includes contracts for works that do not yet exist. Since the first transfers "executed" under the 1976 Act will be ripe for termination on January 1, 2013, courts will soon have to address this ambiguity, and they cannot do so earlier. Given the novel character of the termination of transfers provisions and their highly disputed conception, courts must proceed in this task with a heightened sensitivity and caution.

Adhering strictly to a literal reading of the statute would result in anomalously placing certain works outside the scope of both termination of

57. See H.R. REP. NO. 94-1476, at 124–28; S. REP. NO. 94-473, at 65.

58. See *supra* Section I.C.

59. 17 U.S.C. § 203(a) (2010).

60. See COPYRIGHT OFFICE, GAP GRANTS, *supra* note 9, at iii.

transfer provisions. Consider a work for which an assignment was made prior to January 1, 1978, but the work itself was not created until after January 1, 1978. On its face, section 304(c) is inapplicable to this work because, although it applies to grants made prior to January 1, 1978, it requires a subsisting copyright as of that date.⁶¹ Section 203 similarly might not apply to this fact pattern because it requires the grant to have been “executed . . . on or after January 1, 1978.”⁶² This is the essence of the Gap Works problem.

This “gap” has attracted attention in recent years because it raises threshold questions about the intersection of copyright and contract law in the operation of these novel provisions. As the first § 203 terminations approach in 2013, the copyright community is left wondering: Did Congress inexplicably exclude this class of works entirely from the termination of transfers provisions? What is actually required to “execute” an assignment grant? Is it possible to “execute” a grant of a transfer of rights in a work that has not yet been created, or is the “execution” date implicitly conditioned on the work’s creation date?

Because the statute requires that authors record notice of expected terminations between ten and two years prior to the date they wish to terminate, the 2003–2011 window for termination notice has already passed for the first § 203 terminations and the Copyright Office has already had to confront Gap Works complications. Beginning in March 2010 the Copyright Office conducted a Notice and Comment period to determine whether it should accept and record notice of Gap Works transfer terminations.⁶³ This effort produced two conclusions, one binding and one not binding. In its final rule governing its administrative functions, the Copyright Office stipulated it will accept and record such notice.⁶⁴ However, in December 2010 the Office pushed further in recommending that Gap Works be considered fully terminable under § 203.⁶⁵ But this last recommendation has

61. 17 U.S.C. § 304(c).

62. *Id.* § 203(a).

63. *See* Gap in Termination Provisions; Inquiry, 75 Fed. Reg. 15,390 (Copyright Office Mar. 29, 2010) (to be codified at 37 C.F.R. § 201); Gap in Termination Provisions; Inquiry (Supplemental Notice: extension of comment period), 75 Fed. Reg. 27,248 (Copyright Office May 14, 2010) (to be codified at 37 C.F.R. § 201); Gap in Termination Provisions (Notice of Proposed Rulemaking), 75 Fed. Reg. 72,771 (Copyright Office Nov. 26, 2010) (to be codified at 37 C.F.R. § 201).

64. 37 C.F.R. § 201.10(f)(5) (2011).

65. COPYRIGHT OFFICE, GAP GRANTS, *supra* note 9. The Copyright Office has recommended clarifying the statutory language consistent with this stance, suggesting that § 203(a)(3) be amended by adding a new sentence at the end as follows:

minimal legal impact because the Office conducted its study only in discharging its ministerial duties rather than on a special mandate from Congress, which would have carried more legal authority.⁶⁶ The December 2010 Report explicitly clarifies this point: “[T]he rulemaking is not a substitute for statutory clarification. Although authors must record the notice they serve on grantees as a condition of termination taking effect, . . . [r]ecordation of a notice of termination by the Copyright Office is without prejudice to any party claiming that the legal and formal requirements for issuing a valid notice have not been met.”⁶⁷ But even if this recommendation carries little legal weight, the Notice and Comment period and the Copyright Office’s analysis of the Gap Works problem has importantly illuminated the greater interpretive challenges that § 203 presents.

B. THE PRACTICAL SCOPE OF THE PROBLEM: BEYOND “GAP WORKS”
AND THE NATURE OF CONTRACTING FOR CREATIVE WORKS

The questions underlying the Gap Works problem, however, resonate far beyond the class of works that straddles the Act’s effective date. Practical concerns within creative industries make assignments of rights in subsequently created works (here called “prospective assignments”) a common practice. Such prospective grants characterize book publishing deals, record label contracts, and screenplay acquisition deals.⁶⁸ Because § 203 measures the start of the five-year termination window from the date on which the assignment grant was executed, even when contract signing and work creation do not straddle the January 1, 1978 effective date, grantors and

Termination of the grant may be effected at any time during a period of five years beginning at the end of thirty-five years from the date of execution of the grant; or, if the grant covers the right of publication of the work, the period begins at the end of thirty-five years from the date of publication of the work under the grant or at the end of forty years from the date of execution of the grant, whichever term ends earlier. *For purposes of this section, and without prejudice to the operation of any other provision in Title 17, the date of execution of the grant is no earlier than the date on which the work is created.*

COPYRIGHT OFFICE, GAP GRANTS, *supra* note 9, at iii (emphasis in the original).

66. Compare this function of the Copyright Office with the 1955 commissioning of the studies and the 1961 report. See Andy Gass, *Considering Copyright Rulemaking: The Constitutional Question*, 27 BERKELEY TECH. L.J. (forthcoming 2012).

67. COPYRIGHT OFFICE, GAP GRANTS, *supra* note 9, at iii.

68. See *infra* Sections III.C.2.b)i)–iii); DINA APPLETON & DANIEL YANKELEVITS, HOLLYWOOD DEALMAKING: NEGOTIATING TALENT AGREEMENTS FOR FILM, TV, AND NEW MEDIA 247 (2010); PASSMAN, *supra* note 7, at 136–42; Letter from Perlstein to Pallante, *supra* note 7.

grantees are left to wonder whether a copyright assignment grant can ever be “executed” before the copyright (and thus the actual work) actually exists. Although this inquiry is more acute in the Gap Works context because a negative answer would imply that this group of creators have no right whatsoever to terminate their transfers, it is equally crucial for works fully covered by § 203 because it dictates the point at which the clock starts for the notice and termination windows for all prospective assignments.

III. ANALYSIS: PRACTICAL REASONING AS STATUTORY INTERPRETATION

Regardless of why the Gap exists or the practical scope of the problem the Gap illuminates, its resolution depends on determining what meaning should be given to the statutory text. Over the last three decades, scholars and courts have begun to embrace a philosophy of statutory interpretation based less on any singular historical canon of interpretation and more on “practical reasoning.”⁶⁹ William V. Eskridge, Jr. and Philip P. Frickey defend this approach as “both more natural and more useful,” lauding the coherent analysis that results when courts follow a “practical reasoning model” and schematizing the structure of such interpretation as a “funnel of abstraction” that considers, in turn, textual, historical, and practical evolutive considerations.⁷⁰ This Part engages with the statute in each of these three capacities, acknowledging the strength of multiple interpretations but ultimately determining that the practical superiority of the date-of-agreement interpretation makes for the best construction of the statute.

69. Eskridge, Jr. & Frickey, *supra* note 12.

70. *Id.* at 322, 353 (explaining how this “funnel” model represents both the hierarchy of sources and the degree of abstraction of each, and that inquiries from different sources may be less concrete than inquiries from other sources). The Supreme Court applied a version of this “practical reasoning model” to its interpretation of the Copyright Act of 1976 in *Community for Creative Non-Violence v. Reid* (*CCNV v. Reid*), 490 U.S. 730 (1989). In determining the scope of the “work for hire” provisions of the 1976 Act, the Court considered textual, historical, and evolutive inquiries, ultimately determining that the best interpretation of the statutorily undefined term “employee” was the common-law agency definition. The Court’s analysis in *CCNV v. Reid* is instructive for two reasons. First, it provides an example of thorough, reasoned statutory interpretation in the context of the copyright statute. Second, it shows how common law and practical norms often lead to the most natural and useful interpretation of an ambiguous statutory provision. See Peter S. Menell, *The Mixed Heritage of Federal Intellectual Property Law and Ramifications for Statutory Interpretation*, in *INTELLECTUAL PROPERTY AND THE COMMON LAW* (Shyam Balganeshe ed., forthcoming 2012), available at <http://ssrn.com/abstract=1895784>.

A. TEXTUAL INTERPRETATION

The Practical Reasoning model first looks at the statutory text, starting with the specific words of the provision and then looking to how the provision fits with related provisions and the general structure of the statute.⁷¹ In looking at the specific words of the statute, case law suggests that adopting the common law meaning of a term often results in the proper construction of a statutory provision.⁷²

As discussed in Part II, *supra*, the interpretation of § 203 hinges on what the statute requires by the word “executed”.⁷³ Both interpretations of this word within the context of § 203—date-of-creation and date-of-agreement—find support in a textualist analysis of this provision. The legal meaning of the term “executed” technically refers to a contract in which nothing remains to be done by either party—an interpretation that supports the date-of-creation interpretation.⁷⁴ However, Congress commonly used the term “executed” interchangeably with the term “signed”, suggesting that the term’s conventional meaning supports the date-of-agreement interpretation.⁷⁵ This Section shows how a textualist interpretation of § 203, in the first phase of Eskridge and Frickey’s model, equally supports both interpretations.⁷⁶

1. *Textual Support for Date-of-Creation*

The basis of the date-of-creation interpretation is that the statute is, in fact, not ambiguous once one assumes that the execution cannot be completed until the copyrighted work actually exists. This interpretation follows the reasoning that an assignment of a copyright is not fully executed

71. Eskridge, Jr. & Frickey, *supra* note 12, at 354.

72. See discussion *supra* note 70; see also Menell, *supra* note 70, manuscript at 30 (“When we examine the substance of modern federal intellectual property law, the judiciary’s imprint and evolving role are unmistakable and profound.”).

73. 17 U.S.C. § 203 (2010).

74. E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 1.1 (3rd ed. 2004); WILLIAM W. STORY, A TREATISE ON THE LAW OF CONTRACTS § 22 (5th ed. 1874).

75. See Comment from Jane C. Ginsburg, Professor, Columbia Univ., to Maria Pallante, Associate Register, U.S. Copyright Office, re: Notice of Inquiry 5–7 (Apr. 27, 2010), available at <http://www.copyright.gov/docs/termination/comments/2010/ginsburg-jane.pdf> [hereinafter Ginsburg Comment].

76. In her comment to the Copyright Office, Jane Ginsburg includes a textualist analysis of the provisions surrounding § 203. The analysis consists of identifying each occurrence of a form of the word “execute” in these provisions and a classification of each use as meaning: (1) signing, (2) something other than signing, or (3) either. However, perhaps unsurprisingly, this endeavor fails to illuminate one clear meaning but instead shows the range of potential meanings Congress apparently assigned to this single word even within this particular portion of the Copyright Act. See Ginsburg Comment *supra* note 75.

until the future interest it purports to grant actually vests in the grantee.⁷⁷ Such vesting cannot occur until the copyright subsists, which under § 201(a) of the 1976 Act occurs upon creation and fixation of the work.⁷⁸ The convincing logic behind this reasoning comes from the support it finds in common law conceptions of contract and property law.⁷⁹ U.S. contract law defines an “executed agreement” as “one in which nothing remains to be done by either party, and where the transaction is completed at the moment that the agreement is made.”⁸⁰ Under this definition, prospective copyright assignments, where the work and thus the copyright in the work do not yet exist, are not “executed agreements.” Instead, such assignments are more akin to “executory agreements,” which transfer a future interest that does not take full effect until a later time.⁸¹

The notion that § 203 requires something other than the signing of the assignment contract also finds support in the context provided by the rest of the Section as well as its surrounding provisions within Title 17. To explain, § 203 permits the termination of non-exclusive licenses which, unlike exclusive licenses, are not subject to the statutory writing requirement and may instead be granted orally or inferred from conduct. Since they are not subject to a writing requirement, non-exclusive licenses need never be signed,

77. See, e.g., Letter from Kenneth D. Freundlich & Neil W. Netanel to Marybeth Peters, Register of Copyrights, U.S. Copyright Office 1–2 (Apr. 30, 2010), available at <http://www.copyright.gov/docs/termination/comments/2010/freundlich-kenneth-neil-netanel.pdf> [hereinafter Freundlich & Netanel Letter] (concluding that full execution of the grant does not occur until the day copyright title vests).

78. See 17 U.S.C. § 201(a).

79. FARNSWORTH, *supra* note 74, § 1.1; see Jake Shafer, *The Gap Years*, L.A. LAW. 2 (Nov. 11, 2011), <http://www.lacba.org/Files/LAL/Vol34No8/2866.pdf>; cf. CCNV v. Reid, 490 U.S. 730 (1989) (construing the Copyright Act using a definition of “agency” consistent with the common law definition of the word).

80. FARNSWORTH, *supra* note 74, § 1.1; STORY, *supra* note 74, § 22.

81. BLACK’S LAW DICTIONARY 369 (9th ed. 2009) (defining an “executed contract” as “a contract that has been fully performed by both parties” and an “executory contract” as “a contract that remains wholly unperformed or for which there remains something still to be done on both sides.”); FARNSWORTH, *supra* note 74, § 1.1; see Shafer, *supra* note 79, at 2 (“If property must exist before legal title can pass, and any contract attempting to transfer such nonexisting property is merely executory, then the execution of any transfer agreement of a gap work should by definition date subsequent to the effective date of the 1976 Act (when legal title would vest) and would thus be terminable under section 203.”); see also Freundlich & Netanel L, *supra* note 77, at 6 (citing *T.B. Harms & Francis, Day & Hunter v. Stern*, a Second Circuit case addressing a contract purporting to transfer rights to all musical compositions the author composed during a five-year period where the court held that “[a]t law one cannot transfer by a present sale what he does not then own, although he expects to acquire it; b]ut, while [such a] contract [is] without effect at law as a contract for sale, it operate[s] as an executory agreement to sell”).

or “executed” in the “signed” sense of the word. Therefore, “a permissible inference may be drawn that within the context of § 203 the term ‘executed’ refers to the date of the completed transaction and not to the date of a signed agreement, because there may be no signed agreement.”⁸² To illustrate this, Professor Ginsburg pointed to an Eleventh Circuit case where the court held an oral copyright license that was never reduced to a signed agreement was still “fully executed” for the purposes of copyright.⁸³

Professor Ginsburg offers a textual analysis of §§ 203, 204, and 205 in which she examines the different possible meanings of the term “executed” in these provisions of the Copyright Act.⁸⁴ She highlights usage that indicates “the perfection of the transaction,” usage consistent with signing or entering into an agreement, and usage that could be consistent with either meaning.⁸⁵ However, the result of this meticulous textual analysis is the simple observation that “[i]n most cases, the signature is all that is needed to effect the transaction, so it’s not surprising that most of the usage of the terms ‘executed’ or ‘execution’ could be interpreted to mean both entering into the agreement, and concluding the transaction.”⁸⁶

2. *Textual Support for Date-of-Agreement*

But date-of-creation is not the only possible interpretation. Textual analysis can also support the date-of-agreement interpretation. First, the term “executed” appears many times in the Act to refer solely to signing or otherwise entering into a contract.⁸⁷ Second, § 203(a)(3) provides an alternative method in some cases for calculating the termination window that clearly contrasts the use of the word “execution” with the word “publication”:

if the grant covers the right of publication of the work, the period begins at the end of thirty-five years from the date of publication of

82. Shafer, *supra* note 79, at 40. Section 203 allows for termination of non-exclusive licenses but the writing requirement of section 204 applies to “transfers of copyright.” 17 U.S.C. §§ 203, 304; *see id.* § 101 (defining the transfer of copyright ownership as “not including a nonexclusive license”); *supra* note 21; Shafer, *supra* note 79, at 36, 39–40; *see also* Ginsburg Comment, *supra* note 76, at 2.

83. Ginsburg Comment, *supra* note 76, at 2 (citing *Korman v. HBC Fla.*, 182 F.3d 1291 (11th Cir. 1999)).

84. *Id.* at 5–7.

85. *See id.*

86. *Id.* at 5.

87. *See, e.g., id.*, at 5–7 (demonstrating the range of uses of the word “execute” in the provisions of the Copyright Act of 1976 surrounding section 203.)

the work under the grant or at the end of forty years from the date of execution of the grant, whichever term ends earlier.⁸⁸

Thus the text of § 203 shows that Congress considered a model where exploitation of the rights under a grant could not begin immediately upon the date of the agreement, explicitly calculating the termination window in such cases from the date of publication, as required by fairness concerns, to allow the publisher to enjoy a transfer term closer to the thirty-five years envisioned by the statute. This alternative method sits in opposition to the method that starts the termination clock running upon “execution” of the grant.

B. HISTORICAL INTERPRETATION

The next phase of the Practical Reasoning model looks to historical considerations, like evidence of the statute’s background, including policy considerations, to recover its original meaning. Using the legislative history to understand contemporaneous congressional expectations, historical interpretation seeks to approximate congressional intent to resolve ambiguity in the statutory text.⁸⁹ However, interpreting a particular statutory provision in terms of the general purposes of the statute can prove quite difficult.⁹⁰ Even after focusing the inquiry on the original problems Congress was trying to solve by enacting the statute, the interpreter may find several different purposes that pull her towards divergent interpretations of the provision.

Study reveals precisely this kind of bifurcated intent behind § 203, which explains the inconclusive result of the historical inquiry: while the legislative history of the termination of transfer provisions supports reading the statute as referencing a bright-line rule, it simultaneously indicates that Congress had no intention of creating a Gap.⁹¹ Thus, like the textual interpretation, the historical interpretation of § 203 can plausibly support both the date-of-creation and the date-of-agreement interpretations.

1. *Historical Support for Date-of-Creation*

The historical analysis in support of the date-of-creation interpretation is simple: the articulated public policies and delicate balance between authors’ and publishers’ interests that underwrite the termination provisions, discussed in Section I.C, *supra*, provide no logical explanation for excluding

88. 17 U.S.C. § 203(a)(3) (2010).

89. Eskridge, Jr. & Frickey, *supra* note 12, at 356.

90. *Id.* at 358 (“[P]urposivist analysis is inherently ambiguous.”).

91. *See* 3 OMNIBUS COPYRIGHT REVISION LEGISLATIVE HISTORY (George S. Grossman ed., 2001).

Gap Works entirely from termination eligibility. Interpreting § 203 to apply as of the “date-of-agreement” would leave no termination rights at all for the authors of works that happen to fall within the gap. This goes against every stated policy and purpose of these heavily-disputed and finely-tailored termination provisions, which aim to both protect authors and promote distributive justice and fairness.⁹² Undeniably, historical analysis of § 203 shows Congress did not intend to create a gap, and thus supports a date-of-creation interpretation which sweeps the Gap Works within the purview of the provision.

2. *Historical Support for Date-of-Agreement*

However, historical evidence also clearly indicates Congress’ intent to create termination of transfers provisions that function like a bright-line rule.⁹³ At various stages in the general revision process, Congress considered the concern that using the date of a work’s creation as the operative date for determining rights under copyright was impractical.⁹⁴ For example, such concerns provided the impetus to condition the 1976 Act’s copyright duration on the life of the author rather than the date of creation or fixation.⁹⁵ The legislative history further indicates that Congress wanted to avoid drafting the termination of transfers provisions in a way that would present an “open invitation to endless and costly litigation.”⁹⁶ Ambiguity in determining the proper termination window creates problems with exercising termination rights and, due to the commercial value of the underlying works, such disputes will likely result in litigation. Although some disagreement may be unavoidable, Congress expressed a clear preference for designing a regime that avoided difficulties such as routinely having to discern through litigation the elusive date on which a work was completed.⁹⁷

92. Ginsburg Comment, *supra* note 76, at 3.

93. See *Transcript of Meeting*, *supra* note 55, at 38–39; *infra* Section III.C.2.

94. See, e.g., *Joint Publishers’ Comment*, *supra* note 6, at 276 (“[I]t is wholly impracticable to date the commencement of the copyright term from creation of the work. Publishers have no effective way of ascertaining when such creation took place.”).

95. See *Transcript of Meeting*, *supra* note 55, at 38–39.

96. *Book Publishers’ Comment*, *supra* note 6, at 250 (criticizing an early incarnation of the termination of transfers provisions as “extremely impractical in terms of its open invitation to endless and costly litigation in which the publishers might well find themselves at the mercy of the courts, which would have no objective standard to guide them”). Congress ultimately agreed with this assessment, at least to some extent, because it removed the specific provision that was the subject of this gripe.

97. The argument that Congress intended to create a clear, predictable window is further evidenced by the statute’s notice provisions found in 17 U.S.C. § 203(a)(4). See SUPPLEMENTARY REPORT, *supra* note 45, at 4 (“The thought behind the 2- to 10-year limitation on the time for serving notice was to establish a definite period for filing the

The legislative history also strengthens the argument for the date-of-agreement interpretation by contextualizing the alternative method for calculating the termination window when publication rights are included in the grant.⁹⁸ Congress included this alternative method in § 203, which adds up to five years to the operative period in cases where the contract is signed long before publication,⁹⁹ to protect book publishers and other transferee factions who, in their comments to Congress, argued that “in many cases a straight period of 35 years from the execution of the grant would be illusory, since a number of publication contracts are signed before the work is written, and it may be years before it is completed and published.”¹⁰⁰ These concerns show that Congress must have considered the special issues raised by the prospective grant model as it drafted § 203.¹⁰¹ Furthermore, Congress itself illustrated how this alternative method of calculation would operate in practice:

Contract for a book publication executed on April 10, 1980; book finally published on August 23, 1987. Since the contract covers the right of publication, the 5-year termination period would begin on April 10, 2020 (40 years from execution) rather than April 10, 2015 (35 years from execution) or August 23, 2222 (35 years from publication)¹⁰²

Notably, this illustration clearly assumes that “execution” means the date of the agreement.

Furthermore, several contemporaneous Copyright Office references indicate that date-of-agreement was the accepted meaning of § 203 at the time the statute was enacted. Specifically, the Copyright Office’s *General Guide to the Copyright Act of 1976* not only gives an example of a Gap Work but also

notice toward the end of the 35 or 40 year term, thus avoiding earlier, indiscriminate terminations, and to provide a fair period of advance notice to the grantee that his rights are to be terminated.”).

98. This is discussed in Section III.A.2, *supra*.

99. See 17 U.S.C. § 203(a)(3) (2010); SUPPLEMENTARY REPORT, *supra* note 45, at 75.

100. SUPPLEMENTARY REPORT, *supra* note 45, at 75; see also S. REP. NO. 94-473, at 65 (1975) (“This alternative method of computation is intended to cover cases where years elapse between the signing of a publication contract and the eventual publication of the work.”).

101. In a recent piece published in a practitioners’ journal, Jake Shafer asserts that “[t]his rationale supports the argument that Congress understood the dilemma facing the publishing industry regarding transfer agreements entered into before the delivery of a work and intended the date of execution to be synonymous with the date of the signed agreement.” Shafer, *supra* note 79, at 39.

102. S. REP. NO. 94-473, at 65.

notes that some grants simply “would not be subject to termination.”¹⁰³ That the Copyright Office was already considering this scenario three decades ago seriously undermines assertions that historical evidence supports interpreting the statute so as to eliminate the Gap Works problem. Rather, Congress may even have been fully aware of this result, which would be consistent with choosing date-of-agreement as the proper context for the word “executed”.

C. PRACTICAL REASONING INTERPRETATION

This final phase of interpretation considers sources that reflect how the statute has evolved over time, taking into account social and legal circumstances not anticipated during the statute’s enactment and importing current values, such as modern ideas of fairness related to statutory policies, into the analysis.¹⁰⁴ Unlike the previous two interpretive inquiries, the practical reasoning analysis of § 203 yields only one superior interpretation: date-of-agreement. Despite the fact that such an interpretation would leave Gap Works creators without a right of termination, the certainty and efficiency of a date-of-agreement scheme far outweigh its costs in lost protection.

1. *Practical Reasoning Provides Limited Support for Date-of-Creation . . .*

Since Gap Works, by definition, were created after January 1, 1978, the date-of-creation interpretation simply deems the grants executed after that date, fitting them squarely within the scope of § 203 and affording the creator with a right of termination of transfer, eliminating the Gap entirely.¹⁰⁵ This practical result accords with the fact that, as discussed in Section III.B.1 *supra*, there is no apparent explanation for why Congress excluded this particular group of works from the termination of transfer regime.¹⁰⁶ Another practical advantage of this interpretation is that every assignee would enjoy an equal, thirty-five-year assignment term before becoming vulnerable to § 203 termination, rather than having the term shortened when creation lags behind the signing of the assignment contract. Since both of these results

103. COPYRIGHT OFFICE, LIBRARY OF CONG., GENERAL GUIDE TO THE COPYRIGHT ACT OF 1976 § 6.6 (1977), available at <http://www.copyright.gov/reports/guide-to-copyright.pdf>; see also SUPPLEMENTARY REPORT, *supra* note 45, at 74–75.

104. Eskridge, Jr. & Frickey, *supra* note 12, at 359.

105. See 17 U.S.C. § 203(a) (2010) (“[T]he exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978 . . .”).

106. See Ginsburg Comment, *supra* note 76, at 3 (“The text of the statute and its legislative history amply demonstrate Congress’ intent that authors should enjoy enforceable termination rights. The statute should be interpreted to cover as many works as possible (other than works made for hire).”).

appear consistent with notions of fairness and distributive justice, the date-of-creation interpretation holds substantial practical reasoning appeal.

2. . . . *But It Ultimately Favors Date-of-Agreement*

Nonetheless, practical reasoning dictates the superiority of the date-of-agreement interpretation for two reasons: (1) the date-of-agreement model is an accepted norm in other intellectual property transfer regimes, and (2) the certainty derived from the bright-line rule this interpretation creates promotes efficient business practices in the industries most affected by § 203.

a) Accepted Norm in Other Intellectual Property Transfer Regimes

Practical reasoning favors interpreting the statute to allow execution of prospective assignments to be synonymous with the signing of the assignment contract in part because this is the accepted practice in other areas of intellectual property. For instance, assignment agreements transferring patent ownership frequently cover future inventions—i.e., those inventions for which applications have not yet been issued or filed, or that have not yet been conceived.¹⁰⁷ When a party makes a grant of rights to an invention that has not yet been made, the grant is accepted as sufficient to transfer the title to the invention as soon as it comes into being, requiring no further action to implement or confirm the grant.¹⁰⁸ Although courts have not had the opportunity to directly consider comparable grants of copyrights, it has long been established that a valid transfer of rights under copyright can be made before those rights vest.¹⁰⁹

107. Jake Shafer explains,

Patent assignment agreements are contracts transferring patent ownership in all patents generated in a defined time, often the duration of employment. In a recent decision, the Federal Circuit reaffirmed its position, declaring that if a “contract expressly conveys rights in future inventions, no further act is required once an invention comes into being, and the transfer of title occurs by operation of law.” With patents, as with copyrights, the property must exist before title can vest. However, there is no statutory termination-of-transfer mechanism in patent law, and therefore the determination of the date of execution for such purposes has never been an issue.

Shafer, *supra* note 79, at 39 (internal citation omitted).

108. *DDB Techs., L.L.C. v. MLB Advanced Media, L.P.*, 517 F.3d 1284, 1289–90 (Fed. Cir. 2008); *Speedplay, Inc. v. Bebop, Inc.*, 211 F.3d 1245, 1253 (Fed. Cir. 2000).

109. Reply Comments of the Recording Industry Association of America, Inc. at 4 n.1, *In re Gap in Termination Provisions; Inquiry* (U.S. Copyright Office, Library of Congress), May 21, 2010, available at <http://www.copyright.gov/docs/termination/comments/2010/reply/riaa.pdf> [hereinafter RIAA Comment]; see, e.g., *Fred Fisher Music Co. v. M. Witmark & Sons*, 318 U.S. 643 (1943) (finding author’s assignment of renewal rights made

b) Certainty Promotes Efficient Business Practices in the Industries
Most Affected by § 203

Another rationale favoring the date-of-agreement interpretation is that to actually represent a meaningful compromise between the interests of authors and publishers, the termination of transfers provisions must be useful for both parties, and usefulness requires legal predictability. Even proponents of the date-of-creation interpretation acknowledge its inherent practical difficulties, noting that the date of creation of a work may prove indefinable in part because “Authors’ abilities to recall or document the month and day on which they completed creating a work may be more uncertain.”¹¹⁰ Furthermore, the resultant uncertainty could result in costly litigation or discourage parties from exercising their termination rights in the first place.

Accordingly, despite the theoretical and philosophical appeal of the date-of-creation interpretation, both transferors and transferees (e.g., authors and publishers) are, as a practical matter, likely to find the date-of-agreement interpretation more appealing. A transferee that cannot clearly and definitely discern the finite period during which it will be vulnerable to termination of its rights in the work will likely be reluctant to invest in any projects concerning that work. Despite shortening the term of their assignment if a creator exercises the termination right, transferees may still find this clear definition more attractive because it provides a certain date that better allows them to assess their exposure, to plan ahead for potential terminations, and to determine with certainty when the termination window has expired and

before initial term expires is valid if the author is alive at the commencement of the renewal period). The RIAA further argues that “grants of rights to works that do not yet exist are common, and important to commerce involving copyrighted works.” RIAA Comment, *supra*, at 4 n.1.

110. Ginsburg Comment, *supra* note 76, at 3. But Ginsburg notes that “the statute offers evidence of Congress’ expectation that the author should be able to identify the actual date” referencing 17 U.S.C. § 409(7) (application for registration “shall include” “the year in which creation of the work was completed.”). *Id.* Furthermore, even if an author keeps immaculate records of her creative process, which is a highly unlikely proposition, at what stage in this often-fluid process will a work be deemed to have been created? An author often goes through many drafts and revisions before arriving at the work that is eventually published or distributed by the assignee. Yet, the preliminary versions of a work are likely copyrightable themselves and provide the foundation for the later work, not to mention may allow the transferee to begin exploiting the work (think of a motion picture/ TV script acquisition—the script is constantly in flux, but the studio is still able to move forward on development and perhaps production). Thus, under an interpretation of §203 that looks to the date of creation in calculating the termination window for prospective assignments, there would be substantial difficulty in determining any precise dates. As a result, the transactional efficiency that accompanies predictability would vanish and transferees would be unable to know their rights with any certainty.

their rights are no longer vulnerable. Likewise, an author who is uncertain about how to calculate the termination window and confused about how the process works may decide not to exercise her rights at all. Thus, transferors benefit from this interpretation because it allows them to readily comply with § 203's notice requirements and exercise their rights without having to untangle a vague "creation" requirement or respond to objections by the transferee in the likely case that such a date is not clearly defined. Analysis of three major industries where the termination of transfer provisions will have the greatest impact leads to the undeniable conclusion that the date-of-agreement interpretation is the superior one.

i) Film and Television Production and Distribution

Rights acquisition in the film and television industries varies significantly from some other creative industries primarily because screenplays and motion pictures, unlike sound recordings and a number of other creative works, can both be created as works for hire.¹¹¹ As discussed in Section I.B, *supra*, works for hire are not subject to termination.¹¹² This statutory exception arose following strong lobbying by the Motion Picture Association of America ("MPAA") and other interested parties during the general revision process.¹¹³ Still, the impending tidal wave of § 203 will inevitably make a splash in this multi-billion dollar industry.

As a general practice, motion picture and television studios require all contributing talent (e.g., directors, writers, producers) to sign a certificate of authorship before they can receive any compensation.¹¹⁴ This agreement sets forth the parameters of the employment relationship—be it that of employee or independent contractor.¹¹⁵ The agreement usually stipulates that all future contributions will be deemed "for hire," making the studio the sole author and owner of all copyright interests in the work.¹¹⁶ In cases where a studio acquires content that already exists, it will have the author assign all of the rights in such content to the studio in some sort of option or purchase agreement.¹¹⁷ However, the studio can never retroactively become the statutory author of the work simply by contractually defining the previously

111. 17 U.S.C. § 101 (2010) (defining "work made for hire").

112. *Id.* § 203.

113. *Book Publishers' Comment, supra* note 6, at 250.

114. APPLETON & YANKELEVITS, *supra* note 68, at 232.

115. *Id.* at 247.

116. *Id.* at 232.

117. *Id.*

created work as one “made for hire.”¹¹⁸ These cases are where studios are vulnerable to termination of transfers.

In anticipation of the first wave of terminations, motion picture and television studios have undertaken extensive reviews of their libraries.¹¹⁹ Their goal in this process is to determine the periods during which the rights to properties acquired by assignment or license may be vulnerable to termination. By doing this, the studios can prepare for the worst-case scenario and advise the appropriate internal departments on what can and cannot be done with the properties upon such termination. Identifying periods during which properties are vulnerable also allows studios to know if and when such windows have passed.¹²⁰ Underlying this endeavor is the assumption that the studios can easily ascertain such periods. Studios have likely been conducting their reviews and assessing their vulnerability based on the dates of the assignment contracts, under the assumption that such dates represent the dates of “execution” for the purposes of § 203. Adopting the date-of-creation interpretation instead would force the studios to undertake the massive task of retroactively discerning this often elusive date and recalculating their dates of termination vulnerability.

ii) Book Publishing

In the context of book publishing the two interpretations could produce vastly different results. Most book publishing deals are signed in advance of creation and delivery of the final manuscript, meaning the interpretation of “executed” in § 203 is crucial. Publishers attempting to plan ahead for impending terminations by authors of works with particular commercial longevity are also likely basing such calculations on the plain language of the statute, or the date-of-assignment interpretation. Section 203 explicitly allows the five-year termination window to begin at the earlier of thirty-five years after publication or forty years after “execution of the grant” whenever publishing rights are included in the grant. Under a date-of-agreement interpretation, publishers can sign a work up to five years prior to its publication without suffering a shortened assignment period; book publishers probably never considered basing their calculations on the date of creation.¹²¹

118. *See* 17 U.S.C. § 101 (2010).

119. *E.g.*, Keith Blau, General Counsel, Universal Motion Picture Grp., Guest Lecture in LAW 278.75 Entertainment Law: TV and Film, University of California, Berkeley, School of Law (Nov. 14, 2011) (lecture notes on file with author).

120. *Id.*

121. *See* 17 U.S.C. § 203(a)(3).

The situation that Congress expressly anticipated—of publication occurring up to five years after contract signing—may arise because the publisher delayed publication of a ready work for whatever reason, or because an author created or delivered the work more than five years after the signing of the contract, thereby delaying the publication.¹²² Thus, as discussed in Section III.A.2, *supra*, Congress designed the statute to account for complications caused by prospective grants in the book publishing context, basing the two alternatives on two easily-discernible dates: the date of publication and the date of the agreement.¹²³

iii) Music Publishing

The termination of transfers provisions, in general, present significant issues for parties involved in music publishing.¹²⁴ The issues surrounding what is required for a grant to be “executed” within the meaning of § 203 are especially acute in this arena, not just because neither the work-for-hire exception nor the alternative method for calculating based on date of publication apply, but also because of certain well-established industry practices.

Music industry custom, both today and over at least the last four decades, involves exclusive term contracts between music publishers and songwriters.¹²⁵ Pursuant to such contracts, a writer must deliver to the publisher all compositions she creates during the term of the contract.¹²⁶ During the 1960s, 1970s, and 1980s the term of an exclusive term contract was “typically measured by yearly periods, with an initial period of one year plus up to four one year option periods exercisable by the publisher.”¹²⁷ Thus, not only is the Gap Works issue invoked in cases where the term of a pre-January 1, 1978 contract extends beyond 1977, either because the term straddles this date or by the publisher’s exercise of options, but moreover, nearly every work in this context that becomes ripe for termination involves a prospective assignment and thus implicates the statutory interpretation at issue in this Note.

122. *See id.*

123. *See supra* Section III.B.2 (showing the only logical meaning of “executed” in § 203(a)(3) is the date of the agreement).

124. *See* Adam Halston Dunst, *It’s Mine! No, It’s Mine! No, It’s Mine!*, 7 VAND. J. ENT. L. & PRAC. 382 (2005); David Nimmer & Peter S. Menell, *Poob-Poobing Copyright Law’s ‘Inalienable’ Termination Rights*, 57 J. COPYRIGHT SOC’Y U.S.A. 799 (2010); David Nimmer & Peter S. Menell, *Sound Recordings, Works for Hire and the Termination-of-Transfers Time Bomb*, 49 J. COPYRIGHT SOC’Y U.S.A. 387 (2001).

125. PASSMAN, *supra* note 7, at 136–42; Letter from Perlstein to Pallante, *supra* note 7.

126. PASSMAN, *supra* note 7, at 136–42; Letter from Perlstein to Pallante, *supra* note 7.

127. Letter from Perlstein to Pallante, *supra* note 7.

Leaving aside any consideration of the Gap Works debate, music publishers should generally favor the date-of-creation interpretation because it would allow them to enjoy a full thirty-five year term on each work regardless of when during the exclusive term a songwriter delivers it. By parallel logic, a songwriter should favor the date-of-agreement interpretation as it cuts short the term of the assignments, allowing him to quickly regain rights in works delivered late in the exclusive term. Interestingly, however, the Gap Works debate reverses these positions because the date-of-creation interpretation allows songwriter-transferors to terminate their Gap Works transfers under § 203, while the date-of-assignment interpretation bars them from doing so.¹²⁸

Another industry practice that could potentially complicate matters even more for the music industry than for other creative industries is the “single song” songwriter contract. Under some circumstances, the songwriter will either write a long-form contract or sign a short form memo identifying the title of the new work, co-writers, and date of delivery to the publisher for each composition delivered under an exclusive term contract.¹²⁹ If such a document exists, it may supersede the exclusive term contract and provide a new, later execution date under the date-of-agreement interpretation for the purposes of § 203. However, veteran music attorney Michael Perlstein writes that under industry practices in the 1960s, 1970s, and 1980s, “it was more the case for the writer simply to deliver a composition to the publisher without any written acknowledgement or new single song contract.”¹³⁰ Thus, most transfers of copyrights are made pursuant to the original term deals.

As a result of the disparate outcomes that each interpretation may produce in this context, music publishers and songwriters alike will look to § 203 for guidance, not only to resolve the Gap Works issue, but also to understand if and when prospective assignments of copyrighted works are subject to termination. Since the date of the original agreement, in most scenarios, represents the only bright-line date from which to calculate the termination window, interpreting the statute to reference the agreement date will produce a more efficient, useful rule.

128. Since only a select few works have continuing commercial value three decades after their initial creation, publication, or exploitation, the gap works issue may be significant enough in the minds of interested parties to cause them to support an interpretation of § 203 today that, nevertheless, might not serve their interests in the long run.

129. Letter from Perlstein to Pallante, *supra* note 7.

130. *Id.*

D. A PRACTICAL BUT IMPERFECT SOLUTION

Despite convincing counterarguments, interpreting “executed” within the context of § 203 to refer to the date of the assignment contract produces a sound result: given equally convincing textual and historical justifications for both the date-of-creation and date-of-agreement interpretations, practical concerns justify favoring the latter interpretation. Nonetheless, this interpretation yields the highly undesirable outcome of allowing Gap Works to slip through the cracks of Title 17’s termination of transfers provisions, against congressional intentions. But, since the interpretation of this provision will dictate how the termination of transfers scheme will operate moving forward for the life of the statute, it is crucial to think beyond the Gap.

The apparent congressional oversight that created the Gap Works problem in the first place does not justify creative judicial re-construction of the statute in order to fix poor drafting. In fact, it is often the case with bright-line rules that some cases fall just outside the line and are denied protection, sometimes flagrantly affronting fairness concerns.¹³¹ Moreover, once it has been established that the statute in fact refers to the date of the assignment contract, Congress may be tempted to retroactively revise the termination of transfer provisions specifically to address the Gap Works problem. Despite the apparent attractiveness of this solution, Congress’ power to do this may be limited.¹³² Congress has often created exceptions or transitions to allow for the efficient operation of new laws, allowing transitional periods to ensure that parties had proper notice and that rules were in compliance with due process.¹³³ But in this case, the due process and just compensation clauses of the Fifth Amendment indicate that a retroactive “band-aid” applied to the statute for the purpose of providing authors of Gap Works a right to terminate would simultaneously deny transferees a vested and relied-upon property interest, thus constituting a taking.¹³⁴ Once courts recognize that, properly construed, § 203 refers to the date of the

131. Consider, for example, the notion of a Statute of Limitations.

132. *See* *Roth v. Pritikin*, 710 F.3d 934, 939 (2d Cir. 1983) (“An interest in a copyright is a property right protected by the due process and just compensation clauses of the Constitution.”); *see also* *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1000–16 (1984) (finding a property interest in trade secrets protected by the takings clause of Fifth Amendment; government use and disclosure of trade secrets may constitute a taking).

133. For example, although the Copyright Act of 1976 was signed into law on October 10, 1976, it did not become effective until January 1, 1978.

134. U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”).

agreement, not the date of creation, they will likely have little power to correct the Congressional oversight that created the Gap Works problem.

IV. CONCLUSION

From their conception during the mid-twentieth-century, termination of transfers provisions have been a contentious issue for interested parties.¹³⁵ Though the final statutory provisions present a carefully crafted scheme and a public policy compromise, their successful operation and practical utility will ultimately rest on careful statutory interpretation. The Gap Works issue has illuminated the threshold necessity of interpreting one specific ambiguity in § 203. Whether courts faced with the task of determining what Congress meant by “executed” within the context of § 203 decide to follow the date-of-creation or the date-of-agreement interpretation will determine whether authors of Gap Works have the right to terminate transfers of their copyrights at all. More importantly, however, the final interpretation will define the contours of the § 203 termination of transfers scheme and provide a guide for its operation for the life of the statute. Therefore, given that both interpretations enjoy even textual and historical support, the concerns of certainty, efficiency, and practicality strongly favor the date-of-agreement interpretation as the superior one.

135. *See supra* Section I.C.

APPENDIX: SECTIONS 203 AND 304(C) COMPARED

	§ 304(c)	§ 203
Type of Grants Covered	Applies to grants made by the author or a renewal beneficiary specified under § 304(a). ¹³⁶	Only applies to grants made by the author. ¹³⁷
Who Can Terminate When Author is Living	The author or, for joint works, a majority of authors of a joint work. ¹³⁸	The author or, for joint works, the majority of authors who executed the grant. ¹³⁹
Who Can Terminate When Author is Dead	The surviving widow(er) and/or children own the termination interest. ¹⁴⁰	A majority of owners of author's termination interest (widow(er) and/or children, or if none are living, the author's executor, administrator, personal representative, or trustee). ¹⁴¹
Timing of Termination	May be effected during a five-year window beginning at the end of fifty-six (56) years from the date copyright was originally secured. ¹⁴²	May be effected during a five-year window beginning at the end of thirty-five (35) years from the date of execution of the grant. ¹⁴³ If the grant covers the right of publication, the window begins at the earlier of thirty-five (35) years from the date of publication or forty (40) years from the date of execution of the grant. ¹⁴⁴
How To Terminate	Termination may be effected by serving advanced written notice no less than two (2) or more than ten (10) years before the desired effective date. ¹⁴⁵ Notice must be recorded in the Copyright Office before the effective date of termination and such notice must comply with Copyright Office regulations. ¹⁴⁶	

136. 17 U.S.C. § 304(c)(1).

137. *Id.* § 203(a).138. *Id.* § 304(c)(1)–(2).139. *Id.* § 203(a)(1)–(2).140. *Id.* § 304(c)(1)–(2); *see* H.R. REP. NO. 94-1476, at 125 (1976).

141. 17 U.S.C. § 203(a)(2).

142. *Id.* § 304(c)(3).143. *Id.* § 203(a)(3).144. *Id.*145. *Id.* §§ 304(c)(4), 203(a)(4).

146. 37 C.F.R. § 201.10 (2011).

	§ 304(c)	§ 203
Effect of Termination	All rights revert to those having the right to terminate. ¹⁴⁷ Continued exploitation of derivative works prepared under the authority of the grant allowed, but no new derivative works after the termination date. ¹⁴⁸	
Entitlement to Make Further Grants	Owners of a reverted right are tenants-in-common who can independently authorize further grants if signed by the same number and proportion as are required to terminate. ¹⁴⁹	There is no tenancy-in-common, but rather the same number and proportion as required for termination is required for further grants. ¹⁵⁰

147. 17 U.S.C. §§ 304(c)(6), 203(b)(3).

148. *Id.* §§ 304(c)(6)(a), 203(b)(1).

149. *Id.* § 304(c)(6)(D).

150. *Id.* § 203(b).

LIMITING INITIAL INTEREST CONFUSION CLAIMS IN KEYWORD ADVERTISING

Winnie Hung[†]

Online advertising expenditure is expected to reach \$39.5 billion in 2012.¹ As more consumers use the Internet to make purchases, businesses increasingly invest in search engine marketing, also known as keyword advertising, to attract and retain customers.² Keyword advertising refers to the display of text ads on search engines, in which advertisers pay to show their ads alongside search results for specific “keywords,” or search queries.³ This form of advertising constitutes nearly half of the total spending in online advertising.⁴ Even in a stagnant economy, businesses continue to invest in keyword advertising for two main reasons. First, search engines reach a large audience, including new and existing customers. A consumer may search for a type of product for the first time after realizing that she has a need, she may engage in comparison shopping, or she may already know the specific brand that she intends to purchase.⁵ Advertisers can attract consumers at these different stages of the buying cycle. Second, advertisers can easily optimize their campaigns to maximize return-on-investment. Optimization, or improvement of ad performance, is easier with keyword advertising than with traditional media, such as print (e.g., newspapers and magazines) and television. Optimizing traditional media ads requires more guesswork because performance metrics are not as easily tracked, making it more difficult to determine which ads and targeting strategies work better than others. For example, a consumer can make a store purchase after

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1. *See US Online Ad Spending to Surpass Print in 2012: Report*, THE ECONOMIC TIMES (Jan. 21, 2012, 5:27 PM) <http://economictimes.indiatimes.com/news/politics/nation/us-online-ad-spending-to-surpass-print-in-2012-report/articleshow/11579192.cms>.

2. *See, What's the Difference Between a Search Query and a Keyword?*, GOOGLE, INC., <http://support.google.com/adwords/bin/answer.py?hl=en&answer=68077> (last updated Mar. 20, 2012).

3. *See id.*

4. *See US Online Ad Spending to Surpass Print in 2012*, *supra* note 1.

5. *See* Bernard J. Janse & Simone Schuster, *Bidding on the Buying Funnel for Sponsored Search and Keyword Advertising*, 12 J. OF ELEC. COMMERCE RESEARCH 1, 1–2 (2011).

viewing a newspaper ad, but unless the ad contains a coupon and the consumer remembers to use it, the viewing of the ad and the purchase cannot be easily correlated. By contrast, with keyword advertising, advertisers can track which ad clicks lead to sales on their sites. Additionally, advertisers can easily modify ad texts and add or remove keywords based on readily available performance metrics⁶ like clickthrough rates⁷ and conversion rates⁸ that are recorded in the advertisers' online accounts.⁹

Although keyword advertising is beneficial to many businesses because of its effectiveness and ease of use, it can also be problematic for trademark owners. Trademark owners have claimed that competitors benefit from their marks' goodwill when competitors' ads show alongside the organic¹⁰ search results for their trademarks.¹¹ The competitors' ads potentially divert

6. *Id.*

7. *Clickthrough Rate (CTR)*, GOOGLE, INC., <http://adwords.google.com/support/aw/bin/answer.py?hl=en&answer=107955&from=6305&rd=1> (last updated Dec. 12, 2011) (defining clickthrough rate as "the number of clicks [an] ad receives divided by the number of times [the] ad is shown").

8. *See What is AdWords Conversion Tracking?*, GOOGLE, INC., <http://adwords.google.com/support/aw/bin/answer.py?hl=en&answer=142348> (last updated Jan. 26, 2012) (defining conversion metrics as statistics used to assess the likelihood that someone who clicks on an ad will make a purchase or engage in some other activity that is the goal of the ad campaign (e.g., viewing a specific video, viewing a specific page, signing up for a mailing list)).

9. *See The AdWords Performance Management Environment*, GOOGLE, INC., <http://support.google.com/adwords/certification/bin/answer.py?hl=en&answer=172662> (last visited Dec. 22, 2011).

10. *See Overview of Search Engine Marketing & Online Advertising*, GOOGLE ADWORDS CERTIFICATION PROGRAM HELP, <http://support.google.com/adwords/certification/bin/static.py?hl=en&topic=23613&guide=23611&printable=1&page=guide.cs&answer=151864> (last visited Dec. 19, 2011) ("Most search engines provide two types of results listings in response to the same user query: organic, also called "natural" or "free", listings, and paid listings (i.e., advertisements). Google keeps these two types of listings separate."); *see also Search Engine Optimization Starter Guide*, GOOGLE, INC. (2010), http://static.googleusercontent.com/external_content/untrusted_dlcp/www.google.com/en/us/webmasters/docs/search-engine-optimization-starter-guide.pdf. Organic search results are the non-paid listings that appear when a user enters a search query into a search engine. They are generally ranked based on algorithms unique to each search engine that detects relevance of a website listing to the search query, in which the more relevant results show higher in the list of results on the page. Organic results are different from the "sponsored" results, such as those in Google AdWords. *Id.*

11. *See* Gregory Shea, *Trademarks and Keyword Banner Advertising*, 75 S. CAL. L. REV. 529, 529 (2002) (noting that "[w]hile consumers can obviously benefit from this practice [of competitor ads appearing next to search results for trademark keywords]—as it allows them to see more choices related to their query and learn about new products—many companies feel this practice violates trademark law because it allows competitors to benefit from their goodwill").

customers interested in the trademarked goods and create interest in the competing products. Trademark owners have also claimed that the competitors' ads create consumer confusion, whereby consumers mistakenly buy a competitor's product because they believe the two brands are affiliated.¹²

In light of these concerns, trademark owners have sued search engines for selling their trademarks as keywords and have also sued competitors for paying to show their ads to consumers searching for those marks. One claim is that the ads create a likelihood of confusion; a secondary claim is that the ads create a likelihood of *initial interest* confusion.¹³ Trademark infringement based on a likelihood of confusion is targeted at "prevent[ing] the use of identical or similar marks in a way that confuses the public about the actual source of goods and services."¹⁴ The doctrine of initial interest confusion, however, considers whether the use of a trademark evokes "initial interest" in the competitor's product, even if the initial assumption of affiliation is eventually resolved before the time of purchase.¹⁵ Initial interest confusion has been "likened to getting a 'foot in the door' or a 'free ride' at the trademark owner's expense,"¹⁶ a scenario in which "the alleged-infringer does not escape liability simply because any likely initial confusion will later be rectified."¹⁷

As the doctrine is relatively new, courts have not come to a consensus on how to assess initial interest confusion. Some courts have found that "initial confusion does not reach actionable levels if it is of sufficiently brief duration, for example, when the alleged infringer's confusing material itself corrects any mistaken impression before any activity by the customer can be based thereon."¹⁸ A recent Ninth Circuit decision, instead, draws the line at

12. *See id.* at 548 (citing *Brookfield Comm'ns, Inc. v. W. Coast Entm't Corp.*, 174 F. 3d 1036, 1062 (9th Cir. 1999)).

13. *See* Jonathan Pink, *Initial Interest Confusion*, IP FRONTLINE, <http://www.ipfrontline.com/depts/article.aspx?id=4697&deptid=4> (last updated Jul. 6, 2005) (arguing that "[t]he Initial Interest Confusion Doctrine has allowed some courts to do away with this traditional analysis, creating a short-cut to infringement").

14. Deborah F. Buckman, *Initial Interest Confusion Doctrine Under Lanham Trademark Act*, 183 A.L.R. FED. 553, 553 (2003).

15. *See* Pink, *supra* note 13.

16. Buckman, *supra* note 14, at 553.

17. LOUIS ALTMAN & MALLA POLLACK, *CALLMANN ON UNFAIR COMPETITION, TRADEMARKS AND MONOPOLIES* § 22:15 (4th ed. 2011).

18. *Jews For Jesus v. Brodsky*, 993 F. Supp. 282, 303 (D.N.J. 1998), *judgment aff'd*, 159 F.3d 1351 (3d Cir. 1998); *Teletch Customer Care Mgmt. (Cal.), Inc. v. Tele-Tech Co., Inc.*, 977 F. Supp. 1407, 1410, 1414 (C.D. Cal. 1997); ALTMAN & POLLACK, *supra* note 17, § 22:15 (citing *Savin Corp. v. Savin Group, No. 02 Civ.9377 SAS*, 2003 WL 22451731, at

the point at which “mere diversion” becomes “likely confusion,” which often depends on evidence of actual confusion, such as from consumer surveys.¹⁹ Although, in the initial interest confusion analysis, courts have applied a lower standard of confusion than for traditional likelihood of confusion, the line between the two is unclear. The point at which courts find “initial interest confusion” is still a moving target. Most courts consider initial interest confusion to be a subset of likelihood of confusion and borrow from that analysis.²⁰ Some of them have considered split-second, subliminal confusion to meet the initial interest confusion test, even if the confusion is quickly resolved.²¹ However, others courts require more than a brief moment of subliminal confusion and examine the duration of the confusion to determine infringement.²² Although the Second Circuit has found that mere diversion constitutes initial interest confusion,²³ the Ninth Circuit recently held that initial interest confusion is still fundamentally concerned with

*12 (S.D.N.Y. 2003), *judgment aff'd in part, vacated in part on other grounds*, 391 F.3d 439 (2d Cir. 2004).

19. *Network Automation Inc. v. Advanced Sys. Concepts, Inc.*, 638 F. 3d 1137, 1149 (9th Cir. 2011).

20. *See* Kristin Kemnitzer, *Beyond Rescuecom v. Google: The Future of Keyword Advertising*, 25 BERKELEY TECH. L.J. 401 (2010).

21. *See, e.g.*, Chi-Ru Jou, *The Perils of a Mental Association Standard of Liability: The Case Against the Subliminal Confusion Cause of Action*, 11 VA. J.L. & TECH., no. 2, 2006, at 8 (citing *Suncoast Tours, Inc. v. Lambert Grp., Inc.*, No. CIV.A.98-5627, 1999 WL 1034683, at *5 (D.N.J. 1999); *Resorts Int'l, Inc. v. Greate Bay Hotel & Casino, Inc.*, 830 F. Supp. 826 (D.N.J. 1992); *Verifine Products, Inc., v. Colon Bros., Inc.*, 799 F. Supp. 240, 251 (D.P.R., 1992); *Oxford Indus., Inc. v. JBJ Fabrics, Inc.*, No. 84 CIV.2505, 1988 WL 9959, at *3 (S.D.N.Y. 1988)).

22. *See, e.g.*, *McNeil Nutritionals, LLC v. Heartland Sweeteners, LLC*, 511 F.3d 350, 358 (3d Cir. 2007) (holding “that initial interest confusion is an independently sufficient theory that may be used to prove likelihood of confusion” and applying the Third Circuit’s Lapp test for initial interest confusion cases); *Checkpoint Systems, Inc. v. Check Point Software Technologies, Inc.*, 269 F.3d 270, 292, 297 (3d Cir. 2001) (holding initial interest confusion to be actionable, but “where confusion has little or no meaningful effect in the marketplace, it is of little or no consequence in our analysis”); *Interpace Corp. v. Lapp, Inc.*, 721 F.2d 460, 463 (3d Cir. 1983) (setting forth the ten factors for the likelihood of confusion analysis).

23. *See* *Grotrian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway and Sons*, 523 F.2d 1331, 1341 (2d Cir. 1975) (finding the subliminal confusion between the two piano brands to be actionable because such confusion “can destroy the value of the trademark which is intended to point to only one company”) (quoting *Grotrian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway & Sons*, 365 F. Supp. 707, 717 (S.D.N.Y. 1973)). *But see* *Savin Corp. v. Savin Grp.*, 391 F.3d 439, 462 n. 13 (2d Cir. 2004) (considering initial interest confusion to be a separate factor under the likelihood of confusion analysis and noting that “[b]ecause consumers diverted on the Internet can more readily get back on track than those in actual space, thus minimizing the harm to the owner of the searched-for site from consumers becoming trapped in a competing site, Internet initial interest confusion requires a showing of intentional deception”).

consumer confusion, such that diversion without even a minimal amount of confusion should not lead to a finding of infringement.²⁴

Although the goal of trademark law is twofold—to protect consumers and also trademark owners—the primary goal is to protect consumers.²⁵ Protecting trademark owners encourages them to continue investing in the development of trademarks.²⁶ These marks serve as product identifiers for consumers, helping them find what they want and making the search process more efficient.²⁷ However, when mere diversion is considered infringement, the doctrine potentially protects trademark owners at the expense of consumers.²⁸ Competitor ads, when honest and not misleading, can provide good alternatives to consumers and promote healthy competition among businesses. Thus, initial interest confusion should require more than mere diversion to best meet the goal of protecting consumers.

Although courts have sometimes relied on case-specific surveys to determine whether actionable initial interest confusion exists,²⁹ limited time and money hinder the ability to conduct thorough studies for each case. As case-specific surveys are often difficult to conduct by the preliminary injunction stage,³⁰ this Note proposes that courts take notice of relevant third-party material, including relevant surveys from prior cases and

24. See *Network Automation Inc.*, 638 F.3d at 1149 (stating that “because the sine qua non of trademark infringement is consumer confusion, when we examine initial interest confusion, the owner of the mark must demonstrate likely confusion, not mere diversion”).

25. See J. THOMAS MCCARTHY, 4 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 2:5 (4th ed. 2008).

26. See David W. Barnes, *A New Economics of Trademarks*, 5 Nw. J. TECH. & INTELL. PROP. 22, 29 (2006) (“[T]o encourage investment in trademarking activity, trademark law protects the referential device/product link.”).

27. See Deborah R. Gerhardt, *Consumer Investment in Trademarks*, 88 N.C. L. REV. 427, 436 (2010) (“Consumers use brands to find products and connect to communities with similar interests. Search Engines make it possible to use brands as search terms to find information on the Internet.”).

28. See *id.* at 431 (“The expansion of trademark law is resulting in trends that ignore or harm consumer interests. The harm is especially apparent when trademark law is used to deny consumers the opportunity to use trademarks to find information.”).

29. See Kent D. Van Liere & Sarah Butler, *Emerging Issues in the Use of Surveys in Trademark Infringement on the Web* 4 (Sept. 21, 2007) (unpublished manuscript, on file with NERA Economic Consulting) (“Consumer surveys that provide evidence of confusion are common in trademark litigation.”).

30. See Mark D. Robins, *Actual Confusion in Trademark Infringement Litigation: Restraining Subjectivity Through A Factor-Based Approach to Valuing Evidence*, 2 Nw. J. TECH. & INTELL. PROP. 1, 64 (2004) (“Courts are afforded a wide degree of discretion in granting preliminary injunctions and in what types of procedures should attend their determinations. This discretion can impact both the types of evidence that courts are willing to accept and the types of evidence that parties have an opportunity to present.”).

marketing research from reliable sources, and use that information to assess the likelihood of initial interest confusion. Such data provides insight into how consumers perceive text ads and highlights aspects that contribute to initial interest confusion. Furthermore, the doctrine should be clarified as to require an ad to be misleading, rather than merely diverting. Because such an inquiry is fact-specific, use of prior survey results and market research to supplement limited case-specific surveys would allow courts to better assess when the line is crossed from diversion to actionable confusion.

In Part I, this Note explains how keyword advertising works and describes how trademarks are used in that context. In Part II, the Note examines how trademark law, specifically with regard to initial interest confusion, has been applied in keyword advertising cases. As circuits are split on how to approach the analysis, the Note looks at the common elements used in these analyses to show that confusion, rather than diversion, is at the core of this doctrine across the circuits. To provide context for future consumer confusion analyses, Part III analyzes empirical research to examine how consumers perceive search ads. Finally, the Note recommends in Part IV that courts take judicial notice of prior survey results and market research.

I. HOW KEYWORD ADVERTISING WORKS

Keyword advertising is a method of search engine marketing in which advertisers purchase “keywords” in order to show their ads on specific search results pages relevant to their advertised product.³¹ When advertisers target their ads to keywords—which can be individual words or phrases—their ads are eligible to appear next to organic search results when consumers search for those keywords.³²

Companies frequently advertise with the most popular search engines in order to attract as many consumers as possible. The search engines with the largest market shares are Google, Yahoo!, and Microsoft.³³ Their ad delivery mechanisms are similar, with slight variations between Google AdWords and Microsoft adCenter. The latter has delivered ads to both Bing and Yahoo! since the Microsoft and Yahoo! search alliance commenced in October

31. See *Keyword Advertising*, GOOGLE, INC., <http://support.google.com/adwords/bin/answer.py?hl=en&answer=10949> (last updated Mar. 20, 2011).

32. See *id.*

33. See *comScore Releases August 2011 U.S. Search Engine Rankings*, COMSCORE (Sept. 13, 2011), http://www.comscore.com/Press_Events/Press_Releases/2011/9/comScore_Releases_August_2011_U.S._Search_Engine_Rankings (finding that “Google Sites led the U.S. explicit core search market in August with 64.8 percent market share, followed by Yahoo! Sites with 16.3 percent . . . and Microsoft Sites with 14.7 percent”).

2010.³⁴ Although some differences exist between these two advertising programs, this Note uses Google AdWords to illustrate the mechanics of search advertising since Google has the largest market share³⁵ and its advertising program has been the subject of much litigation.³⁶

In order to create an ad for a search engine, an advertiser needs to create an account with an advertising program. The advertiser can then create an ad and enter a list of user search queries—called “keywords”—that can “trigger” the ad to be shown on the relevant search engine. For AdWords, ads would show on Google.com. The advertiser inputs a “keyword” into his account to show his ad on the search engine page when a user searches for that term.

Companies in the same industry usually target the same or similar keywords. They compete in an auction and bid to show an ad in one of the available ad spots.³⁷ If, for example, a search result list for “running shoes” has space available for three ad placements on the search results page, different shoe companies that sell running shoes—for example, Nike, Adidas, Reebok, Saucony, and New Balance—may all bid in the auction to show their ads on the search results page when consumers search for the keyword phrase “running shoes.” Only three of the advertisers would be able to win the auction.³⁸ The ads would be ranked according to an algorithm that considers both the amounts of the bids and the quality or relevance of the ads to the keyword.³⁹ An ad that has a higher bid and that is also more relevant—for example, an ad text describing the sale of “running shoes” instead of “walking shoes”—would likely rank higher and have a better chance at appearing in one of the three available spots.

34. See David Pann, *Yahoo! and Microsoft Complete Major Search Alliance Milestone in the U.S. and Canada*, ADCENTER BLOG (Oct. 27, 2010), <http://community.microsoftadvertising.com/blogs/advertiser/archive/2010/10/27/yahoo-and-microsoft-complete-major-search-alliance-milestone-in-the-u-s-and-canada.aspx>.

35. See *US Online Ad Spending to Surpass Print in 2012*, *supra* note 1.

36. See Michael Orey, *Google's Trademark Tussle*, BLOOMBERG BUSINESSWEEK (Apr. 15, 2009, 12:01 AM) http://www.businessweek.com/technology/content/apr2009/tc20090414_278741.htm.

37. *Is There a Bid Requirement to Enter the Ad Auction?*, GOOGLE, INC., <http://support.google.com/adwords/bin/answer.py?hl=en&answer=105697> (last updated Mar. 20, 2011) (An auction “is run every time a user enters a search query, which determines which ads show for this query and in what order.”).

38. See *Ad Targeting and Previewing: About the Ad Auction*, GOOGLE, INC., <http://support.google.com/adsense/bin/answer.py?hl=en&answer=160525#3> (last visited Jan. 22, 2012).

39. See *id.*

On AdWords, advertisers can target keywords in three different ways: (1) “broad-match,” (2) “phrase-match,” and (3) “exact-match.”⁴⁰ With broad-match, an ad may show on the search results pages for queries of the keyword, its synonyms, and other related terms.⁴¹ With phrase-match, an ad may show on search results pages for user queries containing the phrase in the exact word order, plus words before or after the phrase.⁴² Finally, with exact-match, an ad may show on the search results page only when a user searches for the exact phrase, with the same words in the same order, and no other words before or after.⁴³

Because of the flexibility in matching options, competitor ads may appear next to multiple variations of search phrases that include a trademark. Someone targeting the trademark “brand x” can also target “brand x shoes.” If the keyword “brand x shoes” was broad-matched, the ad associated with that keyword may enter the auction⁴⁴ for search queries of synonyms or related terms, for example, “brand x sneakers” and “brand x running shoes.” Hence, these targeting mechanisms allow advertisers to target much more than just the specific words they choose, thereby increasing the competition for various phrases containing trademark terms.

In addition to targeting generic keywords like “running shoes,” advertisers may also include branded keywords like “Nike running shoes,” even if they are not selling Nike shoes but are selling competitor brands. This keyword strategy is often effective because consumers searching a trademark may be interested in finding related goods or finding running shoes comparable to those made by Nike. An advertiser may target the trademark to capitalize on this interest and provide consumers with the option to choose; alternatively, the advertiser may use a competitor’s trademark to confuse consumers into believing that the ad is affiliated with the brand, thereby wrongfully benefiting from the mark’s goodwill.

40. See *What are Keyword Matching Options?*, GOOGLE, INC., <http://support.google.com/adwords/bin/answer.py?hl=en&answer=6100> (last updated Mar. 20, 2012).

41. See *id.*

42. See *id.*

43. See *id.*

44. Google, Inc., *Ad Auction*, ADWORDS HELP, <http://support.google.com/adwords/bin/answer.py?hl=en&answer=142918> (last visited Feb. 18, 2012) (stating that an ad auction “is run every time a user enters a search query, which determines what ads show for this query and in what order”).

II. TRADEMARK INFRINGEMENT IN KEYWORD ADVERTISING

In the context of keyword advertising, trademark owners can file complaints for both (1) likelihood of confusion and (2) initial interest confusion. The latter serves as an alternative where the first, which trademark owners generally prefer, is not adequately supported.⁴⁵ In the likelihood of confusion analysis,⁴⁶ courts look at “whether a consumer is likely to be confused as to whether the products offered by the separate parties are affiliated with one another.”⁴⁷ By comparison, initial interest confusion concerns merely “subliminal confusion,”⁴⁸ in which consumers make just a momentary false affiliation between the competitor and the trademark through the competitor’s “unauthorized use of trademarks to divert internet traffic, thereby capitalizing on a trademark holder’s goodwill.”⁴⁹

Currently, trademarks are protected by federal statute under the Lanham Act.⁵⁰ The Act prohibits the “use in commerce” of any reproduction of a registered mark “in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive.”⁵¹ Infringement occurs when one (1) “uses in commerce any word, term, name, symbol, or device, or any combination thereof” which (2) “is likely to cause confusion” or “misrepresents the nature, characteristics, qualities, or geographic origins of his or her or another person’s goods, services, or commercial activities.”⁵² Keyword advertising has been considered by most courts to meet the first requirement of “use in commerce.”⁵³ However,

45. See Pink, *supra* note 13 (arguing that the initial interest doctrine is a “short-cut” to the traditional likelihood of confusion analysis).

46. MCCARTHY, *supra* note 25, § 2.50 (noting that to show that likelihood of confusion exists, courts rely on “1. [s]urvey evidence; 2. [e]vidence of actual confusion; and/or 3. [a]rgument based on a clear inference arising from a comparison of the conflicting marks and the context of their use”).

47. Patrick Ryan Barry, *The Lanham Act’s Applicability to the Internet and Keyword Advertising: Likelihood of Confusion v. Initial Interest Confusion*, 47 DUQ. L. REV. 355, 358 (2009).

48. *Grotian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway and Sons*, 523 F.2d 1331, 1341 (2d Cir. 1975).

49. *Australian Gold, Inc. v. Hatfield*, 436 F.3d 1228, 1239 (10th Cir. 2006).

50. See Lanham Act, 15 U.S.C. §§ 1051–1141 (2006).

51. 15 U.S.C. § 1114.

52. 15 U.S.C. § 1125.

53. See Peter E. Nussbaum & Nancy A. Del Pizzo, *Keyword Advertising “Use in Commerce”: A Pro-Plaintiff Trend Emerges*, 20 INTELLECTUAL PROP. LIT., no. 2, 2009, available at http://www.wolffsamson.com/news_events/46-keyword-advertising-use-commerce-pro-plaintiff-trend-emerges (citing *Hysitron Inc. v. MTS Sys. Corp.*, No. 07-01533, 2008 WL

circuits are split on how to determine which instances of keyword advertising satisfy the second prong. Circuits are divided, in particular, on when initial interest confusion meets the test of “likely to cause confusion.”

Some courts are reluctant to apply this doctrine because it potentially takes trademark rights too far, beyond the fundamental goal of protecting consumers who may not necessarily be confused at the time of purchase under this doctrine.⁵⁴ However, incentivizing trademark owners to value their marks is also important because their investment in upholding the value of their marks often leads to better and more consistent quality of goods.⁵⁵ This need to incentivize trademark owners suggests that addressing consumer confusion at only the point of purchase may not be sufficient, but a moderate form of trademark protection pre-sale that is aimed at protecting trademark owners may be necessary.

Because likelihood of confusion is difficult to prove in keyword advertising cases, trademark owners may also allege infringement under the initial interest confusion doctrine. If a consumer clicks on an ad and goes to a website for a product different from what he was looking for, he can easily click the back button to return to the search results page and look at other ads or organic listings. As any brief moment of confusion is easily corrected, likelihood of confusion is difficult to prove. Trademark owners therefore turn to the initial interest confusion doctrine as an alternative means of seeking a remedy when competitors target consumers who are searching for the mark.⁵⁶ Since trademark owners are increasingly using this doctrine as the basis of infringement in keyword advertising cases, this Part discusses the origin and development of the doctrine and provides examples to illustrate how courts have applied this doctrine.

A. ORIGIN AND DEVELOPMENT OF THE INITIAL INTEREST CONFUSION DOCTRINE

Initial interest confusion is a recently developed concept of pre-sale confusion. It falls within the scope of the 1962 amendments to the Lanham Act that address pre-sale in addition to point-of-sale and post-sale

3161969, at *3 (D. Minn. 2008) (stating that the “majority of courts” hold that using a trademark for keyword advertising is a use in commerce under the Lanham Act)).

54. *See, e.g.,* Checkpoint Sys., Inc. v. Check Point Software Tech., Inc., 269 F.3d 270, 292, 297 (3d Cir. 2001) (holding initial interest confusion to be actionable, but “where confusion has little or no meaningful effect in the marketplace, it is of little or no consequence in our analysis”).

55. *See* MCCARTHY, *supra* note 25, § 2.50.

56. *See* Pink, *supra* note 13.

confusion.⁵⁷ This concept of initial interest confusion was introduced in *Grotrian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway and Sons*, which defined it as “subliminal confusion.”⁵⁸ Consumers had initial interest in Grotrian-Steinweg pianos because of its phonetic and textual similarity to Steinway, a prominent piano brand in the United States.⁵⁹ As a result, Grotrian-Steinweg “attract[ed] potential customers based on the reputation built up” by Steinway,⁶⁰ in which the injury to the trademark owner is the “likelihood that potential piano purchasers will think that there is some connection between the Grotrian-Steinweg and Steinway pianos.”⁶¹ The court found trademark infringement based on subliminal confusion.⁶² This concept of initial interest confusion, based on an amorphous notion of *some* connection between the brands, was later applied in *Mobil Oil Corp., v. Pegasus Petroleum Corp.*⁶³ The *Mobil* court held that even with “sophisticated oil traders, there is still and nevertheless a likelihood of confusion” between “Pegasus Petroleum” and the Pegasus symbol used by Mobil.⁶⁴ Even if consumers only momentarily envisioned a connection between the two companies, the brief initial interest confusion was sufficient proof of trademark infringement.⁶⁵

More recently, the doctrine of initial interest confusion has been applied to cases concerning metatags, domain names, and keyword advertising. In *Brookfield*, the Ninth Circuit found that defendant West Coast’s use of “moviebuff.com” in its metatags⁶⁶ and domain name led to initial interest confusion.⁶⁷ Furthermore, West Coast’s website contained a database of movies similar to that of MovieBuff, such that consumers might decide to

57. See 15 U.S.C. §§ 1114–1127; Anne M. McCarthy, *The Post-Sale Confusion Doctrine: Why the General Public Should Be Included in the Likelihood of Confusion Inquiry*, 67 FORDHAM L. REV. 3337 (1999).

58. *Grotrian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway and Sons*, 523 F.2d 1331, 1341–42 (2d Cir. 1975).

59. *Id.*

60. *Id.* at 1342.

61. *Id.*

62. *See id.*

63. *Mobil Oil Corp. v. Pegasus Petroleum Corp.*, 818 F.2d 254 (2d Cir. 1987).

64. *Id.* at 260.

65. *See id.* at 260 (citing *Grotrian, Helfferich, Schulz, Th. Steinweg Nachf. v. Steinway and Sons*, 523 F.2d 1331, 1342 (2d Cir. 1975)).

66. *See* MCCARTHY, *supra* note 25, § 25:69 (defining “meta tag” as “a list of words normally hidden in a Web site that acts as an index or reference source identifying the content of the Web site for search engines”).

67. *Brookfield Comm’ns, Inc. v. W. Coast Entm’t Corp.*, 174 F. 3d 1036 (9th Cir. 1999).

use West Coast after having been brought to the site because of the initial connection they drew between West Coast and MovieBuff.⁶⁸

In *Playboy Enterprises, Inc. v. Netscape Communications Corp.*, the Ninth Circuit compared the initial interest created by metatags with the initial interest confusion arising from keyword-targeted advertising.⁶⁹ This was one of the first cases in the Ninth Circuit applying the initial interest doctrine to keyword advertising. The court asserted that poorly labeled or unlabeled banner ads appearing on the search results page for Playboy trademarks could create initial interest confusion actionable in court.⁷⁰ Thus, the court reversed the summary judgment and remanded the case to the lower court to resolve the factual dispute concerning consumer confusion. In the case of both trademark keywords and metatags, a finding of initial interest confusion was based on other considerations, including the website content and the labeling of the ad, and not just on the mere fact that a trademark was used on the back-end for keyword targeting or metatags.

B. INITIAL INTEREST CONFUSION IN KEYWORD ADVERTISING CASES

Trademark infringement based on the initial interest confusion doctrine has been adopted in the Second, Third, Fifth, Seventh, Ninth, and Tenth Circuits,⁷¹ but the analysis of initial interest confusion varies from circuit to circuit. Circuits are split on where to draw the line between actionable initial interest confusion and harmless uses of trademarks that allow for legitimate comparison shopping. Many circuits have suggested that initial interest confusion exists when a consumer is merely diverted by the competitor's use of the trademark, but only if the ad in question references the trademark explicitly. In this scenario, the consumer could be aware that the trademark is not affiliated with the competitor, but the mere act of getting "attracted" or "induced" is sufficient to show that the competitor injured the trademark and capitalized on its goodwill.⁷²

However, when the trademark is used as a keyword, the association between the ad and the mark is weaker, and determining initial interest confusion can be more difficult. Courts have therefore looked to a multitude of factors in keyword advertising cases to determine the likelihood of initial

68. *Id.* at 1042.

69. *Playboy Enters., Inc. v. Netscape Commc'ns Corp.*, 354 F.3d 1020 (9th Cir. 2004).

70. *See id.* at 1034.

71. *See* Ian C. Ballon, *Initial Interest Confusion*, 1 E-COMMERCE AND INTERNET LAW 7.08[2] (updated 2010–2011) (providing a summary of the circuits that currently apply the initial interest confusion doctrine).

72. *See, e.g.,* *McNeil Nutritionals, LLC v. Heartland Sweeteners, LLC*, 511 F.3d 350, 358 (3d Cir. 2007).

interest confusion. These factors mirror those used for the likelihood of confusion analysis.⁷³ Although the circuits look at different factors, several of the core factors are the same, as illustrated in Figure 1, *infra*. These similarities highlight the fundamental bases of this doctrine shared across circuits. As illustrated in Figure 1, these main factors are: (1) similarity of the marks, (2) similarity of the products, (3) intent of the defendant, and (4) evidence of actual confusion.

73. *See, e.g.*, *AMF, Inc. v. Sleekcraft Boats*, 599 F.2d 341, 348–49 (9th Cir. 1979) (holding that “[i]n determining whether confusion between related goods is likely, the following factors are relevant: 1. strength of the mark; 2. proximity of the goods; 3. similarity of the marks; 4. evidence of actual confusion; 5. marketing channels used; 6. type of goods and the degree of care likely to be exercised by the purchaser; 7. defendant’s intent in selecting the mark; and 8. likelihood of expansion of the product lines”); *Polaroid Corp. v. Polarad Elecs. Corp.*, 287 F.2d 492, 495 (2d Cir. 1961) (holding that likelihood of confusion “is a function of . . . the strength of [the senior user’s mark], the degree of similarity between the two marks, the proximity of the products, the likelihood that the prior owner will bridge the gap, actual confusion, and the reciprocal of defendant’s good faith in adopting its own mark, the quality of defendant’s product, and the sophistication of the buyers”).

Figure 1: Factors Used by Circuits, with Similar Factors in the Same Row

	Second Circuit ⁷⁴	Third Circuit ⁷⁵	Fifth Circuit ⁷⁶	Seventh Circuit ⁷⁷	Ninth Circuit ⁷⁸	Tenth Circuit ⁷⁹
Similarity of the marks	X	X	X	X	X	X
Strength of trademark	X	X		X	X	X
Consumer sophistication and other factors indicative of consumer care and attention in making purchase	X	X		X	X	X
Duration of trademark use without evidence of actual consumer confusion	X	X				
Intent of defendant in using the trademark or a similar mark	X	X	X	X	X	X
Evidence of actual	X	X	X	X	X	X

74. *Mobil Oil Corp. v. Pegasus Petroleum Corp.*, 818 F.2d 254, 260 (2d Cir. 1987).

75. *Interpace Corp. v. Lapp, Inc.*, 721 F.2d 460, 463 (3d Cir.1983) (setting forth the ten factors for the likelihood of confusion analysis); *see also* *McNeil Nutritionals, LLC v. Heartland Sweeteners, LLC*, 511 F.3d 350, 358 (3d Cir. 2007) (holding “that initial interest confusion is an independently sufficient theory that may be used to prove likelihood of confusion” and applying the Third Circuit’s *Lapp* test for initial interest confusion cases); *Checkpoint Sys., Inc. v. Check Point Software Tech., Inc.*, 269 F.3d 270, 292, 297 (3d Cir. 2001) (holding initial interest confusion to be actionable, but “where confusion has little or no meaningful effect in the marketplace, it is of little or no consequence in our analysis”).

76. *S. Co. v. Dauben Inc.*, No. 08-10248 (5th Cir. Apr. 15, 2009) (setting forth the seven factors for the likelihood of confusion analysis); *see also* *Elvis Presley Enters., Inc. v. Capece*, 141 F.3d 188, 204 (5th Cir. 1998) (holding that “all five digits of confusion that we considered de novo weigh in favor of a likelihood of confusion”).

77. *Promatek Indus., Ltd. v. Equitrac Corp.*, 300 F.3d 808, 812 (7th Cir. 2002) (holding that trademark use in metatags diverts consumers to defendant’s site and allows it to benefit from the goodwill of the plaintiff’s mark).

78. *AMF Inc. v. Sleekcraft Boats*, 599 F.2d 341, 348–49 (9th Cir.1979). (setting forth the eight factors for the likelihood of confusion analysis); *see also* *Perfumebay.com, Inc. v. eBay, Inc.*, 506 F.3d 1165 (9th Cir. 2007); *Nissan Motor Co. v. Nissan Computer Corp.*, 378 F.3d 1002 (9th Cir. 2004), cert. denied, 544 U.S. 974 (2005); *Playboy Enters., Inc. v. Netscape Comm’ns Corp.*, 354 F.3d 1020 (9th Cir. 2004); *Interstellar Starship Servs., Ltd. v. Epix, Inc.*, 304 F.3d 936 (9th Cir. 2002); *Interstellar Starship Servs., Ltd. v. Epix, Inc.*, 184 F.3d 1107 (9th Cir. 1999); *Brookfield Comm’ns, Inc. v. W. Coast Entm’t Corp.*, 174 F.3d 1036 (9th Cir. 1999).

79. *Sally Beauty Co., Inc. v. Beautyco, Inc.*, 304 F.3d 964, 972 (10th Cir. 2002) (setting forth the six factors for the likelihood of confusion analysis); *see also* *Australian Gold, Inc. v. Hatfield*, 436 F.3d 1228, 1238–39 (10th Cir. 2006) (finding initial interest confusing based on the defendant’s use of plaintiff’s mark on its website and in metatags, in which “[i]nitial interest confusion in the Internet context derives from the unauthorized use of trademarks to divert internet traffic, thereby capitalizing on a trademark holder’s goodwill”).

	Second Circuit ⁷⁴	Third Circuit ⁷⁵	Fifth Circuit ⁷⁶	Seventh Circuit ⁷⁷	Ninth Circuit ⁷⁸	Tenth Circuit ⁷⁹
confusion						
Same marketing channels used	X	X			X	X
Similarity of target audience	X	X				
Proximity/relationship of the goods	X	X	X	X	X	X
Likelihood of product line expansion	X	X			X	
Parody			X			

Among the four common factors, the most relevant one to any consumer confusion analysis should be evidence of actual confusion. Circuits are split, however, on what level of confusion is actionable. Some consider diversion to be a form of subliminal confusion that is sufficient to prove infringement.⁸⁰ Others require a longer duration of initial confusion or even actual confusion at time of purchase, which essentially collapses the initial interest confusion doctrine into the likelihood of confusion analysis.⁸¹

Even if initial interest confusion may be manifested in different ways depending on the situation, some courts have attempted to create more uniform boundaries to limit the scope of analysis for this doctrine. For example, the Fifth Circuit has held that some “minimal” amount of actual confusion needs to be shown in order for the initial interest confusion to be actionable.⁸² The court acknowledged that a slight piquing of interest is insufficient to constitute injury to the trademark owner.⁸³ The Fifth Circuit’s holding suggests that this vague doctrine should be limited,⁸⁴ otherwise, it

80. *See, e.g., Promatek Indus.*, 300 F.3d 808, 812–13 (finding that “what is important is not the duration of the confusion, it is the misappropriation of Promatek’s goodwill”).

81. *See, e.g., McNeil Nutritionals, LLC v. Heartland Sweeteners, LLC*, 511 F.3d 350, 358 (3d Cir. 2007) (applying the Third Circuit’s *Lapp* test to an initial interest confusion analysis); *Checkpoint Sys., Inc. v. Check Point Software Tech., Inc.*, 269 F.3d 270, 292, 297 (3d Cir. 2001) (finding that “where confusion has little or no meaningful effect in the marketplace, it is of little or no consequence” in the initial interest confusion analysis); *Mobil Oil Corp. v. Pegasus Petroleum Corp.*, 818 F.2d 254, 260 (2d Cir. 1987) (considering as a factor in the analysis the “probability that potential purchasers would be misled” rather than merely diverted).

82. *Elvis Presley Enters., Inc.*, 141 F.3d at 204 (noting that “[a]n absence of, or minimal, actual confusion . . . weighs against a likelihood of confusion”).

83. *See id.*

84. *See id.* at 204 (examining the likelihood of initial interest confusion in the context of the likelihood of confusion analysis, and noting that “infringement can be based upon

may be overused by trademark owners to reduce competition and eliminate legitimate opportunities for comparison shopping that could be beneficial to consumers.⁸⁵ The Fifth Circuit's application of the initial interest confusion doctrine, along the spectrum of how initial interest confusion is assessed, lies on the cusp and mimics the traditional likelihood of confusion analysis, in which mere diversion is not considered confusion.⁸⁶

Further evidence that actionable consumer confusion should involve more than just diversion can be seen in the way courts interchangeably use the term "likelihood of initial interest confusion" and "likelihood of confusion." In fact, in *Network Automation*, the Ninth Circuit stated that the *Sleekcraft*⁸⁷ court "found a likelihood of initial interest confusion by applying the eight factors we established more than three decades ago."⁸⁸ However, *Sleekcraft* discussed the likelihood of confusion and does not once mention "initial interest confusion."⁸⁹ In applying the *Sleekcraft* factors to the initial interest confusion analysis, the Ninth Circuit suggests that elements demonstrating confusion, and not just diversion, are at the core of this doctrine. Initial interest confusion, as a subset of likelihood of confusion, essentially reduces the standard for proving actual confusion. While some courts find that this protection is necessary to protect trademark owners' rights, others find that this excessively protects marks without clear benefits for consumers.

On the contrary, having alternatives readily accessible is a notable characteristic of e-commerce. Thus, the presence of a competitor's ad, without any false affiliation with the trademark, should not be actionable trademark infringement. The initial interest confusion doctrine should

confusion that creates initial consumer interest," in which "an absence of, or minimal, actual confusion . . . over an extended period of time of concurrent sales weighs against a likelihood of confusion").

85. See Laura A. Heymann, *The Public's Domain in Trademark Law: A First Amendment Theory of the Consumer*, 43 GA. L. REV. 651, 710–711 (2009) (critiquing the expansive doctrine of initial interest confusion and noting that "to the extent that the defendant is using the plaintiff's mark for its persuasive value—either as a lure to attract consumers, with the hope that the consumers will, once attracted, choose the defendant's product instead, or to provide relevant information about the plaintiff (e.g., a trademark used as a keyword in a search engine)—that use seems consistent with the consumer's autonomy interest").

86. *Elvis Presley Enters., Inc.*, 141 F.3d at 204.

87. *Sleekcraft*, 599 F.2d 341.

88. *Network Automation Inc. v. Advanced Sys. Concepts, Inc.*, 638 F. 3d 1137, 1142 (9th Cir. 2011) (citing *Sleekcraft*, 599 F.2d at 348–49 (reversing the district court's ruling that the defendant Network's use of plaintiff System's trademark "ActiveBatch" as a keyword created likelihood of consumer confusion and finding that the district court erred in how it weighed the *Sleekcraft* factors)).

89. See *Sleekcraft*, 599 F.2d 341.

require confusion beyond just a subliminal association. While proof of confusion at the time of purchase may not be necessary, actual confusion about the sources, even if no purchase is made, would be an appropriate level of actual confusion that should be considered in the likelihood of initial interest confusion, since the source confusion affects both trademark owners and consumers when they ultimately make their purchase decisions.

III. IDENTIFYING ADS THAT CREATE CONSUMER CONFUSION

Search ads often provide useful alternatives for the consumer interested in comparison shopping. The availability of options encourages different brands to improve their products to stay competitive, thereby promoting the fundamental goal of trademark law: to improve the quality and legitimacy of goods for consumers. However, there are instances when ads can be misleading, attracting customers through deception and false association with a well-known trademark. Case-specific surveys, as discussed in Section III.A, *infra*, have traditionally been used to assess the likelihood of confusion. In assessing likelihood of confusion in internet advertising, some surveys inquire not only into confusion at time of purchase but look at the change in likelihood of initial confusion based on variations in the ad text or in the targeted keyword. These findings of the different aspects that lead to consumer confusion would be useful in an initial interest confusion analysis. As such research is expensive and difficult to acquire by the preliminary injunction stage, previous surveys as well as third-party marketing and consumer research should be used to establish a more uniform basis for analysis. Use of empirical research would allow for a more consistent analysis and potentially less variation among different circuits.

Below, Section III.A discusses the potential use of case-specific survey results in future initial interest confusion analyses. Section III.B examines market research that may also be relevant to determining initial interest confusion. Section III.C–D discusses the increased consumer sophistication with regard to online activity, which further emphasizes why a mere diversion is unlikely to have enough impact on consumers to be actionable under the initial interest confusion doctrine.

A. USING CASE-SPECIFIC CONSUMER SURVEYS

Courts can apply survey results to find evidence of actual confusion in specific cases and then extrapolate those results to estimate confusion among the larger population of search engine users. Empirical studies and fact-finding conducted at the district court level provide insight into consumer behavior that informs appellate courts in their legal analysis of initial interest

confusion. For instance, if a high percentage of surveyed individuals was uncertain if there was some association between the ad and the trademark and, therefore, decided to click on it, the data may suggest an overall high likelihood of initial interest confusion.

However, hiring an expert to conduct a survey study is very expensive and may also lead to biased results. For example, in a case involving alleged infringement of the Nike trademark, the design and implementation of the survey cost \$75,000.⁹⁰ Furthermore, trial testimony and depositions of experts hired to analyze these survey results can cost \$7,000 per day, plus expenses.⁹¹ Additionally, the accuracy of the surveys is frequently criticized.⁹² Because experts are paid for their work, there is pressure to develop their research in a way consistent with what their clients want in hopes of developing a favorable reputation and attracting more clients. The Federal Judicial Center surveyed district court judges in 1991 and 1998, and in both instances, judges claimed that the most common problem with expert testimony was experts who “abandon objectivity and become advocates for the side that hired them.”⁹³

Despite the potential bias in the survey in any individual case, some results from these expert reports can shed light on related cases. The data can be viewed in light of broader marketing research that may be more objective because the third-party marketing research is not tied to any one party in a litigation proceeding. Use of case-specific research, however, should be limited based on the methodology of the survey and whether or not the specific survey is relevant to an action before the court. Furthermore, case-specific findings should be considered in conjunction with larger marketing trends to make sure that the case-specific survey results are not outliers resulting from case-specific factors that may not be relevant to other keyword advertising cases.

Although case-specific statistics may not be transferable from case to case because of variations in consumer sophistication and involvement, the relative statistics within a case may provide insight into how variations within an ad format or targeting mechanism may affect consumer perception. For example, in *True & Dorin Medical Group, P.C. v. Leavitt Medical Associates*,

90. Michael G. Atkins et al., *Sample Survey Expert Report*, in EXPERT WITNESSES: INTELLECTUAL PROPERTY CASES § 2:43 (2006) (citing Nike, Inc. v. Nikepal Int'l Inc., No. 2:05-cv-1468-GEB-JFM, 2006 WL 3826750 (E.D. Cal. Dec. 28, 2006)).

91. *Id.*

92. See Molly Treadway Johnson et al., *Testimony in Federal Civil Trials: A Preliminary Analysis*, FEDERAL JUDICIAL CENTER (2000), [http://www.fjc.gov/public/pdf.nsf/lookup/ExpTesti.pdf/\\$file/ExpTesti.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/ExpTesti.pdf/$file/ExpTesti.pdf).

93. *Id.* at 5.

surveys were conducted to see how variations in the ad text next to search engine results affected consumer perception of the ad's affiliation with the trademark being searched.⁹⁴ According to the expert report, "[a]n extremely high percentage of more than ninety-one percent (91.2%) said they believed that the sponsored link designated as ELLIOTT AND TRUE was sponsored by, affiliated with, or associated with Elliott and True even though the URL was www.MedHairRestoration.com."⁹⁵ However, the percentage of people who believed there was an affiliation dropped significantly when the ad text no longer mentioned "Elliot and True."⁹⁶ When the text ad used "medical hair restoration" instead of "Elliot and True," the percentage of consumers who believed the ad was associated with the brand dropped from 91.2% down to 60.1%.⁹⁷ Another variation that used "hair transplant recovery" in the ad text was perceived as being affiliated by only 48.6% of surveyed consumers, suggesting that differences in description of the service can significantly affect consumers' belief that the companies are related.⁹⁸ The findings suggest that the ad text itself has a significant impact on the likelihood of confusion, as they provide more tangible points of comparison to the trademarked product or service. The above survey results are useful in showing how the description of the product in the text of the ad can reduce likelihood of confusion, which also sheds light on factors that may contribute to initial interest confusion. Where the ad text clearly describes the service or distinguishes it from the competitor, consumers are less likely to be confused even when initially viewing the ad.⁹⁹

B. USING MARKET RESEARCH TO SUPPLEMENT SURVEYS

While case-specific survey results may be applied to other cases, market research that illustrates broader consumer trends may provide insight into consumer behavior beyond what may be drawn from narrower case-specific surveys. The use of this more readily available third-party information would be helpful for assessing the likelihood of initial interest confusion, especially since this inquiry is usually made at the preliminary injunction stage. This limits the time available for case-specific research and inevitably leaves inferential gaps, which may be appropriately filled with relevant

94. Declaration of James T. Berger, M.S., M.B.A., True & Dorin Medical Grp., P.C. v. Leavitt Med. Assocs. (S.D.N.Y. 2005), No. 06CV00092, 2005 WL 3964710 [hereinafter Berger Declaration].

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *See id.*

generalizations of consumer behavior from reputable third-party research. Specifically, research on consumer perceptions of ad position and ad content, as well as empirical studies on consumer beliefs as to the relevance of organic versus sponsored results provide insight into the likelihood of initial interest confusion. Increased familiarity with search engines and the relationship of ads to the organic results reduces the chance that consumers would be misled merely by the presence of ads. For example, some users may already assume that ads are irrelevant to the search results. Therefore, they would not make even a split-second association between the trademark they key into the search engine and the ads they see next to the organic results. Using third-party market research to understand general trends in consumer perception would aid in the analysis of initial interest confusion.

1. *Consumer Engagement Dependent on Ad Rank*

An understanding of how consumers perceive the results following a search query will likely shed light on the likelihood of confusion and the more abstract initial interest confusion analysis. For instance, forty-nine percent of consumers only examine the first page of results before abandoning the search; eighty-two percent of those who abandon the search then conduct searches on additional terms.¹⁰⁰ These statistics suggest that a large percentage of consumers are savvy enough to refine their searches, perhaps because they understand that not all searches will produce the most relevant results. Supporting this theory is the fact that a majority of consumers “expect leading brands to appear in the top results of every search.”¹⁰¹

However, since ad rank is determined by a combination of relevance as well as the amount the advertiser is willing to pay to show his ad on the search results page for a keyword,¹⁰² a less relevant ad may appear in a higher position than a more relevant ad if the bid is significantly higher. A consumer may be more likely to notice a higher ranked ad even if it is less relevant, but such awareness does not necessarily divert interest from the original brand. In fact, even if a consumer initially thinks the ad is affiliated with the trademark, a view of the website can resolve any brief moment of confusion. Since the consumer can simply click the back button on his browser to return to the original search results page, the cost to him for the diversion is minimal and should not be actionable.

100. *See id.*

101. *See id.*

102. *See supra* Part I.

2. *Content of Ads Affecting Perceptions of Relevancy*

How consumers view ads is shaped by existing perceptions. In fact, “[a]ny ad campaign is most likely to lead to advertising failure if the message is inconsistent with [the consumers’] existing beliefs. . . . Advertisers have to strive to put forward a position that is credible, or at least is not inconsistent with what we as consumers already know and think.”¹⁰³ Unless the ad conveys to the consumers that the advertised product or service is in line with what they are looking for, the ad will have a “weaker influence compared to what they already know or have in [their] minds.”¹⁰⁴ For instance, if an ad is keyword-targeted to a search for “Nike shoes” but the ad text has no relationship to Nike shoes, then the consumer will likely find the ad less relevant. Even if the ad is for a warehouse that sells different brands of shoes, a consumer would likely pay less attention to that ad compared to an organic listing or another ad that specifically mentions that the store stocks Nike shoes.

Although advertisers have played with the concept of subliminal messages to subconsciously create recognition and desire for their products or services, such subliminal messages are generally less effective than direct messages.¹⁰⁵ The covert message is “not processed deeply enough. Its content is not retrievable after more than a few seconds unless we are induced to process it further by having our attention directed to it or by repetition.”¹⁰⁶ As subliminal messages are easily overlooked, the mere presence of an ad next to search results for a trademark query may not necessarily lead consumers to believe that an affiliation exists between the advertised product and the trademark.

3. *Consumers Prioritizing Organic Results over Ads*

Additionally, organic search results are perceived to be more relevant to a search query than sponsored listings. In the results of an eyeball tracker study,¹⁰⁷ consumers were found to look at the first couple of organic results before looking at the ads. Consumers are likely to assume that the most relevant sites will appear near the top of the organic search listings since their

103. MAX SUTHERLAND, *ADVERTISING AND THE MIND OF THE CONSUMER: WHAT WORKS, WHAT DOESN’T, AND WHY* 154 (rev. 3d ed. 2008).

104. *Id.*

105. *See id.*

106. *Id.* at 44.

107. *See* Anne Aula & Kerry Rodden, *Eye-Tracking Studies: More than Meets the Eye*, THE OFFICIAL GOOGLE BLOG (Feb. 6, 2009, 9:45 AM), <http://googleblog.blogspot.com/2009/02/eye-tracking-studies-more-than-meets.html>.

relevance qualifies them for a top spot in an unpaid ranking system.¹⁰⁸ In fact, “banner blindness can occur with text items that do not look like advertisements.”¹⁰⁹ Consumers tend to pay less attention to ads as a result of prior experiences with ad clutter, prior negative experiences with ads, and perceived goal impediment, where ads are perceived to get in the way of the consumer getting to purchase a product in the most direct path.¹¹⁰ However, among the more experienced consumers, ninety to ninety-one percent do look at the sponsored links that appear at the top, above the organic results.¹¹¹ Despite this behavior, they are less likely to be confused because they are more sophisticated than the average user.

C. EASE OF ONLINE SEARCH REDUCES LIKELIHOOD OF CONFUSION

Unlike visiting a brick and mortar store, consumers engaged in online shopping can easily click on a sponsored link, assess a site within a few seconds, and click back, creating, if anything, only a negligible diversion that may not have any harms sufficient for a court to issue a preliminary injunction.¹¹² Because “customers don’t passively receive commercials [but] actively point and click their way to a brand’s website,” online consumers are more empowered to resist a marketer’s attempt to capture their attention.¹¹³ Consumers are more likely to resist capture because they can quickly scroll past the ad if they do not find it to be relevant upon a quick skim, compared to a television ad that automatically plays for thirty seconds. In this sense, the cost to the trademark owner of a competitor bidding on a keyword and gaining some awareness for their product is not significantly harmful to either the trademark owner or to consumers because they are able to quickly return to the plethora of information related to the trademark that is available in the search results. The negligible diversion and the ease with which consumers can quickly get back on track reduces any adverse impact on the

108. *See id.*

109. Yu-Chen Hsieh & Kuo-Hsiang Chen, *How Different Information Types Affect Viewer’s Attention on Internet Advertising*, 27 COMPUTERS IN HUM. BEHAV. 935, 937 (2011).

110. *See* Oliver J. Rutz & Randolph E. Bucklin, *A Model of Individual Keyword Performance in Paid Search Advertising* (2007) (unpublished manuscript) (on file with the Yale School of Management), available at http://mba.yale.edu/news_events/pdf/rutzkeywords.pdf.

111. *See* Matt McGee, *Eye-Tracking Study: Everybody Looks At Organic Listings, But Most Ignore Paid Ads On Right*, SEARCH ENGINE LAND (Mar. 10, 2011, 10:09 AM), <http://searchengineland.com/eye-tracking-study-everybody-looks-at-organic-listings-but-most-ignore-paid-ads-on-right-67698>.

112. *See* *Doran v. Salem Inn, Inc.*, 422 U.S. 922, 911 (1975) (finding that to be granted a preliminary injunction, a plaintiff must show that he is likely to prevail on the merits and that in the absence of its issuance he will suffer irreparable injury); *see also* FED. R. CIV. P. 65.

113. DEBORAH KANIA, *BRANDING.COM* 81–82 (NTC Business Books 2001).

trademark owner, whose site is likely to be displayed in the organic search results and easily within reach of the consumer.¹¹⁴ Although diversion may be common because of the availability of information all in one place, consumers can also easily find information directly related to the trademark and any diversion may be fleeting.

Additionally, when a consumer searches for a specific trademark, his search is usually the result of previous, non-brand-specific research that has made him a more sophisticated consumer, even if he was not familiar with industry brands prior to the research.¹¹⁵ Among search engine users, seventy percent start with a generic keyword and proceed to more specifics, like branded keywords.¹¹⁶ By going through this search funnel, users are generally more familiar with the products available to them by the time they search for a specific brand,¹¹⁷ and thus, less likely to be confused. As a result, consumers are less likely to even be initially confused as to the affiliation of the ad to the trademark because they probably have a clearer sense of what products and websites are related to the trademark. Upon viewing the text of the ad and the website underneath the text, consumers would less likely believe that product to be affiliated with the brand if the description and the website do not fall within the scope of what they have encountered during their prior research into the mark.

D. CHANGES IN MARKETING STRATEGIES ALSO REFLECT INCREASED CONSUMER SOPHISTICATION

The fact that marketers are increasingly fragmenting their ads to reach smaller, niche groups is a response to, and further evidence of, an increasingly sophisticated online consumer base that is able to differentiate between products because of the ease of research on the Internet.¹¹⁸ The presence of ads therefore provides consumers with opportunities for comparison shopping and, furthermore, encourages competition between businesses that will spur continued improvements in the quality and production of the goods. Because consumers are easily able to search for

114. *See id.*

115. *See* Oliver J. Rutz, Three Essays on Paid Search Advertising (2007) (unpublished Ph.D. dissertation, University of California, Los Angeles) (on file with ProQuest Information and Learning Company).

116. *See id.* at 10.

117. *See id.* at 26–27 (discussing the move from the “awareness” stage, when a consumer is conducting research, to the “conversion” stage, when the consumer searches for a specific brand name).

118. JUDY STRAUSS & RAYMOND FROST, E-MARKETING 163 (Prentice Hall 5th ed. 2009).

alternatives online, “[t]hirty-six percent of all online shoppers are price conscious and willing to buy from an unknown online retailer if the price is low.”¹¹⁹ This suggests that many consumers are aware of the multitude of options available and are willing and able to sort through choices rather than stick to one brand. In this context, a consumer searching for a trademark may not be looking just to purchase a product or service of that specific brand; rather, the consumer may be looking for a class of products and using the brand as a door-opener for finding related products that may be cheaper or can act as a viable substitute for the branded product.¹²⁰ Limiting comparison shopping by increasing trademark protections with an expansive interpretation of initial interest confusion would act contrary to trademark law’s primary goal of consumer protection.

Additionally, consumers often examine online reviews before committing to a purchase, thus reducing the chance that consumers would develop an initial interest in a product because of a false belief that it is affiliated with the trademark. Specifically, “[c]onsumers trust each other more than they trust advertising or companies online. The increase in user-generated content in special interest communities has consumers looking to each other for advice.”¹²¹ Since online reviews are so readily accessible and frequently visited, it is unlikely for consumers to consider any product, especially those that are greater investments, without examining various information sources available to them. In light of this, ads serve merely as options that are no more diverting than review sites and other related sites present in the search results page. Ultimately, the availability of options, from ads to review sites, increases consumer sophistication and reduces the chance of initial interest confusion while creating healthy competition in the online consumer market.

IV. TAKING JUDICIAL NOTICE OF SURVEYS AND CONSUMER RESEARCH

Given the vast body of consumer research related to e-commerce, parties to a trademark infringement case would likely be able to find relevant research to support their arguments at the preliminary injunction stage, without having to seek an expert to conduct and analyze time-intensive and costly surveys. Requesting that courts take judicial notice of existing consumer research from reliable sources would increase judicial efficiency,

119. *Id.*

120. *See id.*

121. *Id.* at 159–60.

reduce costs for the parties, and provide an empirical basis for analysis where comprehensive case-specific surveys may not be complete or available.

Evidence admitted under judicial notice is accepted without formal introduction by a witness and is frequently used for obvious facts, such as which day of the week corresponded to a particular calendar date or facts that are found in reference books.¹²² According to Rule 201 of the Federal Rules of Evidence, “[t]he court may judicially notice a fact that is not subject to reasonable dispute because it: (1) is generally known within the trial court’s territorial jurisdiction; or (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned.”¹²³ Because initial interest confusion is a relatively new concept when applied to keyword advertising, the parties would unlikely be able to convince a court that market research on consumer confusion would be “generally known within the . . . jurisdiction.” General trends on marketing and consumer behavior would unlikely be considered “generally known” because most people outside of advertising and marketing departments would not be attuned to this research. Survey results and market research are usually not as obvious and require expert testimony. However, when such consumer research—whether they are case-specific surveys or broad marketing studies—has been vetted by an expert in one case, taking judicial notice of that research in future cases would be a cost-effective and efficient way to support claims of initial interest confusion or to support defenses against them. Section IV.A, *infra*, proposes taking judicial notice of case-specific surveys from related cases, and Section IV.B, *infra*, proposes taking judicial notice of third-party market research to assist in the analysis of initial interest confusion at the preliminary injunction stage.

A. JUDICIAL NOTICE OF CASE-SPECIFIC SURVEYS

Judicial notice should be taken of survey results conducted for cases pertaining to similar industries and consumer demographics. Under 39 C.F.R. § 3001.31(k)(2)(ii), survey evidence may be used when the party provides

- (a) [a] clear description of the survey design, including the definition of the universe under study, the sampling frame and units, and the validity and confidence limits than can be placed on major estimates; and (b) [a]n explanation of the method of selecting the sample and the characteristics measured or counted.¹²⁴

122. See Hiram C. Barksdale, *The Use of Marketing Data in Courts of Law*, 23 J. OF MARKETING 381 (1959).

123. FED. R. EVID. 201(b).

124. 39 C.F.R. § 3001.31(k)(2)(ii) (2007).

If the expert witness in the prior case provided clear descriptions and explanations of the survey design and method of sampling, such that the evidence was considered reliable, then it would be reasonable for courts presiding over related cases, even in different circuits, to take judicial notice of those factual findings and consider them as factors in determining likelihood of initial interest confusion.¹²⁵ Although researching and identifying relevant prior surveys would require some work by the parties, this work would likely be less costly and time-consuming than for the parties to hire an expert to conduct and analyze a completely new survey involving a similar industry and consumer base.

Among the different types of consumer research, surveys are generally the most useful in likelihood of confusion cases because “surveys seem to offer objective evidence of consumer perceptions, measured with scientific controls, projectable with statistical accuracy.”¹²⁶ As evidence of actual confusion is often difficult to find, survey results that provide such evidence is received with “substantial weight.”¹²⁷ Although surveys do not capture all of the relevant consumers, they provide a “statistical means of predicting the likelihood that actual consumers will [be] confuse[d].”¹²⁸ Since likelihood of initial interest confusion requires only some evidence suggesting that there was confusion before purchase or other substantial consumer response, prior survey data showing confusion sufficient to meet the higher standard for the likelihood of confusion analysis would also indicate there was a likelihood of initial interest confusion.

For instance, a hypothetical case of ads promoting hair restoration products or other cosmetic or surgical care for that consumer demographic may benefit from using survey data collected for *True & Dorin Medical Group, P.C. v. Leavitt Medical Associates*.¹²⁹ In that case, surveys were conducted to assess the impact on consumer perception when trademarks were used in ad text and as keywords.¹³⁰ Taking judicial notice of this survey data would allow the parties to use the survey results as a point of comparison, especially in a related industry where the consumer base may use search engines and

125. See *St. Louis Baptist Temple, Inc. v. FDIC*, 605 F.2d 1169, 1172 (10th Cir. 1979) (noting that “[j]udicial notice is particularly applicable to the court’s own records of prior litigation closely related to the case before it”).

126. RICHARD L. KIRKPATRICK, *LIKELIHOOD CONFUSION TRADEMARK LAW* § 7:10 (2012).

127. *Id.*

128. *Id.* (citing *Pfizer, Inc. v. Astra Pharm. Prods., Inc.*, 858 F. Supp. 1305 (S.D.N.Y. 1994)).

129. See Berger Declaration, *supra* note 94.

130. See *id.*

perceive them similarly. Statistics such as 91.2% of survey subjects believing that an ad containing the words “Elliot and True” was promoting a product associated with Elliott and True is compelling and could be considered, along with facts specific to the hypothetical case, as evidence of likelihood of confusion when ad text is used in addition to keyword-targeting.¹³¹ Furthermore, the significant decline in initial interest confusion when the trademark is not used in the ad text but only as a keyword, down to 48.6% of surveyed consumers, suggests that consumers in a similar industry may likewise be more impacted by the ad text than the use of the keyword alone.¹³² Although these statistics are specific to the case involving Elliott and True, the general trend that ads not containing the trademark are less likely to be seen as affiliated with the trademark could be applied to other keyword advertising cases. Such findings can assist accused infringers in showing that use of trademark keywords, alone, is not necessarily sufficient to create a likelihood of initial interest confusion.

B. JUDICIAL NOTICE OF MARKET RESEARCH

Unlike case-specific survey results, general trends may more likely be disputed because of their broad reach and the potential assumptions built into them. Therefore, the scope of what is granted judicial notice may be more limited, but nonetheless, should still be considered. Given the breadth of market research that is available, taking judicial notice of consumer research that expert witnesses have deemed valid in related cases would assist in the analysis of initial interest confusion in later cases concerning similar products and consumers. Using this already-available information, as with case-specific surveys, would make the judicial process more efficient.

According to 39 C.F.R. § 3001.31(k)(2)(i), market research may be considered as long as information validating the research results is provided.¹³³ Rather than having to conduct new surveys and requiring new

131. *Id.*

132. *Id.*

133. 39 C.F.R. § 3001.31(k)(2)(i) (requiring “(1) A clear and detailed description of the sample, observational, and data preparation designs, including definitions of the target population, sampling frame, units of analysis, and survey variables; (2) An explanation of methodology for the production and analysis of the major survey estimates and associated sampling errors; (3) A presentation of response, coverage and editing rates, and any other potential sources of error associated with the survey’s quality assurance procedures; (4) A discussion of data comparability over time and with other data sources; (5) An assessment of the effects of editing and imputation; (6) Identification of applicable statistical models, when model-based procedures are employed; and (7) An explanation of all statistical tests performed and an appropriate set of summary statistics summarizing the results of each test”).

experts to go through the whole vetting process again, parties can look to existing empirical studies that have already been considered valid by other courts.¹³⁴ If the evidence had previously been vetted and used in a similar proceeding, judicial notice should be taken of the market research. This information would be useful where comprehensive studies may otherwise not be feasible at the preliminary injunction stage.

Based on existing empirical studies, accused infringers may gain a new litigation advantage if courts take notice of the recent research that indicates an increasingly more sophisticated consumer base. Market research showing that consumer engagement depends on ad position, that their perceptions of the ad are shaped by the ad content, and that their perceptions of the credibility differ between organic results and ads, could be used as evidence to support the defendant's claim that targeting a keyword does not lead to initial interest confusion. Rather, other factors like the text of the ad and the content of the website linked to the ad are more relevant in determining if such confusion exists. Given the increased consumer sophistication, the initial interest confusion doctrine should be clarified so as to require actual confusion from reading the text of the ad or from visiting the website, rather than mere diversion from the presence of the ad next to search results. Allowing use of prior survey results and market research would allow courts to better assess when actionable confusion exists.

V. CONCLUSION

Although mere diversion has been considered infringing in cases where the trademark was explicitly used in a competitor's ad or website, diversion based on keyword-targeting, alone, seems insufficient to support a claim of initial interest confusion. By taking consumer research into account at the preliminary injunction stage, courts would likely find that targeting a keyword does not create confusion without explicit references to the trademark in the ad text or website, or without at least some parallels between the websites of the competitor and the trademark owner. Confusion is more likely influenced by other factors, such as a consumer's level of interest in the good and their consequent degree of care. A consumer is also likely affected by the content of the ads and whether or not there is any ambiguity in language to suggest a relationship with the trademark.

When courts take notice of third-party surveys and market research, which show that various factors impact consumer confusion, trademark owners may have a more difficult time proving that the use of the keyword,

134. See Rutz, *supra* note 110.

without more, causes actionable confusion. While such consumer studies may reduce the likelihood of trademark owner's succeeding on the initial interest confusion claim, only a narrow range of third-party research would be considered relevant in each case, such that the litigation advantage to the accused infringer is not unreasonable.

To the contrary, allowing accused infringers to use such data to support their claims evens the playing field against trademark owners, who may, in some instances, have more financial resources to conduct case-specific surveys in their favor. By taking notice of such evidence, courts can better assess the likelihood of confusion where expert surveys leave holes, given the time-constraints at the preliminary injunction stage in the proceedings. Furthermore, the use of third-party surveys and research would provide a more consistent empirical basis for determining initial interest confusion across different cases and across different circuits, offsetting potentially biased expert testimony and thereby creating a more uniform understanding of how initial interest confusion applies to keyword advertising.

**AMBIGUITY IN FEDERAL DILUTION LAW
CONTINUES: *LEVI STRAUSS & CO. V.
ABERCROMBIE & FITCH TRADING CO.*,
CASE IN POINT**

Jane Ann Levich[†]

Since Frank Schechter introduced the theory of trademark dilution to the United States in his 1927 law review article,¹ trademark dilution has been the source of criticism and debate.² Although Congress created a federal cause of action for trademark dilution in 1995 when it passed the Federal Trademark Dilution Act (“FTDA”), ambiguities, circuit splits, and a Supreme Court decision prompted Congress to amend the FTDA. In 2006, Congress passed the Trademark Dilution Revision Act (“TDRA”), ostensibly with the goals of narrowing and clarifying trademark dilution.³ However, the recent Ninth Circuit decision, *Levi Strauss & Co. v. Abercrombie & Fitch Trading Co.* (“*Levi’s v. Abercrombie*”),⁴ illustrates that the law of trademark dilution remains indeterminate. Specifically, the case demonstrates that the TDRA fails to address how much similarity is required between a famous mark and an allegedly diluting mark to prove dilution.

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1. Frank I. Schechter, *The Rational Basis of Trademark Protection*, 40 HARV. L. REV. 813 (1927).

2. Barton Beebe, *The Continuing Debacle of U.S. Antidilution Law: Evidence From the First Year of Trademark Dilution Revision Act Case Law*, 24 SANTA CLARA COMPUTER & HIGH TECH. L.J. 449 (2007–08); Jennifer Files Beerline, *Anti Dilution Law, New and Improved: The Trademark Dilution Revision Act of 2006*, 23 BERKELEY TECH. L.J. 511 (2008); Robert G. Bone, *A Skeptical View of the Trademark Dilution Revision Act*, 11 INTELL. PROP. L. BULL. 187 (2007); Jonathan E. Moskin, *Dilution or Delusion: The Rational Limits of Trademark Protection*, 83 TRADEMARK REP. 122 (1993); Sara Stadler Nelson, *The Wages of Ubiquity in Trademark Law*, 88 IOWA L. REV. 731, 732 (2003) (“Courts and scholars have spilled a great deal of ink on the subject of trademark dilution.”); Beverly W. Pattishall, *The Dilution Rationale for Trademark—Trade Identity Protection, Its Progress and Prospects*, 67 TRADEMARK REP. 607 (1977).

3. See *Trademark Dilution Revision Act of 2005: Hearing on H.R. 683 Before the H. Subcomm. on Courts, the Internet, and Intellectual Property of the H. Comm. on the Judiciary*, 109th Cong. 2 (2005) [hereinafter *Hearing on TDR A*] (statement of Rep. Lamar S. Smith, Chair, H. Subcomm. on Courts, the Internet, and Intellectual Property).

4. *Levi Strauss & Co., v. Abercrombie & Fitch Trading Co. (Levi Straus III)*, 633 F.3d 1158, 1159 (9th Cir. 2011).

This Note argues that the TDRA fails to establish a clear legal standard for trademark dilution, particularly with respect to the degree of similarity required between a famous trademark and an allegedly diluting mark. Part I examines the development of trademark dilution law in the United States, tracing the theory of dilution from its introduction in Frank Schechter's 1927 law review article through the passage of both the FTDA and later, the TDRA. Part II summarizes the *Levi Strauss v. Abercrombie*⁵ case, including the Ninth Circuit's interpretation of dilution under the TDRA. Part III engages in statutory interpretation of the TDRA and notes that the requirement for similarity between two marks in a dilution claim remains ambiguous under the statute. Part IV uses the *Levi Strauss v. Abercrombie* case to illustrate three problematic effects that stem from ambiguity in the similarity requirement: (1) over-application of dilution to graphic marks versus word marks; (2) anti-competitiveness; and (3) hindrance of expression via extremely high avoidance costs. Finally, Part V recommends that either courts or Congress clarify the similarity requirement of trademark dilution.

I. THE LAW OF TRADEMARK DILUTION

Unlike trademark infringement, which protects against consumer confusion, mistake, and deception, trademark dilution focuses on protecting famous marks.⁶ Under the TDRA, trademark dilution may occur by tarnishment or by blurring.⁷ Dilution by tarnishment is defined as "an association arising from the similarity between a mark or trade name and a famous mark that harms the reputation of the famous mark."⁸ For example, Toys "R" Us brought a successful dilution by tarnishment claim against a pornographic website, *adultsrus.com*.⁹

Dilution by blurring is the classic form of trademark dilution. It is defined as an "association arising from the similarity between a mark or trade

5. *Id.* at 1158.

6. *See* Trademark Dilution Revision Act of 2006, 15 U.S.C. § 1125(c)(1) (2006) (providing injunctive relief for dilution of famous marks "regardless of the presence or absence of actual or likely confusion, of competition, or of actual economic injury"); *Madrid Protocol Implementation Act and Federal Trademark Dilution Act of 1995: Hearing on H.R. 1270 and H.R. 1295 Before the Subcomm. on Courts and Intellectual Property of the House Comm. on the Judiciary*, 104th Cong. 31 (1995) [hereinafter *Hearing on H.R. 1295*] (statement of Philip G. Hampton II, Assistant Commissioner for Trademarks, Patent and Trademark Office, U.S. Department of Commerce) (stating that "the purpose of a dilution statute is to prevent a weakening of a famous mark").

7. 15 U.S.C. § 1125(c)(1).

8. *Id.* § 1125(c)(2)(C).

9. *Toys "R" Us, Inc. v. Akkaoui*, No. C 96-3381 CW, 1996 WL 772709 (N.D. Cal. Oct. 29, 1996).

name and a famous mark that impairs the distinctiveness of the famous mark.”¹⁰ A classic example of dilution by blurring is the use of the name Buick, originally made famous by the car company, on aspirin pills.¹¹ The argument for protecting against the use of a famous mark like Buick on a non-competing product like aspirin is that over-time, the use of the Buick mark will lose its distinctiveness as a source-identifier for motor vehicles.¹²

It is unanimously accepted that the use of the name Buick on aspirin constitutes trademark dilution in the United States, but the contours of the protection offered by dilution laws¹³ and the purposes asserted for protection have varied widely since its introduction. In a 1927 law review article, Frank Schechter first suggested that trademark dilution should be a separate legal injury in the United States.¹⁴ Schechter observed that, “the value of the modern trademark lies in its selling power,” and that a trademark’s selling power depends largely on its “uniqueness and singularity.”¹⁵ Schechter argued that use of a unique or singular mark on non-competing products or services would cause a mark to “gradually but surely lose its effectiveness and unique distinctiveness.”¹⁶ Based on his observations, Schechter concluded that “the preservation of the uniqueness of a trademark should constitute the only rational basis for its protection.”¹⁷ In articulating the bounds of trademark dilution, Schechter proposed protection only where: (1) the junior mark was identical to the senior mark; (2) the senior mark was coined or arbitrary; and (3) the junior mark was used on noncompeting and non-similar goods or services.¹⁸

The theory of trademark dilution gained little if any traction in the United States for nearly two decades. However, in 1947, Massachusetts passed the first state dilution law.¹⁹ The Massachusetts dilution statute provided for injunctive relief against the likelihood of injury to business reputation and the

10. 15 U.S.C. § 1125 (c)(2)(B).

11. *Hearing on H.R. 1295, supra* note 6, at 2 (statement of Rep. Carlos J. Moorhead).

12. *Id.* at 77 (prepared statement of Mary Ann Alford).

13. Laws that prohibit trademark dilution are commonly referred to as dilution laws rather than anti-dilution laws.

14. Schechter, *supra* note 1, at 831–33. Schechter did not himself use the term “dilution” but he referenced the famous German *Odol* case, which did use the term dilution. *Id.*

15. *Id.* at 831.

16. *Id.* at 830.

17. *Id.* at 831.

18. *Id.*

19. Act of May 2, 1947, ch. 307, §7a, 1947 Mass. Acts 300 (codified as amended at Mass. Gen. Laws Ann. ch. 110H, §13).

likelihood of injury to the distinctive quality of a trade name or trademark.²⁰ By 1995, a total of 25 states prohibited trademark dilution.²¹ Because dilution laws varied significantly from state to state, state-law dilution claims proved problematic and at times ineffective.²² Ultimately, the “patch-quilt”²³ system of protection afforded by state anti-dilution laws, coupled with courts’ reluctance to grant nationwide injunctions for a violation of a right that only half of the states recognized, propelled Congressional consideration of federal dilution protection.²⁴

Trademark dilution became a federal cause of action for the first time in 1996 with the enactment of the Federal Trademark Dilution Act.²⁵ When passing the FTDA, Congress carefully noted that dilution is a “highly selective federal cause of action to protect federally registered marks that are truly famous.”²⁶ The FTDA provided injunctive relief to the owner of a famous mark against another person’s commercial use of a mark or trade name that lessened the “distinctive quality of the [famous] mark,”²⁷ irrespective “of the presence or absence of (1) competition between the owner of the famous mark and other parties, or (2) likelihood of confusion, mistake or deception.”²⁸

Although the FTDA established a federal cause of action for trademark dilution, it did little to explicate the standard for dilution. Application of the statute led to inconsistent outcomes and circuit splits, primarily on four issues. First, circuits disagreed on whether the FTDA required a plaintiff to prove actual dilution or merely likelihood of dilution.²⁹ The Fourth Circuit concluded that a plaintiff in a dilution case had to prove “actual economic

20. *Id.* (stating that “[l]ikelihood of injury to business reputation or of dilution of the distinctive quality of a mark registered under this chapter, or a mark valid at common law, or a trade name valid at common law, shall be a ground for injunctive relief notwithstanding the absence of competition between the parties or the absence of confusion as to the source of goods or services”).

21. *Hearing on H.R. 1295, supra* note 6, at 2 (statement of Rep. Carlos J. Moorhead).

22. *Id.* at 164 (prepared statement of Jonathan E. Moskin).

23. *Id.* at 2 (statement of Rep. Carlos J. Moorhead).

24. *Id.*

25. Federal Trademark Dilution Act of 1995, Pub. L. No. 104-98 § 3 (codified as 15 U.S.C. § 1125 (1996)) *amended by* 15 U.S.C. § 1125 (2006).

26. S. REP. NO. 100-515, at 7 (1988).

27. Federal Trademark Dilution Act of 1995, Pub. L. No. 104-98 § 3.

28. *Id.*

29. *Compare* Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Utah Div. of Travel Development, 170 F.3d 449, 461 (4th Cir. 1999) *with* V Secret Catalogue, Inc. v. Moseley, 259 F.3d 464, 477 (6th Cir. 2001), *rev'd*, 537 U.S. 418 (2003) *and* Nabisco, Inc. v. PF Brands, Inc., 191 F.3d 208 (2d Cir. 1999).

harm to the famous mark's economic value."³⁰ The Second and Sixth Circuits, meanwhile, required a plaintiff to prove only likelihood of dilution.³¹ Ultimately the Supreme Court addressed the circuit split and held that the text of the FTDA "unambiguously require[d] a showing of actual dilution, rather than likelihood of dilution."³²

Second, after enactment of the FTDA, circuit courts disagreed about the meaning of "fame" for purposes of dilution.³³ Although the FTDA enumerated eight non-exclusive factors for a court to consider in determining whether a mark was "famous,"³⁴ courts diverged on whether "niche market fame" sufficed.³⁵ Six federal circuits adopted the niche market theory of fame.³⁶ Courts in three other circuits, however, specifically rejected niche market fame.³⁷

Third, courts split as to whether the FTDA protected both inherently distinctive marks as well as marks with acquired distinctiveness.³⁸ Fourth, a question arose as to whether the FTDA included separate causes of action for dilution by tarnishment and dilution by blurring. Dicta by Justice Stevens in the *Moseley v. V Secret Catalogue* case queried whether dilution by tarnishment was actionable under the FTDA.³⁹

30. *Ringling Bros.*, 170 F.3d at 461.

31. *V Secret Catalogue, Inc.*, 259 F.3d at 477; *Nabisco, Inc.*, 191 F.3d at 208.

32. *Moseley v. V Secret Catalogue, Inc.*, 537 U.S. 418, 433 (2003).

33. *Compare Times Mirror Magazines, Inc. v. Las Vegas Sports News, L.L.C.*, 212 F.3d 157, 166 (3d Cir. 2000) *with* *TCPIP Holding Co. v. Haar Comms., Inc.*, 244 F.3d 88, 99 (2d Cir. 2001).

34. Federal Trademark Dilution Act of 1995, Pub. L. No. 104-98 § 3.

35. Niche market fame is fame or distinctiveness of a mark "only to a select class or group of purchasers." *Advantage Rent-A-Car, Inc. v. Enterprise Rent-A-Car*, 238 F.3d 378, 381 (5th Cir. 2001). For example, *Enterprise Rent-A-Car* argued that its mark "We'll Pick You Up" was famous within the car rental industry. *Id.*

36. *See, e.g., id.; Times Mirror Magazines, Inc.*, 212 F.3d at 166.

37. *See TCPIP Holding Co. v. Haar Comms., Inc.*, 244 F.3d 88, 99 (2d Cir. 2001); *Heidi Ott A.G. v. Target Corp.*, 153 F. Supp. 2d 1055 (D. Minn. 2001); *Caruso & Co., Inc. v. Estafan Enters., Inc.*, 994 F. Supp. 1454 (S.D. Fla. 1998), *aff'd without dec.*, 166 F.3d 353 (11th Cir. 1998).

38. *Compare TCPIP Holding Co.*, 244 F.3d at 95 (reserving protection under the FTDA only for famous marks that are inherently distinctive) *with* *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Utah Div. of Travel Dev.*, 955 F. Supp. 605 (E.D. Va. 1997), *aff'd*, 170 F.3d 449 (4th Cir. 1999) (holding that a famous mark with acquired distinctiveness qualifies for protection under the FTDA).

39. The U.S. Supreme Court stated:

[w]hether [tarnishment] is actually embraced by the statutory text, however, is another matter. Indeed, the contrast between the state statutes, which expressly refer to both 'injury to business reputation' and to 'dilution of the distinctive quality of a trade name or trademark,' and

Although given less attention, application of the FTDA also led to variations concerning the degree of similarity required between a famous mark and an allegedly diluting mark to prove dilution. The text of the statute did not explicitly require similarity between the famous mark and the allegedly diluting mark.⁴⁰ Rather it provided that “[t]he owner of a famous mark shall be entitled . . . to an injunction against another person’s commercial use in commerce of a mark or trade name, if such use begins after the mark has become famous and causes dilution of the distinctive quality of the mark.”⁴¹ Nowhere did the statute mention similarity between the famous mark and the mark that causes dilution.⁴² Regardless, a number of circuits read the FTDA as requiring “identity or near identity” of the marks at issue.⁴³

At least partially prompted to action by the United States Supreme Court’s decision in *Moseley*, holding that the FTDA required proof of actual dilution, not mere likelihood of dilution, Congress convened a subcommittee in 2005 to review the FTDA and amend it.⁴⁴ President George W. Bush signed the Trademark Dilution Revision Act into law on October 6, 2006.⁴⁵

In passing the TDRA, Congress reaffirmed its intent that dilution laws provide “extraordinary protection for extraordinary marks.”⁴⁶ However, the

the federal statute which refers only to the latter, arguably supports a narrower reading of the FTDA.

Moseley v. V Secret Catalogue, Inc., 537 U.S. 418, 432 (2003).

40. Federal Trademark Dilution Act of 1995, Pub. L. No. 104-98 § 3 (codified as 15 U.S.C. § 1125 (1996)) amended by 15 U.S.C. § 1125 (2006).

41. *Id.*

42. The FTDA stated:

[t]he owner of a famous mark shall be entitled, subject to the principles of equity and upon such terms as the court deems reasonable, to an injunction against another person’s commercial use in commerce of a mark or trade name, if such use begins after the mark has become famous and causes dilution of the distinctive quality of the mark.

Id.

43. *See, e.g.*, *Playtex Prods., Inc. v. Georgia-Pacific Corp.*, 390 F.3d 158, 167 (2d Cir. 2004); *Playboy Enters., Inc. v. Welles*, 279 F.3d 796, 806 (9th Cir. 2002); *Luigino’s, Inc. v. Stouffer Corp.*, 170 F.3d 827, 833 (8th Cir. 1999).

44. *Hearing on TDR A, supra* note 3, at 2 (statement of Rep. Lamar S. Smith, Chair, H. Subcomm. on Courts, the Internet, and Intellectual Property) (noting that “[t]he Supreme Court’s decision in the *Mosley* case . . . compelled our Subcommittee last spring to review the FTDA and a Committee Print to amend it. The contents of the bill before us, H.R. 683, were largely culled from that Committee Print”).

45. *See H.R. 683: Trademark Dilution Revision Act of 2006*, GOVTRACK.US, <http://www.govtrack.us/congress/bill.xpd?bill=h109-683> (last visited Oct. 28, 2011).

46. *Hearing on TDR A, supra* note 3, at 6 (statement of Anne Gundelfinger) (explaining that “[d]ilution protection was never meant for the average trademark”).

TDRA represents both a congressional reaction to judicial interpretation of the FTDA, as well as the culmination of successful lobbying by owners of famous trademarks and their attorneys.⁴⁷ The TDRA unambiguously responds to the *Moseley* decision by providing relief for likely as opposed to actual dilution⁴⁸ and by expressly enumerating a separate cause of action for dilution by tarnishment.⁴⁹ The TDRA also addresses other ambiguities that led to circuit splits under the FTDA. For example, the TDRA introduces a new standard for fame that specifically excludes marks with only “niche market” fame.⁵⁰ Additionally, the statute provides relief to owners of famous marks that are “distinctive, inherently or through acquired distinctiveness.”⁵¹

The TDRA also redefines dilution by blurring.⁵² The TDRA characterizes dilution by blurring as an “association arising from the similarity between a mark or trade name and a famous mark that impairs the distinctiveness of the famous mark.”⁵³ It also instructs courts to consider six non-exclusive factors in determining whether a mark is likely to cause dilution by blurring:

- (i) The degree of similarity between the mark or trade name and the famous mark[;]
- (ii) The degree of inherent or acquired distinctiveness of the famous mark[;]
- (iii) The extent to which the owner of the famous mark is engaging in substantially exclusive use of the mark[;]
- (iv) The degree of recognition of the famous mark[;]
- (v) Whether the user of the mark or trade name intended to create an association with the famous mark[;]
- (vi) Any actual association between the mark or trade name and the famous mark.⁵⁴

The legislative history sheds little light on why the definition of dilution by blurring changed.⁵⁵ It also fails to elaborate or explain what baseline

47. See *Hearing on TDRA*, *supra* note 3; Barton Beebe, *A Defense of the New Federal Trademark Antidilution Law*, 16 *FORDHAM INTELL. PROP. MEDIA & ENT. L.J.* 1143, 1155 (2006) (noting that the TDRA was the product of extensive work by the International Trademark Association, a trade association of mark holders and their attorneys, and the American Intellectual Property Law Association, a bar association of corporate intellectual property attorneys).

48. Trademark Dilution Revision Act of 2006, 15 U.S.C. § 1125(c)(1) (2006) (stating in relevant part that the owner of a famous mark shall be entitled to an injunction against another person who uses a mark that is likely to cause dilution).

49. *Id.* § 1125(c)(2)(B).

50. *Id.* § 1125(c)(2)(A).

51. *Id.* § 1125(c)(1).

52. *Id.* § 1125(c)(2)(B).

53. *Id.*

54. *Id.* § 1125(c)(2)(B)(i)–(vi).

55. See J. THOMAS MCCARTHY, 4 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 24:101 (4th ed. 2011) (noting that one of the highlights of the TDRA is its

similarity is required in an action for dilution by blurring. The statute uses similarity to define the action but also includes degree of similarity as one of six factors a court should consider.⁵⁶ The ambiguity as to what degree of similarity is required and the tension between considering rather than requiring similarity proves problematic as will be discussed in Part IV, *infra*.

While the TDRA patched certain problems, federal dilution law remains plagued by ambiguity and opaqueness, especially with respect to how much similarity is required in a claim for dilution by blurring.⁵⁷ The TDRA also exacerbates problems that existed under the FTDA but have been largely ignored by the courts and Congress.⁵⁸ One such problem is the rampant tacking on of dilution claims to infringement claims.⁵⁹ Other problems continue to stem from the application of a single dilution standard to both word marks and graphic marks, as will be discussed in Part IV.⁶⁰

sparse legislative history: “[t]he 2006 TDRA must largely speak from the text of the statute itself [as] [t]here is very little legislative history”).

56. § 1125(c)(2)(B)(i).

57. *See* Beerline, *supra* note 2, at 513 (stating that “the TDRA, like the FTDA, gives courts ample room to develop and apply their own standards for interpreting the law, which may lead to the same sort of unpredictably that characterized the FTDA”).

58. *See* Beebe, *supra* note 2, at 450–51 (noting that the case law reported in the year following the adoption of the TDRA “presents strong and disturbing evidence of the continuing debacle of U.S. antidilution law and of the failure of the TDRA so far to effect any substantial change in course”).

59. *Id.*

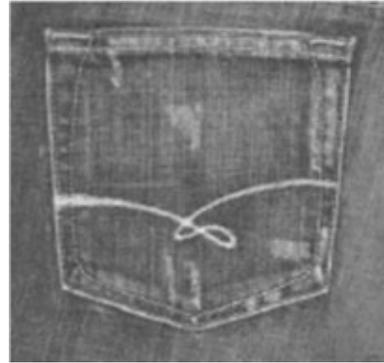
60. Jasmine Abdel-khalik, *Is a Rose by any Other Image Still a Rose? Disconnecting Dilution’s Similarity Test From Traditional Trademark Concepts*, 39 U. TOL. L. REV. 591 (2008).

II. LEVI STRAUSS V. ABERCROMBIE

Figure 1: Levi's Arcuate Mark Versus Abercrombie's Ruehl Mark⁶¹



Levi's Arcuate Mark



Abercrombie's Ruehl Mark

A. BACKGROUND

Levi Strauss & Company (“Levi’s”) created and began selling blue jeans in the 1870s.⁶² Since 1873, the company has stitched the back pocket of its jeans with its “Arcuate” design.⁶³ Since 1879, Levi’s has used the mark in print and other forms of advertising.⁶⁴ The Arcuate design, Figure 1, *supra*, generally consists of “two parallel lines stitched in two arches that meet at a point in the middle of the back pocket.”⁶⁵ Levi’s owns four federal trademark registrations on the Arcuate design, and the design has been registered on the Principal Register of Trademarks since 1943.⁶⁶ According to Levi’s, “virtually all of the Levi’s brand jeans bear the Arcuate mark and . . . 90–95% of Levi’s brand products display the Arcuate mark.”⁶⁷ Levi’s devotes substantial

61. *Levi Strauss III*, 633 F.3d 1158 (9th Cir. 2011).

62. *Id.*

63. The Levi’s back-pocket stitching is a graphic mark, referred to by Levi’s as the “Arcuate” design. It is worthwhile to note that name of the mark serves to describe the mark, the word arcuate is an adjective that means, “curved like a bow.” *Arcuate Definition*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/arcuate> (last visited Feb. 20, 2012).

64. *Levi Strauss & Co., v. Abercrombie & Fitch Trading Co. (Levi Strauss I)*, No. C 07-035752 JSW, 2008 U.S. Dist. LEXIS 87625, at *1, *3 (N.D. Cal. Oct. 16, 2008), *rev’d*, 633 F.3d 1158 (9th Cir. 2011).

65. *Levi Strauss & Co., v. Abercrombie & Fitch Trading Co. (Levi Strauss II)*, No. C 07-03752 JSW, 2009 WL 1082175, at *1, *2 (N.D. Cal. Apr. 22, 2009), *rev’d*, 633 F.3d 1158 (9th Cir. 2011).

66. *Id.*

67. *Levi Strauss I*, 2008 U.S. Dist. LEXIS 87625, at *1, *3–4.

resources to policing the mark.⁶⁸ In the last fifteen years alone, Levi's has initiated between 400 and 500 matters involving the mark.⁶⁹

In 2004, Abercrombie & Fitch Trading Company ("Abercrombie") launched the Ruehl No. 925 clothing line, which included a line of women's denim.⁷⁰ Shortly after launching the denim line, Abercrombie decided that Ruehl jeans required a more iconic stitching design.⁷¹ Accordingly, Abercrombie filed an intent-to-use application for the "Ruehl" back pocket design in 2005.⁷² In 2006, Abercrombie began making and selling jeans with the Ruehl mark on the back pocket.⁷³ Courts described the Ruehl mark in various ways. The district court judge described the Ruehl mark as an embroidered script "R" flipped upside down with the legs of the R extended to the edges of the pocket.⁷⁴ The Ninth Circuit described it as "two-less pronounced arches that are connected by a dipsy doodle, which resembles the mathematical sign for infinity."⁷⁵ All accounts of the Ruehl mark note, however, that it generally sits lower on the back pocket than the Arcuate mark.⁷⁶

B. DISTRICT COURT LITIGATION

In 2007, Levi's filed suit against Abercrombie in the Northern District of California, asserting trademark infringement, unfair competition, and trademark dilution under both federal and California state laws based on Abercrombie's use of the Ruehl mark.⁷⁷ Abercrombie filed an Amended Answer and Counterclaim, in which it sought cancellation of Levi's Arcuate mark for reasons including fraud, abandonment, and the affirmative defenses of waiver, estoppel, laches, acquiescence, unclean hands, and trademark misuse.⁷⁸

A jury rendered a verdict for Abercrombie on Levi's unfair competition and trademark infringement claims in December of 2008.⁷⁹ Levi's subsequently dropped its state-law trademark dilution claim and withdrew its

68. *Id.*

69. *Levi Strauss II*, 2009 WL 1082175, at *2.

70. *Levi Strauss I*, 2008 U.S. Dist. LEXIS 87625, at *4–5.

71. *Id.* at *5.

72. *Id.* at *14.

73. *Id.*

74. *Levi Strauss II*, 2009 WL 1082175, at *2.

75. *Levi Strauss III*, 633 F.3d 1158, 1159 (9th Cir. 2011).

76. *Id.*

77. *Id.*

78. *Levi Strauss I*, 2008 U.S. Dist. LEXIS 87625, at *16.

79. *Levi Strauss II*, 2009 WL 1082175, at *1.

claim for monetary relief on its federal dilution claim.⁸⁰ In April 2009, Levi's federal trademark dilution claim, for which it sought only injunctive relief, was tried before the district court with advisory rulings from the jury.⁸¹

Evaluating Levi's trademark dilution claim under the TDRA, the court concluded that Levi's failed to meet its burden of establishing by a preponderance of the evidence that the Ruehl design is likely to cause dilution by blurring of the Arcuate mark.⁸² In applying the TDRA, the district court stated that:

To prevail on its dilution claim, [Levi's] has the burden of proving by a preponderance of evidence the following elements: (a) that [Levi's] is the owner of a trademark that is famous; (b) that the famous mark is distinctive, either inherently or through acquired distinctiveness; (c) *that [Abercrombie] is making or has made use in commerce of an identical or nearly identical trademark, in this case the Ruehl design*; (d) that [Abercrombie's] use of its Ruehl design began after [Levi's] Arcuate mark became famous; and (e) that [Abercrombie's] use of its Ruehl design is likely to cause dilution by blurring of [Levi's] Arcuate mark.⁸³

On the matter of identity or near identity, the court instructed the advisory jury that in order to be nearly identical, the two marks must be similar enough that a significant segment of the target group of customers sees the two marks as essentially the same.⁸⁴ The court also noted that, “[i]n the dilution context, the similarity of the marks test is more stringent than in the infringement context.”⁸⁵ The advisory jury found that the Ruehl design and the Arcuate mark were not identical or nearly identical.⁸⁶ The court agreed with the advisory jury's findings, noting that the two marks were “not visually similar.”⁸⁷ Relying heavily on the finding that the Arcuate mark and

80. *Levi Strauss III*, 633 F.3d at 1159–60.

81. *Levi Strauss II*, No. 2009 WL 1082175, at *1.

82. *Id.* at *9.

83. *Id.* at *7 (emphasis added). Although Levi's argued that the TDRA did not require a finding that the marks be “identical or nearly identical” to one another, the district court noted that case law in the Ninth Circuit continued to recognize identity or near identity as an element of trademark dilution even after passage of the TDRA. The district court pointed to four cases in the Ninth Circuit that continued to recognize the “identical or nearly identical requirement” as an element of trademark dilution. *Jada Toys, Inc. v. Mattel, Inc.*, 518 F.3d 628, 634 (9th Cir. 2007); *Perfumebay.com, Inc. v. eBay, Inc.*, 506 F.3d 1165, 1180–81 (9th Cir. 2007); *adidas-Am., Inc. v. Payless Shoe Source, Inc.*, 546 F. Supp. 2d 1029, 1063 (D. Ore. 2008); *Visa Int'l Serv. Ass'n v. JSL Corp.*, 590 F. Supp. 2d 1306, 1316 (D. Nev. 2008).

84. *Levi Strauss II*, 2009 WL 1082175, at *8.

85. *Id.* at *7.

86. *Id.*

87. *Id.* at *9.

the Ruehl design failed to meet the similarity requirement, the court concluded that Levi's did not meet its burden of establishing by a preponderance of the evidence that the Ruehl design is likely to cause dilution by blurring of the Arcuate mark.⁸⁸

C. NINTH CIRCUIT'S OPINION

Levi's sought review of the district court's judgment on the grounds that the district court applied an incorrect legal standard, the "identical or nearly identical standard," in evaluating its dilution claim.⁸⁹ In support of its position, Levi's relied on the plain language of the TDRA.⁹⁰ Levi's pointed out that the terms "identical or nearly identical" do not appear in the language of the statute.⁹¹ Abercrombie based its opposition not on the statutory language of the TDRA, but on Ninth Circuit precedent.⁹² On appeal, Abercrombie argued that even after passage of the TDRA, the Ninth Circuit thrice utilized the "identical or nearly identical" test when evaluating trademark dilution claims.⁹³ Rejecting Abercrombie's arguments, the Ninth Circuit held that the "identical or nearly identical" standard did not survive the enactment of the TDRA.⁹⁴ Accordingly, the Ninth Circuit reversed the judgment of the district court and remanded the case for further proceedings.⁹⁵

The Ninth Circuit undertook a six-part analysis⁹⁶ in arriving at its conclusion that the TDRA does not require two marks to be "identical or

88. *Id.*

89. *Levi Strauss III*, 633 F.3d 1158, 1159 (9th Cir. 2011).

90. *Id.* at 1162.

91. *Id.*

92. *Id.*

93. *Id.* Abercrombie cited to *Visa International Service Ass'n. v. JSL Corp.*, 610 F.3d 1088 (9th Cir. 2010); *Jada Toys, Inc. v. Mattel, Inc.*, 518 F.3d 628 (9th Cir. 2008); and *Perfumebay.com Inc. v. eBay, Inc.*, 506 F.3d 1165 (9th Cir. 2007).

94. *Id.*

95. *Id.* at 1175.

96. The Ninth Circuit first looked to the origin of the "identical or nearly identical" standard. The standard first appeared in the Ninth Circuit in the case of *Playboy Enterprises v. Welles*, 279 F.3d 796, 806 (9th Cir. 2002) in which the Ninth Circuit stated that if a mark is not "identical or nearly identical" to the trademarked term, the mark cannot as a matter of law dilute the trademark. In *Playboy Enterprises*, the Ninth Circuit cited the Eighth Circuit case of *Luigino's, Inc. v. Stouffer Corp.*, 170 F.3d 827, 833 (8th Cir. 1999) as authority for this statement. *Luigino's*, in turn, cited the Second Circuit case of *Mead Data Central v. Toyota Motor Sales, U.S.A., Inc.*, 875 F.2d 1026, 1029 (2d. Cir. 1989). By tracing the origins of the "identical or nearly identical" standard, the Ninth Circuit concluded that the requirement pre-dated the adoption of the FTDA and was rooted in state dilution law, specifically New York state dilution law.

nearly identical.” The court began with the plain language of the statute, finding that a comparison of the language in the FTDA and the language in the TDRA “provide[d] a firm basis for decision.”⁹⁷ The court initially focused on the text of subsection (c)(1) of 15 U.S.C. § 1125, which states that “the owner of a famous mark . . . shall be entitled to an injunction against another person who . . . commences use of a mark or trade name in commerce that is likely to cause dilution.”⁹⁸ According to the court, Congress’s use of “a,” an indefinite article, as opposed to “the,” a definite article, indicated that Congress did not intend to require a junior mark to be the same as the senior mark.⁹⁹ Instead, it indicated Congress’s intent that “any number of unspecified junior marks may be likely to dilute the senior mark.”¹⁰⁰

Next, the court observed that in defining dilution by blurring in § 1125(c)(2)(B) as an “association arising from the similarity between a mark and a trade name,” Congress did not require an association arising from “identity,” “near identity,” or “substantial similarity” of the two marks.¹⁰¹ The Ninth Circuit interpreted the language in Section 1125(c)(2)(B) as setting

Second, the Ninth Circuit examined pre-TDRA Ninth Circuit case law employing the “identical or nearly identical standard” and determined that although rooted in state dilution law, the identical or nearly identical standard comported with the language, purpose, and history of the FTDA. *Levi Strauss III*, 633 F.3d at 1165.

Third, turning to the adoption of the TDRA, the Ninth Circuit noted several important aspects of the new legislation. (1) The text of the TDRA does not include any reference to “identical or nearly identical” marks. *See* Trademark Dilution Revision Act of 2006, 15 U.S.C. § 1125(c)(2)(B) (2006). (2) The TDRA defines dilution by blurring as an “association arising from the *similarity* between a mark or trade name and a famous mark that impairs the distinctiveness of the famous mark.” *See id.* The text of the TDRA does not require that a mark be “substantially” or “very” similar. (3) The first of the six dilution factors set forth by Congress is “[t]he degree of similarity between the mark or trade name and the famous mark.” The Ninth Circuit finally stated the viewpoint that “the TDRA articulates a different standard for dilution from that . . . under the FTDA.” *Levi Strauss III*, 633 F.3d at 1166.

Fourth, after determining that the TDRA articulated a new standard for dilution, the Ninth Circuit reviewed the three post-TDRA Ninth Circuit cases cited by Abercrombie on appeal, *Visa International Service Ass’n v. JSL Corp.*, 610 F.3d 1088 (9th Cir. 2010); *Jada Toys, Inc. v. Mattel, Inc.*, 518 F.3d 628 (9th Cir. 2008); and *Perfumebay.com Inc. v. eBay, Inc.*, 506 F.3d 1165 (9th Cir. 2007), and concluded that the Ninth Circuit had yet to “squarely resolve[]” the issue of “whether, to establish dilution by blurring under the TDRA, the junior mark must be identical or nearly identical to the senior mark.” *Levi Strauss III*, 633 F.3d at 1167.

Fifth the Ninth Circuit interpreted the TDR. Sixth, the court evaluated the district court’s use of the “identical or nearly identical” standard. *Id.* at 1167.

97. *Levi Strauss III*, 633 F.3d at 1171.

98. 15 U.S.C. § 1125(c) (emphasis added).

99. *Levi Strauss III*, 633 F.3d at 1171.

100. *Id.*

101. *Id.*

forth a less demanding standard “than that employed by many courts under the FTDA.”¹⁰²

The court also stated that the non-exhaustive list of factors in § 1125(c)(2)(B) does not comport with a requirement of identity or near identity: “Congress’s decision to make degree of similarity one consideration in a multi-factor list strongly suggests that it did not want degree of similarity to be the necessarily controlling factor.”¹⁰³ Lastly, the Ninth Circuit determined that by wholly rewriting § 1125(c), Congress indicated that it “did not wish to be tied to the language or interpretation of prior law, but instead crafted a new approach to our consideration of dilution-by-blurring claims.”¹⁰⁴

Ultimately, the court held that under the TDRA, dilution by blurring “does not require a plaintiff to establish that the junior mark is identical, nearly identical, or substantially similar to the senior mark in order to obtain injunctive relief.”¹⁰⁵ The court noted that a plaintiff need only show that based on the factors set forth in § 1125(c)(2)(B), including the degree of similarity, a junior mark is likely to impair the distinctiveness of the famous mark.¹⁰⁶

III. STATUTORY INTERPRETATION OF THE TDRA

The *Levi’s v. Abercrombie* case makes clear that the threshold requirement for similarity between two marks in a dilution claim remains ambiguous under the TDRA. Indeed, a close reading of the text of the TDRA and review of the legislative history of dilution provides little clarification. This Part explores the Ninth Circuit’s problematic approach to the identity or near identity standard.

The text of the TDRA clearly requires similarity between marks, but leaves open the question of how much similarity is required. The TDRA defines dilution by blurring as an “association arising from the *similarity* between a mark and a trade name and a famous mark that impairs the distinctiveness of the famous mark.”¹⁰⁷ This language indicates not only that similarity between a senior mark and a junior mark is at the core of dilution, but that, “[t]here is a floor of similarity below which no dilution claim is

102. *Id.*

103. *Id.* at 1172.

104. *Id.*

105. *Id.*

106. *Id.*

107. Trademark Dilution Revision Act of 2006, 15 U.S.C. § 1125(c)(2)(B) (2006) (emphasis added).

viable.”¹⁰⁸ In fact, reading the statute otherwise would be antithetical to the language itself: dilution simply does not apply to wholly dissimilar marks.

Though the text of the TDRA clearly requires a threshold of similarity, there is uncertainty as to how much similarity is required to meet the threshold. Congressional intent and purpose, as expressed in the legislative history, often elucidates ambiguous statutory language. However, in the case of the TDRA, the legislative history is of little help in finding the threshold of similarity required for dilution by blurring.¹⁰⁹ Furthermore, the scant legislative history largely focuses on the likelihood of dilution standard, fame in the context of dilution, and relevant concerns regarding the impact of expanded trademark protection on First Amendment rights.¹¹⁰ The record reveals that Congress paid very little attention to the subtle, yet critical introduction of a multi-factor test for dilution by blurring. In fact, Anne Gundelfinger, President of the International Trademark Association (“INTA”), provided the only testimony related to the amended definition of blurring and the new multi-factor test.¹¹¹ Gundelfinger expressed support for the multi-factor approach to dilution by blurring and stated that as to the inclusion of the degree of similarity between the marks, it is

self-evident and refers to step one of the blurring analysis . . . [t]he less similar the marks, the less likely a consumer association between the marks; the more similar the marks, or if they are identical, the more likely it is that the junior mark will impair the association of the senior mark with the source and/or its particular brand attributes.¹¹²

The testimony provided by Gundelfinger indicates a sliding scale for marks that meet a threshold requirement of similarity, but fails to clarify the minimum degree of similarity required between two marks.

Similarly, the legislative history of the FTDA, which also discusses the purpose and character of anti-dilution laws, also fails to explicate the similarity threshold.¹¹³ Debate on the FTDA focused primarily on whether federal dilution protection should extend to both registered and unregistered

108. Abdel-khalik, *supra* note 60, at 601.

109. MCCARTHY, *supra* note 55, § 24:101 (noting that the legislative history of the TDRA is sparse).

110. *Hearing on TDRA*, *supra* note 3.

111. *Id.* at 13 (statement of Anne Gundelfinger).

112. *Id.*

113. Although the TDRA made significant amendments to federal dilution law, Congress expressed that the TDRA “represents a clarification of what Congress meant when it passed the dilution statute [FTDA] almost a decade ago.” *Id.* at 2 (statement of Rep. Lamar S. Smith, Chair, H. Subcomm. on Courts, the Internet, and Intellectual Property).

marks, what the proper definition of a “famous” mark should be, and relevant First Amendment concerns.¹¹⁴ One witness, Jonathan Moskin, urged Congress to pay further attention to the degree of similarity that would suffice to state a claim for dilution.¹¹⁵ Moskin posited that the statute should limit protection to “identical trademarks or marks that are essentially indistinguishable from the registered marks.”¹¹⁶ Moskin further argued that if protection was not limited in this way, “legitimate businesses will be subjected to meritless or pretextual suits for dilution brought by owners of marks having only a general similarity to the allegedly diluting mark.”¹¹⁷ Congress did not heed Moskin’s warnings. Instead, in fashioning and enacting the FTDA, Congress ignored the issue of similarity altogether.

In concluding that the TDRA does not require “identity,” “near identity,” or “substantial similarity,” the Ninth Circuit simply illustrated that the TDRA fails to adequately address existing ambiguities in federal dilution law, including the requisite degree of similarity in a claim for dilution by blurring.¹¹⁸ Although it is safe to say that a claim for dilution by blurring requires some degree of similarity between the mark seeking protection and the allegedly diluting mark,¹¹⁹ courts are left without a means for consistently applying the law to claims for dilution by blurring. As occurred under the FTDA, the uncertainties that remain under the TDRA, including ambiguity as to the similarity requirement in dilution by blurring, will likely lead to inconsistent application of the law,¹²⁰ judicially created mechanisms for comparing marks,¹²¹ and uncertainty for all trademark owners.

114. *Hearing on H.R. 1295, supra* note 6.

115. *Id.* at 156–57.

116. *Id.*

117. *Id.*

118. According to Jasmine Abdel-khalik, Congress’ failure to define the parameters of similarity is highly problematic. She states, “[l]eft to their own devices to create an appropriate test, courts have struggled to articulate a suitable and clear standard and, instead, have created ambiguous or simply fallacious mechanisms for comparing marks in a dilution claim.” Abdel-khalik, *supra* note 60, at 601.

119. The TDRA defines dilution by blurring with reference to similarity between two marks. Trademark Dilution Revision Act of 2006, 15 U.S.C. § 1125(c)(2)(B) (2006).

120. *See, e.g.*, Robert G. Bone, *A Skeptical View of the Trademark Dilution Revision Act*, 11 INTEL. PROP. L. BULL. 187, 195 (2007) (“In the end, judicial determinations of likelihood of blurring will probably turn on the judges’ all-things-considered moral intuitions.”).

121. The text, intent, and purpose of the FTDA did not require the marks to be “identical,” yet multiple circuits adopted this narrowing test in the face of an ambiguous statute. Although the language of the TDRA differs from that of the FTDA, continuing ambiguity is likely to lead to the same type of judicially constructed tools.

IV. DOWN THE RABBIT HOLE: THE COST OF AMBIGUITY WITH RESPECT TO THE SIMILARITY REQUIREMENT

As exemplified by *Levi's v. Abercrombie*, ambiguity with respect to the similarity requirement in dilution by blurring comes at a very high cost.¹²² Without a similarity threshold in the context of dilution by blurring, trademark owners, especially small businesses, are subject to extremely high avoidance costs¹²³ and are increasingly vulnerable to costly lawsuits. Additionally, freedom of expression is susceptible to even greater restriction.¹²⁴

A. GRAPHIC MARKS VERSUS WORD MARKS: OVER-EXPANSION OF DILUTION PROTECTION?

The *Levi's v. Abercrombie* case illustrates a latent issue in federal dilution law, whether dilution by blurring should be applied in the same manner, if at all, to graphic marks as it is to word marks. Although the distinction is rarely acknowledged, it is unclear from the history, purpose, and legislative history of federal dilution law in the United States, whether dilution by blurring contemplates application to graphic marks. To the extent that dilution does apply to graphic marks, like Levi's Arcuate mark, a vague similarity requirement allows for expansive use of dilution to restrict expression. In part because there is an inherent difference between graphic marks and word marks, a clearer, and potentially higher, similarity requirement should be applied to graphic marks.

Graphic marks and word marks are inherently different. Word marks, unlike graphic marks, can be described both audibly and visually by reference to universally identifiable components such as the letters in the English Alphabet or phonetics. For example, KODAK, a widely recognized word mark, can be conveyed visually by displaying the five letters K, O, D, A, and K in that order. Audibly, the mark can be described by reference to the

122. Bone, *supra* note 120, at 197 (“The TDRA, on balance, expands the scope of Section 43(c) relative to pre-TDRA law, and it does so without a careful policy analysis. Expanding dilution law, even with a safe harbor for parody and criticism, risks creating high social costs without corresponding benefits. We need to take a closer look at dilution and in particular the extremely problematic blurring prong. Legal protection should be given only when it is clearly justified on policy grounds, and this means we should err on the side of a narrow statute rather than a broad one that has flimsy support.”).

123. Abdel-khalik, *supra* note 60, at 607.

124. *Hearing on TDRA*, *supra* note 3, at 31 (prepared statement of Marvin J. Johnson) (stating that the TDRA “proposes to . . . make dilution actions easier for trademark holders while simultaneously diluting protections for free speech”).

letters in the English alphabet used to form the mark or by pronouncing the mark phonetically (koh-dack).

Whereas word marks can be compared with respect to spelling, phonetics, phrasing, and other common audio-linguistic tools, a much more limited tool kit exists for comparing differences and similarities between graphic marks like the Arcuate and the Ruehl marks in Figure 1, *supra*. Graphic marks can only be presented visually and generally cannot be broken down into discrete and universally identifiable components. For example, the district court and the Ninth Circuit each struggled to describe the Ruehl mark and the two descriptions are very different. The district court described the Ruehl mark as generally consisting of “an embroidered script ‘R’ that was flipped upside down, with the legs of the ‘R’ extended to the edges of the pocket . . . [t]he Ruehl design also includes a swooping loop toward the center of the pocket.”¹²⁵ The Ninth Circuit in contrast described the mark as “two-less pronounced arches that are connected by a dippy doodle, which resembles the mathematical sign for infinity.”¹²⁶ Although each court referenced commonly accepted shapes and symbols like a letter, an arch, and an infinity sign, each court’s description fails to clearly communicate the mark. The Ruehl mark, like many other graphic marks, must be conveyed visually.¹²⁷

It is unclear from the history and purpose of dilution law whether the federal dilution statute accounts for the inherent differences between word marks and graphic marks. Frank Schechter, to whom U.S. dilution law owes its origin, confined his examples of dilution to word marks. Schechter used examples like Kodak, Vogue, Rolls-Royce, and Aunt Jemima.¹²⁸ Graphic marks were in use when Schechter wrote his article 1927,¹²⁹ but he limited his discussion of dilution to word marks. It is not evident whether Schechter supported expansion of the theory of dilution to graphic marks.

More importantly, the legislative histories of both the FTDA and TDRA focus almost exclusively on word marks when discussing dilution by blurring.¹³⁰ The Senate Report on the FTDA defines dilution then

125. *Levi Strauss II*, No. C 07-03752 JSW, 2009 WL 1082175, at *1–2 (N.D. Cal. Apr. 22, 2009), *rev’d*, 633 F.3d 1158 (9th Cir. 2011).

126. *Levi Strauss III*, 633 F.3d 1158, 1159 (9th Cir. 2011).

127. The Ninth Circuit seems to have implicitly acknowledged this when it included pictures of both the Arcuate and Ruehl marks in its decision.

128. Schechter, *supra* note 1, at 825.

129. In fact, the Levi’s Arcuate mark was in use by 1927. See *Levi Strauss I*, No. C 07-03752 JSW, 2008 U.S. Dist. LEXIS 87625, at *1, *3 (N.D. Cal. Oct. 16, 2008), *rev’d*, 633 F.3d 1158 (9th Cir. 2011).

130. See *Hearing on TDRA*, *supra* note 3; *Hearing on H.R. 1295*, *supra* note 6.

immediately offers Kodak pianos or Buick aspirin as examples of dilution by blurring.¹³¹ Similarly, when introducing the FTDA to the House Subcommittee on Courts and Intellectual Property, Representative Carlos J. Moorhead noted that, “the use of Dupont shoes, Buick aspirin, and Kodak pianos would be actionable under this bill.”¹³²

Additionally, every witness at the House hearing on the FTDA used word marks to illustrate or define dilution by blurring. Mary Ann Alford, Executive Vice President of the INTA in 1995, cited to *Mead Data Central, Inc. v. Toyota Motor Sales, U.S.A., Inc.*,¹³³ for the proposition that dilution by blurring would occur in the cases like “DuPont shoes, Buick aspirin tablets, Schlitz varnish, Kodak pianos, [and] Bulova gowns.”¹³⁴ James K. Baughman, assistant general counsel for Campbell’s Soup Company, supported protection of marks like Campbell’s, Godiva, V8, Pepperidge Farm, Vlasic, and Prego.¹³⁵ The counsel for Warner Brother’s gave an example involving graphic depictions of Looney Tunes characters in support of a dilution by tarnishment cause of action,¹³⁶ but he used the Warner Brother’s shield to demonstrate the need for protection against dilution by blurring.¹³⁷ Although the WB shield arguably could be considered a graphic mark, it likely qualifies as a word mark because the shield centers around the letters “WB” and a banner reading “Warner Bros. Studios.”¹³⁸ The congressional record contains no clear examples or separate considerations of dilution by blurring with respect to graphic marks.

The limited legislative history of the TDRA also focuses exclusively on word marks in defining, discussing, and illustrating dilution by blurring. Anne Gundelfinger, President of the INTA in 2005, illustrated dilution by blurring with reference to the word mark Pentium.¹³⁹ Similarly, William G. Barber,

131. S. REP. NO. 100-515, at 7 (1988).

132. *Hearing on H.R. 1295, supra* note 6 at 2 (statement of Rep. Carlos J. Moorhead).

133. *Mead Data Central v. Toyota Motor Sales, U.S.A., Inc.*, 875 F.2d 1026, 1029 (2d Cir. 1989).

134. *Hearing on H.R. 1295, supra* note 6, at 77 (statement of Mary Ann Alford, Executive Vice-President of the INTA) (citing *Mead Data Central*, 875 F.2d at 1031).

135. *Id.* at 91–93 (statement of James K. Baughman, Assistant General Counsel, Campbell’s Soup Company).

136. *Id.* at 114 (statement of Nils Victor Montan, Vice President and Senior Intellectual Property Counsel, Warner Brothers, Exhibit B).

137. *Id.* at 104 (statement of Nils Victor Montan, Vice President and Senior Intellectual Property Counsel, Warner Brothers).

138. *Id.* at 113 (statement of Nils Victor Montan, Vice President and Senior Intellectual Property Counsel, Warner Brothers).

139. *Hearing on TDRA, supra* note 3, at 13 (statement Anne Gundelfinger, President, International Trademark Association).

representing the American Intellectual Property Law Association, stated that dilution by blurring is intended to protect marks like Kodak or Dupont.¹⁴⁰ Congress simply ignored, or potentially overlooked, the distinction between word marks and graphic marks in enacting a cause of action for dilution by blurring. At the least, the lack of clear consideration of the application and effect of dilution by blurring to graphic marks, and the absolute focus on the application and effect of dilution by blurring on word marks, should caution against rote application of dilution by blurring to graphic marks.

Although Congress failed to distinguish between word and graphic marks, the district court adjudicating the *Levi's v. Abercrombie* case carefully noted the distinction between the two types of marks. In its opinion on cross motions for summary judgment, the district court applied precedential case law, but noted that the *Levi's v. Abercrombie* case differed because it involved a design mark rather than a word mark.¹⁴¹ Similarly, in its opinion on Levi's dilution claim, the district court applied precedential case law that specifically concerned a symbol as a trademark.¹⁴² On appeal, however, the Ninth Circuit, like Congress, did not acknowledge a distinction between word marks and graphic marks.¹⁴³

The *Levi's v. Abercrombie* case demonstrates that a clearer threshold for similarity is needed with respect to graphic marks. Dilution is meant to be an extraordinary remedy, but in the case of the Levi's Arcuate mark, dilution by blurring may serve to protect a simplistic graphic mark with little remaining distinctiveness. According to the Ninth Circuit, dilution may protect the Levi's Arcuate mark, which consists of "two parallel lines stitched in two arches that meet at a point in the middle of the back pocket,"¹⁴⁴ from Abercrombie's Ruehl mark, which consists of "two-less pronounced arches that are connected by a dippy doodle, which resembles the mathematical sign for infinity."¹⁴⁵ Although the two marks both utilize two arch-like shapes, there are obvious differences between the two marks. For example, Abercrombie's Ruehl mark consists of one line, while Levi's Arcuate mark

140. *Id.* at 22 (statement of William G. Barber, on behalf of the American Intellectual Property Law Association).

141. *Levi Strauss I*, No. C 07-035752 JSW, 2008 U.S. Dist. LEXIS 87625, at *1, *41-42 (N.D. Cal. Oct. 16, 2008), *rev'd*, 633 F.3d 1158 (9th Cir. 2011) (distinguishing *Nissan Motor Co., Ltd. v. Nissan Computer Corp.*, No. CV 99-12980 DDP, 2007 U.S. Dist. LEXIS 90487 (C.D. Cal. Sept. 21, 2007) because it involved a word mark rather than a design mark).

142. *Levi Strauss II*, No. C 07-03752 JSW, 2009 WL 1082175, at *1, *8 (N.D. Cal. Apr. 22, 2009), *rev'd*, 633 F.3d 1158 (9th Cir. 2011).

143. *See Levi Strauss III*, 633 F.3d 1158 (9th Cir. 2011).

144. *Levi Strauss II*, 2009 WL 1082175, at *2.

145. *Levi Strauss III*, 633 F.3d 1158, 1159 (9th Cir. 2011).

consists of two lines. Abercrombie's Ruehl mark also utilizes a "dipsy doodle," whereas Levi's mark does not, Figure 1, *supra*.

The difficulty in articulating similarities and differences between one graphic mark and another exemplifies the need for a clearer standard for similarity. Without a clearer, and potentially higher threshold, the reasoning employed by the Ninth Circuit seemingly leads to the conclusion that any back-pocket stitching that employs two arches in any way may dilute Levi's Arcuate mark. This undue constraint on expression expands dilution protection beyond any sensible basis.

B. JUST TACK IT ON: DILUTION AS ANTI-COMPETITIVE

The lack of a clear similarity threshold for trademark dilution allows the owners of famous trademarks to use dilution law in an anti-competitive manner. Rather than being an extraordinary remedy restricted to a narrow class of famous marks, dilution law increasingly¹⁴⁶ serves as an alternate, and less burdensome, means for trademark owners to restrict competitors with marks that may only be marginally or minimally similar to the famous mark.¹⁴⁷ The *Levi's v. Abercrombie* case illustrates the problematic and excessive use of dilution by blurring.

In its suit against Abercrombie, Levi's originally alleged trademark infringement, unfair competition, and trademark dilution under both federal and California laws.¹⁴⁸ Levi's claims for trademark infringement and unfair competition were tried before a jury, which rendered a verdict in favor of Abercrombie.¹⁴⁹ Levi's claims against Abercrombie aligned well with a cause of action for trademark infringement.¹⁵⁰ At trial, Levi's presented survey evidence that Abercrombie's use in commerce of the Ruehl design on the

146. Leah Chan Grinvald, *Shaming Trademark Bullies* 639, n. 86 (Saint Louis Univ. Sch. Of Law, Working Paper Series, Paper No. 2011-01) available at <http://ssrn.com/abstract=1739008>. "A quick Lexis database search of trademark-infringement cases filed in federal district courts from 1995 to 2010 shows 2,417 cases alleging dilution as a cause of action (out of 7,773 filed trademark-infringement claims)." *Id.*; see also Clarissa Long, *Dilution*, 106 COLUM. L. REV. 1029, 1054 (2006) (stating that "dilution claims were almost always brought in conjunction with other trademark claims").

147. *But cf.* Beebe, *supra* note 2, at 459 (explaining that his research "strongly suggest that courts' dilution determinations are largely redundant of their infringement determinations, and that the former fail to yield any remedies not already provided by the latter").

148. *Levi Strauss II*, 2009 WL 1082175, at *1.

149. *Id.*

150. See 15 U.S.C. § 1114(1)(a) (2006) (defining trademark infringement).

back pocket of jeans was likely to cause confusion with Levi's Arcuate mark.¹⁵¹

Why did Levi's also bring a claim for trademark dilution? As noted, dilution by blurring "is not designed to apply where the goods or services of the parties are competitive."¹⁵² Here, Levi's jeans bearing the Arcuate mark and Abercrombie's jeans bearing the Ruehl design are competing goods.¹⁵³ Furthermore, although the Arcuate mark and the Ruehl design may be somewhat similar, they are not so similar that target customers would see the mark as essentially the same.¹⁵⁴ Levi's action for dilution raises the question, is dilution law even applicable in this scenario? And, why, if trademark infringement applies, do plaintiffs, like Levi's, continue to supplement trademark infringement claims with claims of dilution by blurring?

One explanation is that trademark owners do not expect dilution claims to be highly effective; rather trademark owners use dilution claims to serve an alternative function. As one scholar noted:

Most plaintiffs are likely using classic trademark infringement claims to predict their chances of prevailing in the suit; dilution is just a fillip on the side. Pleading dilution as an additional claim will present low marginal costs to the trademark holder in most cases. Even if a dilution claim gives the trademark holder only a small increment of leverage in forcing a settlement, that leverage coupled with the additional costs to the defendant will often make it worthwhile to bring even a weak dilution claim.¹⁵⁵

Did Levi's simply add a dilution claim because it was inexpensive and might increase pressure on Abercrombie to settle? This argument seems unavailing in the *Levi's v. Abercrombie* case because Levi's spent considerable time and money litigating its dilution claim, even after a jury returned a verdict on its trademark infringement claims.¹⁵⁶

151. *Levi Strauss I*, No. C 07-035752 JSW, 2008 U.S. Dist. LEXIS 87625, at *1, *9–11 (N.D. Cal. Oct. 16, 2008) (noting that at trial, Levi's presented a "Likelihood of Confusion Survey" conducted by Dr. Sood).

152. MCCARTHY, *supra* note 55, § 24:69.

153. *Levi Strauss I*, 2008 U.S. Dist. LEXIS 87625, at *9–11. Levi's relied on a "Likelihood of Confusion Survey" conducted by Dr. Sood. The survey itself and its results indicate that Levi's jeans bearing the Arcuate mark and Abercrombie's jeans bearing the Ruehl mark are in competition. Dr. Sood's survey results were as follows: "92 of 299 participants (30.8%) selected the Ruehl jeans as being made, sponsored or endorsed by LS&CO, and 66 of 299 participants (22.1%) identified the Ruehl jeans exclusively." *Id.*

154. *Levi Strauss II*, 2009 WL 1082175, at *7.

155. Long, *supra* note 146, at 1054.

156. *See Levi Strauss III*, 633 F.3d 1158 (9th Cir. 2011).

The more plausible explanation is that owners of famous trademarks, recognizing the broad and ambiguous scope of the TDRA, use dilution by blurring as one more avenue for restricting competition.¹⁵⁷ Levi's history of suing competitors in the denim industry comports with this explanation. According to the *New York Times*, Levi's who was "once the undisputed king of denim . . . has emerged as the most litigious in the apparel industry when it comes to trademark infringement lawsuits, firing off nearly 100 against its competitors since 2001."¹⁵⁸ Although nearly all of Levi's lawsuits settle out of court,¹⁵⁹ the few lawsuits that do make it to court generally allege trademark infringement and trademark dilution.¹⁶⁰ Levi's claims that the lawsuits are not about the money, they are about "removing copycats from stores."¹⁶¹ Levi's use of dilution by blurring to reduce competition not only flies in the face of the purpose of dilution, but it signals the need for congressional and judicial attention to the state of dilution law under the TDRA. If the courts or Congress articulated a clearer threshold requirement of similarity under the TDRA, companies like Levi's would not be able to exact the effects of a trademark infringement suit via the less burdensome mechanism of dilution law. Instead, where two marks are only minimally similar, companies like Levi's would be forced to meet the higher standard of proving trademark infringement.

C. HINDRANCE OF EXPRESSION/AVOIDANCE COSTS

The high avoidance costs Levi's competitors face also illustrate the need for a clear minimum standard of similarity. In evaluating avoidance costs in the dilution by blurring context, one scholar stated that "dilution places stricter duties of avoidance on third parties than does classic trademark law . . . requir[ing] third parties to ascertain the elements of the protected trademark so as to avoid infringing it."¹⁶² Yet, under the TDRA, this is

157. Shubha Ghosh, *Dilution and Competition Norms: The Case of Federal Trademark Dilution Claims Against Direct Competitors*, 24 SANTA CLARA COMPUTER & HIGH TECH. L.J. 571, 591 (2008) ("The problem is that the dilution action and the weakness of the likelihood of confusion standard act together to expand trademark owner's rights . . . [t]he concern is that trademark owners bring trademark infringement and dilution claims simply to appropriate rents in the marketplace.").

158. Michael Barbaro & Julie Criswell, *With a Trademark in its Pocket, Levi's Turns to Suing Its Rivals*, N.Y. TIMES, Jan. 29, 2007, at A1.

159. *Id.*

160. *See, e.g.*, *Lois Sportswear, U.S.A., Inc. v. Levi Strauss & Co.*, 631 F. Supp. 735 (S.D.N.Y. 1985); Complaint at 1, *Levi Strauss & Co., v. Dolce & Gabbana S.R.L.*, (No. 3:11CV00127), 2011 WL 147643, at *1.

161. Barbaro & Criswell, *supra* note 158.

162. Long, *supra* note 146, at 1068.

virtually impossible for trademark owners to do. It seems that at the very least, federal dilution law should articulate a standard for “whether a mark is sufficiently dissimilar to avoid a dilution claim.”¹⁶³

Without a clearer standard, Levi’s competitors constantly face the threat of litigation even where the allegedly diluting mark owner does not recognize a similarity between the famous mark and the allegedly diluting mark. Mark Breitband, the General Manager of the Ruehl brand at the time that Abercrombie adopted the accused Ruehl design, testified that although he was aware of the Arcuate mark, the Ruehl design did not remind him of the Arcuate mark.¹⁶⁴ Rather, the only proposed designs that reminded him of other jeans in the marketplace were designs with “R’s” on them.¹⁶⁵

In a *New York Times* article about Levi’s notorious litigation campaign, the author noted that, “[e]ven companies that have painstakingly worked to avoid infringing on Levi’s trademarks have found themselves in the company’s crosshairs.”¹⁶⁶ The journalist provided the example of denim-makers Rock & Republic who intentionally placed a cloth label on the right hand side of a back pocket, rather than on the left hand side to avoid violating a Levi’s trademark.¹⁶⁷ According to the article, “Levi’s sued anyway, arguing its trademarks forbid placing such a label on a vertical seam of a back-pocket.”¹⁶⁸ Like Abercrombie, Rock & Republic claimed not to see similarity between the mark and Levi’s mark.¹⁶⁹ The chief executive of Rock & Republic stated that the back pocket stitching “was not remotely close to Levi’s.”¹⁷⁰ Not only do Levi’s competitors pay the costs of litigation, but also apparently some of Levi’s smaller rivals have agreed to stop producing the offending pants and even to destroy unsold pairs of offending pants.¹⁷¹ If a trademark owner cannot see a dilution claim coming, avoidance requires creating a mark wholly dissimilar to any other mark or paying to litigate to use a mark.¹⁷² Ultimately, competitors must restrict expression and censor products beyond what is legally necessary to avoid dilution claims.

163. Abdel-khalik, *supra* note 60, at 607.

164. *Levi Strauss II*, No. C 07-03752 JSW, 2009 WL 1082175, at *1, *3 (N.D. Cal. April 22, 2009), *rev’d*, 633 F.3d 1158 (9th Cir. 2011).

165. *Id.*

166. Barbaro & Criswell, *supra* note 158.

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. Daniel Klerman, *Trademark Dilution, Search Costs and Naked Licensing*, 74 FORDHAM L. REV. 1759, 1767 (2006) (stating that “[t]he existence of anti-blurring legislation leads to

V. CONCLUSION: WHERE DO WE GO FROM HERE?

Federal dilution law requires clarification and reform. Federal courts and ultimately Congress should participate in the process of clarifying and reforming federal dilution law. Although traditionally federal courts serve to interpret statutes passed by Congress, in the realm of modern intellectual property law courts have come “to play a principal role in fleshing out and evolving terse early legislative enactments.”¹⁷³ Throughout the development of intellectual property law in the United States, Congress has codified what federal courts develop.¹⁷⁴ As a result, courts have filled in the details and limitations of intellectual property law in a way usually reserved for the legislative process.¹⁷⁵

For example, courts have actively developed some aspects of trademark law.¹⁷⁶ Furthermore, many federal courts, including the Ninth Circuit, embraced a less formal and more common-law oriented approach to interpreting trademark dilution under the FTDA. In interpreting the FTDA, courts developed limitations and contours of the fame requirement,¹⁷⁷ the

lawsuits, the need to investigate whether a new trademark might blur an existing one, and the need to negotiate licenses for what otherwise would be free”).

173. Peter S. Menell, *The Mixed Heritage of Federal Intellectual Property Law and Ramifications for Statutory Interpretation*, in INTELLECTUAL PROPERTY AND THE COMMON LAW (Shyam Balganeshe ed., forthcoming 2011).

174. *Id.* Patent and copyright laws illustrate the unique role of federal courts in defining the metes and bounds of broad intellectual property statutes. *Id.* The first copyright and patent acts, passed in 1790 and 1793 respectively, “left many of the operational details open.” *Id.*

175. *Id.* In the context of copyright law, courts articulated the standards for infringement, the scope of indirect copyright liability, and the doctrine of fair use. *Id.* Likewise, in the realm of patent law, federal courts created the doctrine of equivalents in patent infringement and articulated limitations on patentable subject matter. *Id.*

176. Notably, the core test of trademark infringement, likelihood of confusion, stems from common law judicial interpretation, not from the statutory text. Although 15 U.S.C. § 1114 defines infringement as any use of a mark that is likely to cause confusion, the courts, not Congress, developed a multi-factor test to determine when likelihood of confusion occurs. *See* AMF, Inc. v. Sleekcraft Boats, 599 F.2d 341 (9th Cir. 1979); Polaroid Corp. v. Polarad Elect. Corp., 287 F.2d 492 (2nd Cir. 1961).

177. Some courts read ambiguous language in the FTDA to require both distinctiveness and fame. The Second Circuit limited dilution to inherently distinctive marks. Other Circuits disagreed and articulated that dilution applied to both inherently distinctive marks and marks with acquired distinctiveness. *See, e.g.*, Thane Int'l, Inc. v. Trek Bicycle Corp., 305 F.3d 894 (9th Cir. 2002) (stating that a party could satisfy the fame requirement by a showing of acquired distinctiveness or inherent distinctiveness); Times Mirror Magazines, Inc. v. Las Vegas Sports News, L.L.C., 212 F.3d 157 (3d Cir. 2000) (holding that a mark is not subject to separate test for fame and distinctiveness).

nature of the injury protected,¹⁷⁸ and the similarity requirement for dilution by blurring.¹⁷⁹

In concluding that trademark dilution under the TDRA does not require “identity,” “near identity,” or “substantial similarity” between the allegedly diluted mark and the allegedly diluting mark, the Ninth Circuit failed to consider its role in the broader context of intellectual property law.¹⁸⁰ Although the TDRA codified some judicially defined contours and limitations to trademark dilution,¹⁸¹ the passage of the TDRA did not extinguish the courts’ role in patching the remaining holes in trademark dilution law through a more common-law oriented approach. The similarity requirement in a cause of action for dilution by blurring remains a “hole” in dilution law.¹⁸²

Federal courts should explore the ambiguities in the TDRA, including the similarity requirement. In contrast to the Ninth Circuit’s approach in the *Levi’s v. Abercrombie* case, in the future, courts should apply common law concepts and embrace their role as developers in the intellectual property law making process. Once federal courts have had a chance to fully delve into the TDRA, Congress should examine the federal case law and once again codify trademark dilution reform.

178. The Fourth and Fifth Circuits held that a plaintiff had to present proof of actual injury to the famous mark. *See Westchester Media v. PRL USA Holdings, Inc.*, 214 F.3d 658 (5th Cir. 2000); *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Utah Div. of Travel Development*, 170 F.3d 449 (4th Cir. 1999). The Second Circuit disagreed and held that proof of present, actual injury was not necessary. *Nabisco, Inc. v. PF Brands, Inc.*, 191 F.3d 108, 224–25 (2d Cir. 1999).

179. *See Playboy Enters., Inc. v. Welles*, 279 F.3d 796, 806 (9th Cir. 2002); *Thane Intern., Inc.*, 305 F.3d at 905. The Ninth Circuit limited dilution by blurring to marks that are “identical” or “nearly identical.” As the Ninth Circuit acknowledged, the language of the FTDA did not explicitly include language requiring identity, near identity, or substantial similarity. Nevertheless, the Ninth circuit adopted the identity or near identity standard. *Playboy Enters.*, 279 F.3d at 806; *Thane Int’l, Inc.*, 305 F.3d at 905.

180. *Levi Strauss III*, 633 F.3d 1158 (9th Cir. 2011).

181. For example, the TDRA codified judicial precedent limiting dilution to marks that are nationally famous and excluding marks with only niche market fame. Trademark Dilution Revision Act of 2006, 15 U.S.C. §1125(c)(2)(A) (2006).

182. Although one witness urged Congress to address the similarity requirement in enacting the FTDA, Congress ignored the similarity requirement in drafting and passing both the FTDA and TDRA. *See Hearing on H.R. 1295, supra* note 6, at 156–57.

TO TAX OR NOT TO TAX? THAT'S NOT THE QUESTION: THE ROLE OF TAX WITHIN THE MATURING WORLD OF E-COMMERCE

Hannah V. Minkevitch[†]

Tax moratoriums¹ and internet growth have paved a path for garage-style e-commerce start-ups to mature into retail titans. As states struggle with reduced budgets, the market gap widens between these internet retailers and their “brick and mortar” competitors. Initially, tax moratoriums on internet commerce were created to protect budding internet companies and to encourage growth.² Today, e-commerce is a dominant means of purchasing for many consumers.³ As consumers move rapidly from the physical to the virtual world, the law has attempted to impose a physical presence standard on e-commerce.

This Note discusses the question of *how* to tax e-commerce, focusing specifically on use taxes and sales taxes. One example of the online tax requirement, and the controversy surrounding it, was recently addressed in *Amazon.com v. New York State Department of Taxation & Finance*.⁴ This lawsuit occurred after the state of New York attempted to impose a sales tax requirement on out-of-state internet retailers.⁵ Amazon attacked New York's sales tax law as “unconstitutional” and, as a result, chose to remove a substantial amount of its business from the state.⁶ Because the New York Supreme Court upheld the sales tax requirement as constitutional, the

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1. In 1998, President Clinton signed the Internet Tax Freedom Act into law, which barred certain taxes on electronic commerce transactions. See *Statement by the President*, The White House Office of the Press Secretary (Oct. 8, 1998), available at <http://govinfo.library.unt.edu/npr/library/news/100898.html>.

2. See Christopher J. Schafer, *Federal Legislation Regarding Taxation of Internet Sales Transactions*, 16 BERKELEY TECH. L.J. 415 (2001).

3. Michelle Kessler, *More Shoppers Proceed to Checkout Online*, USA Today (November 18, 2011, 11:49 am), http://www.usatoday.com/tech/news/2003-12-22-shoppers_x.htm.

4. *Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2010).

5. *Id.* at 846.

6. *Id.*

Amazon case has ignited debate about fair business and a state's constitutional ability to impose a sales tax requirement on internet retailers.⁷

This Note will provide an overview of the debate surrounding internet taxation. Part I provides the background and the historical jurisdictional issues of U.S. tax law. Part II explains the *Amazon* case, highlighting the constitutional arguments regarding e-commerce taxation. Part III discusses proposals and legislation involving internet taxation. Also, in Part III, this Note will argue that legislation created to address tax collection on internet transactions should meet four requirements. The legislation (1) should clarify the tax landscape for internet retailers and consumers; (2) it must be constitutional;⁸ (3) it should promote virtual business equally and foster e-commerce growth,⁹ and (4) it should be forward thinking, addressing developments in technology and e-commerce.¹⁰

I. BACKGROUND

A. UNITED STATES APPROACH TO JURISDICTION OF OUT-OF-STATE RETAILERS

When discussing the United States's approach to the jurisdiction of out-of-state retailers, it is important to understand three things. First, although there are two types of taxes involved in the discussion of internet transactions taxation—use tax and sales tax—this discussion is primarily concerned with the latter type. Second, a state's ability to tax is determined by its ability to assert personal jurisdiction over a particular entity.¹¹ Once a state establishes personal jurisdiction, however, the question is not *whether to tax* internet transactions, but instead *how to tax* internet transactions. Third, courts are primarily concerned with analyzing Dormant Commerce Clause issues because the Dormant Commerce Clause focuses on state actions that might abuse power in a way that discriminates against interstate commerce, and internet retailers typically engage in interstate commerce.¹² The rest of Section I.A will explore these three considerations in greater detail.

7. *Id.* at 850.

8. *See* Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

9. *See* Forst, *Old and New Issues in the Taxation of Electronic Commerce*, 14 BERKELEY TECH. L.J. 711 (1999).

10. *See* Megan Groves, *Tolling the Information Superhighway: State Sales and Use Taxation of Electronic Commerce*, 13 HARV. J.L. & TECH. 619 (2000).

11. *Quill*, 504 U.S. at 306–09.

12. *Gibbons v. Ogden*, 22 U.S. 1 (1824).

1. *Types of Tax Involved in Internet Transactions*

a) Use Tax

The Supreme Court in *McLeod v. J.E. Dilworth Co.* defined a use tax as “a tax on the enjoyment of that which was purchased.”¹³ Because use taxes are harder to enforce, lawmakers are more inclined to impose a sales tax collection requirement on internet retailers.¹⁴ Two primary issues are at the root of this enforcement problem.¹⁵ First, it is logistically challenging for states to educate consumers and to hold them responsible for collecting use taxes.¹⁶ Second, enforcement of use tax laws is administratively onerous, often impractical, and expensive.¹⁷ These issues will be addressed in turn below.

States generally find it too impractical and expensive to educate consumers about their obligations under the use tax laws. Typically, most states apply a use tax requirement to items that would be subject to a sales tax if they were purchased in that state.¹⁸ Most consumers are unaware they must pay a use tax on purchases ranging from television sets to tennis shoes.¹⁹ Furthermore, many who know of the use tax have no idea how to calculate what they owe.²⁰ The calculation percentage is usually the same as the state’s sales tax rate.²¹ For example, if a consumer buys a television online, she is required to record the price of the television, multiply this price by the standard use tax rate, and then insert the product of this calculation into a specifically delineated section of her income tax form for the year.²² This task may not be too challenging if all she purchased online that year was a television. The modern consumer, however, typically buys numerous things online that are subject to sales taxes.²³ Such consumers are technically required to keep track of these items and make calculations to input into

13. *McLeod v. J.E. Dilworth Co.*, 322 US 327, 330 (1944).

14. Eric Menhart, *Taxing the Internet: Analyzing the States’ Plan to Derive Online Sales Revenue*, J. OF ST. TAX’N, July–Aug. 2007, at 35, available at <http://www.cyberlaw.pro/docs/taxingtheinternet.pdf>.

15. *Id.* at 37.

16. *Id.*

17. *Id.*

18. Ronald J. Huefner & Arlene M. Hibscheiler, *Calculating and Reporting Use Tax in New York*, THE CPA JOURNAL (Nov. 14, 2011), <http://www.nysscpa.org/cpajournal/2004/704/essentials/p38.htm>.

19. *Id.*

20. Huefner & Hibscheiler, *supra* note 18.

21. Menhart, *supra* note 14.

22. Tonya Moreno, *What is Use Tax*, ABOUT.COM (Nov. 4, 2011), <http://taxes.about.com/od/statetaxes/a/use-tax.htm>.

23. See Kessler, *supra* note 3.

their annual tax returns.²⁴ Because many consumers are unaware of these obligations, states would be required to spend a significant amount of time and money educating millions of people.²⁵ Such a task would take a serious bite out of any possible revenue the states would hope to gain from use taxes. Consumers are also unlikely to take the time to record, calculate, and file their use tax forms because of the low chance of being prosecuted for failing to do so.²⁶ On average, the IRS audits 1.5% of individual taxpayers each year.²⁷ As such, the functioning of the tax system generally, and the use tax specifically, depends on voluntary compliance.²⁸

Second, strict use tax enforcement imposes abundant administrative and economic challenges on a state.²⁹ States would be required to keep detailed records of individual consumer spending patterns over the course of each tax year.³⁰ As with the problem of educating consumers, the cost of monitoring their behavior would likely exceed the revenues gained from use tax collection.³¹

b) Sales Tax

Unlike a use tax, a sales tax is “a tax levied on the retail price of merchandise and collected by the retailer or entity selling the good.”³² Contrary to use taxes that hold the consumer responsible for the tax activity, sales taxes impose the tax collection burden on the retailer.³³

Because of use tax challenges, legislators have determined that sales taxes are the more realistic method of collecting tax from internet sales.³⁴ States often have greater opportunities to create legislation incentivizing internet retailers to collect sales taxes on merchandise.³⁵ Additionally, internet businesses are likely better positioned than the individual consumer to develop methods to collect taxes that can be implemented throughout the

24. *Use Tax Basics*, CALIFORNIA STATE BOARD OF EQUALIZATION (Sept. 1, 2011), <http://www.boe.ca.gov/taxprograms/usetax/index.html>.

25. Huefner & Hibscheiler, *supra* note 18, at 37.

26. *Id.*

27. *How to Avoid an IRS Audit?*, WORLDWIDEWEB TAX (Nov. 14, 2011), http://www.wwwwebtax.com/audits/audit_avoiding.htm.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Sales Tax Definition*, MERRIAM-WEBSTER.COM (Sept. 1, 2011), <http://www.merriam-webster.com/dictionary/sales%20tax>.

33. Menhart, *supra* note 14.

34. *Id.* at 37.

35. *Id.*

course of business.³⁶ Lawmakers can create strict business requirements, holding internet retailers accountable for collecting sales taxes, thus facilitating a logistically possible method of enforcement.³⁷

2. *Personal Jurisdiction*

Whether a state can require an out-of-state retailer to remit a sales tax depends upon whether that state can assert personal jurisdiction over that retailer.³⁸ The Supreme Court has established a physical presence nexus requirement that determines proper jurisdiction and when a state can constitutionally require an out-of-state retailer to pay taxes or collect sales taxes from consumer transactions.³⁹ Traditionally, taxation was constitutional when an out-of-state retailer made minimum contacts with a state and that state was not trying to hinder interstate commerce by that taxation.⁴⁰ Courts determined whether a state constitutionally had jurisdiction to tax an entity by using the *International Shoe* standard of minimum contacts.⁴¹ This analysis, however, evolved into a “more flexible inquiry” with courts typically looking past a physical presence requirement and determining whether the entity has “purposefully availed” itself enough to satisfy minimum contacts under the Due Process Clause.⁴² Judges typically engage in this “flexible inquiry” by addressing the constitutionality of personal jurisdiction through a bifurcated analysis incorporating both the Due Process Clause and the Commerce Clause.⁴³

The Due Process Clause, under the Fourteenth Amendment of the Constitution of the United States, holds that no state shall “deprive any person of life, liberty, or property, without due process of law”⁴⁴ For a court to assert tax law jurisdiction, judges must use a personal jurisdiction analysis and first determine if the parties involved have minimum contacts with the forum “such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’”⁴⁵ Judges usually

36. *Id.*

37. *See id.*

38. *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992).

39. *Id.*

40. *Id.*

41. *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945). In *International Shoe*, the Court explained that due process requires that a defendant have minimum contacts with the forum “such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.” *Id.* at 316.

42. *Quill*, 504 U.S. at 307.

43. *Id.* at 305–07.

44. U.S. CONST. amend. XIV, § 1.

45. *Int'l Shoe*, 326 U.S. at 316 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)).

expand this analysis by determining whether a defendant was able to foresee that his “conduct and connection with the forum State were such that he should [have] reasonably anticipate[d] being haled into court there.”⁴⁶ The “conduct or connection,” however, need not be physical. The Court has determined that “it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for [a] physical presence within a State in which business is conducted.”⁴⁷ Therefore, to constitutionally assert personal jurisdiction, a court usually determines whether the out-of-state defendant has “purposefully directed” his conduct or connection to the residents of the forum state.⁴⁸

3. *The Commerce Clause and the Dormant Commerce Clause*

The second part of the jurisdictional analysis involves the Commerce Clause, where judges typically consider whether a state’s nexus or physical requirement laws prohibit interstate commerce.⁴⁹ Judges divide this physical presence element into two inquiries involving the Commerce Clause and the Dormant Commerce Clause, which, in different ways, attempt to regulate the relationship between federal and state power.⁵⁰

The Commerce Clause expressly grants Congress the power to regulate commerce with “foreign Nations, and among the several States.”⁵¹ Essentially, the Constitution has specifically detailed certain powers listed for the federal government and those that are not specifically listed are reserved for the states.⁵² The Commerce Clause grants power to Congress and restricts states’ ability to regulate.⁵³

By contrast, the Dormant Commerce Clause is not expressly inscribed in the Constitution, but instead is a power that the Supreme Court has read into the Commerce Clause.⁵⁴ The Dormant Commerce Clause attempts to limit state and local governments from impeding interstate commerce by imposing “an implicit restraint on state authority, even in the absence of a conflicting

46. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980).

47. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985).

48. *Id.* at 472.

49. Julie M. Buechler, *Virtual Reality: Quill’s “Physical Presence” Requirement Obsolete When Cogitating Use Tax: Collection in Cyberspace*, 74 N.D. L. REV. 479, 487 (1998).

50. *Quill Corp. v. North Dakota*, 504 U.S. 298, 305 (1992).

51. *United States v. Lopez*, 514 U.S. 549, 554 (1995).

52. *Commerce Clause*, CORNELL UNIVERSITY LAW SCHOOL (Nov. 1, 2011), http://www.law.cornell.edu/wex/commerce_clause.

53. *Id.*

54. *Gibbons v. Ogden*, 22 U.S. 1, 189 (1824).

federal statute.”⁵⁵ Essentially, the Dormant Commerce Clause is concerned with state actions that might abuse power over particular areas of commerce in ways that discriminate against interstate commerce.⁵⁶ For instance, if a state created a tax that effectively bars foreign state businesses from competing in the state, a court would likely view that state’s act as economic protectionism, and Congress would have the ability to restrict that state from enacting such a tax.⁵⁷

Because internet retailers typically engage in interstate commerce, laws that tax out-of-state retailers implicate Dormant Commerce Clause issues. States, however, can typically overcome a Dormant Commerce Clause challenge to an imposed tax if the “tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.”⁵⁸

B. HISTORICAL GUIDELINES FOR TAXATION OF REMOTE SALES: THE PHYSICAL PRESENCE STANDARD

Personal jurisdiction challenges the constitutionality of a state tax on an internet retailer. Increasingly, however, courts are reading into a state’s constitutional powers the ability to tax out-of-state retailers.⁵⁹ Section I.B. will explain the historical guidelines for determining personal jurisdiction for taxation purposes through two foundational cases, *National Bellas Hess, Inc. v. Department of Revenue of Illinois*⁶⁰ and *Quill Corp. v. North Dakota*.⁶¹

In *National Bellas Hess*, the Supreme Court established a bright-line limitation on state taxation powers.⁶² The Court determined—by the Dormant Commerce Clause—that for taxation purposes, an appropriate nexus between an out-of-state retailer and the desired forum required a physical presence.⁶³ Subsequently, in *Quill Corp.*, the Court reaffirmed its position in *National Bellas Hess* that the Dormant Commerce Clause requires

55. *United Haulers, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. 330, 338 (2007).

56. *Gibbons*, 22 U.S. at 189.

57. *See id.*

58. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

59. *See Amazon.com, LLC v. N.Y. State Dep’t of Taxation and Fin.*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2010).

60. *Nat’l Bellas Hess v. Dep’t of Revenue*, 386 U.S. 753 (1967).

61. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

62. *Nat’l Bellas Hess*, 386 U.S. at 758–60; *see also Quill*, 504 U.S. at 311.

63. *See Nat’l Bellas Hess*, 386 U.S. at 758–60.

some physical presence in the taxing state for that state to assert taxation jurisdiction over out-of-state retailers.⁶⁴

1. National Bellas Hess

In *National Bellas Hess*, a use tax case, the Court created a bright-line rule that requires states to establish a physical presence nexus between an out-of-state retailer and the desired forum before asserting personal jurisdiction:

[the] State of Illinois had no power to impose liability on out-of-state mail order firm to collect use taxes imposed by Illinois Use Tax Act, where mail order firm maintained no office, had no agents or solicitors, owned no property, and had no telephone listing in Illinois, and where all contacts which firm had with state were via United States mail or common carrier.⁶⁵

In *National Bellas Hess*, the state of Illinois attempted to require National Bellas Hess, a mail-order company located in Missouri, to remit taxes on mail-order purchases.⁶⁶ The primary issue was whether the state could constitutionally require an out-of-state company to remit a tax, even though the company had no physical location within the state.⁶⁷ Although mail-order catalogues were a new advancement at the time that affected interstate commerce, the Court required a physical nexus to exist before the state could override the Dormant Commerce Clause.⁶⁸ Courts used this physical presence requirement to determine whether or not a state could tax an out-of-state entity.⁶⁹ The Supreme Court later upheld the requirement in a subsequent case, *Quill Corp. v. North Dakota*.⁷⁰

2. Quill Corp.

In 1992, the Supreme Court reaffirmed the physical presence requirement in *Quill Corp. v. North Dakota*, holding that “a vendor whose only contacts with the taxing State are by mail or common carrier lack[ed] the ‘substantial nexus’ required by the Commerce Clause.”⁷¹ Quill was a Delaware corporation with offices in California, Georgia, and Illinois, but the company solicited business in other states, including North Dakota.⁷² Quill

64. *Quill*, 504 U.S. at 331.

65. *Nat'l Bellas Hess*, 386 U.S. at 753.

66. *Id.* at 753–54.

67. *Id.*

68. *Id.* at 758.

69. *Id.*

70. *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

71. *Id.* at 311.

72. *Id.* at 302.

conducted most of its out-of-state business “through catalogs and flyers, advertisements in national periodicals, and telephone calls.”⁷³ Prior to 1987, North Dakota had a statute that required “every ‘retailer maintaining a place of business in the State to collect the tax from the consumer and remit it to the State.’”⁷⁴ In 1987, North Dakota expanded its definition of “retailer” to include “every person who engages in regular or systematic solicitation of a consumer market in the state.”⁷⁵ The new definition mandated that Quill collect a tax on all of the orders it received from North Dakota residents. Quill objected to this requirement and challenged the state’s mandate.⁷⁶

Quill attacked North Dakota’s tax requirement by asserting that the tax was unconstitutional on Due Process Clause and Commerce Clause grounds.⁷⁷ When considering Quill’s claims that the state could not constitutionally assert personal jurisdiction to impose a tax requirement, the Court shifted its focus from the historical jurisdiction standard in *International Shoe Co. v. Washington*⁷⁸ to a “more flexible inquiry”⁷⁹ to determine whether Quill had “purposefully avail[ed] itself of the benefits of an economic market in the forum State.”⁸⁰ Using this flexible inquiry, the Court determined that the state had personal jurisdiction over Quill because Quill had purposefully availed itself enough to satisfy minimum contacts under the Due Process Clause.⁸¹

The Court then addressed Quill’s argument that the tax requirement violated the Dormant Commerce Clause. The Court applied a four-part test from *Complete Auto Transit, Inc. v. Brady*, stating that when addressing taxes facing Dormant Commerce Clause challenges, courts should uphold the tax if it “(1) is applied to an activity with a substantial nexus with the taxing State,

73. *Id.*

74. *Id.* (quoting N.D. CENT. CODE § 57-40.2-07 (Supp. 1991)).

75. *Id.* at 302–03 (quoting N.D. CENT. CODE § 57-40.2-01(6) (Supp. 1991)). “Regular or systematic solicitation” meant “three or more advertisements within a 12-month period.” *Id.* at 303 (quoting N.D. ADMIN. CODE 81-04.1-01-03.1 (1988)).

76. *Quill*, 504 U.S. at 303.

77. *See id.* at 303–04.

78. *Int’l Shoe Co. v. Washington*, 326 U.S. 310 (1945). In *International Shoe*, the Court explained that due process requires that a defendant have minimum contacts with the forum “such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’” *Id.* at 316; *see also Quill*, 504 U.S. 298 at 307 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)).

79. *Quill*, 504 U.S. at 307.

80. *Id.*; *see also Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985) (“So long as a commercial actor’s efforts are ‘purposefully directed’ toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.”).

81. *Quill*, 504 U.S. at 308.

(2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State.”⁸² In *Quill*, the Court was primarily concerned whether the mail-order business had an adequate nexus to justify taxation under the first prong of *Complete Auto*.⁸³ The Court found no substantial nexus, and thus upheld the bright-line rule that the Dormant Commerce Clause requires some physical presence in the taxing state for that state to assert taxation jurisdiction over out-of-state retailers.⁸⁴

Since *National Bellas Hess* and *Quill*, the Court has engaged in case-by-case determinations of what constitutes a substantial nexus, with no clear standard prevailing.⁸⁵ The determination is muddled by a fact-specific analysis and, as such, courts have not found a predictable answer in many cases.⁸⁶

It is important to understand, however, that the decision in *Quill Corp.* does not prevent states from collecting taxes for items sold online. Instead, it only provides that the state must have some type of substantial nexus to justify a state’s exercise of personal jurisdiction.⁸⁷ Therefore, the characterization of the debate surrounding the taxation of internet transactions as pro-tax versus anti-tax is inaccurate. Instead, the debate focuses on whether a state has justified personal jurisdiction that allows the state to constitutionally require out of state retailers to remit a tax on transactions.

82. *Id.* at 311 (quoting *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977)).

83. *See id.* at 311.

84. *Id.*

85. *See Standard Pressed Steel Co. v. Dep’t of Revenue*, 419 U.S. 560, 564 (1975) (stating the presence of an employee of a corporation within a state in which the corporation owned no property was sufficient to sustain a tax on sales); *see also Tyler Pipe Indus., Inc. v. Washington State Dep’t of Revenue*, 483 U.S. 232 (1987) (finding a substantial nexus where the out-of-state retailer used independent contractors to solicit sales).

86. *See Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 207 Cal. App. 3d 734 (Ct. App. 1989) (labeling teachers ‘agents’ of Scholastic who “obtain[ed] sales within California from local customers for a foreign corporation and such a nexus was substantial enough to make Scholastic liable for taxes.); *see also Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995) (holding that (1) in order to impose duty on out-of-state vendors to collect compensating use taxes from their in-state customers, physical presence of vendors was required, which did not have to be substantial but had to be demonstrably more than “slightest presence,” and (2) activity of out-of-state vendors was sufficient to the impose obligation on vendors to collect sales and use taxes); *see also St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575, 577 n.1 (E.D. La. 2007) (holding that an out-of-state internet bookseller did not have substantial nexus to be required to remit a sales tax to the foreign state).

87. *See Quill*, 504 U.S. at 311.

C. APPLYING THE PHYSICAL PRESENCE REQUIREMENT FOR ASSERTING PERSONAL JURISDICTION TO THE INTERNET

E-commerce challenges laws that use geographic location or nexus as a fulcrum for determining jurisdiction.⁸⁸ Tax law jurisdiction has traditionally focused on the physical location where the transaction occurred.⁸⁹ Individuals, however, conduct internet transactions over a network and, as a result, such transactions are difficult to attribute to a single geographic location.⁹⁰ The decentralized nature of the Internet also makes it difficult to determine whether an e-business meets the constitutional requirement of establishing a substantial nexus with a state to remit a tax there. Moreover, as discussed in Section I.B, *supra*, a court's determination on this issue typically hinges on facts about the specific transaction.

Despite the ambiguity surrounding how states can tax internet transactions, states are nevertheless eager to access the potential revenue from these transactions.⁹¹ As such, state governments have become more creative in finding ways to establish a substantial nexus between internet retailers and their state's geographic borders in order to access this source of revenue.⁹² New York was the first state to statutorily create a nexus between the state of New York and out-of-state retailers and to impose a sales tax and use tax on companies like Amazon and Overstock.⁹³ Since New York took the first leap, numerous other states passed or are considering passing a similar tax on internet retailers.⁹⁴ These states include California,⁹⁵

88. Buechler, *supra* note 49, at 483.

89. *See id.* Many states, however, have attempted to draft around the *Quill* holding. *See* Mark Alan McGinnis, Comment, *Marching to the Beat of the Itinerant Drummer: States Increasingly Refuse to Get Physical Before Finding Nexus*, 32 CAP. U.L. REV. 149, 185–86 (2003).

90. *See* Buechler, *supra* note 49, at 479, 479–80, 483.

91. In Part III, *infra*, Table 1 depicts the states that proposed or enacted bills that create a tax requirement on internet retailers.

92. *See* *Amazon.com, LLC v. N.Y. State Dep't of Taxation and Fin.*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2010).

93. *Internet Sales Tax Fairness*, NEW RULES PROJECT (Oct. 1, 2011), <http://www.newrules.org/retail/rules/internet-sales-tax-fairness>.

94. *See* Table 1 in Part III, *infra*, for a state-by-state discussion.

95. ABx1 28, proposed by Assembly member Bob Blumenfield (D-San Fernando Valley), specifies the obligations under existing law for out-of-state retailers to collect and remit use tax on sales of tangible personal property to California residents. This bill was passed into law in on June 29, 2011. *Governor Brown Signs Legislation*, CA.GOV (Oct. 3, 2011), <http://gov.ca.gov/news.php?id=17101>.

Colorado,⁹⁶ Connecticut,⁹⁷ Florida,⁹⁸ Hawaii,⁹⁹ Illinois,¹⁰⁰ Indiana,¹⁰¹ Maryland,¹⁰² Minnesota,¹⁰³ Mississippi,¹⁰⁴ New Mexico,¹⁰⁵ Rhode Island,¹⁰⁶ Vermont,¹⁰⁷ Virginia,¹⁰⁸ Washington,¹⁰⁹ and Wyoming.¹¹⁰ Nevertheless, some internet retailers have not readily accepted these state tax requirements.¹¹¹ For example, when New York enacted its sales tax and use tax statute, internet retailers like Amazon responded with a lawsuit.¹¹²

II. *AMAZON.COM, LLC V. NEW YORK STATE DEPARTMENT OF TAXATION & FINANCE*

In 2008, the state of New York attempted to clarify through legislation what constituted a substantial nexus for purposes of taxation jurisdiction. The New York state legislature addressed the issue of e-commerce taxation

96. H.B. 10-1193, 112 Leg., 2nd Sess. (Colo. 2011).

97. S.B. 1239, 112 Leg., 1st Sess. (Conn. 2011).

98. *SB 204: Streamlined Sales and Use Tax Agreement*, FLORIDA HOUSE OF REPRESENTATIVES (Oct. 3, 2011), http://www.myfloridahouse.gov/Sections/Bills/bills_detail.aspx?BillId=42322&BillText=specified+digital+good&HouseChamber=H&SessionId=64&.

99. H.B. 1405, 25th Leg., Reg. Sess. (Haw. 2009). Although the Hawaii Legislature passed the bill, Hawaii Governor Linda Lingle vetoed it. *See* Mike Sachoff, *Hawaii Governor Vetoes Amazon Tax Law*, WEB PRO NEWS (July 2, 2009), <http://www.webpronews.com/topnews/2009/07/02/hawaii-governor-vetoes-amazon-tax-law>.

100. Janet Novak, *Illinois Governor Signs Amazon Internet Sales Tax Law*, FORBES.COM (Oct. 3, 2011), <http://www.forbes.com/sites/janetnovack/2011/03/10/illinois-governor-signs-amazon-internet-sales-tax-law/>.

101. S.B. 250, 111 Leg., (Ind. 2010).

102. *Maryland and Connecticut Updates*, AFFILIATE ADVOCACY (Oct. 3, 2011), <http://affiliateadvocacy.com/2010/maryland-and-connecticut-updates/>. The bill, however, failed to make it out of committee. *See* Missy Ward, *Maryland Advertising Tax SB 1071 Gets Squashed*, MISSYWARD.COM (Oct. 3, 2011), <http://www.missyward.com/2009/04/14/maryland-advertising-tax-sb-1071-gets-squashed/>.

103. S.F. No. 2074, 110 Leg., 2nd Engrossment (Minn. 2009).

104. S.B. 2927, 111 Leg., 54 Reg. Sess. (Miss. 2010).

105. Ken Garcia, *New Mexico HB 50-New Internet Tax Bill*, GTOMANAGEMENT (Oct. 3, 2011), <http://gtomanagement.com/new-mexico-hb-50-new-internet-tax-bill/>.

106. H. 7071, 111 Leg., 1st Sess. (R.I. 2010).

107. H. 661, 111 Leg., 2nd Gen. Assembly (Vt. 2010).

108. S.B. 660, 111 Leg., 1st Gen. Assembly (Va. 2010).

109. H.B. 2620, 111 Leg., 1st Sess. (Wash. 2010).

110. H.B. 0029, 111 Leg., 2nd Sess. (Wyo. 2010).

111. *See* Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin., 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2010).

112. *See id.*

when it passed § 1101(b)(8)(vi)¹¹³ of the New York Tax Law, more commonly known as the “Amazon Tax” because of one of the major internet retailers to which it applies.¹¹⁴ The statute creates a rebuttable presumption that an out-of-state online retailer has a nexus with the state of New York if the retailer enters into an agreement with a New York resident to refer customers to the retailer’s website for a commission, for example, through a link on the resident’s website.¹¹⁵

Predictably, internet retailers like Amazon responded negatively to this new obligation. Consequently, only a month after New York enacted the statute, Amazon filed a lawsuit against the state challenging the constitutionality of the statute. The New York Supreme Court¹¹⁶ ruled in favor of the state of New York, granting its motion for summary judgment.¹¹⁷

A. BACKGROUND OF THE CASE

At the time of the case, Amazon had operated its internet retail services for approximately fifteen years.¹¹⁸ Although many New York residents purchased products from Amazon, the company did not own any property in New York, maintain any New York offices, and none of its employees worked or resided in the state.¹¹⁹

113. N.Y. TAX LAW § 1101(b)(8)(vi) (McKinney 2012) provides that a person making sales of tangible personal property or services taxable under this article (“seller”) shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods. . . . This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States constitution during the four quarterly periods in question.

114. Joel West, *California May Never Collect the Amazon Tax*, SEEKINGALPHA (Nov. 2, 2011), <http://seekingalpha.com/article/277365-california-may-never-collect-the-amazon-tax>.

115. *Amazon*, 877 N.Y.S.2d at 846.

116. The New York Supreme Court is a court of original instance in the state. The New York Court of Appeals is the highest court.

117. *Amazon*, 877 N.Y.S.2d 842.

118. *Id.* at 846.

119. *Id.*

Amazon's presence in the state was limited to its "Associates Program" that allowed participants ("Associates") to maintain links to Amazon.com on their own websites.¹²⁰ In return for this link, Amazon would pay its Associates a percentage of its proceeds for any sale from a consumer who accessed Amazon.com through the link on the Associate's website.¹²¹ Furthermore, Amazon incentivized Associates to refer customers to the Amazon Prime program by compensating Associates twelve dollars for every new enrollee.¹²² Individuals who aspired to be an Associate for Amazon had to apply.¹²³ Once Amazon accepted her application, the Associate would sign an operating agreement that stated, "the relationship of the Parties [was] that of 'independent contractors.'" ¹²⁴ Amazon granted Associates "a revocable, non-exclusive, worldwide, royalty-free license . . . solely for purposes of facilitating referrals from their sites to the Amazon site."¹²⁵

Of the hundreds of thousands Amazon Associates, only a small percentage resided in New York.¹²⁶ Amazon stated, "sales to New York customers originating from New York based Associate referrals constituted less than 1.5% of Amazon's New York sales."¹²⁷

On April 23, 2008, New York ratified N.Y. Tax Law § 1101(b)(8)(vi) that requires out-of-state sellers to collect sales tax when these sellers pay commissions to New York residents for referring potential customers.¹²⁸ The new law essentially expanded the nexus requirement a state needed to collect sales taxes from an out-of-state retailer.¹²⁹ Under the new law, an out-of-state seller is exempt from the sales tax only if it could establish its commissioned New York residents "did not engage in any solicitation . . . that would satisfy the nexus requirement of the U.S. Constitution."¹³⁰

B. THE NEW YORK SUPREME COURT DECISION

About two weeks after New York passed the statute, Amazon filed a complaint against the state, alleging three primary issues.¹³¹ First, Amazon argued that the state statute violated "the Commerce Clause of the United

120. *Id.* at 845.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.* at 846.

129. *Id.*

130. *Id.*

131. *Id.*

States Constitution, both facially and as applied to Amazon, because it impose[d] tax collection obligations on out-of-state entities who [had] no substantial nexus with New York.”¹³² Second, Amazon contended that “the provision violate[d] the Federal and State constitutions’ Due Process Clauses, both facially and as applied, because ‘it effectively create[d] an irrebuttable presumption of solicitation’ and [was] overly broad and vague.”¹³³ Third, Amazon alleged the statute “violate[d] the constitutions’ Equal Protection Clauses because ‘it intentionally target[ed] Amazon.’”¹³⁴

The New York Supreme Court did not accept Amazon’s arguments that the statute violated the Constitution and conflicted with U.S. Supreme Court precedent.¹³⁵ The court ruled in favor of the state, granting its motion for summary judgment and holding that the statute was “not facially invalid as violative of the Commerce Clause, did not violate the Commerce Clause as applied to the retailer, did not employ improper statutory presumption in violation of the Due Process Clause and was not targeted at the retailer alone.”¹³⁶ The court supported its holding on four grounds, determining that (1) Amazon had a substantial nexus to the state of New York, (2) the New York statute did not violate the Commerce Clause, (3) there was no Due Process Clause violation, and (4) the statute did not solely target Amazon’s program in New York.¹³⁷

The New York Supreme Court dismissed Amazon’s allegation that the statute was facially invalid because of a lack of a substantial nexus.¹³⁸ The court cited *National Geographic Society v. California Board of Equalization* stating, “so long as there is a ‘substantial nexus’ with the taxing State, the taxes that must be collected need not derive from the seller’s in-state activity.”¹³⁹ The court emphasized that the statute required collecting taxes if a seller enters into a contract with a New York resident, that the New York resident refer potential customers to the seller, and that the seller receive in excess of \$10,000 from New York customers referred through this contractual

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at 851.

137. *Id.*

138. *See id.* at 848.

139. *Id.* at 847 (citing *Nat’l Geographic Soc’y v. California Bd. of Equalization*, 430 U.S. 551, 560 (1977)).

arrangement.¹⁴⁰ The court found that all three of these elements were present in Amazon's Operating Agreement with its Associates.¹⁴¹

The New York Supreme Court also rejected Amazon's second argument, that the statute violated the Commerce Clause.¹⁴² The court based its analysis on the U.S. Supreme Court's decision in *Scripto v. Carson*.¹⁴³ In *Scripto*, the Supreme Court held that "a state could require tax collection by an out-of-state company that had contracts with ten in-state residents—deemed 'independent contractors'—who solicit orders for products on its behalf."¹⁴⁴ Following *Scripto*, the New York court stated that Amazon was benefiting from its New York Associates who were labeled "independent contractors" in the Operating Agreement.¹⁴⁵ Thus, the court determined that these Associates who encouraged Amazon sales reasonably fell within the statute.¹⁴⁶

Rejecting Amazon's allegations of due process violations, the New York Supreme Court stated that a legislative presumption—here, the presumption of solicitation—will withstand constitutional challenge if "there is some rational connection between the fact proved and the ultimate fact presumed, and . . . the inference of one fact from proof of another shall not be so unreasonable as to be a purely arbitrary mandate."¹⁴⁷ Consequently, the court determined that there was a "reasonably high degree of probability" that Amazon would want to encourage its Associates to solicit sales through the click-through links.¹⁴⁸ The court determined that Amazon was incorrect in stating that the presumption was "irrebuttable" by finding that out-of-state sellers could prevent tax collection by stopping all in-state solicitation activities.¹⁴⁹

Finally, the New York court dismissed Amazon's argument that the statute targeted Amazon specifically because it failed to state in its complaint that it was treated differently from other internet retailers. To state a valid claim under the Equal Protection Clause, a plaintiff "must allege that it was

140. *Id.* at 848.

141. *Id.*

142. *Id.* at 849.

143. *Id.*

144. *Id.* at 847 (quoting *Scripto v. Carson*, 362 U.S. 207, 209 (1960)).

145. *Id.*

146. *Id.*

147. *Id.* at 850 (quoting *Mobile, Jackson & Kansas City R.R. Co. v. Turnipseed*, 219 U.S. 35, 43 (1910)).

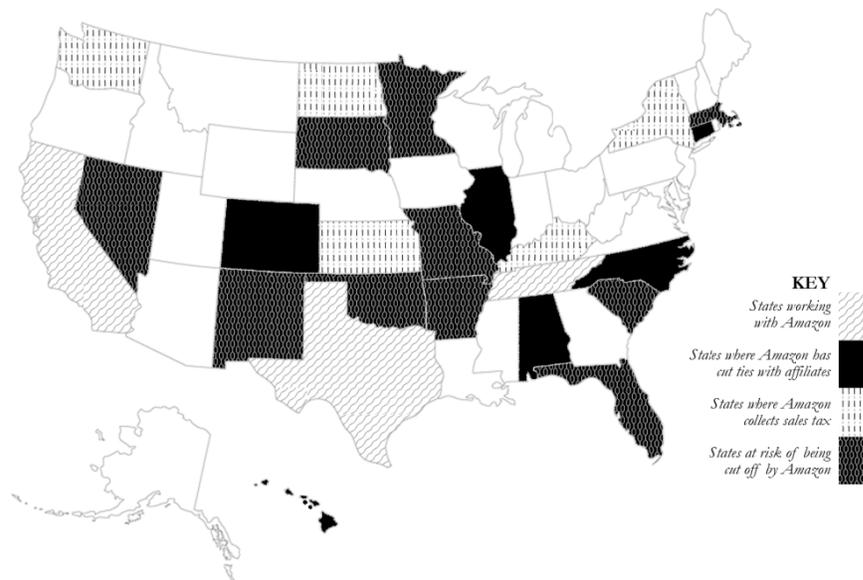
148. *Id.* at 849.

149. *Id.* at 846.

intentionally treated differently from similarly situated individuals.”¹⁵⁰ Had Amazon distinguished itself as being treated differently from other internet retailers in its complaint, it may have had a viable Equal Protection claim.¹⁵¹

Having rejected all of Amazon’s constitutional arguments, the court upheld the New York statute. Because of this decision, the New York statute and the similar statutes enacted by other states have affected the relationship between those states and Amazon.¹⁵²

Figure 1: Amazon Sales Tax Battle in the United States¹⁵³



III. TAX’S ROLE IN THE WORLD OF E-COMMERCE

As e-commerce evolves, so too does the discussion about its appropriate taxation. Events following the Amazon case reveal some of the primary arguments at play regarding the taxation of internet transactions. This Part will briefly summarize the main arguments for and against sales tax collection on internet transactions. Next, this Part will explain the national proposals aimed at addressing this issue. Then, this Part will examine what courts are likely to decide in light of state and national legislation on the subject. Finally,

150. *Id.* at 851 (quoting *Seabrook v. City of New York*, 509 F. Supp. 2d 393, 400 (S.D.N.Y. 2007)).

151. *Id.*

152. Jeanine Poggi, *Amazon Sales Tax: The Battle, State By State*, THE STREET (Nov. 14, 2011), <http://www.thestreet.com/story/11052898/amazon-sales-tax-the-battle-state-by-state.html>.

153. *Id.* This figure was re-created by the author.

this Part will suggest four requirements legislation should meet with regard to the taxation of internet transactions.

A. TWO SIDES OF THE DEBATE

1. *Pro-Sales Tax Collection*

There are four primary arguments for imposing a sales tax on internet transactions.¹⁵⁴ These arguments revolve around preferential treatment by bureaucrats toward internet retailers, unfair advantage of e-commerce against brick-and-mortar establishments, antiquated need to incubate and protect internet retailers, and suffering state economies needing additional revenue sources.

Advocates of sales taxation on internet transactions argue that lobbying organizations and political pandering inappropriately discourage lawmakers from imposing sales taxes on e-commerce.¹⁵⁵ Many on this side of the debate argue that this preferential treatment of e-commerce distorts economic decision-making because such treatment may lead consumers to choose e-commerce over traditional forms of commerce.¹⁵⁶

Second, proponents for the sales tax argue that lack of such taxation increases the digital divide, favoring consumers with internet access and retailers in the digital space.¹⁵⁷ They suggest that the only way to even the playing field is to tax both e-commerce and brick-and-mortar commerce transactions equally.¹⁵⁸

Third, the argument that internet retailers are small and in need of protection to survive in the marketplace is no longer as viable as it was in the 1990s.¹⁵⁹ Giants like Amazon, eBay, and Overstock.com account for significant portion of consumer purchases today.¹⁶⁰ Consequently,

154. Charles McLure, *The Taxation of Electronic Commerce: Background and Proposal*, in PUBLIC POLICY AND THE INTERNET: TAXATION AND PRIVACY (Nicholas Imparato, ed. forthcoming), available at <http://www.egov.ufsc.br/portal/sites/default/files/anexos/20477-20478-1-PB.pdf>.

155. *Id.* at 3.

156. *Id.*

157. *Id.*

158. *Id.*

159. See Stefany Moore, *Barnes & Noble's e-Commerce Site Is No Longer Just About Books*, INTERNET RETAILER (Oct. 19, 2011), <http://www.internetretailer.com/2011/10/19/barnes-nobles-e-commerce-site-no-longer-just-about-books>. (discussing the growth of internet retailers).

160. According to Internet Retailer's Top 100 Guide, Amazon.com is number 1 in the industry. *Id.*

proponents for the internet tax argue that it is no longer necessary to shield such companies from a sales tax requirement to support growth.¹⁶¹

Finally, proponents for the sales tax highlight the struggling economy and the reality that states could use internet taxes as a source of revenue for state coffers.¹⁶² These individuals argue that as e-commerce continues to grow, the inability of states to collect taxes on consumer purchases will lead to serious negative economic consequences.¹⁶³

2. *Anti-Sales Tax Collection*

Those against requiring internet retailers to collect sales tax from internet transactions assert that the tax is unconstitutional and unfair to e-commerce. The anti-sales taxation position is buttressed by three primary arguments.

First, sales tax opponents argue that an e-commerce sales tax will lead to loss of jobs by harming small businesses.¹⁶⁴ Many of the Amazon affiliates were small businesses and, because of state “affiliate” statutes, Amazon simply cut ties with these individuals, negatively affecting their businesses.¹⁶⁵ Furthermore, many small e-businesses have stated that they lack the capability to collect taxes on consumer purchases in numerous states, thus affecting their ability to do business in multiple areas.¹⁶⁶

Second, those against internet sales taxation argue that legislation—like that at issue in the *Amazon* case—violates the Commerce Clause.¹⁶⁷ Because Supreme Court precedent prohibits a state from requiring an out-of-state retailer to collect and remit a tax unless the retailer has a “substantial nexus” with the taxing state, and because this nexus is arguably lacking in the relationship between internet retailers and the taxing state, laws that impose a sales tax on internet transactions run afoul of the Commerce Clause.¹⁶⁸

161. See Moore, *supra* note 159.

162. See Laura Gordon-Murnane, *E-Commerce and Internet Taxation, Issues, Organizations, and Findings*, KNOWLEDGE NET UNLIMITED (Dec. 1, 2011), <http://www.infotoday.com/searcher/jun00/gordon-murnane.htm>.

163. *Id.*

164. *Tax Collection Laws Could Harm Small e-Commerce Business*, PATRICIA WEBER CONSULTING (Feb. 3, 2012), <http://www.patriciaweberconsulting.com/online-payment-processing-blog/benefits-of-accepting-online-payments/tax-collection-laws-could-harm-small-e-commerce-businesses/>.

165. Katy Grimes, *Amazon Tax Would Kill 25K CA Businesses*, CAL WATCHDOG, 3 (Nov. 14, 2011), <http://www.calwatchdog.com/2011/06/21/>.

166. *Tax Collection Laws Could Harm Small e-Commerce Business*, *supra* note 164.

167. Daniel Cowan, *New York's Unconstitutional Tax on the Internet: Amazon.com v. New York State Dep't of Taxation & Finance and the Dormant Commerce Clause*, 88 N.C. L. REV. 1423 (2010).

168. *Tax Collection Laws Could Harm Small e-Commerce Business*, *supra* note 164.

Third, those against the sales tax argue that its imposition is unfair to e-commerce because, even today, internet retailers need protection from taxes to thrive in the marketplace.¹⁶⁹ Opponents of the tax primarily rest their argument on the effect of such a tax on small businesses.¹⁷⁰ For example, over 17,000 small businesses in California submitted letters to their legislators to oppose laws that impose a tax collection obligation on internet retailers.¹⁷¹ These small businesses primarily oppose this tax collection because many of these businesses earn revenue by placing advertisements from out-of-state retailers on their websites and, “[t]he bill states that if someone has advertisements on California Web sites, then there is a nexus in California, and the business needs to pay taxes on all revenue collected in the state.”¹⁷² This portion of the argument primarily rests on the need to foster the growth of e-commerce as it continues to develop.

B. STATUTES AND PROPOSALS

The inconsistent laws and the complexity of state-by-state legislation have compelled lawmakers to attempt to create uniform tax acts to regulate e-commerce taxation. Most of the legislation attempts to address arguments from both sides of the debate. One example is the Streamlined Use Tax and Sales Agreement, enacted in 2002.¹⁷³ Lawmakers have drafted other national proposals, such as the Main Street Fairness Act and the Marketplace Fairness Act.¹⁷⁴ This Section will explain the details of each of these acts and how they attempt to mitigate the constitutional, logistical, and policy challenges facing sales tax collection on internet transactions.

1. *Streamlined Sales and Use Tax Agreement*

Congress adopted the Streamlined Sales and Use Tax Agreement (“SSUTA”) on November 12, 2002.¹⁷⁵ The fundamental purpose of the act was to “simplify and modernize sales and use tax administration in order to

169. *Id.*

170. *Id.*

171. Grimes, *supra* note 165.

172. *Id.*

173. *Streamlined Sales and Use Tax Agreement*, STREAMLINED SALES TAX GOVERNING BOARD, INC. (Nov. 14, 2011), <http://www.streamlinedsalestax.org/index.php?page=modules>.

174. *The Main Street Fairness Act*, THE NEW RULES PROJECT (Nov. 15, 2011), [http://www.newrules.org/retail/rules/internet-sales-tax-fairness/main-street-fairness-act](http://www.newrules.org/retail/rules/internet-sales-tax-fairness/main-street-fairness-act;); *see also* Jason Hamilton, *Bi-Partisan Marketplace Fairness Act Introduced in the Senate Today*, 404 TECH SUPPORT (Nov. 9, 2011), <http://www.404techsupport.com/2011/11/bi-partisan-marketplace-fairness-act-introduced-to-senate-today/>.

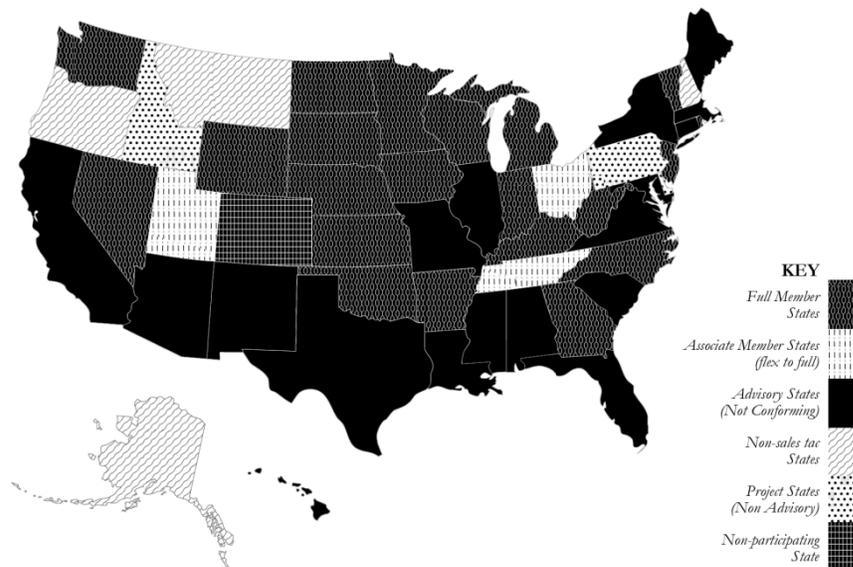
175. *Streamlined Sales and Use Tax Agreement*, *supra* note 173.

substantially reduce the burden of tax compliance.”¹⁷⁶ The Streamlined Sales Tax Governing Board, responsible for drafting the act, stated that

the goal of [the] effort is to find solutions for the complexity in state sales tax systems that resulted in the U.S. Supreme Court holding (*Bellas Hess v. Illinois and Quill Corp. v. North Dakota*) that a state may not require a seller that does not have a physical presence in the state to collect tax on sales into that state.¹⁷⁷

The SSUTA sets standards by which states can create legislation that encourages internet retailers and other remote sellers to collect tax on sales to consumers living in the participating states.¹⁷⁸ States participating in the SSUTA typically work within their own borders to pass legislation that follows the SSUTA and requires sales tax collection.¹⁷⁹ Figure 2, *infra*, illustrates state participation in the SSUTA.

Figure 2: Streamlined State Status as of August 8, 2011¹⁸⁰



2. Main Street Fairness Act

Senator Dick Durbin sponsored the Main Street Fairness Act in August 2011.¹⁸¹ The Main Street Fairness Act attempts to create consistency and to

176. *Id.*

177. *Id.*

178. *Frequently Asked Questions*, STREAMLINED SALES TAX GOVERNING BOARD, INC. (Nov. 14, 2011), <http://www.streamlinedsalestax.org/index.php?page=faqs>.

179. *Id.*

180. Poggi, *supra* note 152. This figure was re-created by the author.

level the competition for all businesses. The legislation would require states to “adhere to uniform product definitions, adopt uniform requirements for filing sales tax returns, administer both state and local sales tax collection through a single state office, and allow retailers to register through a centralized, one-stop multistate registration system.”¹⁸²

The passing of the Main Street Fairness Act would impose a national tax standard but allow states abiding by the SSUTA to force internet sellers to collect tax based on their own state’s legislation.¹⁸³ Traditional retailers such as Target, Wal-Mart, Best Buy, Home Depot, and Sears all support the Main Street Fairness Act.¹⁸⁴ Most large retailers support the passage of a national tax, arguing that it would level the playing field between them and large internet retailers.¹⁸⁵

Advocates for the Main Street Fairness Act argue that it would eliminate some of the negative, unintended consequences of nexus legislation such as New York’s “Amazon Tax.” For example, under the “Amazon Tax,” small businesses suffer a disproportionate amount of the adverse consequences, as Amazon has terminated its relationship with some of these businesses when states have passed these laws.¹⁸⁶ This type of legislation has also harmed many brick-and-mortar businesses, as customers price shop in their stores and subsequently purchase the item online to save on sales tax.¹⁸⁷ By allowing states to require all online retailers, not just those with affiliate programs or substantial nexus, to collect sales tax, the Main Street Fairness Act could purportedly eliminate these harms to small businesses and brick-and-mortar stores.¹⁸⁸

Nevertheless, not everyone is pleased with the Main Street Fairness Act. Some internet businesses argue that it is brick-and-mortar retailers who have the competitive advantage. This argument follows from the observation that brick-and-mortar businesses have the tangible advantages of community

181. *The Main Street Fairness Act*, THE NEW RULES PROJECT (Nov. 15, 2011), <http://www.newrules.org/retail/rules/internet-sales-tax-fairness/main-street-fairness-act>.

182. *Id.*

183. *Id.*

184. *Wall Street Journal: Retailers Support the Main Street Fairness Act*, BLOG.FEDTAX.NET (Nov. 28, 2011), <http://blog.fedtax.net/2011/03/17/wall-street-journal-retailers-support-main-street-fairness-act/>.

185. *Id.*

186. See Zak Stambor, *Amazon Cuts Affiliate Ties Over Sales Tax, and Retail Chain Rivals Try to Take its Place*, INTERNET RETAILER (Mar. 31, 2011), <http://www.internetretailer.com/2011/03/31/amazon-cuts-affiliate-ties-over-sales-tax>.

187. Gordon-Murname, *supra* note 162.

188. *Main Street Fairness Act*, New Rules Project, (Dec. 1, 2011), <http://www.newrules.org/retail/rules/internet-sales-tax-fairness/main-street-fairness-act>.

involvement, ease of returns, and customer satisfaction, as the customer can see and hold a product prior to purchase.¹⁸⁹ Many small online businesses also oppose the Main Street Fairness Act. These businesses argue that the tax imposition will stifle growth on budding e-businesses, especially in the tough economic climate.¹⁹⁰

3. *Marketplace Fairness Act*

In response to some of the concerns about the Main Street Fairness Act, Senators Mike Enzi (Republican of Wyoming), Dick Durbin (Democrat of Illinois), Lamar Alexander (Republican of Tennessee), and Tim Johnson (Democrat of South Dakota) introduced the Marketplace Fairness Act, also referred to as the Enzi-Durbin-Alexander bill.¹⁹¹ If enacted, the Act will create a constitutional framework for collecting sales tax online; it will “allow states to require out of state retailers to collect sales tax at the time of purchase[,] . . . remit those taxes on behalf of customers, and . . . facilitate collection on behalf of third party sellers.”¹⁹²

The support for the bill is mixed. Amazon has expressed strong support for the bill’s passage, stating that it “strongly supports enactment of the Enzi-Durbin-Alexander bill and will work with Congress, retailers, and the states to get this bi-partisan legislation passed.”¹⁹³ Amazon argues that, unlike other bills addressing national taxation that target its affiliate program, the Marketplace Fairness Act is simplified and applies broadly so as to not only target Amazon.¹⁹⁴

By contrast, eBay does not support the Marketplace Fairness Act. A trade group that represents the company, the Computer and Communications Industry Association, responded to the bill and those fighting against it. The Association stated that “it is extremely heartening to know that there are

189. Ken Berry, *Will Congress Green Light the Main Street Fairness Act?*, ACCOUNTINGWEB TAX, SALES & USE TAX (Nov. 16, 2011), <http://www.accountingweb.com/topic/tax/will-congress-green-light-main-street-fairness-act>.

190. *Lungren Introduces Resolution to Protect Small Business and Entrepreneurs from New Sales Taxes*, CONGRESSMAN DAN LUNGREN (Nov. 14, 2011), <http://lungren.house.gov/index.cfm?sectionid=39§iontree=6,39&itemid=759>.

191. Jason Hamilton, *Bi-Partisan Marketplace Fairness Act Introduced in the Senate Today*, 404 TECH SUPPORT (Nov. 9, 2011), <http://www.404techsupport.com/2011/11/bi-partisan-marketplace-fairness-act-introduced-to-senate-today/>.

192. *Id.*

193. *Amazon Strongly Supports Enactment of Enzi-Durbin-Alexander Federal Online Sales Tax Bill*, AMAZON.COM (Nov. 14, 2011), <http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=1628503&highlight=>.

194. See Nate Anderson, *Surprise: Amazon “Strongly Supports” New Sales Tax Bill*, ARSTECHNICA (Dec. 1, 2011), <http://arstechnica.com/tech-policy/news/2011/11/surprise-amazon-strongly-supports-new-sales-tax-bill.ars>.

those in the Senate, as well as the House, who are willing to stand up in support of innovation and entrepreneurship against retrogressive measures that would draft online vendors into service as remote sales tax collectors.”¹⁹⁵ Furthermore, Tod Cohen, the vice president for government relations at eBay, argued “it does not make sense to expand Internet sales tax burdens on small businesses at a time when we want entrepreneurs to create jobs and economic activity.”¹⁹⁶

In response, opponents to eBay’s position contend that the Marketplace Fairness Act exempts small e-businesses whose gross sales are less than \$500,000 annually from sales tax collection.¹⁹⁷ Such a provision takes into consideration the concerns expressed by small businesses that argue that a sales tax collection would disproportionately harm them.

C. THE POTENTIAL EFFECTS OF INTERNET TRANSACTIONS SALES TAX LEGISLATION ON CONSUMERS, RETAILERS, AND STATES

A sales tax on online purchases would affect consumers, internet retailers, and state governments in a variety of ways. Consumers would no longer have the option to avoid sales taxes by purchasing online.¹⁹⁸ Consequently, those consumers who would have purchased online for this reason will likely resort to physical establishments, which would promote brick-and-mortar commerce. Internet retailers may lower prices to maintain an advantage over their brick-and-mortar competitors.¹⁹⁹ The Act may also force internet retailers to develop the logistical systems necessary to collect sales taxes on all transactions. State governments may benefit from streamlined national proposals, as the sales tax collected from internet retailers could go into state budgets, potentially increasing collective state revenue by “23 billion a year in uncollected taxes.”²⁰⁰

D. JUDICIAL RESPONSE TO INTERNET TRANSACTIONS SALES TAX LEGISLATION

The divergent nexus requirements detailed on a case-by-case basis reveal an already growing new problem: lack of predictability. Proposals like the

195. Hamilton, *supra* note 191.

196. Jan Norman, *U.S. Senate Moves To Allow Internet Sales Tax*, THE ORANGE COUNTY REGISTER (Nov. 14, 2011), <http://m.ocregister.com/articles/tax-326546-states-sales.html>.

197. *Small Businesses Applaud Introduction of Marketplace Fairness Act*, THE KITSAP PENINSULA BUSINESS JOURNAL (Nov. 14, 2011), http://kpbj.com/business_weekly/2011-11-14/small_businesses_applaud_introduction_of_marketplace_fairness_act.

198. Hamilton, *supra* note 191.

199. *See* Gordon-Murname, *supra* note 162.

200. Kyung M. Song, *Tax Free Shopping Doomed?*, CHICAGO SUN-TIMES (Nov. 14, 2011), <http://www.suntimes.com/8747010-417/tax-free-shopping-doomed.html>.

Main Street Fairness Act, the Marketplace Fairness Act, and a pending decision in the New York Supreme Court reveal the effort legislators and courts are making to address the proper method of taxing internet transactions. Furthermore, courts will likely continue to decide questions of constitutionality and jurisdiction of internet transactions taxation. This Section will discuss how courts will likely decide when faced with state statutes and the pending national proposals.

1. *State Statutes*

Table 1, *infra*, provides a list of states that either proposed or enacted bills that would require internet retailers to collect and remit a sales tax. One likely concern for the Courts is whether or not such statutes contain an “affiliate” requirement. As noted by the New York Supreme Court in *Amazon*, such individualized tactics can possibly violate the Constitution.²⁰¹ Another primary concern will be the “intentionality requirement,” which requires the plaintiff to “allege that [she] was intentionally treated differently from similarly situated individuals” under the Equal Protection Clause.²⁰² If a court finds that a statute unjustly targets only one type of retailer, it will likely deem such a law unconstitutional as impeding interstate commerce.²⁰³ However, the plaintiff will typically bear this high burden of alleging the intentionality of the defendant.²⁰⁴ Furthermore, if Congress passes the Marketplace Fairness Act into law, most of these states will have to simplify their nexus legislation to conform with the law.²⁰⁵

201. *See* *Amazon.com, LLC v. N.Y. State Dep’t. of Taxation & Fin.*, 877 N.Y.S.2d 842, 850–51 (N.Y. Sup. Ct. 2010).

202. *Id.* at 851.

203. *See id.*; *see also* *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

204. *See* *Village of Willowbrook v. Olech*, 528 U.S. 562, 564 (2000).

205. *Small Businesses Applaud Introduction of Marketplace Fairness Act*, Market Watch, THE WALL STREET JOURNAL (Nov. 14, 2011), <http://www.marketwatch.com/story/small-businesses-applaud-introduction-of-marketplace-fairness-act-2011-11-09>.

Table 1: Selected/Implemented E-Commerce Tax Statutes by State²⁰⁶

STATE	STATUTE	AFFILIATE AS NEXUS?
California ²⁰⁷	AB 28 1x 28: Enacted. However, Governor Jerry Brown signed AB 155 into law, which repealed the affiliate nexus tax for one year from September 2011.	Yes, included in the Democrats' 2010 budget proposal and would impose an "affiliate nexus tax" on all purchases made online from out-of-state retailers
Colorado ²⁰⁸	H.B. 10-1193: Enacted	Yes
Connecticut ²⁰⁹	Senate Bill 239: Enacted	Yes, "affiliate nexus tax" on all purchases made online
Florida ²¹⁰	Senate Bill 204: Died in committee on April 30, 2010	Not specifically, would have established Streamlined Sales Tax in Florida with the goal of extending the sales tax to out-of-state online purchases
Hawaii ²¹¹	H.B.1405: Vetoed by governor	Yes, would have imposed "affiliate nexus" on all online purchases
Illinois ²¹²	House Bill 3659: Enacted	Yes, imposes an "affiliate nexus tax" on all internet purchases

206. This table was created by the author.

207. *Governor Brown Signs Legislation*, CA.GOV (June 29, 2011), <http://gov.ca.gov/news.php?id=17101>. *But see* Shelly Sullivan, *Governor Signs Legislation That Will Help 25,000 California Companies Get Back in Business*, PERFORMANCE MARKETING ASSOCIATION (Sept. 23, 2011), <http://performancemarketingassociation.com/california-repeals-the-affiliate-nexus-tax-law>.

208. H.B. 10-1193, 112 Leg., 2nd Sess. (Colo. 2011).

209. S.B. 1239, 112 Leg., 1st Sess. (Conn. 2011).

210. *SB 204: Streamlined Sales and Use Tax Agreement*, FLORIDA HOUSE OF REPRESENTATIVES (Oct. 3, 2011), http://www.myfloridahouse.gov/Sections/Bills/bills_detail.aspx?BillId=42322&BillText=specified+digital+good&HouseChamber=H&SessionId=64&.

211. H.B. 1405, 25th Leg., Reg. Sess. (Haw. 2009). Although the Hawaii Legislature passed the bill, Hawaii Governor Linda Lingle vetoed it. *See* Mike Sachoff, *Hawaii Governor Vetoes Amazon Tax Law*, WEB PRO NEWS (July 2, 2009), <http://www.webpronews.com/topnews/2009/07/02/hawaii-governor-vetoes-amazon-tax-law>.

212. Janet Novak, *Illinois Governor Signs Amazon Internet Sales Tax Law*, FORBES.COM (Oct. 3, 2011), <http://www.forbes.com/sites/janetnovack/2011/03/10/illinois-governor-signs-amazon-internet-sales-tax-law/>.

STATE	STATUTE	AFFILIATE AS NEXUS?
Indiana ²¹³	House Bill 250; In committee	Not specifically, would apply the sales tax to sales of digital goods and also conforms the state's tax code to the Streamlined Sales Tax
Maryland ²¹⁴	Senate Bill 824: Bill never made it out of committee	Not specifically, would apply the sales tax to all products purchased online from out-of-state retailers
Minnesota ²¹⁵	Minnesota Senate omnibus tax bill, SF2074: Abandoned without legislative action	Yes
Mississippi ²¹⁶	Senate Bill 2927: Died in committee on February 2, 2010	Yes, would have enacted an "affiliate nexus tax" on all online sales made by in-state consumers and out-of-state retailers would have been required to collect the tax and remit it back to the state
New Mexico ²¹⁷	House Bill 50: Tabled	Yes, would establish an "affiliate nexus tax" and would require out-of-state retailers to collect tax on state consumers and remit it to the state
Nevada ²¹⁸	Governor has proposed a nexus tax in budget	Yes, proposal included "affiliate nexus tax" provision
North Carolina ²¹⁹	HB 867: Enacted	Yes, "Click through nexus" sufficient for sales tax collection

213. S.B. 250, 111 Leg., (Ind. 2010).

214. *Maryland and Connecticut Updates*, AFFILIATE ADVOCACY (Oct. 3, 2011), <http://affiliateadvocacy.com/2010/maryland-and-connecticut-updates/>. The bill, however, failed to make it out of committee. See Missy Ward, *Maryland Advertising Tax SB 1071 Gets Squashed*, MISSYWARD.COM (Oct. 3, 2011), <http://www.missyward.com/2009/04/14/maryland-advertising-tax-sb-1071-gets-squashed/>.

215. S.F. No. 2074, 110 Leg., 2nd Engrossment (Minn. 2009).

216. S.B. 2927, 111 Leg., 54 Reg. Sess. (Miss. 2010).

217. Ken Garcia, *New Mexico HB 50-New Internet Tax Bill*, GTOMANAGEMENT (Oct. 3, 2011), <http://gtomanagement.com/new-mexico-hb-50-new-internet-tax-bill/>.

218. Cy Ryan, *Gibbons' Budget Plan Calls for Higher Taxes, Fees*, THE LAS VEGAS SUN (Nov. 14, 2011), <http://www.lasvegassun.com/news/2010/feb/17/gibbons-budget-plan-calls-higher-taxes-fees/>.

219. H.B. S.715, 112th Leg., 2nd Sess. (N.C. 2011).

STATE	STATUTE	AFFILIATE AS NEXUS?
Rhode Island ²²⁰	HB 7071: Pending committee	Not specifically, but would require online retailers and catalogue sellers to collect sales tax like other local businesses
Vermont ²²¹	House Bill 661: In committee	Yes; proposal includes "affiliate nexus tax" provision
Virginia ²²²	Senate Bill 660: Tabled in finance by voice vote in 2010.	Yes; language included affiliate tax provision
Washington ²²³	House Bill 2620: Enacted	Not specifically, clarifies prior legislation that enacted a digital goods tax on consumers.
Wyoming ²²⁴	House Bill 29: Enacted	Not specifically, enacts a digital goods tax on digital goods

2. Federal Proposals

Courts will likely look at the federal proposals and analyze whether they provide states with excessive power in a way that obstructs interstate commerce.²²⁵ The primary concern of the Supreme Court in *National Bellas Hess* and *Quill Corp.* was whether states had the power to enforce tax burdens on out-of-state retailers in a way that effectively prohibited interstate commerce and thus violated the Constitution.²²⁶ The *Amazon* case reveals how some courts are moving away from the strict physical presence requirement in *Quill Corp.* and questioning whether a streamlined proposal might be more appropriate.²²⁷

E. REQUIREMENTS INTERNET TRANSACTION TAXATION LEGISLATION SHOULD MEET

The legal landscape surrounding e-commerce taxation, both statutorily and within case law, is ambiguous and difficult to predict. This Note argues

220. H. 7071, 111 Leg., 1st Sess. (R.I. 2010).

221. H. 661, 111 Leg., 2nd Gen. Assembly (Vt. 2010).

222. S.B. 660, 111 Leg., 1st Gen. Assembly (Va. 2010).

223. H.B. 2620, 111 Leg., 1st Sess. (Wash. 2010).

224. H.B. 0029, 111 Leg., 2nd Sess. (Wyo. 2010).

225. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992); *see, e.g., Nat'l Bellas Hess v. Dep't of Revenue*, 386 U.S. 753, 760 (1967); *Amazon.com, LLC v. N.Y. State Dept. of Taxation & Fin.*, 877 N.Y.S.2d 842, 847 (N.Y. Sup. Ct. 2010).

226. *Quill*, 504 U.S. at 310.

227. *See, e.g., Amazon*, 877 N.Y.S.2d 842.

that lawmakers should aim to meet the following four requirements when drafting such legislation: (1) the legislation should clarify the tax landscape not only for internet retailers but for consumers as well;²²⁸ (2) the legislation must be constitutional;²²⁹ (3) the legislation should promote virtual business equally and foster e-commerce growth;²³⁰ and (4) the legislation should be forward thinking, addressing developments in technology and in e-commerce.²³¹

First, the law must be clear and consistent for consumers and businesses alike. As one commentator has explained:

Anyone doing business in cyberspace needs to know what laws to obey, whether it be a question of what taxes are due and where, or what consumer protections apply to the sale of their products and services. . . . [A] legal infrastructure that can provide the requisite elements of certainty and predictability . . . will allow electronic commerce to flourish as efficiently as market forces dictate.²³²

By having a clear standard, both consumers and businesses will know what to expect. This would create a predictable foundation upon which e-commerce would thrive. Predictability is a crucial point in both the pro-sales taxation and anti-sales taxation debates.²³³ Small and large businesses will benefit from the ability to incorporate tax issues into their accounting methods, and consumers will benefit from having a better understanding of when they must calculate taxes into their purchase prices.

The law may affect various types of businesses differently, but a consistent standard will promote efficiency the most effectively. For example, if each state had a different set of accounting laws and reporting requirements, a business would need to research each state's laws when doing business there. Such a process, through both research and compliance, could require substantial efforts and resources from a business. Some small business might be indirectly prevented from participating because of such an impediment. This type of inconsistency is at play in the current online sales tax landscape. Instead, legislators should draft a clear requirement that could better manage expectations, facilitate planning for businesses and consumers, and thus help to ensure greater diversification in the market.

228. Dan Stempel, *Who Has Jurisdiction over the Internet?*, 39 FAIRFIELD COUNTY BUS. J., no. 41, 2000, at 10.

229. See, e.g., *Quill*, 504 U.S. 298.

230. See Gordon-Murname, *supra* note 162.

231. See Groves, *supra* note 10, at 619.

232. Stempel, *supra* note 228, at 10.

233. *Id.*

Second, legislation around internet taxation must be constitutional. The Framers designated the Commerce Clause and the Due Process Clause as a means to promote the economy and sustain interstate commerce, and courts will likely address constitutional concerns after the enactment of the aforementioned statutes.²³⁴ The new law should be uniform so as to allow states access to the potential revenue sources while promoting virtual business across state lines.²³⁵

Internet retailers will likely argue that sales tax collection on online transactions is unconstitutional.²³⁶ Internet retailers, however, seem analogous to mail-order catalogues.²³⁷ Since the laws that require mail-order catalogues to collect sales taxes are constitutional, legislators have the opportunity to create something similar and constitutional for internet retailers. Legislators, however, must take care that such a provision does not target only one particular type of business.

Third, the new law should not be overly burdensome on small retailers. Although some internet retailers are large enterprises, there are still several small e-business that are trying to survive.²³⁸ In order to maintain a diversified marketplace and greater options for consumers, it is necessary that more than a few large businesses dominate the space. As such, legislators should consider whether taxation would limit small businesses from adequately competing.²³⁹

Fourth, the legislation should be timely. New developments should take into account how the e-commerce landscape will evolve by attempting to create legislation that anticipates further e-commerce evolution. Lawmakers should take into account other issues involved in online transactions—such as privacy or new business technology—and create legislation that is encompassing, but not outdated. E-commerce is essentially an evolution of the mail-order catalogue. Accordingly, lawmakers should analyze what new technological developments are and will be part of the consumer landscape. As technology evolves, so too does consumer mobility. Perhaps the physical nexus and state sales tax is no longer the proper means to determine tax responsibility. It is possible that lawmakers may need to create an entirely

234. See, e.g., *Quill*, 504 U.S. 298.

235. See Stempel, *supra* note 228, at 10.

236. See, e.g., *Amazon.com, LLC v. N.Y. State Dep't of Taxation & Fin.*, 877 N.Y.S.2d 842 (N.Y. Sup. Ct. 2010).

237. See *Quill*, 504 U.S. 298.

238. See Grimes, *supra* note 165.

239. *What Is the eTax?*, STOP ETAXES.COM (Dec. 15, 2011), <http://stopetaxes.com/what-is-etax>.

new type of tax that addresses online shopping and develops an equitable model to distribute tax revenue to states.

IV. CONCLUSION

A state's ability to tax an out-of-state entity is not a new discussion. When analogized to mail-order catalogues, the question of how to tax e-commerce transactions is not a completely new discussion either. Initially, legislatures decided issues of taxation in a way to ensure that e-commerce continued to thrive and to protect budding internet retailers. Today, however, many internet retailers are large enterprises, and although the growth of e-commerce has changed many components of the discussion, some elements remain the same. Courts are still fundamentally concerned with the constitutionality of taxes. Although the physical nexus requirement has evolved, courts are primarily interested in whether an entity has "purposefully availed"²⁴⁰ itself of a particular state as a way to determine whether taxation requirements are proper. One particular case, *Amazon v. New York Department of Taxation & Finance*, lays out the constitutional debate and the elements a court considers when facing a taxation constitutionality question.²⁴¹

As the discussion evolves, legislators should consider legislation that clarifies the tax landscape, not only for internet retailers, but for consumers as well.²⁴² Any new laws should promote virtual business equally and foster e-commerce growth.²⁴³ As such, new laws should be forward thinking, addressing developments in technology and e-commerce. As this discussion reveals, the controversy is not about *whether* to tax, but instead about *how* to tax. Accordingly, legislators should consider the multifaceted nature of the issue so as to impose tax requirements effectively and within constitutional limits.

240. *Quill*, 504 U.S. at 307.

241. *See Amazon*, 877 N.Y.S.2d 842.

242. *See Strempel*, *supra* note 228, at 10.

243. *Id.*

LIMITING EMPLOYEE LIABILITY UNDER THE CFAA: A CODE-BASED APPROACH TO “EXCEEDS AUTHORIZED ACCESS”

David J. Rosen[†]

David Nosal was a senior executive at Korn/Ferry International, an executive search firm.¹ Upon his resignation from Korn/Ferry in 2004, Nosal agreed to serve as a consultant for one year in exchange for monthly payments of \$25,000. The consultancy contract included a provision that prohibited Nosal from competing with Korn/Ferry for the duration of the agreement.²

While still under contract, Nosal allegedly conspired with three Korn/Ferry employees to obtain source lists, names, and contact information from the company’s proprietary “Searcher” database.³ The employees possessed valid user names and passwords that allowed them to access the data in Searcher.⁴ All of the employees, however, had signed agreements that specified that the information in Searcher could be used only for “legitimate Korn/Ferry business.”⁵

Korn/Ferry became suspicious when an audit revealed that the employees had downloaded an unusually large number of records from Searcher.⁶ After conducting an investigation and learning that Nosal had obtained source lists and other client contact information from the database, Korn/Ferry filed a civil suit against Nosal and his accomplices, in state court,

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1. United States v. Nosal (*Nosal I*), No. CR 08-00237, 2009 WL 981336, at *1 (N.D. Cal. Apr. 13, 2009).

2. *Id.*

3. *Id.*

4. *Id.* at *4.

5. United States v. Nosal (*Nosal*), 642 F.3d 781 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011).

6. See Declaration of Dan Demeter in Support of Plaintiff Korn/Ferry International’s Ex Parte Applications for Temporary Restraining Order and Order to Show Cause and for Leave to Take Expedited Discovery at 1–4, Korn/Ferry Int’l v. Becky Christian, No. CIV 448606 (Cal. Supr. Ct. San Mateo Cnty. Aug. 3, 2005).

for theft of trade secrets.⁷ In addition, Korn/Ferry notified the federal authorities of the alleged theft.⁸ The FBI began a criminal investigation, which led to an indictment by a federal grand jury.⁹ The indictment, not surprisingly, charged Nosal with the theft of Korn/Ferry's proprietary information.¹⁰ But the indictment charged Nosal with more than substantive trade secret crimes: it also charged him with violating the Computer Fraud and Abuse Act ("CFAA"), a law enacted in the 1980s to address the problem of computer hacking.¹¹

The charges against Nosal are part of a trend. For years, criminal prosecutions under the CFAA primarily targeted hackers and other outsiders who accessed computers "without authorization."¹² Recently, however, the government has begun to use the CFAA to prosecute employees who "exceed[] authorized access" on their employers' computers.¹³ Unlike the targets of past CFAA prosecutions, these employee defendants have not misused a computer to obtain information that they are not authorized to access. Rather, they have obtained information with authorized access and

7. Complaint, *Korn/Ferry Int'l v. Becky Christian*, No. CIV 448606 (Cal. Supr. Ct. San Mateo Cnty. Aug. 2, 2005); see also Joann S. Lublin, *A Company And Its Secrets*, WALL ST. J., Aug. 16, 2005, at B1.

8. *Nosal I*, 2009 WL 981336, at *1.

9. *Id.* at *2.

10. The indictment charged Nosal and one of his accomplices, Becky Christian, with the theft and misappropriation of trade secrets in violation of the Economic Espionage Act. See *Nosal I*, 2009 WL 981336, at *2. Christian eventually reached a plea agreement with the government, leaving Nosal as the only defendant at trial. The indictment also included several mail fraud charges, which were later dismissed. See *id.* at *7-9.

11. See H.R. REP. NO. 98-894, at 10-11, 20 (1984), reprinted in 1984 U.S.C.C.A.N. 3689, 3695-97, 3706 (focusing on "hackers" who "trespass into" computer systems); S. REP. NO. 99-432 at 2-3 (1986), reprinted in 1986 U.S.C.C.A.N. 2479, 2480-81 (discussing a "group of adolescents" who "broke into" a medical center's computer system and gained access to patients' medical records).

12. See, e.g., *United States v. Lindsley*, 254 F.3d 71 (5th Cir. 2001) (prosecuting defendants who "used their personal computers to illegally access Sprint Corporation's . . . computer system" to obtain Sprint calling card numbers); *United States v. Petersen*, 98 F.3d 502, 504 (9th Cir. 1996) (prosecuting defendant for "'hacking' into credit reporting services"); *United States v. Morris*, 928 F. 2d 504 (2d Cir. 1991) (prosecuting defendant who exploited vulnerabilities in various programs to launch worms that harmed hundreds of computers on the internet).

13. See, e.g., *Nosal*, 642 F.3d 781 (9th Cir.), *reh'g granted en banc*, 661 F.3d 1180 (9th Cir. 2011); *United States v. Rodriguez*, 628 F.3d 1258 (11th Cir. 2010); *United States v. John*, 597 F.3d 263 (5th Cir. 2010); *United States v. Zhang*, No. CR-05-00812, 2011 WL 4954152, at *1 (N.D. Cal. Oct. 18, 2011); see also Orin S. Kerr, *Vagueness Challenges to the Computer Fraud and Abuse Act*, 94 MINN. L. REV. 1561, 1583 (2010) [hereinafter Kerr, *Vagueness Challenges*] ("In the last five years, cases applying the CFAA to allegedly disloyal employees have become by far the most common type of CFAA case.").

then used the information in a manner that violated their employers' use policies.¹⁴

In the prosecution of David Nosal, the government's theory was that Nosal and his accomplices exceeded authorized access to Searcher when they obtained information from the database for a purpose not permitted by the terms of their access.¹⁵ In *United States v. Nosal*, a divided Ninth Circuit panel essentially accepted the government's theory, holding that an employee "exceeds authorized access" when the employee violates his employer's explicit restrictions regarding the use of information on his employer's computer.¹⁶ If Nosal's accomplices had notice of the policy that restricted their use of Searcher to "legitimate Korn/Ferry business," and if the accomplices violated this policy when they obtained information from Searcher for the purpose of starting a competing firm, then they exceeded authorized access to Searcher.¹⁷

Judge Campbell dissented. The majority's construction of "exceeds authorized access," Judge Campbell argued, is inconsistent with the purpose of the CFAA, which was designed to prevent "computer crimes" such as "hacking."¹⁸ Judge Campbell noted that the majority's interpretation would, contrary to Congress's intent, "proscribe fraud (a standalone crime) that happens to be effectuated through the use of a computer and in violation of a computer use policy."¹⁹

Judge Campbell is not the first judge to conclude that the CFAA should not criminalize the mere violation of an employer's use restrictions.²⁰ But Judge Campbell's reading of the statute raises a difficult question: If the

14. See discussion *infra* Section II.C.1.

15. See Brief for the United States at 19, *Nosal*, 642 F.3d 781 (No. 10-10038). The government did not allege that Nosal directly accessed Searcher; rather, Nosal's liability under the CFAA was premised on both *Pinkerton* liability and an "aiding and abetting" theory. See *id.* at 4 n.4.

16. *Nosal*, 642 F.3d at 783.

17. *Id.* at 783-84. After the panel's judgment, Nosal successfully petitioned for rehearing en banc. *United States v. Nosal*, 661 F.3d 1180 (9th Cir. 2011). At the time of this writing, the ruling of the en banc panel is pending.

18. *Nosal*, 642 F.3d at 789 (Campbell, J., dissenting).

19. *Id.* at 791.

20. See, e.g., *Orbit One Commc'ns, Inc. v. Numerex Corp.*, 692 F. Supp. 2d 373, 386 (S.D.N.Y. 2010) ("It would be imprudent to interpret the CFAA, in a manner inconsistent with its plain meaning, to transform the common law civil tort of misappropriation of confidential information into a criminal offense."); *Shamrock Foods Co. v. Gast*, 535 F. Supp. 2d 962, 966 (D. Ariz. 2008) ("[T]he CFAA was intended to prohibit electronic trespassing, not the subsequent use or misuse of information."); *Lockheed Martin Co. v. Kelly*, No. 6:05-CV-1580-ORL-31, 2006 WL 2683058, at *1, *5 (M.D. Fla. Aug. 1, 2006) (holding that § 1030(a)(4) addresses access to information, not use of information).

CFAA's "exceeds authorized access" language does not cover the misuse of information, then what does the language cover? What does it mean to "exceed authorized access" on a computer? If a person is authorized to access a computer, how does the person exceed her authority if not by misappropriating or misusing information obtained from the computer?

Judges and scholars have yet to provide satisfactory answers to these questions. Some courts, for example, have concluded that the term "exceeds authorized access" regulates employees who exceed limits on access to information, not limits on use of information.²¹ When defending this interpretation, these courts have offered incomplete explanations and hypotheticals that make it difficult to understand what limits on access might look like and how a computer user would exceed those limits.²²

Meanwhile, the leading scholarly approach to interpreting the CFAA—the "code-based" theory—focuses primarily on outsiders who access computers "without authorization."²³ Under a code-based theory, a user acts without authorization by circumventing code that regulates access to a computer.²⁴ Defenders of the theory, however, do not explain in any detail how or if a code-based interpretation might apply to an employee who "exceeds authorized access" on an employer's computer, thus exposing the theory to the criticism that it effectively reads the phrase "exceeds authorized access" out of the statute.²⁵

This Note attempts to explain how a code-based reading of "exceeds authorized access" can be consistent with the text and purpose of the CFAA. The Note expands on the code-based theory in the employer-employee

21. See, e.g., *LVRC Holdings LLC v. Brekka*, 581 F.3d 1127, 1133 (9th Cir. 2009); *United States v. Nosal (Nosal II)*, No. C 08-0237, 2010 WL 934257 at *1, *6 (N.D. Cal. Jan. 6, 2010), *rev'd*, 642 F.3d 781 (9th Cir.), *reh'g granted en banc*, 661 F.3d 1180 (9th Cir. 2011); *Lockheed*, 2006 WL 2683058, at *5.

22. See discussion *infra* Part II.D.

23. See Patricia L. Bellia, *Defending Cyberproperty*, 79 N.Y.U. L. REV. 2164, 2254–58 (2004); Orin S. Kerr, *Cybercrime's Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes*, 78 N.Y.U. L. REV. 1596 (2003) [hereinafter Kerr, *Cybercrime's Scope*].

24. Kerr, *Cybercrime's Scope*, *supra* note 23, at 1642.

25. See, e.g., Peter A. Winn, *The Guilty Eye: Unauthorized Access, Trespass and Privacy*, 62 BUS. LAW 1395, 1419 (2007) ("Unfortunately, code based readings of unauthorized access are flatly inconsistent with the explicit language of an unauthorized access statute such as the CFAA, which makes a clear distinction between 'unauthorized access' and 'access in excess of authorization.'"); see also Brief for the United States at 19, *United States v. John*, 597 F.3d 263 (5th Cir. 2010) (No. 08–10459) ("[A code-based interpretation] would mean that any employee with access to a computer system . . . could do anything while using that access and not run afoul of the 'exceeds authorized access' prong of the statute [sic]. . . . This would essentially read the 'exceeds authorized access' prong of the statute out of existence and leave only the 'without authorization' with any meaning.").

context, explaining how an employee can exceed authorized access by bypassing technical barriers to employer-maintained computer systems and applications. The discussion demonstrates that the Ninth Circuit's "misappropriation" interpretation, which is shared by at least two other circuits,²⁶ is not necessary to preserve the meaning of the phrase "exceeds authorized access" in the statute.

This Note proceeds in three parts. Part I summarizes the text and history of the phrase "exceeds authorized access" in various provisions of the CFAA. Part II surveys different scholarly and judicial approaches to defining "authorization" in the CFAA. Two of the judicial approaches have transformed the CFAA, a computer misuse statute, into a broader law that regulates various forms of employee misconduct. Finally, Part III offers a proposal for interpreting the phrase "exceeds authorized access" in the employer-employee context. The proposal preserves the distinction between acting without authorization and in excess of authorization, respects the legislative intent to distinguish between outsiders and insiders, and focuses on prohibiting computer misuse.

I. OVERVIEW OF "EXCEEDS AUTHORIZED ACCESS" IN THE CFAA

A. STATUTORY TEXT

The Computer Fraud and Abuse Act, codified at 18 U.S.C. § 1030, identifies seven distinct crimes in seven subsections of § 1030(a). Three of those subsections—§§ 1030(a)(1), (a)(2) and (a)(4)—include the phrase "exceeds authorized access."²⁷ Section 1030(a)(1), which covers obtaining classified information to injure the United States, has never been used.²⁸ Both §§ (a)(2) and (a)(4), on the other hand, arise frequently in criminal and civil contexts.

26. See discussion *infra* Section II.C.1.

27. 18 U.S.C. § 1030 (2010).

28. See ORIN S. KERR, *COMPUTER CRIME LAW* 27 (2d ed. 2009) [hereinafter KERR, *COMPUTER CRIME LAW*].

Section 1030(a)(2) subjects to punishment anyone who:

intentionally accesses a computer without authorization or exceeds authorized access, and thereby obtains—

[. . .]

(C) information from any protected computer.²⁹

The CFAA does not include a definition of “without authorization.”³⁰ The statute does, however, provide a definition of “exceeds authorized access.” According to § 1030(e)(6), the term “means to access a computer with authorization and to use such access to obtain or alter information in the computer that the accesser is not entitled so to obtain or alter.”³¹

Subsection 1030(a)(2)(C) exposes to liability those who obtain “information from any protected computer.”³² The definition of “protected computer” is very broad. The term encompasses a computer “which is used in interstate or foreign commerce or communication, including a computer located outside the United States that is used in a manner that affects interstate or foreign commerce or communication of the United States”³³ In recent years, several courts have concluded that any computer connected to the Internet is a “protected computer.”³⁴ Today, the CFAA covers practically every workplace computer in the United States.³⁵

Punishments for violations of § 1030(a)(2) vary. Most violations are punished as misdemeanors.³⁶ Some violations, however, may be charged as felonies if the offense was committed for purposes of commercial advantage

29. 18 U.S.C. § 1030(a)(2).

30. See Part II, *infra*, for a discussion of how courts have formulated approaches to this definitional vagueness.

31. 18 U.S.C. § 1030(e)(6).

32. *Id.* § 1030(a)(2)(C).

33. *Id.* § 1030(e)(2)(B). Section (e)(2)(A) states that a “protected computer” can also be a computer that is “exclusively for the use of a financial institution or the United States Government, or, in the case of a computer not exclusively for such use, used by or for a financial institution or the United States Government and the conduct constituting the offense affects that use by or for the financial institution or the Government.”

34. See, e.g., *Multiven, Inc. v. Cisco Systems, Inc.*, 725 F. Supp. 2d 887, 892 (N.D. Cal. 2010) (concluding that a computer is “protected” within the meaning of the CFAA if it is connected to the internet); *National City Bank v. Prime Lending, Inc.*, No. CV-10-034-EFS, 2010 WL 2854247, at *1, *4 n.2 (E.D. Wash. July 19, 2010) (stating that “any computer connected to the internet is a protected computer”).

35. See Kerr, *Vagueness Challenges*, *supra* note 13, at 1570–71.

36. See 18 U.S.C. § 1030(c)(2)(A).

or private financial gain, in furtherance of any criminal or tortious act, or if the value of the information obtained exceeded \$5,000.³⁷

Section 1030(a)(4), the provision of the CFAA at issue in *Nosal*, contains many of the same terms as § 1030(a)(2). Section 1030(a)(4) subjects to punishment anyone who:

knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value, unless the object of the fraud and the thing obtained consists only of the use of the computer and the value of such use is not more than \$5,000 in any 1-year period.³⁸

Like section 1030(a)(2), section 1030(a)(4) covers one who accesses without authorization, or exceeds authorized access on, a protected computer. There are, however, significant differences between the two sections. Whereas the mens rea required under § 1030(a)(2) is simple intent, the mens rea required under § 1030(a)(4) is “knowingly and with intent to defraud.”³⁹ Furthermore, punishments are generally more severe under § 1030(a)(4). All violations of § 1030(a)(4) are felonies.⁴⁰

Finally, the CFAA offers civil remedies to those who suffer damages as a result of violations of the law, including violations of §§ 1030(a)(2) and (a)(4). Section 1030(g) states that “[a]ny person who suffers damage or loss by reason of a violation of this section may maintain a civil action against the violator to obtain compensatory damages and injunctive relief or other equitable relief.”⁴¹ Although the CFAA is primarily a criminal statute, most of the cases that hinge on the meaning of “unauthorized access” or “exceeds authorized access” in the workplace arise in the civil context.⁴²

37. *Id.* § 1030(c)(2)(B).

38. *Id.* § 1030(a)(4).

39. *Id.*

40. *See id.* § 1030(c)(3).

41. *Id.* § 1030(g).

42. *See, e.g.,* Univ. Sports Pub. Co. v. Playmakers Media Co., 725 F. Supp. 2d 378 (S.D.N.Y. 2010) (considering advertising company's claim against its employee for accessing information in the company's database and then giving it to a competitor); Hanger Prosthetics & Orthotics, Inc. v. Capstone Orthopedic, Inc., 556 F. Supp. 2d 1122 (E.D. Cal. 2008) (considering prosthetic care company's claim against its former employees for obtaining patient lists from the company's computers for the purpose of starting a competing company); Black & Decker (US), Inc. v. Smith, 568 F. Supp. 2d 929 (W.D. Tenn. 2008) (considering Black & Decker's claim against its employee for copying proprietary information from Black & Decker's computer and then sharing that information with a competitor); ViChip Corp. v. Lee, 438 F. Supp. 2d 1087 (N.D. Cal. 2006) (considering

B. LEGISLATIVE HISTORY

In 1984, Congress passed the Comprehensive Crime Control Act. This Act included three provisions that later became part of the CFAA,⁴³ including an early version of § 1030(a)(2) that prohibited a person from accessing a computer without authorization to obtain information contained in a financial record of a financial institution.⁴⁴ The legislative record indicates that Congress designed the provisions to deter various forms of computer hacking.⁴⁵ Similar to the current version of § 1030(a), each provision prohibited accessing a computer “without authorization.”⁴⁶ None of the provisions, however, included the phrase “exceeds authorized access.” In the place where “exceeds authorized access” is today, the text read: “[o]r having accessed a computer with authorization, uses the opportunity such access provides for purposes to which authorization does not extend.”⁴⁷

Two years later, Congress passed the CFAA, which amended most of the substantive provisions of 18 U.S.C. § 1030.⁴⁸ Congress replaced the phrase “[h]aving accessed a computer with authorization, uses the opportunity such access provides for purposes to which authorization does not extend” with the phrase “exceeds authorized access” in § 1030(a)(2).⁴⁹ In addition to revising the existing provisions of § 1030, Congress added several new computer crimes, including the felony provision for fraud in § 1030(a)(4), which included the term “exceeds authorized access” as well.⁵⁰

The legislative history contains little indication of what Congress intended when it added the term “exceeds authorized access.” The 1986 Senate Report that accompanied the bill is largely unhelpful: it describes the term as “self-explanatory.”⁵¹ Perhaps because of the sparse legislative record, judges generally steer clear of the CFAA’s legislative history when

electrical engineering company’s claim against its employee for deleting files from the company’s server and the employee’s company-issued laptop).

43. See H.R.J. Res. 648, 98th Cong. (1984) (enacted).

44. 18 U.S.C. § 1030(a)(2) (Supp. II 1985).

45. See H.R. REP. NO. 98-894, at 10–11, 20 (1984), *reprinted in* 1984 U.S.C.C.A.N. 3689, 3695–97, 3706 (focusing on “hackers” who “trespass into” computer systems).

46. 18 U.S.C. § 1030(a)(1)–(3).

47. *Id.* For a more detailed history of the Comprehensive Crime Control Act of 1984, see Kerr, *Vagueness Challenges*, *supra* note 13, at 1563–64.

48. H.R.J. Res. 4718, 99th Cong. (1986) (enacted).

49. *Id.*

50. 18 U.S.C. § 1030(a)(4) (Supp. IV 1987).

51. S. REP. NO. 99-432 at 13 (1986), *reprinted in* 1986 U.S.C.C.A.N. 2491.

interpreting the meaning of “exceeds authorized access” in §§ 1030(a)(2) and (a)(4).⁵²

Although judges tend to avoid discussing the CFAA’s legislative history, advocates are not as reticent. In its briefing for *Nosal*, the government focused on the original language in 18 U.S.C. § 1030: “[h]aving accessed a computer with authorization, uses the opportunity such access provides for purposes to which authorization does not extend.”⁵³ The government argued that this language “specifically discussed accesses in violation of purpose-based restrictions” and therefore encompassed *Nosal*’s conduct.⁵⁴ Congress later substituted the phrase “exceeds authorized access,” the government reasoned, because it was a “shorter” and “simpler” way of expressing the same idea.⁵⁵ The Electronic Frontier Foundation (“EFF”), on the other hand, examined the CFAA’s legislative history and reached the opposite conclusion. In an amicus brief in support of *Nosal*, EFF argued that Congress amended the statute in 1986 to eliminate the possibility that a court would find a computer user liable for the mere misuse of information.⁵⁶ According to EFF’s reading of the legislative history, Congress substituted the phrase “exceeds authorized access” to make clear that the CFAA covered those who exceeded access restrictions, not use restrictions.⁵⁷ Against the backdrop of the CFAA’s thin legislative history, both the government’s and EFF’s interpretations are defensible.

Although it is unclear if Congress intended for the phrase “exceeds authorized access” to address acts of information misuse, there is some evidence suggesting that Congress was attempting to distinguish between “insiders, who are authorized to access a computer,” and “outside hackers who break into a computer.”⁵⁸ In explaining why §§ 1030(a)(3) and (a)(5) did not include the term “exceeds authorized access,” a 1986 Senate Report stated that those provisions were aimed exclusively at outsiders.⁵⁹ The

52. *But see* *Shamrock Foods Co. v. Gast*, 535 F. Supp. 2d 962, 966 (D. Ariz. 2008) (“The legislative history confirms that the CFAA was intended to prohibit electronic trespassing, not the subsequent use or misuse of information.”).

53. 18 U.S.C. § 1030(a)(1)–(3) (Supp. II 1985).

54. Reply Brief for the United States at 10–11, *Nosal*, 642 F.3d 781 (9th Cir. 2011) (No. 10–10038).

55. *See id.* at 11.

56. Brief for Electronic Frontier Foundation as Amici Curiae Supporting Appellee at 6–7, *Nosal*, 642 F.3d 781 (9th Cir. 2011) (No. 10–10038).

57. *See id.*

58. *See* S. REP. NO. 104-357, at 11 (1996).

59. *See* S. REP. NO. 99-432, at 10 (1986), *reprinted in* 1986 U.S.C.C.A.N. 2479, at 2488.

reasonable inference is that Congress aimed the “exceeds authorized access” prongs of §§ 1030(a)(2) and (a)(4) at insiders, not outside hackers.⁶⁰

II. APPROACHES TO INTERPRETING “AUTHORIZATION” IN THE CFAA

Since 2010, three federal circuit courts have issued rulings where a defendant’s criminal liability turned on the meaning of “exceeds authorized access” in the CFAA.⁶¹ Before discussing these recent decisions, it will be helpful to survey the different approaches to interpreting the “without authorization” language that appears in most provisions of the CFAA. Sections (a)(2) and (a)(4)—the two subsections of the CFAA under which defendants have been prosecuted for exceeding authorized access on a computer—also prohibit accessing a computer “without authorization.”⁶² It is difficult to discuss the meaning of “exceeds authorized access” without examining what it means to access a computer with or without authorization. Accordingly, this Part first reviews different approaches to defining “authorization,” and then moves to recent judicial readings of “exceeds authorized access.”

First, this Part describes the “code-based” approach to authorization. Although the code-based approach tracks well with the early criminal cases decided under the CFAA, courts have been reluctant to use the approach in cases concerning an employee’s alleged misuse of a workplace computer. Second, this Part reviews the “agency approach” to authorization—which, despite being endorsed only by the Seventh Circuit, has influenced district court judges in various circuits around the country. Third, this Part turns to the “employer-policy” approach, recently adopted by three circuit courts, that seeks to distinguish acting without authorization from acting in excess of authorization on computers in the workplace. Finally, this Part discusses an unsuccessful—or at least incomplete—attempt by a federal district court to limit the scope of “exceeds authorized access” in the employer-employee context.

60. See *United States v. Phillips*, 477 F. 3d 215, 219 (5th Cir. 2007) (relying on legislative history to support the argument that Congress intended to distinguish “insiders . . . who are authorized to access a computer” from “outside hackers who break into a computer”).

61. *Nosal*, 642 F.3d 781 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011); *United States v. Rodriguez*, 628 F.3d 1258 (11th Cir. 2010); *United States v. John*, 597 F.3d 263 (5th Cir. 2010).

62. See *supra* Section I.A.

A. THE “CODE-BASED” APPROACH

1. Description

In a 2003 law review article, Professor Orin Kerr advocated a “code-based” approach to access and authorization in computer misuse statutes.⁶³ Under the code-based approach, a user acts without authorization only by circumventing code that regulates access to a computer.⁶⁴ The approach has two primary virtues. First, the code-based approach comports with the CFAA’s general goal of regulating specific computer use crimes. Circumventing code is a form of the “hacking” that precipitated the enactment of the computer misuse crimes in 18 U.S.C. § 1030.⁶⁵ Second, the code-based approach avoids some of the constitutional pitfalls of other approaches to authorization, which risk rendering the access provisions of the CFAA unconstitutional on overbreadth or vagueness grounds.⁶⁶ In contrast to the agency and employer-policy approaches, the code-based approach criminalizes a relatively narrow range of conduct.⁶⁷

According to Professor Kerr, there are two ways in which a user can circumvent code and thus access a computer without authorization. First, a computer user can “engage in false identification” by using another person’s credentials to obtain access to a computer.⁶⁸ The user could, for example, steal or guess another user’s password and then use it to sign on to the computer.⁶⁹

The second way a user can circumvent code is by exploiting a vulnerability in the code to gain access to a computer.⁷⁰ The facts of *United States v. Morris*,⁷¹ one of the first cases decided under the CFAA,⁷² illustrate how a computer user can exploit such a vulnerability. Robert Morris, a computer science graduate student at Cornell University, had coded and launched an internet “worm” that exploited vulnerabilities in the “send mail” and “finger” programs.⁷³ The worm replicated itself and spread via the Internet, interfering with the operation of thousands of computers at

63. Kerr, *Cybercrime’s Scope*, *supra* note 23.

64. *Id.* at 1642.

65. *See supra* note 11.

66. *See infra* Sections II.A.2, II.C.2.

67. *See Bellia*, *supra* note 23, at 2258.

68. Kerr, *Cybercrime’s Scope*, *supra* note 23, at 1645.

69. *See id.* at 1645, 1664.

70. *Id.*

71. 928 F. 2d 504, 510 (2d Cir. 1991).

72. Kerr, *Cybercrime’s Scope*, *supra* note 23, at 1645.

73. *Morris*, 928 F. 2d at 506.

universities, military sites, and medical research facilities.⁷⁴ The cost of repairing the effects of the worm on each computer ranged from \$200 to \$53,000.⁷⁵

The government charged Morris with violating § 1030(a)(5)(A) of the CFAA, which, at the time, penalized the conduct of an individual who “intentionally accesses a Federal interest computer without authorization.”⁷⁶ Morris maintained that his actions were not without authorization. He had valid user accounts on several computers on the Internet, each of which gave him authorized access to the sendmail and finger programs.⁷⁷ Morris argued that his use of these programs was not “without authorization” and thus could not serve as a basis for convicting him under § 1030(a)(5)(A).⁷⁸

The Second Circuit rejected Morris’s argument, holding that an individual accesses a computer without authorization when using a computer’s features in ways unrelated to their intended function.⁷⁹ The sendmail program is intended to send e-mail; the finger program is intended to look up the directory information of other computer users.⁸⁰ Instead of using these programs for these intended functions, Morris “found holes in both programs that permitted him a special and unauthorized access route into other computers.”⁸¹ Thus, Morris had accessed these other computers without authorization.⁸²

2. *Problems with the Code-Based Approach*

The principle criticism of the code-based approach is that it reads the phrase “exceeds authorized access” out of the CFAA. Critics of the approach assert that code-based restrictions can only prevent unauthorized access; these restrictions cannot regulate those who act in excess of authorization.⁸³ Although Professor Kerr implies that the phrase “exceeds authorized access” could govern “an insider who circumvents code-based restrictions,”⁸⁴ he

74. *Id.*

75. *Id.*

76. *See id.*

77. In addition to his access at Cornell, Morris had authorized access to computers at Harvard and UC Berkeley. *Id.* at 509.

78. *Id.* at 507.

79. *Id.* at 510.

80. *Id.* at 507.

81. *Id.* at 510.

82. *Id.*

83. *See* sources cited *supra* note 25.

84. Kerr, *Cybercrime’s Scope*, *supra* note 23, at 1663.

does not offer examples of such restrictions or describe how an insider would circumvent them.⁸⁵

Other advocates of the code-based approach are skeptical of its relevance to the phrase “exceeds authorized access.” Patricia Bellia, for example, suggests that non-code-based restrictions could be relevant in defining conduct that exceeds authorized access under the CFAA:

Some provisions of the CFAA . . . also contemplate conduct that “exceed[s] authorized access,” and it is conceivable that restrictions in policy statements or terms of use should be relevant there. Because such provisions are designed to target activities by persons whose access to the system is not constrained by code in the same way as the general public’s, such provisions align with a reading of “access[] without authorization” that depends on breach of code-based limitations on access.⁸⁶

As Section II.C discusses, three circuit courts found that “restrictions in policy statements or terms of use” were highly relevant in identifying the sort of conduct that exceeds authorized access under the CFAA.⁸⁷ The next Section, however, discusses an approach to authorization where a computer user’s access can become unauthorized even if the user has not breached a code-based barrier or violated a use policy.

B. THE AGENCY APPROACH

1. Description

Judge Posner popularized the agency approach in *International Airport Centers v. Citrin*.⁸⁸ In *Citrin*, an employer sued a former employee for violating the “computer damage” provision of the CFAA, which subjects to liability anyone who “knowingly causes the transmission of a program, information, code, or command, and as a result of such conduct, intentionally causes damage without authorization, to a protected computer.”⁸⁹ Citrin, the

85. Kerr states that “it is not clear whether ‘exceeding authorized access’ governs an insider who breaches contract-based restrictions or an insider who circumvents code-based restrictions.” *Id.* at 1663. Kerr suggests that courts should resolve this ambiguity in favor of criminal defendants: “If we interpret the phrase ‘exceeds authorized access’ to include breaches of contract, we create a remarkably broad criminal prohibition that has no connection to the rationales of criminal punishment.” *Id.*

86. Bellia, *supra* note 23, at 2254.

87. *See infra* Section II.C.1.

88. 440 F.3d 418 (7th Cir. 2006).

89. *Id.* at 419 (quoting 18 U.S.C. § 1030(a)(5)(A) (2006)).

employee, used a laptop provided by his employer.⁹⁰ Citrin decided to quit and start his own business in violation of his employment contract.⁹¹

Before Citrin returned the laptop to his employer, he used a “secure erasure” program to delete all the files on his laptop.⁹² The program prevented the employer from restoring the deleted files. The Seventh Circuit considered, among other issues, whether Citrin had accessed his laptop “without authorization” when he deleted the files.⁹³

The Seventh Circuit held that Citrin’s authorized access to the laptop ceased as soon as he breached a common law “agency” duty of loyalty to his employer.⁹⁴ Even though Citrin was still an employee when he accessed his laptop, and even though his employer had no policy prohibiting him from deleting files in the manner that he did, his access was without authorization. “[Citrin’s] authorization to access the laptop terminated when, having already engaged in misconduct and decided to quit [his employer] in violation of his employment contract, he resolved to destroy files that . . . [were] the property of his employer, in violation of the duty of loyalty that agency law imposes on an employee.”⁹⁵ In the wake of *Citrin*, several district courts adopted this “agency” theory of unauthorized access.⁹⁶

2. *Problems with the Agency Approach*

There are two significant problems with the agency approach. First, the approach might violate the due process clause of the Fourteenth Amendment under the void-for-vagueness doctrine.⁹⁷ As Professor Kerr has argued, the agency approach “gives employees insufficient notice of what line distinguishes computer use that is allowed from computer use that is prohibited.”⁹⁸ Furthermore, the approach would “encourage arbitrary and discriminatory enforcement” due to the lack of clear guidelines for law enforcement.⁹⁹

90. *Id.* at 419.

91. *See id.*

92. *Id.*

93. *Id.*

94. *Id.* at 420.

95. *Id.*

96. *See, e.g., Nosal I*, No. CR 08-00237, 2009 WL 981336, *1, *4 (N.D. Cal. Apr. 13, 2009); *Hanger Prosthetics & Orthotics, Inc. v. Capstone Orthopedic, Inc.*, 556 F. Supp. 2d 1122, 1131 (E.D. Cal. 2008); *Calyon v. Mizuho Sec. USA, Inc.*, No. 07 Civ. 2241(RO), 2007 WL 2618658, *1 (S.D.N.Y. Sept. 7, 2007); *ViChip Corp. v. Lee*, 438 F. Supp. 2d 1087, 1100 (N.D. Cal. 2006).

97. *See Kerr, Vagueness Challenges*, *supra* note 13, at 1585–86.

98. *Id.* at 1586.

99. *Id.*

The second problem is that the agency approach, if applied to the text of §§ 1030(a)(2) and (a)(4), would collapse the distinction between “without authorization” and “exceeds authorized access.”¹⁰⁰ If an employee’s authorization to access a computer ceases as soon as she does something that is not in her employer’s interests, then “exceeds authorized access” likely becomes textually superfluous and meaningless.¹⁰¹ Judge Posner anticipated this objection, writing that the difference between “exceeds authorized access” and “without authorization” is “paper thin . . . but not quite invisible.”¹⁰² In support of his claim that “exceeds authorized access” is still textually relevant under his interpretation, he pointed to *EF Cultural Travel BV v. Explorica, Inc.*¹⁰³

EF Cultural Travel concerned a dispute between two “tour companies” with online presences.¹⁰⁴ Several employees of one of the tour companies, EF, left to join another tour company, Explorica. While at Explorica, a former EF employee helped the company build a web site “scraper” that culled pricing information from EF’s web site.¹⁰⁵ The scraper used “tour codes” provided by the former EF employees. The significance of these codes “was not readily understandable to the public.”¹⁰⁶ Furthermore, the codes were, according to EF, proprietary information and covered by confidentiality agreements.¹⁰⁷ Explorica ran the scraper twice, downloading 60,000 lines of data, which Explorica then used to “systematically undercut EF’s prices.”¹⁰⁸

The First Circuit considered whether the use of the scraper “exceed[ed] authorized access” to EF’s computer under § 1030(a)(4).¹⁰⁹ The court found that the former employee exceeded his authorized access when he used proprietary information to help build an “efficient” scraper that accessed his former employer’s web site.¹¹⁰ Judge Posner, in *Citrin*, described the holding of *EF Cultural Travel* as follows: “The website was open to the public, so [the defendant] was authorized to use it, but he exceeded his authorization by

100. 18 U.S.C. §§ 1030(a)(2), (4) (2010).

101. See KERR, *COMPUTER CRIME LAW*, *supra* note 28, at 69.

102. *Int’l Airport Ctrs. v. Citrin*, 440 F.3d 418, 420 (7th Cir. 2006).

103. *Id.*

104. *EF Cultural Travel BV v. Explorica, Inc.*, 274 F.3d 577, 579 (1st Cir. 2001).

105. *Id.*

106. *Id.*

107. *Id.* at 582–83.

108. *Id.* at 580.

109. The First Circuit did not resolve the question of whether the use of the scraper was “without authorization” under § 1030(a)(4). See *id.* at 582 n.10.

110. *Id.* at 583.

using confidential information to obtain better access than other members of the public.”¹¹¹

Judge Posner’s reading of *EF Cultural Travel*, combined with his agency approach, results in an interpretation of “exceeds authorized access” that seems to frustrate the intent of Congress. As discussed in Section I.B, *supra*, the legislative history suggests that the term “unauthorized access” regulates outsiders while the term “exceeds authorized access” regulates insiders.¹¹² Judge Posner’s approach inverts this understanding. If a current employee, an insider, is accessing an employer’s computer, she can never exceed authorized access: as soon as she breaches her common law duty of loyalty to her employer, her access becomes unauthorized. But a former employee—one who is now outside the company—can exceed authorized access by accessing a computer that is “open to the public.”¹¹³

C. THE EMPLOYER-POLICY APPROACH

1. Description

After *Citrin*, many courts refused to embrace the agency approach.¹¹⁴ Some of these same courts, however, held that employers had the right to define the limits of authorization on their computers, and that employees could be liable under the CFAA for exceeding those limits. For these courts, the problem with the agency approach was that it failed to provide employees with sufficient notice of what activities would render their access without authorization.¹¹⁵ An employer is free to define authorization according to its interests, but it must communicate those interests in the form of a written use policy.¹¹⁶ This “employer-policy” approach paved the

111. *Int’l Airport Ctrs. v. Citrin*, 440 F.3d 418, 420 (7th Cir. 2006).

112. *See supra* note 58.

113. *See Lockheed Martin Corp. v. Speed*, No. 6:05-CV-1580-ORL-31, 2006 WL 2683058, at *1, *6 (M.D. Fla. Aug. 1, 2006) (arguing that *Citrin* turned “the plain reading of the statutory definition of ‘exceeds authorized access’ on its head” because Congress aimed the phrase at the company insider).

114. *See, e.g., LVRC Holdings LLC v. Brekka*, 581 F.3d 1127, 1135 (9th Cir. 2009) (“[N]othing in the CFAA suggests that a defendant’s liability for accessing a computer without authorization turns on whether the defendant breached a state law duty of loyalty to an employer.”).

115. *See, e.g., Nosal*, 642 F.3d 781, 786 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011) (“How is an employee supposed to know when authorization has been revoked if the employer does not inform the employee of the revocation?”).

116. *See id.* at 787–88.

way for three different circuit courts to find employees liable under the CFAA for exceeding authorized access on workplace computers.¹¹⁷

In *United States v. John*, the Fifth Circuit interpreted the meaning of “exceeds authorized access” in the context of a criminal prosecution of a bank employee who misused account information to which she had access.¹¹⁸ The defendant, Dimetriace John, was an account manager at Citigroup.¹¹⁹ John accessed and printed information pertaining to over seventy corporate customer accounts. She provided the information to her half-brother, who in turn used it to incur fraudulent charges.¹²⁰ John was convicted of, among other crimes, “exceeding authorized access to a protected computer in violation of 18 U.S.C. §§ 1030(a)(2)(A) and (C).”¹²¹

On appeal, the Fifth Circuit considered John’s argument that § 1030(a)(2) does not prohibit “unlawful *use* of material that she was authorized to access through authorized use of a computer.”¹²² Instead, John contended, the term “exceeds authorized access” in § 1030(a)(2) applies only to using authorized access to obtain information that an employee is not entitled to obtain or alter information that the employee is not entitled to alter.¹²³ In rejecting John’s argument, the Fifth Circuit held that authorization “may encompass limits on the use of information obtained by permitted access to a computer system and data available on that system.”¹²⁴

The Fifth Circuit’s opinion makes it difficult to identify its precise holding. On the one hand, the court placed significant weight on the fact that John’s misuse of the information was contrary to Citigroup employee policies.¹²⁵ The government, the court stressed, demonstrated that Citigroup’s policies were reiterated in training programs, and that John was aware of the policies.¹²⁶ There is, however, language in the opinion that suggests that the Fifth Circuit would be reluctant to find that an employee exceeds authorized access on her employer’s computer whenever she violates a computer use policy. At one point, the court seems to limit its holding to instances in

117. Other commentators have described similar judicial approaches as examples of “contract-based interpretation” of authorization under the CFAA. *See, e.g.*, Katherine Mesenbring Field, *Agency, Code, or Contract: Determining Employees’ Authorization Under the Computer Fraud and Abuse Act*, 107 MICH. L. REV. 819, 827–29 (2009).

118. 597 F.3d 263, 269 (5th Cir. 2010).

119. *Id.*

120. *Id.*

121. *Id.* at 270.

122. *Id.* at 271 (emphasis in original).

123. *Id.*

124. *Id.*

125. *See id.* at 272.

126. *Id.*

which the access is “in furtherance of or to perpetuate a crime.”¹²⁷ It is possible to read *John* as requiring the government to establish a violation of a clear employee use policy *and* an intent to commit a separate crime.¹²⁸

The Eleventh Circuit rejected this reading of *John* in *United States v. Rodriguez*.¹²⁹ There, the government prosecuted a Social Security Administration (“SSA”) employee, under the CFAA, for using the agency’s computer to access records of women he was romantically interested in.¹³⁰ The Eleventh Circuit concluded that the employee exceeded his authorized access under § 1030(a)(2) when he accessed personal records for non-business reasons, in violation of SSA policies.¹³¹ The employee argued that he was not liable under the CFAA because, in contrast to the defendant in *John*, his use of the obtained information was not criminal.¹³² The Eleventh Circuit was unpersuaded.¹³³ John exceeded authorized access, the Eleventh Circuit concluded, when he violated Citigroup policies while accessing a Citigroup computer.¹³⁴ Similarly, Rodriguez exceeded his authorized access when he obtained personal information from a SSA computer in violation of SSA policies.¹³⁵

In *United States v. Nosal*, discussed in the Introduction, *supra*, the Ninth Circuit employed essentially the same interpretation of “exceeds authorized access” as the Eleventh Circuit in *Rodriguez*. An employee exceeds authorized access, the Ninth Circuit held, when he violates his employer’s policies governing the use of information on the employer’s computers.¹³⁶ However, unlike the Fifth and Eleventh Circuits, the Ninth Circuit in *Nosal* had to distinguish a recent decision by another panel in its circuit.

Two years before the *Nosal* decision, a different Ninth Circuit panel decided *LVRC Holdings LLC v. Brekka*.¹³⁷ There, the operators of a residential treatment center (“LRVC”) brought a civil suit against Brekka, a former employee.¹³⁸ While working at LRVC, Brekka had emailed “a master

127. *Id.* at 271.

128. See Brief for the Appellant at 10–11, *United States v. Rodriguez*, 628 F.3d 1258 (11th Cir. 2010) (No. 09–15265).

129. 628 F.3d 1258 (11th Cir. 2010).

130. *Id.* at 1260–62.

131. *Id.* at 1263.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Nosal*, 642 F.3d 781, 783 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011).

137. 581 F.3d 1127 (9th Cir. 2009).

138. *Id.* at 1128–29.

admissions report, which included the names of past and current [LRVC patients], to his personal email account.”¹³⁹ In seeking damages under § 1030(g), LRVC argued that Brekka had accessed LRVC’s computer “without authorization” when he e-mailed the report with the purpose of “further[ing] his own interests.”¹⁴⁰ The Ninth Circuit ruled in Brekka’s favor, finding that his act of emailing documents to his own personal computer did not violate either §§ 1030(a)(2) or (a)(4) because he was authorized to access LRVC’s computers during his employment with LRVC.¹⁴¹

LRVC argued only that Brekka acted without authorization, not that he had exceeded his authorized access.¹⁴² Nevertheless, the panel offered an interpretation of the meaning of exceeds authorized access: “[a] person who ‘exceeds authorized access’ has permission to access the computer, but accesses information on the computer that the person is not entitled to access.”¹⁴³ A person would not be entitled to access the information if that access “violate[s] employer-placed limits.”¹⁴⁴ What might “employer-placed limits” look like? The panel in *Brekka* did not say, but the panel in *Nosal* offered an answer.

The *Nosal* majority distinguished *Brekka* on the basis that Brekka had “unfettered access” to his employer’s computer, whereas the Korn/Ferry employees were “subject to a computer use policy that placed clear and conspicuous restrictions on the employees’ access both to the system in general and to the Searcher database in particular.”¹⁴⁵ Brekka, the *Nosal* majority reasoned, did not exceed his authorized access because his employer did not have a policy that prohibited its employees from e-mailing company documents to personal computers; the Korn/Ferry employees, on the other hand, did exceed authorized access because Korn/Ferry had a policy that limited the use of its database to legitimate Korn/Ferry business.¹⁴⁶ If an employer has policies regulating the use of information on its computers, and if the employee has notice of the policies, then the employee “exceeds authorized access” under § 1030(a)(4) when he violates the policies knowingly and with intent to defraud.¹⁴⁷

139. *Id.* at 1130.

140. *Id.* at 1132.

141. *Id.* at 1137.

142. *Id.* at 1135 n.7.

143. *Id.* at 1134.

144. *Id.* at 1135.

145. *Nosal*, 642 F.3d 781, 787 (9th Cir.), *reh’g granted en banc*, 661 F.3d 1180 (9th Cir. 2011).

146. *Id.* at 787.

147. *Id.* at 786–88.

Recall that § 1030(a)(2), which does not limit liability to those who act “knowingly and with an intent to defraud,” also contains an “exceeds authorized access” prong.¹⁴⁸ In response to Nosal’s argument that a “misuse” interpretation would, via § 1030(a)(2), make criminals out of millions of employees who routinely violate their employers’ computer use policies, the majority stressed that its interpretation applied only to § 1030(a)(4), which requires fraudulent intent and an action that furthers the intended fraud to obtain something of value.¹⁴⁹ The Ninth Circuit’s effort to limit its interpretation to § 1030(a)(4) slightly differentiates *Nosal* from *John* and *Rodriguez*, both of which applied an employer-policy approach to § 1030(a)(2).¹⁵⁰ In dissent, however, Judge Campbell pointed out the “firm rule of statutory construction that ‘identical words used in different parts of the same statute are generally presumed to have the same meaning.’”¹⁵¹ Thus, contrary to the majority’s assurances, the *Nosal* majority’s reading of “exceeds authorized access” could also apply to § 1030(a)(2), which has no fraudulent intent requirement.¹⁵²

2. *Problems with the Employer-Policy Approach*

The employer-policy approach is, like the agency approach, susceptible to void-for-vagueness challenges. Although the employer-policy approach claims to provide notice by tying authorization to written use policies, the vagueness and breadth of many of these policies pose constitutional problems.¹⁵³ In *Nosal*, for example, Korn/Ferry’s terms of use specified that the Searcher database could be used only for “legitimate Korn/Ferry business.”¹⁵⁴ Such a generally-worded policy provides insufficient notice of what computer use is prohibited. A Korn/Ferry employee’s criminal liability under the CFAA turns on the definition of “legitimate . . . business,” a vague standard that is susceptible to different interpretations. Is any personal use of Korn/Ferry’s computer, for example, inconsistent with legitimate

148. 18 U.S.C. § 1030(a)(2) (2010).

149. *Nosal*, 642 F.3d at 788–89; see also discussion *supra* Section I.A.

150. *United States v. Rodriguez*, 628 F.3d 1258, 1263 (11th Cir. 2010); *United States v. John*, 597 F.3d 263, 269 (5th Cir. 2010).

151. *Nosal*, 642 F.3d. at 789 (Campbell, J., dissenting) (quoting *IBP, Inc. v. Alvarez*, 546 U.S. 21, 34 (2005)).

152. See U.S.C. § 1030(a)(2).

153. See *Nosal*, 642 F.3d. at 790 n.1 (Campbell, J., dissenting) (“[T]o invoke the federal criminal law, employers merely need to include in their computer access restrictions that an employee’s authorization to access a computer ends when he breaches his duty of loyalty.”).

154. *Id.* at 782 (majority opinion).

Korn/Ferry business and thus a crime?¹⁵⁵ Given the number of employees who routinely use an employer's computer in violation of a computer use policy, the CFAA could "lend itself to arbitrary enforcement, rendering it unconstitutionally vague."¹⁵⁶

Even if the government elects not to prosecute employees for routine violations of an employer's computer use policy, the employers can still bring civil suits against employees for minor violations.¹⁵⁷ In *Wendi J. Lee v. PMSI, Inc.*, for example, an employer sued an employee, under the CFAA, for accessing "facebook pages" on company time.¹⁵⁸ The employer's theory was that the employee exceeded authorized access on her employer's computers because the employer had a policy that prohibited employees from accessing Facebook while at work.¹⁵⁹

The court dismissed the employer's CFAA claim, rejecting the employer's argument that the employee was liable under *United States v. Rodriguez*.¹⁶⁰ The court strained to distinguish *Rodriguez*: whereas *Rodriguez* accessed information on his employer's (the Social Security Administration's) computers, the court noted, the employee in this case accessed information on Facebook's computers.¹⁶¹ Although the court dismissed the employer's CFAA claim here, it is not difficult to imagine a less sympathetic judge finding an employee liable under the "employer-policy approach" for violating an employer's routine use restrictions.

D. THE *NOSAL* DISTRICT COURT'S APPROACH TO READING "EXCEEDS AUTHORIZED ACCESS"

As discussed above, there are serious problems—possibly even constitutional problems—with reading the phrase "exceeds authorized access" to cover acts of information misuse. One possible alternative is to limit the phrase's application to acts of access and not acts of use. The

155. See Kerr, *Vagueness Challenges*, *supra* note 13, at 1586 ("Is use of an employer's computer for personal reasons always prohibited? Sometimes prohibited? If sometimes, when? And if some amount of personal use is permitted, where is the line?").

156. *Nosal*, 642 F.3d. at 790 (Campbell, J., dissenting).

157. See 18 U.S.C. § 1030(g).

158. *Wendi J. Lee v. PMSI, Inc.*, No. 8:10-cv-2904-T-23TBM, 2011 WL 1742028, at *1–2 (M.D. Fla. May 6, 2011).

159. *Id.* at *2.

160. *Id.* at *3.

161. *Id.* at *2. The court appeared to either misunderstand or misread the employer's theory of liability. The employer claimed that the employee's use of Facebook resulted in her exceeding authorized access on her employer's computer, not on Facebook's computers. *Id.*

district court in *Nosal II*, which the Ninth Circuit reversed, attempted to describe such an alternative.¹⁶²

The district court, applying the Ninth Circuit's recent decision in *Brekka*,¹⁶³ concluded that "an individual only 'exceeds authorized access' if he has permission to access a portion of the computer system but uses that access to 'obtain or alter information in the computer that [he or she] is not entitled so to obtain or alter.'" ¹⁶⁴ The court reasoned that the "exceeds authorized access" prong of § 1030(a)(4) applies to exceeding employer-imposed limits on *access* to information, not to exceeding employer-imposed limits on the *use* of information. To illustrate the sort of conduct that would exceed authorized access, the court offered the following example:

[I]f a person is authorized to access the "F" drive on a computer or network but is not authorized to access the "G" drive of that same computer or network, the individual would "exceed authorized access" if he obtained or altered anything on the "G" drive.¹⁶⁵

This example leaves out some important information. First, assume the example occurs in a workplace. Is the "G" drive protected by a code barrier that restricts access? That is, does access to the drive require authentication credentials (e.g., a password) that the person in the example does not possess? Or is the "G" drive technically accessible to all employees but, as a matter of policy or protocol, certain employees are not supposed to access the information on it?¹⁶⁶

It is important to clarify these ambiguities. If access to the "G" drive is protected by an authentication scheme that the employee circumvents (either by using another employee's credentials or by hacking into the drive), then the court is endorsing a code-based approach to defining "exceeds authorized access."¹⁶⁷ If, on the other hand, access to the "G" drive is regulated by a use policy that the employee violates, then the court is proposing a variant of the employer-policy approach to exceeding authorized

162. *Nosal II*, No. C 08-0237, 2010 WL 934257, at *1, *6 (N.D. Cal. Jan. 6. 2010), *rev'd*, 642 F.3d 781 (9th Cir.), *reh'g granted en banc*, 661 F.3d 1180 (9th Cir. 2011).

163. See discussion *supra* Section II.C.1.

164. *Nosal II*, 2010 WL 934257, at *7 (citing 18 U.S.C. § 1030(e)(6) (2010)) (emphasis in original).

165. *Id.* at *6.

166. *Nosal's* brief in the Ninth Circuit offered a similarly sparse hypothetical: "An employer may say to an employee: 'You have permission to access the Cronos database but not the Poseidon database, because the Poseidon database is highly confidential.' Under *Brekka*, if an employee violates those limitations, he has committed a crime under the CFAA." Appellee's Brief at 10, *Nosal*, 642 F.3d 781 (9th Cir. 2011) (No. 10-10038).

167. See discussion *supra* Section II.A.1.

access.¹⁶⁸ This variant would be different from the approaches in *John, Rodriguez*, and *Nosal* in that it would not cover the misuse or misappropriation of information that employees have authority to access.¹⁶⁹ The variant would be similar, however, in that it would allow the employer to set the scope of authorized access via use policies instead of only through code-based restrictions.¹⁷⁰

It is unclear if the *Nosal II* district court's example represents a code-based approach or an employer-policy approach to defining "exceeds authorized access." In the context of the district court's example, either approach is problematic. Under the code-based scenario, where code completely blocks the employee from accessing the "G" drive, the access is arguably "without authorization" at all. To classify hacking into the "G" drive as "exceeding authorized access," the court needs to explain how authorized access enabled the person to hack the drive.¹⁷¹

Under the employee-policy scenario, where the employer's policy forbids the employee from accessing content on the "G" drive, there are similar void-for-vagueness risks that plague the approaches of *John, Rodriguez*, and *Nosal*.¹⁷² Admittedly, the risks are lessened because the approach would not cover acts of misuse or misappropriation, but the approach still allows employers to dictate, perhaps through vague policies, what constitutes criminal conduct under the CFAA.¹⁷³

III. A CODE-BASED APPROACH TO "EXCEEDS AUTHORIZED ACCESS" IN THE CFAA

Although the district court in *Nosal II* attempted to confine the scope of "exceeds authorized access" by limiting its application to violations of access restrictions,¹⁷⁴ its approach was ultimately unpersuasive because it failed to describe how an employer could impose limits on access and how an employee could exceed such limits.¹⁷⁵ This Part proposes a reading of "exceeds authorized access" that fills in the gaps in the district court's approach. The proposed approach takes elements of the code-based

168. See discussion *supra* Section II.C.1.

169. See *id.*

170. See *id.*

171. See 18 U.S.C. § 1030(e)(6) (2010).

172. See discussion *supra* Section II.C.2.

173. See *id.*

174. *Nosal II*, No. C 08-0237, 2010 WL 934257, at *1, *6 (N.D. Cal. Jan. 6, 2010), *rev'd*, 642 F.3d 781 (9th Cir.), *reh'g granted en banc*, 661 F.3d 1180 (9th Cir. 2011).

175. See discussion *supra* Section II.D.

approach and applies them to the term “exceeds authorized access,” tying employee liability to breaches of an employer’s technical restrictions on access. The approach is based on the following principles:

- Avoid the void-for-vagueness problems posed by the agency and employer-policy approaches.¹⁷⁶
- Preserve the textual distinction between “without authorization” and “exceeds authorized access.”¹⁷⁷
- Respect the apparent Congressional understanding that “exceeds authorized access” applies to “insiders.”¹⁷⁸
- Comport with the general statutory purpose of regulating computer misuse, as opposed to any misconduct—even criminal misconduct—that happens to be effectuated through the use of a computer.¹⁷⁹

A. DESCRIPTION OF A CODE-BASED APPROACH TO EXCEEDING AUTHORIZATION

Under the proposed code-based approach, an employee exceeds authorized access when she (1) encounters a code-based barrier on her employer’s computer and then (2) proceeds to use her authorized access to obtain or alter information that exists behind the barrier. The second step—using authorized access to obtain or alter information—occurs when the employee uses a program (to which she has access) for a function for which the program was not intended.

The first element of the approach avoids the potential void-for-vagueness problems of the employer-policy approach.¹⁸⁰ If a user attempts to obtain or alter information, and if a code-based barrier blocks the attempt, the user has clear notice that the attempted action is prohibited. Much like an employee who encounters a locked file cabinet at work, the employee who encounters a code-based barrier on a work computer has notice that they are not authorized to enter the electronic resource unless they have a key (or a password).

The requirement that an employee uses a program in a manner unrelated to its intended function ensures that the approach covers actual computer

176. See discussion *supra* Sections II.B.2, II.C.2.

177. See *supra* text accompanying notes 58–60.

178. See *supra* Section I.B.

179. See *Nosal*, 642 F.3d 781, 793 (9th Cir. 2011) (Campbell, J. dissenting).

180. See *supra* Section II.C.2.

misuse.¹⁸¹ Although the approach borrows language from *United States v. Morris*, the “intended function” test here is subtly but significantly different than the Second Circuit’s test in that case.¹⁸² Recall that Morris exploited vulnerabilities in the “finger” and “sendmail” programs that “permitted him a special and unauthorized access route into *other* computers.”¹⁸³ By using programs in a manner unrelated to their intended function, Morris obtained privileges on computers that he was not authorized to access at all.¹⁸⁴ The proposed approach, by contrast, covers instances where an employee uses her access to exploit a vulnerability to obtain information on a computer to which she has at least some authorized access. Unlike Morris, whose exploit was “without authorization,”¹⁸⁵ the employee’s exploit under the proposed approach “exceeds authorized access.”

B. HYPOTHETICAL EXAMPLE

Using a hypothetical fact pattern, this Section demonstrates how the proposed approach would distinguish between computer use in excess of authorization, use without authorization, and use with authorization under the CFAA.

Aaron works in the financial aid office of a large public university. Aaron has access to a student information system that contains academic and financial records for all of the university’s students. The student information system includes different tools that allow employees to access a central database. Aaron, like his fellow employees, does most of his work using a web browser through which he signs on to a web application that gives him access to student information in the database. Although the web interface is the primary way that employees interact with the system, there are other tools—including a report writer—that employees use to access the data in the information system.

The student information system, like most modern applications, allows the system owner to configure which users get to access which features, pages, and records. The university configured the web application so that the employees in the financial aid office can access the pages that display a student’s financial information. The financial aid employees cannot, however,

181. Before the recent explosion of civil and criminal litigation that relied on the agency and employer-policy theories, most CFAA prosecutions targeted instances of computer misuse. *See* cases cited *supra* note 12.

182. *See* *United States v. Morris*, 928 F. 2d 504, 509 (2d Cir. 1991); *see also* discussion *supra* Section II.A.1.

183. *Morris*, 928 F. 2d at 510 (emphasis added).

184. *Id.*

185. *Id.*

access any of the pages that display a student's courses and grades. Those pages are accessible to employees in the registrar's office, but not to employees in the financial aid office.

One summer evening, Aaron is taking out the garbage when he runs into Bob, his neighbor. Aaron dislikes Bob, whose son Ryan attends the university. Bob constantly brags about how well Ryan is doing in life, and this evening is no exception. Ryan, Bob says, just got his spring semester grades: straight A's.

1. Possible Violation #1

Aaron is skeptical about Bob's boast. The next day at work, Aaron thinks about how he can view Ryan's grades. Aaron opens up his web browser and logs on to the student information system's web application. He navigates around for a while, but finds that the web application is locked down: he can only access pages that display a student's financial aid information. Aaron cannot access any of the pages that would allow him to view a student's grades.

Next, Aaron opens up the report writer client. The report writer connects to the same database as the web application, but it has a different purpose: whereas the purpose of the web application is to permit employees to view and update individual student records, the purpose of the report writer is to query large volumes of data and then to assemble that data into charts and reports. Aaron is thrilled to find that the report writer, in contrast to the web application, does not limit him to financial aid data. The report writer allows him to view all kinds of data, including the grades of students. Aaron uses his access to write a "report" that returns the grade records for a single student: Ryan. Aaron is disappointed to see that Ryan did, in fact, get all A's last semester.

Under the proposed code-based reading of "exceeds authorized access," Aaron has exceeded his authorized access to the student information system database. In the web application that Aaron routinely used to access the database, code-based barriers prevented him from viewing a student's grades. He subverted this barrier by using another tool, the report writer, for a function for which it was not intended. The report writer's intended function is to allow for the querying and aggregating of large volumes of data; it is not intended for the purpose of querying individual records. Aaron thus used his authorized access to view information that he was not permitted to obtain.

It is worth emphasizing that Aaron did not exceed his authorized access merely because he used a program for a purpose that is inconsistent with the program's intended function. Had there been no code-based barrier in place in the web application (i.e., if Aaron could view the "student grades" pages in

the web application), Aaron would not have exceeded authorized access by using the report writer to view Ryan's grades. For an employee to exceed authorized access, he must be trying to find a way around a code-based barrier that prevents access.

Aaron could also have liability under the agency and employer-policy approaches. Under the agency approach, Aaron's access would be "without authorization" if he used the information system in a manner that was contrary to his employer's (the university's) interests.¹⁸⁶ Under the employer-policy approach, Aaron would have exceeded his authorized access if the university had a written policy that prohibited Aaron's purpose or intent in looking up the information. If, for example, the university had a policy that prohibited employees from accessing academic records for non-business reasons, Aaron would have exceeded authorized access.¹⁸⁷

2. Possible Violation #2

While Aaron viewed Ryan's grades, he noticed that one grade from the spring semester was not yet posted. Aaron thought it would be funny to give Ryan a "D" in the class. Aaron could not insert or change a grade with the report writer tool. The report writer allows for the viewing, but not the updating, of data.

Aaron knew that the student information system was a commercial product that the university had purchased and then configured. He did an online search of the name of the product along with the words "hack" and "exploit," finding instructions for how to launch a cross-site scripting attack that would allow the attacker to hijack another user's web session.¹⁸⁸ There was, Aaron read, a patch available for the vulnerability, but he figured there was a decent chance that the university's IT group had not yet patched the system.

Aaron launched the cross-site scripting attack. It turned out that the system had not been patched, and Aaron was able to hijack the web session of an employee at the registrar's office. Unlike the financial aid office's employees, the registrar office's employees had access to pages that allowed for the updating of student grades. Aaron used this access to assign Ryan a "D" in his final spring semester class.

186. See *supra* Section II.B.1.

187. See, e.g., *United States v. Rodriguez*, 628 F.3d 1258, 1260–62 (11th Cir. 2010).

188. See Robert Auger, *Cross Site Scripting*, THE WEB APPLICATION CONSORTIUM, [http://projects.webappsec.org/w/page/13246920/Cross Site Scripting](http://projects.webappsec.org/w/page/13246920/Cross%20Site%20Scripting) (last modified Feb. 1, 2011).

Aaron's access to the system was "without authorization" under the proposed code-based approach. Aaron did not exceed authorized access because he did not use his existing access to obtain or alter information in the system;¹⁸⁹ instead, he directly breached a code barrier in the same way that an outsider would have. The fact that Aaron had some access to the system is not relevant to the analysis. For Aaron to act in excess of authorization (as opposed to without authorization), he must *use his authorized access* to help bypass a code-based barrier. He did not do so here.¹⁹⁰

3. Possible Violation #3

Aaron is pleased that Bob will soon learn that his son got a "D." But it is not enough for Aaron, who really wants Bob to suffer. Aaron logs on to the student information system and navigates to a financial page that allows him to view Ryan's financial aid records. Ryan has a grant of \$7,000 scheduled for distribution at the beginning of fall semester. Purely out of spite, Aaron reduces the award to \$1,000. The award reduction violates the financial aid office's policies, which permit award reductions only for certain reasons. Spite is not one of them.

Aaron is not guilty of a crime under the proposed code-based approach to "exceeds authorized access." Aaron's access to the student information system was authorized; he was permitted to view and update a student's financial aid data using the information system. There was no code barrier in place that prevented Aaron from accessing or updating the information. Although Aaron is guilty of violating his employer's policies, and although Aaron may have committed other state and federal crimes, he did not commit a computer misuse crime and did not violate a provision of the CFAA.

By contrast, Aaron would likely have CFAA liability under both the agency and employer-policy approaches. Under the agency approach, Aaron's act of reducing the award amount was probably contrary to his employer's interests and thus without authorization.¹⁹¹ Under the employer-policy approach, Aaron exceeded his authorized access to the system when

189. See 18 U.S.C. § 1030(e)(6) (2010).

190. Neither the agency approach nor the employer-policy approach have much to say about external breaches of technical barriers. Advocates of both approaches would, presumably, agree that the CFAA prohibits code-based breaches of computers. The agency and employer-policy approaches effectively add a layer of prohibited behavior beyond the basic code-based approach. See discussion *supra* Part II.

191. See *supra* Section II.B.1.

he violated his office's policies regarding the reasons for reducing a student's award amount.¹⁹²

C. LIMITATIONS OF A CODE-BASED APPROACH TO EXCEEDING AUTHORIZED ACCESS

The proposed code-based approach to "exceeds authorized access" covers a much narrower range of conduct than does the employer-policy approach. As the hypothetical discussed above demonstrates, the code-based approach will often fail to prohibit reprehensible conduct. Indeed, none of the defendants in *John, Rodriguez*, and *Nosal* bypassed any code-based barriers, and thus none would have CFAA liability for their misconduct under the proposed code-based approach.¹⁹³ It should be noted, however, that John and Nosal are liable for other crimes. John was also charged with committing various federal fraud crimes.¹⁹⁴ And Nosal faces civil and criminal litigation for his alleged theft of his former employer's intellectual property.¹⁹⁵

The defendant's conduct in *Rodriguez* presents a more difficult case. There, a government employee used his access to Social Security Administration computers to browse the records of women he knew.¹⁹⁶ Although this conduct violated the administration's policies, it was apparently not criminal.¹⁹⁷ If Rodriguez is not liable under the CFAA for exceeding authorized access on his employer's computer, then he may have no criminal liability at all for browsing the women's records.¹⁹⁸

192. See *United States v. John*, 597 F.3d 263, 272 (5th Cir. 2010).

193. See discussion *supra* Section II.C.1.

194. *John*, 597 F.3d at 269.

195. See *supra* text and accompanying notes 1–7.

196. *United States v. Rodriguez*, 628 F.3d 1258, 1263 (11th Cir. 2010).

197. *Id.*

198. James A. Baker, testifying before the Senate Judiciary Committee on behalf of the Department of Justice, argued that a narrow reading of "exceeds authorized access" would rob the Department of a useful tool with which to prosecute and deter "insider threats." Baker stated:

Employers should be able to set and communicate access restrictions to employees and contractors with the confidence that the law will protect them when their employees or contractors exceed these restrictions to access data for a wrongful purpose. Limiting the use of such terms to define the scope of authorization would, in some instances, prevent prosecution of exactly the kind of serious insider cases the Department handles on a regular basis: situations where a government employee is given access to sensitive information stored by the State Department, Internal Revenue Service, or crime database systems subject to express access restrictions, and then violates those access restrictions to access the database for a prohibited purpose.

There are at least two responses to the issues raised by Rodriguez's lack of criminal liability under the code-based approach to exceeding authorized access. First, not every instance of employee misconduct requires a legal remedy. Employers can address most employee misconduct by disciplining and, if necessary, firing the employee. Second, legislatures can pass laws that protect the privacy of confidential information. If Congress, for example, wishes to prohibit government employees from accessing confidential information for non-business reasons, it may pass a law to address this specific problem. Congress could specify the types of confidential information (e.g., personal medical records) that it wants to protect. A specific law would be more fair, and more effective, than relying on a combination of a broad reading of a computer misuse statute and the content of various agency use policies.

IV. CONCLUSION

Congress passed the CFAA to address the problem of hacking and other forms of computer misuse. Over time, courts developed interpretations of the CFAA that transformed the statute into a broader law that prohibits various forms of information misuse and misappropriation. Most recently, three circuit courts endorsed an employer-policy theory of liability, which holds that employees are liable for "exceed[ing] authorized access" under the CFAA when they violate their employers' computer use restrictions. The employer-policy approach, which risks rendering certain provisions of the CFAA unconstitutional, should be abandoned. Instead, courts should adopt the proposed code-based approach to reading the phrase "exceeds authorized access" in the CFAA. The code-based approach respects the text of the statute, avoids constitutional void-for-vagueness issues, and comports with the CFAA's general purpose of regulating computer misuse crimes.

Cybercrime: Updating the Computer Fraud and Abuse Act to Protect Cyberspace and Combat Emerging Threats: Hearing Before the Committee on the Judiciary, 112th Cong. 35–36 (2011) (statement of James A. Baker, Associate Deputy Attorney General).

NO SERVICE: FREE SPEECH, THE COMMUNICATIONS ACT, AND BART'S CELL PHONE NETWORK SHUTDOWN

Jennifer Spencer[†]

On August 11, 2011, the Bay Area Rapid Transit (“BART”) District officials shut down cell phone service in several BART stations in San Francisco for more than three hours to interfere with and impede political demonstrations against BART police.¹ On July 3, 2011, a BART policeman had fatally shot a homeless man, leading to disruptive demonstrations on July 11. BART claimed it shut down phone service on August 11 to prevent similar violence or disruptions.²

The American Civil Liberties Union (“ACLU”) of Northern California sent a letter to BART (and copied the letter to the Federal Communications Commission (“FCC” or “Commission”)) outlining the First Amendment issues and claiming that BART acted unconstitutionally.³ Additionally, Public Knowledge and several other public interest groups⁴ filed a petition to the FCC on August 29, 2011 seeking a declaratory ruling that disconnection of telecommunications services violates the Communications Act of 1934, 47 U.S.C. § 151 (amended 1996).⁵

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1. Bob Franklin, BART Board of Directors President, *A Letter From BART to Our Customers*, BART (Aug. 20, 2011), <http://www.bart.gov/news/articles/2011/news20110820.aspx>; Letter from Abdi Soltani & Alan Schlosser, American Civil Liberties Union of Northern California, to Kenton Rainey & BART (Aug. 15, 2011), *available at* http://www.aclunc.org/issues/technology/blog/asset_upload_file335_10381.pdf.

2. Casey Miner, *FCC: We're Monitoring BART's Cell Service Shutdown*, THE INFORMANT, KALW NEWS (Aug. 15, 2011, 3:19 PM), <http://informant.kalwnews.org/2011/08/fcc-were-monitoring-barts-cell-service-shutdown/>.

3. Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1.

4. Harold Feld & Sherwin Siy, *Emergency Petition for Declaratory Ruling of Public Knowledge*, *Broadband Institute of California, Center for Democracy and Technology, Center for Media Justice, Electronic Frontier Foundation, Media Access Project, Minority Media and Telecommunications Council, National Hispanic Media Coalition, and New America Foundation's Open Technology Initiative*, PUBLIC KNOWLEDGE (Aug. 29, 2011), <http://www.publicknowledge.org/files/docs/publicinterestpetitionFCCBART.pdf>.

5. The Communications Act of 1934, 47 U.S.C. § 151 (2006) (“[Congress enacted the Communications Act] for the purpose of regulating interstate and foreign commerce in communication by wire and radio so as to make available, so far as possible, to all the people

BART's actions raise a number of immediate concerns. The fact that what a government deems necessary for safety is ambiguous and undefined makes the possibilities endless. Moreover, by shutting down cell phone service and thus interfering with speech, BART's actions implicate First Amendment issues. Finally, BART's actions possibly constitute violations of the Communications Act and FCC's rules and regulations.

Whether governments have the ability to hinder access to social networking and cell phones has increasingly become not only part of a First Amendment and censorship debate, but also the touchstone of actual controversies, and will likely be at the center of future court cases. Government authorities claim that, when necessary for safety, they should have the ability to interfere with social networking platforms—such as Facebook and Twitter—and mobile phone activity.⁶ Until the recent controversial decision to shut down cell phone service by BART officials in San Francisco in August 2011,⁷ many Americans may have thought that government interference with social networking and mobile devices is something that takes place in lands of dictatorships and non-democratic nations. For example, former Egyptian President Hosni Mubarak's government notably shut down the Internet entirely in order to interfere with the ability of Facebook and Twitter users to coordinate protests.⁸ While democratic nations criticized Egypt for this, United Kingdom Prime Minister David Cameron revealed his desire to resort to similar measures if and when necessary:

Free flow of information can be used for good. But it can also be used for ill. So we are working with the police, the intelligence services and industry to look at whether it would be right to stop people communicating via these websites and services when we know they are plotting violence, disorder and criminality.⁹

of the United States . . . a rapid, efficient, Nation-wide, and world-wide wire and radio communication service . . . for the purpose of promoting safety of life and property.”); Feld & Siy, *supra* note 4.

6. See, e.g., Alexandra Dunn, *Unplugging a Nation: State Media Strategy during Egypt's January 25 Uprising*, 35 FLETCHER F. WORLD AFF. 15 (2011); Declan McCullagh, *Renewed Push to Give Obama an Internet “Kill Switch,”* CBS NEWS (Jan. 24, 2011, 10:12 AM), http://www.cbsnews.com/8301-501465_162-20029302-501465.html; Dan Nosowitz, *U.K. Prime Minister David Cameron Wants a Master Kill-Switch for Social Networks*, POPULAR SCIENCE (Aug. 11, 2011, 11:55 AM), <http://www.popsci.com/technology/article/2011-08/uk-prime-minister-david-cameron-considers-switching-entire-social-networks>.

7. Zusha Elinson, *After Cellphone Action, BART Faces Escalating Protests*, N.Y. TIMES (Aug. 20, 2011), <http://www.nytimes.com/2011/08/21/us/21bcbart.html?pagewanted=all>.

8. Nosowitz, *supra* note 6; see also Dunn, *supra* note 6.

9. Nosowitz, *supra* 6.

The major difference between Prime Minister Cameron and BART officials, however, is that Mr. Cameron stated the desire and the need to inquire into the necessity of hindering social networking and cell phone use,¹⁰ while BART blocked the cell tower and Internet access without this preliminary inquiry.¹¹ Government officials may at times have good reasons to restrict the use of technological devices and networks to protect the safety of its citizens. Because mobile devices are increasingly utilized for protests worldwide, this issue is of current importance and may be adjudicated in the future.

Bob Franklin, the BART board president, declared that he “cannot tolerate a protest on the [BART] platform” because the number of people, speed of trains, and volts of electricity involved with running the train in downtown San Francisco make for too dangerous of a situation.¹² The e-mails exchanged among BART employees obtained by *The Bay Citizen*,¹³ however, do not mention safety concerns, and instead discuss ways to get the “upper hand” in inhibiting communication necessary to organize a protest.¹⁴ BART Chief Communications Officer, Linton Johnson, stated that “passengers have a Constitutional right to safety. People are forgetting the fact that there are multiple Constitutional [sic] rights, and we have to protect them all.”¹⁵ A plaintiff would argue that BART chose not to protect the freedom of speech on August 11 and deemed safety concerns more important than the constitutional right of free speech.¹⁶ The ACLU argued, in its letter to BART, that restraining free speech was not the proper reaction to safety concerns.¹⁷

10. *Id.*

11. *See* Miner, *supra* note 2 (explaining that since BART shutdown its cell phone equipment without making a preliminary inquiry, it consequently shut down access to the Internet since passengers did not have access to the Internet through their cell phone service provider).

12. *Id.*

13. *About the Bay Citizen*, THE BAY CITIZEN, <http://www.baycitizen.org/about/> (last visited Feb. 20, 2012). *The Bay Citizen*, which covers civic and cultural news in the San Francisco Bay Area, “was launched as a nonprofit, nonpartisan, member-supported news organization dedicated to promoting innovation in journalism and catalyzing citizen engagement with the news.” *Id.*

14. Zusha Elinson, *BART Cut Cell Service on Spur of the Moment, E-mails*, THE BAY CITIZEN (Oct. 11, 2011, 2:58 PM), <http://www.baycitizen.org/bart-protests/story/bart-cut-cell-service-spur-moment-e-mails/>.

15. *Id.*

16. Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1, at 2.

17. *Id.*

FCC spokesman Neil Grace also commented on BART's actions, stating that the FCC "is continuing to collect information about BART's actions and will be taking steps to hear from stakeholders about the important issues those actions raised, including protecting public safety and ensuring the availability of communications networks."¹⁸ Additionally, the Electronic Frontier Foundation ("EFF") has called "cutting off cell phone service in response to a planned protest a shameful attack on free speech."¹⁹

This Note analyzes the issue through two legal frameworks: (1) the First Amendment and (2) the Communications Act of 1934, as amended. This Note will focus on BART's recent shut down of access to cell phone service, which effectively prevented Internet and social networking communications conducted through cell phones. Part I explains the known logistics of the shutdown, including e-mails exchanged among BART officials planning the shutdown. Part II addresses the First Amendment concerns related to the shutdown, including whether BART's platforms constitute public fora, prior restraint concerns, and explaining that the First Amendment does not protect actual incitement of illegal activity. Part III analyzes possible violations under the Communications Act relating to under which role BART was acting, as well as possible liability for willful interference with communications networks. Additionally, Part III addresses how the shutdown disrupted communication during an emergency and prevented free speech through online communication. Part IV analyzes BART's liability as a state actor under California law.

I. BART'S WIRELESS SHUTDOWN

At the time of this Note, no complaint has been filed, and the FCC has yet to respond to Public Knowledge's Emergency Petition.²⁰ Although many of the facts remain unclear, e-mails exchanged among BART officials indicate that BART decided to shut down its cell phone equipment for a brief period of time without consulting its board of directors.²¹

According to BART spokesman Linton Johnson's 2:20 a.m. e-mail to several BART officials, he suggested shutting down cell phone service entirely:

18. Miner, *supra* note 2.

19. Eva Galperin, *BART Pulls a Mubarak in San Francisco*, ELECTRONIC FRONTIER FOUNDATION (Aug. 12, 2011), <https://www.eff.org/deeplinks/2011/08/bart-pulls-mubarak-san-francisco>.

20. *BART Cellphone Shutdown Won't Lead to ACLU Suit*, CBS NEWS (Aug. 16, 2011, 9:39 AM), http://www.cbsnews.com/8301-501465_162-20092903-501465.html.

21. Elinson, *supra* note 14.

A whole heck of a lot their ability to carry out this exercise is predicated on being able to communicate with each other. Can't we just shut off wireless mobile phone and Wifi communication in the downtown stations? It's not like it's a constitutional right for BART to provide mobile phone and Wifi service. Additionally, the wireless phone companies and Wifi Rail rent space from us. We have radios—seems to me have the upper hand communication wise. Yes, it's a small inconvenience for our customers, but heck if they were on Muni just above BART downtown SF, they'd have no wireless signal.²²

BART Deputy Police Chief Benson Fairrow approved of the suggestion in a 5:00 a.m. e-mail, at which time he asked if anyone could think of a downside to the plan.²³ BART Police Chief Kenton Rainey approved of the idea in an e-mail to Fairrow and Johnson at 6:38 a.m., stating: "I think this is a great ideal [sic] especially if it will prevent them from texting as well. However, our media release regarding the protest states we will update passengers via texting and e-mails."²⁴

The shutdown began at 7:45 a.m. when acting manager of BART police, Lieutenant Kevin Franklin, asked the telecommunications staff how to shut off BART's cell phone equipment.²⁵ BART employee Dirk Peters—who communicated with the cell carriers renting the use of BART's cell tower—then questioned the shutdown of the cell phone carriers in an 8:18 a.m. e-mail: "Its [sic] common courtesy in the wireless industry to notify all carriers at least 24 hours in advance. Can this be scheduled at a later date?"²⁶ In response to Peters' questioning of the hastiness of the shut down and the logistics with telephone carriers, Franklin stated at 8:24 a.m. that they could not wait that long: "This is a last minute event and we can't schedule what the bad guys do. We appreciate your help and this is important for BART. Thanks."²⁷

At 8:45 a.m., Peters then e-mailed Forza Telecom, the contractor that runs BART's cell phone network: "Gentlemen, [t]he BART Police require the M-Line wireless from the Trans Bay Tube Portal to the Balboa Park Station, to be shut down today between 4 pm & 8 [sic] Steve, please help notify all the carriers."²⁸

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

According to Johnson's statement obtained by the *Bay Citizen*, BART's lawyer Sherwood Wakeman consulted the Supreme Court case *Brandenburg v. Ohio*²⁹ before signing off on the shutdown.³⁰ Thus, from the current record, it appears that the only legal analysis came when BART lawyer Wakeman considered *Brandenburg* and how imminent danger may affect free speech. Wakeman stated at a public hearing, "[t]his is an issue which, from my own experience, when there is an imminent danger or threat of violation of law, there is legal authority, um, to curtail free speech."³¹

Although spokesman Johnson proposed the hastily implemented idea, during a press conference on August 16, 2011, he declared it a "gut-wrenching decision" and stated that BART "struggled" with making the decision.³² In the weeks following the shutdown, BART drafted a proposed policy with the help of the ACLU that would allow BART to shut down cell phone access only during times of terrorist threats.³³ However, the Board delayed the scheduled vote on the policy on October 27.³⁴ BART announced its new policy for cell phone interruptions on December 1, 2011, allowing for a shut down only during "extraordinary circumstances."³⁵ The new policy allows for a temporary interruption only when BART "determines that there is strong evidence of imminent unlawful activity that threatens the safety of District passengers, employees and other members of the public."³⁶ The policy explicitly mentions examples of "extraordinary circumstances" that may result in a temporary interruption, including "evidence of use of cell phones as instrumentalities in explosives; to facilitate criminal activity or endanger District passengers; or] . . . to facilitate specific plans or attempts to destroy District property or substantially disrupt public transit services."³⁷ Additionally, the new policy states that the BART general manager must approve the operational procedure used to temporarily interrupt service and that the interruption "shall be promptly reported to first responders and the

29. *Brandenburg v. Ohio*, 395 U.S. 444 (1969).

30. Elinson, *supra* note 14.

31. *Id.*

32. *Id.*

33. *Id.*

34. Michael Krasny, *BART's New General Manager*, KQED RADIO (Sep. 29, 2001, 9:00 AM), <http://www.kqed.org/a/forum/R201109290900>; Will Reisman, *BART Board Delays Vote on Cellphone Shutdown Policy*, SF EXAMINER (Oct. 27, 2011, 1:04 PM), <http://www.s Examiner.com/local/bay-area/2011/10/bart-board-delays-vote-cellphone-shutdown-policy>.

35. *Extraordinary Circumstances Only for Cell Phone Interruptions*, BART.ORG (Dec. 1, 2011), <http://www.bart.gov/news/articles/2011/news20111201.aspx>.

36. *BART Cell Service Interruption Policy*, BAY AREA RAPID TRANSIT (Feb. 1, 2012), http://www.bart.gov/docs/final_CSIP.pdf.

37. *Id.*

Board of Directors.”³⁸ BART Board President Bob Franklin stated that BART developed the policy with input from the FCC and ACLU and that he hopes it will serve as a model for U.S. government agencies in the future.³⁹

The FCC is continuing to investigate and review the August 11 shutdown, as FCC Chairman Julius Genachowski wrote that he has “asked Commission staff to review these critical issues and consider the constraints that the Communications Act, First Amendment, and other laws and policies place upon potential service interruptions. The FCC will soon announce an open, public process to provide guidance on these issues.”⁴⁰ The FCC has the power and duty to enact the necessary rules and regulations and to issue orders necessary to carry out the Communications Act.⁴¹ Therefore, the FCC’s guidelines and opinions are authoritative in this area of law.

II. FIRST AMENDMENT

The Supreme Court examines First Amendment issues against the backdrop of the “profound national commitment to the principle that debate on public issues should be uninhibited, robust, and wide-open, and that it may well include vehement, caustic, and sometimes unpleasantly sharp attacks on government and public officials.”⁴² The Supreme Court has held that the First Amendment protects speech made through the telephone⁴³ and the Internet.⁴⁴ The First Amendment analysis in this Note stems from the ACLU’s letter to BART discussing the constitutionality of the shutdown, as it represents the arguments a plaintiff would bring.⁴⁵

First, Section II.A explains the differences between public and non-public fora. If BART’s stations and platforms are public fora, BART can only restrict speech in a content-neutral way, and such regulation is subject to a “time, place, and manner” restriction, which “serves an important government interest and leaves open adequate alternative places for speech.”⁴⁶ Next, Section II.B discusses whether or not BART’s shutdown

38. *Id.*

39. *Extraordinary Circumstances Only for Cell Phone Interruptions*, *supra* note 35.

40. *FCC To Review BART Cell Service Shutdown Policy*, CBS NEWS (Dec. 2, 2011, 10:34 PM), http://www.cbsnews.com/8301-205_162-57336077/fcc-to-review-bart-cell-service-shut-down-policy.

41. 47 U.S.C. § 154(i) (2006).

42. *New York Times v. Sullivan*, 376 U.S. 254, 270 (1964).

43. *Sable Comm’n of California, Inc. v. FCC*, 425 U.S. 115 (1989).

44. *Reno v. ACLU*, 521 U.S. 844 (1997).

45. Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1.

46. *Ovadal v. City of Madison*, 416 F.3d 531, 536 (7th Cir. 2005) (“When speech takes place in a traditional public forum, it receives heightened constitutional protection. The

constitutes a prior restraint on free speech, explaining that government action should only come after a protest occurs because it is impossible to know the nature of a protest before it takes place. A court must determine whether a restriction qualifies as a prior restraint because prior restraints are presumed to be unconstitutional.⁴⁷ Finally, Section II.C explains that speech that may cause disruptions is still protected as long as it does not incite illegal activity. However, the First Amendment does not protect actual threats.

A. WHETHER BART’S PLATFORMS AND STATIONS CONSTITUTE PUBLIC FORA AFFECTS BART’S POWER TO RESTRICT SPEECH IN THESE AREAS

The First Amendment does not give people “a constitutional right to [engage in public protest] whenever and however and wherever they please.”⁴⁸ To regulate speech in a public forum, the regulation must be both content-neutral and “be a reasonable time, place, or manner restriction.”⁴⁹ Free speech protects protests only in “traditional” and “designated” public fora, whereas “nonpublic” fora “are not appropriate platforms for unrestrained communication.”⁵⁰

Whether the government can impose speech restrictions depends on what type of forum the affected property is.⁵¹ When the government regulates a nonpublic forum, it has “maximum control over communicative behavior,”⁵² as it needs only a reasonable rationale to impose restrictions on

government may restrict the time, place, and manner of the speech, but only if the restrictions are content-neutral, narrowly tailored to serve a significant government interest, and leave open ample alternative means of communication. If a restriction is based on the content of the speech, it is unconstitutional unless the state can prove that the regulation is necessary to serve a compelling state interest and that the regulation is narrowly drawn to achieve that end.”). There are also restrictions on licensing and permit systems. Additionally, the government does not have to use the least restrictive alternative when regulating. *See* ERWIN CHERMERINSKY, CONSTITUTIONAL LAW 1167 (4th ed. 2011).

47. *See* Bantam Books, Inc. v. Sullivan, 372 U.S. 58, 70 (1963).

48. Greer v. Spock, 424 U.S. 828, 836 (1976) (quoting Adderley v. Florida, 385 U.S. 39, 48 (1966)); *see* Kevin Francis O’Neill, *Disentangling The Law of Public Protest*, 45 LOY. L. REV. 411 (1999).

49. CHERMERINSKY, *supra* note 46, at 1167.

50. O’Neill, *supra* note 48, at 421.

51. *Id.* at 411; *see* Int’l Soc’y for Krishna Consciousness, Inc. v. Lee, 505 U.S. 672, 678–79 (1992).

52. Paulsen v. City of Nassau, 925 F.2d 65, 69 (2d Cir. 1991).

that forum. However, the government cannot “suppress expression merely because public officials oppose the speaker’s view.”⁵³

BART issued a letter after the shutdown incident stating:

BART’s temporary interruption of cell phone service was not intended to and did not affect any First Amendment rights of any person to protest in a lawful manner in areas at BART stations that are open for expressive activity. The interruption did prevent the planned coordination of illegal activity on the BART platforms, and the resulting threat to public safety.⁵⁴

BART contends that its platforms are not open as public fora, but people are free to protest at other areas designated by BART.⁵⁵

1. *If BART’s Stations and Platforms Constitute Public Fora, BART Must Meet Higher Standards To Restrict Free Speech in These Areas*

A court must first determine whether BART’s property constitutes a public forum.⁵⁶ The Supreme Court analyzes government property under three categories, as articulated in *Christian Legal Society v. Martinez*:⁵⁷

Government entities create designated public forums when “government property that has not traditionally been regarded as a public forum is intentionally opened up for the purpose”; speech restrictions in such a forum “are subject the same strict scrutiny as restrictions in a traditional public forum.” Third, governmental entities establish limited public forums by opening property “limited to use by certain groups or dedicated solely to the discussion of certain subjects.” As noted in text, “[i]n such a forum, a governmental entity may impose restrictions on speech that are reasonable and view-point neutral.”⁵⁸

53. *Lee*, 505 U.S. at 679; *United States v. Kokinda*, 497 U.S. 720, 730 (1990); *Cornelius v. NAACP Legal Def. & Educ. Fund*, 473 U.S. 788, 800 (1985); *Perry Educ. Ass’n v. Perry Local Educators’ Ass’n*, 460 U.S. 37, 46 (1983).

54. *Franklin*, *supra* note 1.

55. *BART Special Board Meeting*, BAY AREA RAPID TRANSIT (Aug. 24, 2011), <http://www.bart.gov/about/bod/multimedia.aspx>.

56. *See* CHEMERINSKY, *supra* note 46, at 1167.

57. *Christian Legal Soc’y v. Martinez*, 130 S. Ct. 2971 (2010); Tim Newcomb, *Quote: Free Speech on BART Platforms*, TIME NEWS FEED (Aug. 17, 2011) (quoting BART spokesperson Linton Johnson as stating that “[o]utside the fare gates, that’s the public forum area. Inside fare gates is a non-public forum and by law, by the Constitution, the U.S. Supreme Court, there is no right to free speech there”), <http://newsfeed.time.com/2011/08/17/quote-free-speech-on-bart-platforms>.

58. *Christian Legal Soc’y*, 130 S.Ct. at 2984, n.11 (citations omitted).

Because BART's platforms differ from parks and public sidewalks, a court will likely determine that they do not constitute traditional public fora. It is also unlikely that they fall into the second or third categories of public fora, as BART did not open these areas up to anyone for protests. Nevertheless, if a court found that BART's platforms constitute public fora, BART's restrictions on free speech must be content-neutral, and "time, place, and manner" restrictions apply.

a) Restrictions on Free Speech and Protests Must Be Content-Neutral

If BART platforms are public fora, any restriction must be content-neutral.⁵⁹ Even if BART's shutdown was "on its face . . . neutral as to the content and speaker," a court will likely find that BART's "purpose to suppress speech and its unjustified burdens on expression would render it unconstitutional."⁶⁰ BART claims it disrupted wireless service due to safety concerns for its customers, rather than to prevent people from speaking out against and protesting BART's actions.⁶¹ However, despite BART's alleged safety concerns, a court might believe that its true intentions were to prevent criticism of BART, which it could find constitutes a content-based restriction.⁶²

In *Police Department of Chicago v. Mosley*, in which a public forum was at issue, the Supreme Court found that "above all else, the First Amendment means that government has no power to restrict expression because of its message, its ideas, its subject matter, or its content."⁶³ In *Mosley*, a Chicago ordinance defined permissible picketing on the basis of subject matter, specifically, in regard to the messages on picket signs.⁶⁴ The ordinance allowed peaceful picketing on a school's labor-management dispute, but prohibited all other peaceful picketing.⁶⁵ Mosley claimed that the ordinance violated the First Amendment and the Equal Protection Clause of the

59. *Police Dept. of Chicago v. Mosley*, 408 U.S. 92, 95–96 (1972).

60. *Sorrell v. IMS Health Inc.*, 131 S. Ct. 2653, 2664 (2011). The Court found that Vermont designed a statute to specifically impose content-based burdens on protected expression, which the Court found were not justified. The statute restricted the sale, disclosure, and use of pharmacy records that revealed the prescribing practices of individual doctors. The law was subject to heightened scrutiny because the First Amendment protects speech in the aid of pharmaceutical marketing. *Id.*

61. Elinson, *supra* note 14.

62. *See id.*

63. *Mosley*, 408 U.S. at 95–96.

64. *Id.* at 95.

65. *Id.*

Fourteenth Amendment.⁶⁶ Prior to the ordinance, Mosley peacefully and quietly protested on the sidewalk by a high school, holding signs stating the school discriminated against African Americans.⁶⁷ The Court found that the ordinance violated the Equal Protection Clause because of its impermissible distinction between labor picketing and other peaceful picketing.⁶⁸ However, the Court also discussed the First Amendment issues involved in this controversy:

To permit the continued building of our politics and culture, and to assure self-fulfillment for each individual, our people are guaranteed the right to express any thought, free from government censorship. The essence of this forbidden censorship is content control. Any restriction on expressive activity because of its content would completely undercut the “profound national commitment to the principle that debate on public issues should be uninhibited, robust, and [wide]-open.”⁶⁹

Once a forum is opened up to assembly or speaking by some groups, government may not prohibit others from assembling or speaking on the basis of what they intend to say. Selective exclusions from a public forum may not be based on content alone, and may not be justified by reference to content alone.⁷⁰

Because the prevented demonstrators planned to protest against BART and its officers, BART arguably had a desire to prevent that protest. BART maintains that it acted purely in the interest of safety concerns and was not trying to restrict the content of speech.⁷¹ Nonetheless, a court will likely find that BART “restrict[ed] expression because of its message, its ideas, its subject matter, or its content,” which is impermissible under *Mosley*.⁷² In *Mosley*, the government allowed some speech and prohibited other speech on the picket signs,⁷³ while BART prohibited all speech communications made through text messages, only some of which would have been related to the looming protest.⁷⁴ On the other hand, BART may argue that it did not prevent speech based on content because it prohibited all communication.

66. *Id.* at 94.

67. *Id.* at 93.

68. *Id.* at 100.

69. *Id.* at 95–96 (quoting *New York Times Co. v. Sullivan*, 376 U.S. 254, 270 (1964)).

70. *Id.* at 96.

71. *BART Special Board Meeting*, *supra* note 55.

72. *Mosley*, 408 U.S. at 95.

73. *Id.* at 92.

74. *See* Franklin, *supra* note 1 (“[T]here was no cellular service on the platform level.”).

However, a court may nevertheless find that BART violated the First Amendment because it restricted speech “because of its message.”⁷⁵ Despite the limited nature of the speech restriction in *Mosley*, the Supreme Court found that the government unconstitutionally prohibited Mosley’s speech.⁷⁶ According to the Court, “[a]ny restriction on expressive activity because of its content would completely undercut the ‘profound national commitment to the principle that debate on public issues should be uninhibited, robust, and wise-open [sic] (emphasis added).’”⁷⁷ BART restricted expressive activity because of its content, as illustrated by the numerous e-mails exchanged the morning of the shut down.⁷⁸ A plaintiff could argue that a restriction motivated by content violates the First Amendment, regardless of the amount of speech restricted.

BART may have been looking for ways to prevent protesting in its e-mail correspondence, as evidenced by the fact that the chain of e-mails began by stating “[the customers] ability to carry out this exercise is predicated on being able to communicate with each other,” which evidences BART’s intent to prevent the “exercise” by interfering with their means of communicating.⁷⁹ After identifying the problem as “[the] exercise,” the BART official suggested shutting off phone service as a solution to the problem.⁸⁰ BART purportedly had “the upper hand communication wise” to prevent the protest.⁸¹ The e-mail indicates that the intent was to prevent criticism of BART through a demonstration or protest, characterized as an “exercise,” not to prevent danger or violence. In fact, in all of the e-mail communications made available by the *Bay Citizen*, BART never considered the safety of its customers when making its decision to shut down service.⁸² Prior to August 11, BART provided all passengers with access to its wireless equipment, allowing all customers to communicate through cell phones without regard to the contents of these communications.⁸³ A court will likely hold, as indicated above, that the motive was to restrict certain content, despite the restriction’s seemingly content-neutral implementation.

75. *Id.*

76. *Id.* at 95–96.

77. *Id.*

78. *See* Elinson, *supra* note 14.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *See* Michael Cabanatuan, *BART Admits Halting Cell Service to Stop Protests*, SAN FRANCISCO CHRONICLE (Aug. 13, 2011), <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2011/08/12/baeu1kms8u.dtl>.

In light of BART's correspondence prior to the shutdown of wireless communication, a court will likely find that BART suppressed speech based on content, that is, communications related to protesting BART. Accordingly, a court will likely find the decision neither content-neutral nor constitutional.

b) If BART's Stations and Platforms Constitute Public Fora, BART Restrictions May Be Subject to Limits on "Time, Place, and Manner"

Because BART maintains that it acted out of safety concerns, it will likely take the position that the "time, place, and manner restriction" was necessary to minimize disruption on the platform, and that it still protected free speech because protesters could go to the designated areas for expressions,⁸⁴ which were not on the platforms.⁸⁵ Time, place, and manner restrictions must be "justified without reference to the content of the regulated speech, . . . narrowly tailored to serve a significant government interest, . . . [and] leave open ample alternative channels for communication of the information."⁸⁶ "The concept of 'time, place, and manner restrictions' . . . refers to the ability of the government to regulate speech in a public forum in a manner that minimizes disruption of a public place while still protecting freedom of speech."⁸⁷

The analysis of the interaction between a cell phone and a forum raises the question of whether the government could restrict cell phone use because the government believed a protest would develop in an unprotected forum.

c) If BART's Stations and Platforms are Non-Public Fora, BART Has a Stronger Argument for Restricting Speech

BART will likely claim its stations and platforms are not public fora because while they are government property, the government created them for transportation purposes.⁸⁸ If BART's stations are not public fora, BART

84. Franklin, *supra* note 1.

85. However, in *United States v. Grace*, 461 U.S. 171 (1983) the Court found a total ban on all speech unnecessary to prevent disruption in that case. Therefore, strong arguments could be made in opposition of the necessity of a total ban.

86. *Ward v. Rock Against Racism*, 491 U.S. 781, 791 (1989) (quoting *Clark v. Cmty. for Creative Non-Violence*, 468 U.S. 288, 293 (1984)).

87. See CHEMERINSKY, *supra* note 46, at 1171.

88. See Justin Silverman, *BART Phone Blackout: Did the S.F. Transit Agency Violate Free Speech Protections? Part 2*, CIT MEDIA LAW (Aug. 26, 2011), <http://www.citmedialaw.org/blog/2011/bart-phone-blackout-did-sf-transit-agency-violate-free-speech-protections-part-2>.

can impose broader restrictions.⁸⁹ Even though BART's platforms constitute public facilities, they may not constitute public fora. A court will likely determine that BART stations are similar to airport terminals, which the Supreme Court has deemed non-public fora because they are "among those publicly owned facilities that could be closed to all except those who have legitimate business there."⁹⁰ The government can legally regulate and discriminate between messages in non-public fora, provided that the regulations remain viewpoint neutral. Moreover, viewpoint neutral restrictions are not subject to the strict scrutiny test mentioned above.⁹¹ If BART can show that its stations are not public fora, it will likely be able to successfully argue that it did not violate the First Amendment because a court will likely find that BART's wholesale prohibition of speech did not discriminate among messages or speakers.

B. IF THE GOVERNMENT SUPPRESSES FREE SPEECH BEFORE THE
COMMUNICATION OCCURS, ITS ACTIONS CONSTITUTE
UNCONSTITUTIONAL PRIOR RESTRAINTS

Regardless of whether or not BART's platform is a public forum, the Supreme Court has long held that prior restraints on speech infringe on First Amendment rights.⁹² "The special vice of a prior restraint is that communication will be suppressed either directly or by inducing excessive caution in the speaker, before an adequate determination that it is unprotected by the First Amendment."⁹³ According to Thomas Emerson, a prominent First Amendment scholar, "[a] system of prior restraint is in many ways more inhibiting than a system of subsequent punishment: It is likely to bring under government scrutiny a far wider range of expression; it shuts off communication before it takes place."⁹⁴ BART's claim that its restraint on speech was necessary in order to prevent speech that might have resulted in violence is probably not an acceptable justification in light of the Supreme Court's holding that speech cannot be banned simply because it might disturb the public peace.⁹⁵ Moreover, federal appellate courts have held that the government cannot impede free speech because of potential violence

89. See CHEMERINSKY, *supra* note 46, at 1181.

90. *Int'l Soc'y for Krishna Consciousness v. Lee*, 505 U.S. 672 (1992) (ruling that airports constitute nonpublic fora); *United States v. Grace*, 461 U.S. 171, 178 (1983).

91. CHEMERINSKY, *supra* note 46, at 1181.

92. *Nebraska Press Ass'n. v. Stuart*, 427 U.S. 539, 559 (1976).

93. *Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations*, 413 U.S. 376, 390 (1973).

94. CHEMERINSKY, *supra* note 46, at 982 (citing THOMAS EMERSON, *THE SYSTEM OF FREEDOM OF EXPRESSION* 506 (1970)).

95. *Near v. Minnesota*, 283 U.S. 697, 721–22 (1931).

resulting from protests and public demonstrations.⁹⁶ Moreover, a “heavy presumption” of unconstitutionality exists for prior restraints on speech.⁹⁷

In *Near v. Minnesota*,⁹⁸ the Supreme Court held that court orders preventing speech constitute prior restraints.⁹⁹ The Minnesota law at issue in *Near* declared a “malicious, scandalous, and defamatory newspaper, magazine or other periodical” to be a public nuisance that the state could ban.¹⁰⁰ A district court issued an injunction enjoining the Saturday Press from publishing or circulating publications “whatsoever containing a malicious, scandalous and defamatory matter” after the Saturday Press published anti-Semitic and defamatory articles.¹⁰¹ The Court held the injunction unconstitutional, noting “almost an entire absence of attempts to impose previous restraints upon publications.”¹⁰² The Court stated that unprotected speech should be punished after it occurs, rather than utilizing prior restraints.¹⁰³ The Court further found that injunctions preventing speech should only be used in “exceptional cases.”¹⁰⁴ The Court listed several situations where the law allows prior restraints, and stated that “[t]he security of the community life may be protected against incitements to acts of violence and the overthrow by force of orderly government.”¹⁰⁵

Although the facts of the BART incident differ from those in *Near*, as the possible prior restraint did not come in the form of a court order and press publications were not at issue, *Near* is nevertheless instructive. Like in *Near*, BART prevented speech it thought would be illegal, rather than allowing the speech that would have been punished after it took place if it was in fact illegal.¹⁰⁶ BART will likely argue that this incident fell within the exception mentioned in *Near* for incitements to acts of violence, an argument which is discussed in Section II.C, *infra*.

96. *Ovadal v. City of Madison*, 416 F.3d 531, 537 (7th Cir. 2005); *Collins v. Jordan*, 110 F. 3d 1363, 1372 (9th Cir. 1997); *see also* *Carroll v. President & Comm'rs of Princess Anne*, 393 U.S. 175, 180–81 (1968); Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1, at 2.

97. *See* *Bantam Books, Inc. v. Sullivan*, 372 U.S. 58, 70 (1963).

98. *Near*, 283 U.S. 697.

99. *See id.*

100. *Id.* at 701–02.

101. *Id.* at 705.

102. *Id.* at 718.

103. *Id.* at 720 (“Subsequent punishment for such abuses as may exist is the appropriate remedy.”).

104. *Id.* at 716.

105. *Id.*

106. *See id.* at 720.

Furthermore, BART defends its actions by asserting that free speech rights are not recognized on BART platforms.¹⁰⁷ However, whether BART decides to recognize free speech rights may not matter. While cell phone service in BART stations has not always been available, EFF claims that once BART made this service available to patrons, shutting the service down to prevent demonstrations “constitutes a prior restraint on the free speech rights of every person in the station, whether they’re a protester or a commuter.”¹⁰⁸ EFF seemingly takes the position that because BART gave its customers access to mobile communication, taking away this access constitutes a prior restraint.

1. *Government Action Should Come After the Protest Takes Place*

The government presumptively violates the First Amendment if it prevents free speech activities prior to any illegal action by demonstrators or before a demonstration poses a clear and present danger.¹⁰⁹ In its letter, the ACLU reminded BART that claiming a restraint on speech was necessary in order to prevent speech that may “disturb public peace” does not adequately justify its actions under Supreme Court precedent.¹¹⁰ Rather, the government needs to ensure that police are present in case such violence does occur, at which point the police can take control of the situation.¹¹¹ The government cannot interfere with First Amendment rights based on the mere possibility of violence resulting.¹¹² While *Near* provided exceptions to this rule precluding government interference on possibilities, including “incitements to acts of violence,” the government must still wait to interfere until after the protesters have incited violence under *Brandenburg*, as discussed in Section II.C, *infra*.¹¹³ The ACLU further argued that “it would *undermine* BART’s safety rationale by precluding riders from reporting unlawful activity or communicating with family members about their whereabouts.”¹¹⁴ Passengers

107. *Statement on Temporary Wireless Service Interruption in Select BART Stations on Aug. 11*, BART.GOV (Aug. 12, 2011, 1:08 PM), <http://www.bart.gov/news/articles/2011/news20110812.aspx>.

108. Galperin, *supra* note 19.

109. *Carroll v. President and Comm’rs of Princess Anne*, 393 U.S. 175, 180–81 (1968); *Collins v. Jordan*, 110 F.3d 1363, 1371 (9th Cir. 1997).

110. *Near*, 283 U.S. 697, 721–22.

111. *Ovadal v. City of Madison*, 416 F.3d 531, 537 (7th Cir. 2005); *Collins*, 110 F. 3d at 1372.

112. *Collins*, 110 F.3d at 1372.

113. *See Brandenburg v. Ohio*, 395 U.S. 444, 447 (1969); *Near*, 283 U.S. at 716.

114. Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1, at 3.

could have used social networking and cell phones to promote safety during the demonstrations, but BART's shutdown eliminated that possibility.

In *Collins v. Jordan*, the Ninth Circuit held that the police and the mayor acted unconstitutionally when restricting speech based on violence that occurred at previous protests.¹¹⁵ In *Collins*, the court considered whether the arrests of demonstrators following the verdict of the Rodney King case in San Francisco were unconstitutional.¹¹⁶ Many demonstrated in San Francisco the day after the verdict was announced.¹¹⁷ Peaceful demonstrations in San Francisco, as well as demonstrations involving violence in the downtown Civic Center area, occurred the day after the verdict was announced.¹¹⁸ The following day, the mayor presented an Emergency Order to the Board of Supervisors that authorized custodial arrests and directed officers to discontinue any public gatherings in San Francisco whenever the officer “[had] reason to believe that the gatherings endanger[ed] or [was] likely to endanger persons or property.”¹¹⁹

That day the mayor and police learned of a protest that was to take place at the BART plaza (at 24th and Mission Street) at 7:00 p.m.¹²⁰ The record was unclear as to how the authorities learned of the protest and whether or not there was reason to expect violent or illegal activities. However, the court found that this was not dispositive to its analysis.¹²¹ Police were present at the BART plaza and the surrounding areas when people began gathering at around 6:30 p.m.¹²² Some police members testified that there were around thirty people present and no violent activities, while others testified that there were hundreds of people present and displays of aggressive and hostile behavior.¹²³ Around 6:45 p.m. police gave dispersal orders.¹²⁴ A videotape showed that “prior to the dispersal order, there were few people on the plaza and almost no activity.”¹²⁵ People then left the BART plaza and headed to the other areas occupied by crowds.¹²⁶ The parties to the case disagreed as to “whether these were organized groups that were refusing to obey the dispersal orders or simply individual people trying to leave an area they had

115. *Collins*, 110 F. 3d 1363.

116. *Id.* at 1367.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

been ordered to leave.”¹²⁷ Officers subsequently arrested a number of these people as well as several groups of people at other locations, who were then held in jail for one to two nights.¹²⁸ Following these events, the Board of Supervisors rescinded the Emergency Order that had authorized such arrests.¹²⁹

The plaintiffs in *Collins* claimed that the then-mayor and the then-police chief violated their First Amendment rights when they “individually and acting together decided to ban all demonstrations, peaceful and otherwise, effective May 1, 1992, and to arrest all demonstrators who refused to obey dispersal orders.”¹³⁰ The district court held that evidence supported an inference that the police chief and mayor decided to “ban all demonstrations, peaceful or otherwise,” and the police chief intended to “prevent all demonstrations relating to the Rodney King verdicts.”¹³¹ The court found that material issues of fact existed as to whether the assembled crowds were engaging in any illegal activity and whether a threat of imminent danger existed.¹³² The court found that the police could have reasonably believed that the crowds constituted illegal assemblies and could have arrested them.¹³³ However, the police could not have reasonably believed that a number of the arrested passersby had violated any laws.¹³⁴ The police chief defended his actions based on the fact that violence occurred during demonstrations the day before and claimed that the First Amendment allows the banning of all protests when a continuing threat of past misconduct is inferred.¹³⁵ The court disagreed, holding that “[a]s a matter of law . . . that the occurrence of limited violence and disorder on one day is not a justification for banning all demonstrations, peaceful and otherwise, on the immediately following day (or for an indefinite period thereafter).”¹³⁶ Essentially, the government improperly inferred future violence from past violence when deciding to restrict speech.

As the police in *Collins* acted to restrict speech prior to any violent activity, BART officials in the August 2011 communication network shutdown acted prematurely when shutting down its equipment before any

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at 1369.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 1372.

136. *Id.*

violent activity occurred on the platform.¹³⁷ BART acted similarly to the government officials in *Collins* when it attempted to prevent protests on August 11 that it assumed could turn violent as the protests on July 11 had.¹³⁸ Because the Ninth Circuit held that the officials in *Collins* could not prevent free speech because they expected violence would result as it had before, a court will likely find that BART impermissibly based its decision on the fact that violence had previously occurred during a protest of the same nature.¹³⁹ BART may argue that its decision on August 11 is distinguishable from *Collins* because the expected activity in *Collins* occurred on the BART Plaza, rather than on the actual platform. The *Collins* court, however, did not restrict its holding or analysis to the location of the protesters; thus, BART's actions should still fall under the precedent of *Collins*.¹⁴⁰

C. THE FIRST AMENDMENT PROTECTS POSSIBLY DISRUPTIVE SPEECH,
ALTHOUGH IT DOES NOT PROTECT SPEECH INCITING ILLEGAL
ACTIVITY

Case law relating to the protection against indirect disruption and incitement of illegal activity only includes cases where the speech actually occurred and a court subsequently analyzed whether the First Amendment protected it.¹⁴¹ Accordingly, the following doctrines and cases—specifically *Terminiello v. Chicago* and *Brandenburg v. Ohio*—may not even apply to the BART issue, as BART suppressed speech on the speculation of illegal activity occurring.

137. *Id.*

138. *Id.*

139. *See id.*

140. *Id.*; *see also* *Ovadal v. City of Madison*, 416 F.3d 531 (7th Cir. 2005). In *Ovadal*, the Seventh Circuit found a statute preventing free speech unconstitutional even after the speech threatened divers' safety on a highway. The court held that a Wisconsin disorderly conduct statute, which prohibited the petitioner from protesting on highway overpasses was not unconstitutionally vague. After the protester displayed a message against homosexuality on a pedestrian overpass above a busy highway in Madison that caused erratic driving and congestion, police threatened to arrest him, and subsequently banned him from such activity on the overpass. The district court found the restriction on free speech was justified, but the Seventh Circuit found genuine issues of material fact existed; therefore, it remanded the case. *Id.*

141. At the time of this Note, the author could not find any cases that discussed these doctrines when the government prevented the activity or speech before considering it illegal activity.

1. *Protection for Indirect Disruption*

Speech is not protected when it is “directed to inciting or producing imminent lawless action and is likely to incite or produce such action.”¹⁴² However, the First Amendment does protect speech that may indirectly lead to disruption.¹⁴³ It follows that to lawfully restrict free speech rights, BART will need to prove that the use of mobile devices likely would have “produce[d] a clear and present danger of a serious substantive evil that rises far above public inconvenience, annoyance, or unrest.”¹⁴⁴ It would not be enough to prove that the protesters would have advocated for illegal activities,¹⁴⁵ as BART cannot legally deny free speech “unless there is a substantial likelihood of imminent harm.”¹⁴⁶

In *Terminiello v. Chicago*, the Supreme Court focused on whether the petitioner’s speech composed of fighting words and was therefore unprotected.¹⁴⁷ In *Terminiello*, the trial court found the defendant petitioner guilty of violating a Chicago ordinance that deemed “[a]ll persons who shall make, aid, countenance, or assist in making any improper noise, riot, disturbance, breach of the peace, or diversion tending to a breach of the peace, within the limits of the city” guilty of disorderly conduct.¹⁴⁸ The defendant delivered a speech in which he criticized various racial and political groups to a large audience in an auditorium while condemning a crowd of about one thousand protesting outside of the auditorium.¹⁴⁹ The Court held that the trial court misconstrued the First Amendment because it allowed for a conviction if the petitioner’s speech “stirred people to anger, invited public dispute, or brought about a condition of unrest.”¹⁵⁰ According to the Court, “[free speech] may indeed best serve its high purpose when it induces a condition of unrest, creates dissatisfaction with conditions as they are, or even stirs people to anger.”¹⁵¹

142. *Brandenburg v. Ohio*, 395 U.S. 444, 447 (1969).

143. *Id.*

144. *Terminiello v. Chicago*, 337 U.S. 1, 4 (1949).

145. *Whitney v. California*, 274 U.S. 357, 376 (1927) (Brandeis, J., concurring); CHEMERINSKY, *supra* note 46, at 1019.

146. CHEMERINSKY, *supra* note 46, at 1019.

147. *Terminiello*, 337 U.S. at 1, 3; see Aviva O. Wertheimer, *The First Amendment Distinction Between Conduct and Content: A Conceptual Frameworks for Understanding Fighting Words Jurisprudence*, 63 FORDHAM L. REV. 793 (1994).

148. *Terminiello*, 337 U.S. at 1, 2.

149. *Id.* at 3.

150. *Id.* at 5.

151. *Id.* at 4.

Because BART prevented the protesters on August 11 from speaking, it is unclear as to what the nature of their speech would have been. If the speech would have caused only anger and unrest, or even “invited public dispute,” the First Amendment would have still protected such speech, as in *Terminiello*.¹⁵² However, the First Amendment would not have protected this speech if it would have directly incited illegal activity.¹⁵³

2. *Inciting Illegal Activity*

Incitement of illegal activity constitutes unprotected speech under *Brandenburg v. Ohio*.¹⁵⁴ BART reportedly consulted *Brandenburg v. Ohio*¹⁵⁵ prior to shutting down its equipment.¹⁵⁶ Some consider *Brandenburg* to be “the most speech-protective standard yet evolved by the Supreme Court.”¹⁵⁷ The *Brandenburg* test for constitutionally constraining free speech due to incitement requires “imminent harm, a likelihood of producing illegal action, and an intent to cause imminent illegality.”¹⁵⁸ Although, the *Brandenburg* test requires imminence, likelihood, and intent, it fell short of defining and explaining how courts should analyze these factors.¹⁵⁹

In *Brandenburg*, a jury convicted a Ku Klux Klan leader for syndicalism¹⁶⁰ based on a video recording of a rally that served as evidence of incitement.¹⁶¹ The film showed racist and anti-Semitic speech, as well as items that appeared to be firearms.¹⁶² The statute at issue in the case punished “persons who ‘advocate or teach the duty, necessity, or propriety’ of violence ‘as a means of accomplishing industrial or political reform.’”¹⁶³ The First Amendment protects actions that lead to violence or even advocate force as long as the speech does not direct or incite imminent illegal activity.¹⁶⁴ The Court held that:

152. *See id.* at 4–5.

153. *See* *Brandenburg v. Ohio*, 395 U.S. 444 (1969).

154. *Id.*

155. *See* Susan M. Giles, *Brandenburg v. State of Ohio: An Accidental, Too Easy, and Incomplete Landmark Case*, 38 CAP. U. L. REV. 517 (2010).

156. Elinson, *supra* note 14.

157. *E.g.*, Gerald Gunther, *Learned Hand and the Origins of Modern First Amendment Doctrine: Some Fragments of History*, 27 STAN. L. REV. 719, 755 (1975).

158. CHEMERINSKY, *supra* note 46, at 1029.

159. *Id.* at 1030.

160. Syndicalism is an economic system contrary to industrial capitalism. *See* Ahmed A. White, *The Crime of Economic Radicalism: Criminal Syndicalism Laws and the Industrial Workers of The World, 1917–1927*, 85 OR. L. REV. 649 (2006).

161. *Brandenburg v. Ohio*, 395 U.S. 444, 445–46 (1969).

162. *Id.*

163. *Id.* at 449.

164. *Id.* at 447.

[T]he constitutional guarantees of free speech and free press do not permit a State to forbid or proscribe advocacy of the use of force or of law violation except where such advocacy is directed to inciting or producing imminent lawless action and is likely to incite or produce such action.¹⁶⁵

After *Brandenburg* and subsequent cases, such as *Hess v. Indiana* and *NAACP v. Claiborne Hardware Co.*, the government must prove (1) a likelihood of imminent illegal conduct and (2) that the speech was made to cause imminent illegal conduct.¹⁶⁶ The First Amendment protects advocating force or violence without the desire to cause it.¹⁶⁷ The Court in *NAACP* held that the free speech protected the statement, “[i]f we catch any of you going in any of them racist stores, we’re gonna break your damn neck,” made by an NAACP official before a boycott of white-owned businesses.¹⁶⁸ In *NAACP*, the Court explained:

In the passionate atmosphere in which the speeches were delivered, they might have been understood as inviting an unlawful form of discipline or, at least, intending to create a fear of violence whether or not improper discipline was specifically intended This court has made clear, however, that mere advocacy of the use of force or violence does not remove speech from the protection of the First Amendment The emotionally charged rhetoric of Charles Evers’ speeches did not transcend the bounds of protected speech set forth in *Brandenburg*.¹⁶⁹

The Court decided these cases during “times where there were strong pressures to suppress speech.”¹⁷⁰ Therefore, it appears that the current social climate and context of the protest may affect whether a court would find BART’s actions unconstitutional.

BART will likely argue that its actions were permissible because cell phones would have been used to incite illegal activity. However, this would require a factual determination of whether or not illegal activity was imminent.¹⁷¹ Because BART prevented the speech that may or may not have incited illegal activity, incitement analysis under *Brandenburg* relates to prior restraints discussed in Section II.B, *supra*.

165. *Id.*

166. *NAACP v. Clairborne Hardware Co.*, 458 U.S. 886 (1982); *Hess v. Indiana*, 313 U.S. 105 (1973); CHEMERINSKY, *supra* note 46, at 1031.

167. *Brandenburg*, 395 U.S. at 447.

168. *Clairborne*, 458 U.S. at 902.

169. *Id.* at 927–28.

170. CHEMERINSKY, *supra* note 46, at 1031.

171. *See Brandenburg*, 395 U.S. at 447.

With respect to protests and demonstrations in particular, federal appellate courts have held that the government cannot impede free speech in these contexts merely because of potential violence.¹⁷² Rather, the government needs to ensure that the police are present in case such violence does occur, at which point the police should take control of the situation.¹⁷³ Just as the government cannot interfere with First Amendment rights based on the mere possibility of violence under *Collins*,¹⁷⁴ it follows that the government cannot prevent free speech because it may incite illegal activity. Because *Brandenburg* requires that (1) illegal conduct is likely (2) and the speech causes the illegal conduct to prove incitement,¹⁷⁵ this Note claims that the speech would need to first take place before a determination as to whether the speech is protected under *Brandenburg*. BART likely cannot rely on *Brandenburg* because it cannot show that the prevented protest would have caused illegal conduct.

Nonetheless, BART may argue that the Supreme Court's current tests should not apply to this situation due to advancements in technology and the way protesters would have communicated. Critics have argued that the Internet—which may have been accessed through cell phones by the expected protesters—changes the traditional framework for determining incitement of illegal activity.¹⁷⁶ Because the Supreme Court has stated that the person must direct the speech at a specific person and the speech must likely provoke a violent response for the First Amendment to not protect it,¹⁷⁷ some have argued that online speech would be overly protected because it would not be directed at a specific person.¹⁷⁸ Additionally, critics argue that courts should not require imminence on internet communication, as those inciting illegal activity on the Internet would too easily pass that test.¹⁷⁹ Speech may remain on the Internet for a long period of time, and illegal activity stemming from it may not occur right after the posting of the

172. *Ovadal v. City of Madison*, 416 F.3d 531, 537 (7th Cir. 2005); *Collins v. Jordan*, 110 F. 3d 1363, 1372 (9th Cir. 1997); see also Letter from Abdi Soltani & Alan Schlosser to Kenton Rainey & BART, *supra* note 1, at 2.

173. *Ovadal*, 416 F.3d at 537; *Collins*, 110 F. 3d at 1372.

174. *Collins*, 110 F. 3d at 1372.

175. CHEMERINSKY, *supra* note 46, at 1031.

176. See John P. Cronan, *The Next Challenge for the First Amendment: The Framework for an Internet Incitement Standard*, 51 CATH. U. L. REV. 425 (2002); Tiffany Komasa, *Planting the Seeds of Hatred: Why Imminence Should No Longer Be Required to Impose Liability on Internet Communications*, 29 CAP. U. L. REV. 835 (2002).

177. *Cohen v. California*, 403 U.S. 15, 21–22 (1971).

178. Cronan, *supra* note 176.

179. Komasa, *supra* note 176.

content.¹⁸⁰ However, these are merely criticisms and suggestions; a court would need to apply the current standards until the Supreme Court declares otherwise.

3. *True Threats*

This analysis would be incomplete without mentioning that the First Amendment protects speech that incites illegal activity, provided it does not meet the *Brandenburg* test. However, “true” threats are not protected.¹⁸¹ *Brandenburg* covers incitement, while threatening speech (“true” threats) differs. “The issue is related to *Brandenburg* because it involves speech that threatens violence, yet it is a distinct issue because the focus is not on the likely consequences but on the need to protect people from the adverse effects of feeling threatened.”¹⁸² Circuit courts are split on what constitutes a “true” threat. The Ninth Circuit has held that the perspective of a reasonable listener should be determinative,¹⁸³ while the Second Circuit found the perspective of the reasonable speaker to be determinative.¹⁸⁴

An actual threat, such as speech that materially assists a foreign terrorist organization, is not protected by the Constitution.¹⁸⁵ The proposed plan by BART states that it would not shut down cell phone equipment in the future, except in cases of imminent harm, such as terrorist threats.¹⁸⁶ The new policy would likely pass constitutional muster, as the Supreme Court has held that the Constitution does not protect speech expressed in concert with terrorist organizations in *Holder v. Humanitarian Law Project*.¹⁸⁷ However, the new policy also contains provisions for imminent situations other than terrorist activities, which the Court has not specifically held unprotected by the First Amendment.¹⁸⁸ The dissent in *Holder*, however, found that “cases [have] permit[ed] pure advocacy of even the most unlawful activity—as long as that

180. *Id.*

181. *See* *Madsen v. Women’s Health Ctr.*, 512 U.S. 753, 773 (1994); *United States v. Watts*, 394 U.S. 705, 708 (1969).

182. CHEMERINSKY, *supra* note 46, at 1031.

183. *See, e.g.*, *Lovell v. Poway Unified School Dist.*, 90 F.3d 367 (9th Cir. 1996); *United States v. Orozco-Santillan*, 903 F.2d 1262 (9th Cir. 1990); *United States v. Gilbert*, 884 F.2d 454 (9th Cir. 1989).

184. *United States v. Kelner*, 534 F.2d 1020 (2d Cir. 1976).

185. *Holder v. Humanitarian Law Project*, 130 S. Ct. 2705 (2010).

186. Rina Palta, *Draft BART Policy on Cell Phone Shutdown*, THE INFORMANT, KALW NEWS (Sept. 7, 2011, 3:57 PM), <http://informant.kalwnews.org/2011/09/draft-bart-policy-on-cell-phone-shutdown>.

187. *Holder*, 130 S. Ct. 2705.

188. *See BART Cell Service Interruption Policy*, *supra* note 36.

advocacy is not directed to inciting or producing imminent lawless action and . . . likely to incite or produce such action.”¹⁸⁹

III. THE COMMUNICATIONS ACT

In addition to a First Amendment claim, a plaintiff could also sue BART under the Communications Act of 1934 (as amended), 47 U.S.C. § 154. A claim under the Communications Act would differ from a First Amendment claim, as it would rely more heavily on statutes and the FCC’s authority.¹⁹⁰ Claims under the Communications Act would relate much less to freedom of expression and instead would rely on the fact that BART cut off federally regulated channels of communication.

The Communications Act provides the FCC with broad authority to regulate¹⁹¹ interstate and foreign communication by wire or radio to make available nation-wide communication services.¹⁹² This Part analyzes whether BART violated the Communications Act by deliberately interfering with public access to Commercial Mobile Radio Service (“CMRS”),¹⁹³ the term of art for cell phones as Title II telecommunications carriers.¹⁹⁴ “Commercial mobile service” means “any mobile service . . . that is provided for profit and makes interconnected service available (A) to the public or (B) to such classes of eligible users as to be effectively available to a substantial portion of the public.”¹⁹⁵ As the Communications Act treats cell phones as telephones, the disruption of a cell phone node is akin to interfering with a telephone system.¹⁹⁶ The legal theories discussed in this Part are largely derived from the emergency petition submitted to the FCC by Public Knowledge in which Public Knowledge outlined how BART’s actions may have violated the Communications Act.¹⁹⁷ Because BART provides interstate

189. *Holder*, 130 S. Ct. at 2737.

190. *See* 47 U.S.C. § 154(i) (2006).

191. “The Commission may perform any and all acts, make such rules and regulations, and issue such orders . . . as may be necessary in the execution of its functions.” 47 U.S.C. § 154(i).

192. 47 U.S.C. §§ 151, 154(i).

193. *See* 47 C.F.R. § 20.15(a) (2011). CMRS providers must comply with §§ 201, 202, 206–209, 216, 217, 223, and 225–228 of the Communications Act. *Id.*

194. Aside from violations of federal communications laws, speech through telephones and the Internet is also protected by the First Amendment, as declared by the Supreme Court in *Sable Comm’n of California, Inc. v. FCC*, 425 U.S. 115 (1989) and *Reno v. ACLU*, 521 U.S. 844 (1997).

195. 47 U.S.C. § 332(d)(1).

196. *See* 47 U.S.C. § 332(c) (defining commercial mobile services as Title II telecommunications common carriers); *see also* 47 C.F.R. § 20.9.

197. Feld & Siy, *supra* note 4.

telecommunication access,¹⁹⁸ shutting down such access arguably violates Title II and the Communications Act.¹⁹⁹ Additionally, the California Public Utilities Commission (“CPUC”) claims that it—and not BART—has exclusive authority to shut down phone service.²⁰⁰ The FCC has authority over wireless communication, and restrictions that impair reception signals are prohibited.²⁰¹ The FCC prohibits “any restriction . . . that impairs the installation, maintenance, or use of an antenna”²⁰² A “restriction impairs . . . use of an antenna if it . . . precludes reception or transmission of an acceptable quality signal.”²⁰³

Public Knowledge’s petition suggests that when BART shut down the cell service equipment, it was acting in one of three possible capacities: “as a network operator or agent of a network operator, as an agent of state or local government exercising police power, or as a private actor.”²⁰⁴ While the FCC has yet to promulgate a rule or issue an order in response to Public Knowledge’s petition, on March 1, 2012, it released a public notice seeking “comment on concerns and issues related to the intentional interruptions of [CMRS] by government authorities for the purpose of ensuring public safety.”²⁰⁵ Section III.A addresses BART’s liability if it acted as a common carrier (network operator) or agent. The following section, Section III.B,

198. The Communications Act defines “interstate communication” (or interstate transmission) as

communication or transmission (A) from any State, Territory, or possession of the United States . . . to any other State, Territory, or possession of the United States . . . from or to the United States . . . insofar as such communication or transmission takes place within the United States or (C) between points within the United States but through a foreign country; but shall not . . . include wire or radio communication between points in the same State . . . if such communication is regulated by a State commission.

47 U.S.C. § 153(28).

199. Feld & Siy, *supra* note 4, at 12.

200. *People v. Brophy*, 120 P.2d 946 (Cal. App. 1942).

201. 47 C.F.R. § 1.4000.

202. *Id.* § 1.4000(a)(1).

203. *Id.* § 1.4000(a)(3)(iii).

204. Feld & Siy, *supra* note 4, at 4.

205. FCC Public Notice, *Commission Seeks Comment on Certain Wireless Service Interruptions*, DA 12-311 (Mar. 1, 2012), available at http://transition.fcc.gov/Daily_Releases/Daily_Business/2012/db0301/DA-12-311A1.pdf. This Public Notice was the most recent issuance by the FCC at the time of this Note’s publication. In the Public Notice, the Commission sought comments to be submitted by April 30, 2012 and replies submitted by May 30, 2012. Specifically, the Commission raised the following issues (1) past practices and precedents for interrupting wireless service for public safety concerns, (2) bases for interrupting wireless service, (3) risks in interrupting wireless service, (4) scope of interruption, (5) authority to interrupt service, and (6) legal constraints on interrupting wireless service. *Id.*

analyzes BART's liability if it acted as an agent of a common carrier. Section III.C analyzes BART's liability if it acted as a private party willfully interfering with communication access. Section III.D explains the Commission's prohibition on disrupting emergency services, with which BART's shutdown is in tension. Section III.E discusses the Commission's recent order to preserve "free expression on the Internet." Part IV analyzes BART's liability as an agent of the state government.

A. BART ACTING AS A COMMON CARRIER

Whether BART is considered a CMRS carrier or an agent of a CMRS carrier is a factual question that requires consideration of the details of the arrangement between BART and the wireless carriers providing service in the BART stations. If BART is considered a carrier,²⁰⁶ §§ 214(a)(3) and 202 of the Communications Act—which require the FCC's approval to interrupt

206. "Common carrier" or "carrier" is defined as "any person engaged as a common carrier for hire, in interstate or foreign communication by wire or radio or interstate or foreign radio transmission of energy . . . but a person engaged in radio broadcasting shall not, insofar as such person is so engaged, be deemed a common carrier." 47 U.S.C. § 153(11) (2006). The primary *sine qua non* is that it will "carry for all people indifferently," which does not require the carrier's services be made available to the entire public. "A specialized carrier whose services is of possible use to only a fraction of the population may nonetheless be a common carrier if he holds himself out to serve indifferently to all potential users." National Ass'n of Regulatory Utility Comm'rs v. FCC, 533 F.2d 601, 608 (D.C. Cir. 1976). It is not a common carrier if "its practice is to make individualized decisions in particular cases whether and on what terms to serve." *Id.* at 609. A telecommunications carrier is considered a common carrier "only to the extent that it is engaged in providing telecommunication services." 47 U.S.C. § 153(51). A "telecommunication carrier" is "any provider of telecommunications services, except that such term does not include aggregators of telecommunications services." *Id.* § 153(51). The Communications Act defines "telecommunications equipment" as "equipment, other than customer premises equipment, used by a carrier to provide telecommunications services." *Id.* § 153(52). The Communications Act defines "telecommunications service" as "the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used." *Id.* § 153(53). The Communications Act defines "telephone exchange service" as

(A) service within a telephone exchange, or within a connected system of telephone exchanges within the same exchange area operated to furnish to subscribers intercommunicating service of the character ordinarily furnished by a single exchange, and which is covered by the exchange service charge, or (B) comparable service provided through a system of switches, transmission equipment, or other facilities (or combination thereof) by which a subscriber can originate and terminate a telecommunication service.

Id. § 153(54). The Communication Act defines "electronic messaging service" as "a service that provides real-time or near real-time non-voice messages in text form between individuals over communication networks." *Id.* § 153(19).

service and do not allow carriers to discriminate in its access—would apply. Section 216 provides for liability if BART acted as an agent of a CMRS carrier, while § 217 provides for employee liability.

1. *Section 214 of the Communications Act*

Section 214(a) allows for temporary, emergency, or permanent discontinuance of service as well as changes in operation or equipment.²⁰⁷ However,

no carrier shall discontinue, reduce, or impair service to a community, or part of a community, unless and until there shall first have been obtained from the Commission a certificate that neither the present nor future public convenience and necessity will be adversely affected thereby; except that the Commission may, upon appropriate request being made, authorize temporary or emergency discontinuance, reduction, or impairment of service, or partial discontinuance, reduction, or impairment of service.²⁰⁸

The Communications Act requires the FCC's authorization prior to discontinuance of service to prevent the community²⁰⁹ or part of a community's loss or impairment of service "without adequate public interest safeguards."²¹⁰ The FCC primarily cares about the customers' loss of service, even in disputes between carriers where a carrier-to-carrier connection was disrupted.²¹¹ Because the Commission's authorization for a disruption of communication stems from its concern for the public's access to communication networks, it is likely that a court and the Commission would disfavor BART's shutdown because of the impact it had on the community.²¹²

Unless the Commission authorized BART to turn off its underground equipment, BART would seemingly be in violation of § 214.²¹³ However, the Commission can only authorize restrictions pursuant to § 214(c), which requires that the Commission affirmatively determine whether "the public

207. 47 U.S.C. § 214(a).

208. *Id.* § 214(a)(3).

209. The concept of "community" in section 214 is considered to be the public interest. *ITT World Comm'n, Inc. v. New York Tel. Co.*, 381 F. Supp. 113, 121 (S.D.N.Y. 1974).

210. *Total Telecomm. Servs., Inc. v. Am. Tel. & Tel. Co.*, 919 F. Supp. 472, 480 (D.D.C. 1996) (quoting Memorandum Opinion and Order, *Western Union Telegraph Co. Petition for Order to Require the Bell Sys. to Continue to Provide Group/Supergroup Facilities*, 74 F.C.C.2d 293, 295 (1979)).

211. *Id.* at 480. This case involved the relationship between two carriers (carrier-to-carrier connection), *Total Telecommunications Services and AT&T*. *Id.*

212. *See id.*

213. *See* 47 U.S.C. § 214(a).

convenience and necessity require [the restrictions].”²¹⁴ Nonetheless, BART may argue that “the primary purpose of 214(a) is prevention of unnecessary duplication of facilities, not regulation of services,” as the D.C. Circuit declared in *MCI Telecommunications Corp. v. FCC*.²¹⁵ However, the D.C. Circuit explicitly stated that § 214 “also applies to abandonment of service,” which was not at issue in that case.²¹⁶ Therefore, if the Commission were to authorize restrictions and interruptions of service in the future by virtue of § 214, a court will still require it to prove that the “the public convenience and necessity [so] require[d] [it].”²¹⁷

2. *Emergency Shutdowns by Network Providers Without FCC Permission May Be Permissible*

BART will likely argue it did not have time to contact the FCC for authorization due to the emergency situation. The Commission may not require authorization in times of emergency, as it has dispensed with the authorization requirement with respect to similar provisions of the Communications Act.²¹⁸

For example, § 202 prohibits “unjust and unreasonable discrimination in . . . charges, practices . . . facilities, or services . . . directly or indirectly, by any means or device.”²¹⁹ “Services” is defined as those “in connection with . . . the use of common carrier lines of communication, whether derived from wire or radio facilities, in chain broadcasting or incidental to radio communication of any kind.”²²⁰ In order for a plaintiff to prove discrimination under § 202, she must meet a three-part test.²²¹ First, the plaintiff must show that the services in question are “like” services and that the defendant provided them under different terms and conditions.²²² The

214. *Id.* § 214(c); *MCI Telecomm. Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040; *see also* *W.U. Div., Commercial Telegraphers’ Union v. United States*, 87 F. Supp. 324, 335 (D.D.C. 1949) (explaining that the “public convenience and necessity” standard for discontinuance of service should be construed to secure the broad aims of the Communication Act for the public).

215. *MCI Telecomm.*, 561 F.2d at 375; *see* 78 CONG. REC. 10,314 (1934) (“The section [§ 214] is designed to prevent useless duplication of facilities, with consequent higher charges upon the users of services.”).

216. *MCI Telecomm.*, 561 F.2d at 375 n.51.

217. *See* 47 U.S.C. § 214(c); *MCI Telecomm. Corp.*, 561 F.2d at 377.

218. *See In re Total Telecomm. Servs., Inc. v. AT&T Corp.*, 16 FCC Rcd. 5726, 5741 (F.C.C. 2001).

219. 47 U.S.C. § 202(a). Carriers who knowingly violate § 202 must pay a penalty of \$6,000 for each such offense to the United States. *Id.* § 202(c).

220. *Id.* § 202(b).

221. *Union Tel. Co. v. Qwest Corp.*, 495 F.3d 1187, 1195 (2007).

222. *Id.*

burden then shifts to the defendant to justify the difference as reasonable.²²³ Therefore, BART cannot shut down cell services if it were discriminating against the free speech that the protesters planned.

a) The Commission's Prohibition on Self-Help

The FCC prohibits telecommunication carriers from engaging in self-help by blocking calls or disconnecting service, even if that carrier believes that the calls violate FCC rules.²²⁴ In its *Call Blocking Order*, the FCC held that the CMRS carriers and interexchange did not have the right to block or refuse to carry calls because they thought the calls were generated or engineered by local exchange carriers in order to support unjust and unreasonable call termination rates.²²⁵

Public Knowledge's Emergency Petition argues that BART's shutdown exemplifies a government engaging in self-help because it cut off telecommunications access without first consulting the FCC and waiting to respond to dangerous activity, had it occurred.²²⁶

While call blocking on the basis of unreasonable call termination rates differs from BART's blocking access to telecommunications, the fact that the FCC has previously ruled on call blocking is relevant to this Note's analysis. In its *Call Blocking Order*, the FCC specifically stated, "Commission precedent provides that no carriers, including interexchange carriers, may block, choke, reduce, or restrict traffic in any way."²²⁷ In that case, the FCC found the practices unjust and unreasonable under § 201(b) of the Communications Act and that the carriers violated their Title II duties, even though the FCC itself was considering proposed rules on the same subject.²²⁸ The FCC has allowed call blocking only under "rare and limited circumstances."²²⁹ For instance, the FCC found it reasonable for AT&T to block its customers from calling a chat line that was set up as a sham.²³⁰ In that case, the chat line

223. *Id.*

224. Declaratory Ruling and Order, *In re Call Blocking by Carriers*, WC Docket No.07-135 (F.C.C. June 28, 2007), available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-07-2863A1.pdf.

225. *Id.* at 1.

226. See Feld & Siy, *supra* note 4 at 7.

227. Declaratory Ruling and Order, *In re Call Blocking by Carriers*, WC Docket No.07-135.

228. *Id.*

229. *Id.* at 3, n.20.

230. See *In re Total Telecomm. Servs., Inc. v. AT&T Corp.*, 16 FCC Rcd. 5726, 5741 (F.C.C. 2001).

service provider and competitive access providers set up the chat line to avoid customers and did not provide local exchange access²³¹ services.²³²

Because BART's equipment provides interstate communication by wire or radio, public interest organizations have urged the FCC to declare that BART contravened its obligations under Title II and the Communications Act when it cut off access to the interstate communication by shutting down its equipment.²³³

B. IF BART WAS ACTING AS AN AGENT, SECTIONS 216 AND 217 OF THE COMMUNICATIONS ACT APPLY

If BART is deemed an “operating trustee” of a common carrier, § 216 of the Communications Act states that the same provisions apply to carriers.²³⁴ Section 217 provides for the liability of the carrier if an agent's or employee's actions are in violation of the Communications Act.²³⁵ Section 217 “is, in essence, a provision codifying the common law respondeat superior doctrine.”²³⁶ Therefore, if BART itself is not a common carrier, but is an agent of a common carrier, it would still be liable for violating the Act if the Act prohibits common carriers from turning off access to communications in the BART context.

However, at least one technology think tank, TechFreedom, argues that the FCC should find that BART did not violate the Communications Act by virtue of acting as an agent of a carrier. TechFreedom's founder and president, Berin Szoka, claimed that:

BART simply turned off equipment it doesn't own—a likely violation of its contractual obligations to the carriers. But BART did nothing that violated FCC rules governing network operators. To declare the local government an ‘agent’ of the carriers would set

231. “Exchange access” means “offering of access to telephone exchange services or facilities for the purpose of the origination or termination of telephone toll services.” 47 U.S.C. § 153(2) (2006).

232. *See In re Total Telecomm. Servs., Inc.*, 16 FCC Rcd. 5726.

233. Feld & Siy, *supra* note 4, at 8.

234. 47 U.S.C. § 216; see also § 20.1(a), providing that CMRS providers must comply with §§ 202, 216, and 217. *Id.* § 20.15(a).

235. *Id.* § 217 (stating that “the act, omission, or failure of any officer, agent, or other person acting for or employed by any common carrier or user, acting within the scope of his employment, shall in every case be also deemed to be the act, omission, or failure of such carrier or user as well as that of the person”).

236. *Hammann v. 1800Ideas.com, Inc.*, 455 F. Supp. 2d 942 (D. Minn. 2006).

an extremely dangerous precedent for an agency with a long track record of regulatory creep.²³⁷

C. BART MIGHT HAVE VIOLATED THE COMMUNICATIONS ACT BY ACTING AS A PRIVATE PARTY

Section 333 of the Communications Act provides:

[n]o person shall willfully or maliciously interfere with or cause interference to any radio communications or any station licensed or authorized by or under this chapter or operated by the United States Government.²³⁸

Accordingly, Public Knowledge argued that even if BART is not considered a common carrier or government agent for purposes of operating its cellular service equipment, it may nevertheless violate § 333 as a private party.²³⁹ Under a plain reading of § 333, it seems that BART interfered with every wireless carrier's network communications.²⁴⁰ Moreover, the language indicates that Congress intended to protect the exchange of ideas through § 333;²⁴¹ therefore, Congress likely wanted to prevent the interference of free speech through radio communication. The legislative history shows that the House of Representatives was specifically concerned with personal communications when enacting § 333.²⁴²

In the aftermath of the shutdown, BART stated that passengers did not always have access to cell phone service and that BART had only recently provided this service through its equipment.²⁴³ Regardless of the fact that BART now provides a service that was not provided in the past, it still interfered with and cut off that service on August 11. It may be true that the Communications Act and the First Amendment do not require BART to provide cell phone service in its tunnels and stations.²⁴⁴ However, under

237. Katy Bachman, *FCC Opens Inquiry Into BART Mobile Shutdown*, ADWEEK (Mar. 2, 2012), <http://www.adweek.com/news/communications-act/fcc-opens-inquiry-bart-mobile-shutdown-138737>

238. 47 U.S.C. § 333.

239. Feld & Siy, *supra* note 4.

240. *See* H.R. REP. NO. 101-316, at 13 (1990).

241. *See id.* at 13; *see also* Andrew Kowalewski, *Placing a Ban on Police Radar Jammers*, *Rocky Mountain Radar v. F.C.C.*, 19 TEMP. ENVTL. L. & TECH. J. 137, 149 (2000) ("The very language indicates that the issue the Congress was taking up was the protection of the exchange of ideas.").

242. *See* H.R. REP. NO. 101-316, at 13. The House noted increased deliberative and malicious interference in services, including public safety and private land mobile. *Id.*

243. *See* Cabanatuan, *supra* note 83.

244. Feld & Siy, *supra* note 4.

§ 333, BART cannot interfere with the wireless service of the licensed CMRS providers with which it contracts.

BART may argue that it is not liable under § 333 because BART informed the wireless providers prior to shutting down its equipment.²⁴⁵ Even though the CMRS providers may have known that BART planned to shut down the service, BART still willfully interfered with that service. Section 333 does not require that the provider be ignorant of the willful interference.²⁴⁶ Furthermore, BART's willful interference disrupted personal communications and the exchange of ideas through the network, which Congress intended to protect with § 333.²⁴⁷

D. THE COMMISSION PROHIBITS THE DISRUPTION OF EMERGENCY SERVICES

In addition to potentially violating the Communications Act, BART also acted against the Commission's position on ensuring access to CMRS networks during emergencies.²⁴⁸ Authorities use telecommunications to administer emergency alerts during times of crises, and CMRS users use their phones to call for help during emergencies.²⁴⁹ The Communications Act requires the FCC to "encourage and support . . . comprehensive end-to-end emergency communications infrastructure and programs, based on coordinated statewide plans, including seamless, ubiquitous, reliable wireless telecommunications networks and enhanced wireless 9-1-1 service . . ."²⁵⁰

BART claims that it acted for the safety of passengers during what might have become a dangerous situation.²⁵¹ However, BART prevented its passengers from receiving emergency information.²⁵² The FCC has repeatedly acknowledged the importance of CMRS networks during emergency situations.²⁵³ After a cell phone carrier failed to connect over 8,000 911 calls,

245. Elinson, *supra* note 14.

246. *See* 47 U.S.C. § 333 (2006).

247. *See* H.R. REP. No. 101-316, at 13.

248. *See* 47 U.S.C. § 615.

249. *See In re* Matter of Amending the Definition of Interconnected VoIP Service in Section 9.3 of the Commission's Rules, 25 FCC Rcd. 10074 (F.C.C. 2011), *available at* http://transition.fcc.gov/Daily_Releases/Daily_Business/2011/db0713/FCC-11-107A1.pdf.

250. *Id.*

251. Miner, *supra* note 2.

252. *See* Zusha Elinson, *BART: 'We Were Within Our Legal Right' To Shut Down Cell Service*, THE BAY CITIZEN (Aug. 12, 2011, 6:24 PM), <http://www.baycitizen.org/bart-police-shooting/story/bart-cell-phone-service-legal/>.

253. *See* Proposed Extension of Part 4 of the Commission's Rules Regarding Outage Reporting to Interconnected Voice Over Internet Protocol and Broadband Service Providers, Notice of Proposed Rulemaking, 26 FCC Rcd. 7166 (F.C.C. 2011); Jamie Barnett,

the Bureau of Public Safety, a bureau within the FCC, declared “any 911 call that is not connected can have serious consequences.”²⁵⁴ BART even acknowledged how its actions would prevent it from contacting passengers with updates during emergencies.²⁵⁵ Had BART been concerned primarily with the safety of its passengers and bystanders, it likely would have worked to ensure that it could use its alert system to communicate with its passengers and that they had the ability to call 911 or their loved ones. Instead, Public Knowledge argues that BART intended to prevent a protest against itself by shutting down communication.²⁵⁶

E. THE COMMISSION PRESERVES “FREE EXPRESSION ON THE OPEN INTERNET”

The FCC recently issued an order to “preserve the Internet as an open platform for . . . free speech.”²⁵⁷ The Commission adopted three rules to provide clarity on how to keep the Internet open and free:

Transparency: Fixed and mobile broadband providers must disclose the network management practices, performance characteristics, and terms and conditions of their broadband services.

No blocking: Fixed broadband providers may not block lawful content, applications, services, or non-harmful devices; mobile broadband providers may not block lawful Web sites, or block applications that compete with their voice or video telephony services; and

No unreasonable discrimination: Fixed broadband providers may not unreasonably discriminate in transmitting lawful network traffic.²⁵⁸

Tips for Communicating in an Emergency, FCC.GOV (Aug. 27, 2011), <http://www.fcc.gov/blog/tips-communicating-emergency>; Dugald McConnell & Brian Todd, *FCC to Investigate Cell Phone Network After Earthquake*, CNN.COM (Aug. 25, 2011), http://articles.cnn.com/2011-08-25/us/earthquake.cell.phones_1_cell-phone-phone-bills-wireless-service; see also Shayne Adamski, *New Digital Tools: FEMA APP and Text Message Updates*, FEMA BLOG (Aug. 26, 2011), <http://blog.fema.gov/2011/08/new-digital-tools-femaapp-and-text.html>.

254. *FCC’s Public Safety Bureau and Homeland Security Bureau Requests Verizon To Take Action To Prevent Future Blocking of 911 Calls*, FCC.GOV (Feb. 18, 2011), http://fjallfoss.fcc.gov/edocs_public/attachmatch/DOC-304751A1.pdf.

255. Elinson, *supra* note 14.

256. *Id.*

257. Preserving the Open Internet, 76 Fed. Reg. 185 (Sept. 23, 2011) (codified at 47 C.F.R. pts. 0 & 8 (2011)).

258. 47 C.F.R. §§ 8.3, 8.5, 8.7 (2011).

The newly adopted rules include a prohibition on blocking. In particular, “mobile broadband providers may not block lawful Web sites, or block applications that compete with their voice or video telephony services.”²⁵⁹ While most of the analyses and arguments put forth by the ACLU and Public Knowledge relate to telephone communications, BART also prevented internet access on mobile phones.²⁶⁰ Because online communication, particularly through mobile devices, is so prevalent, and because protesters throughout the world have relied on the Internet,²⁶¹ this Note calls for an exploration on the Commission’s latest ruling on this matter.

The FCC Order protects freedom of expression on the Internet via mobile broadband.²⁶² The FCC passed these rules on September 23, 2011, and they became effective November 20, 2011.²⁶³ As these rules were not in effect at the time BART shut down cell phone equipment on August 11, they have no binding effect on BART’s actions that day.²⁶⁴ However, analyzing their effects with respect to BART’s actions will be helpful for the broader analysis of this debate.

According to these rules, “[a] person engaged in the provision of mobile broadband Internet access service, insofar as such person is engaged, shall not block consumers from accessing lawful Web sites.”²⁶⁵ The FCC will closely monitor “any conduct by mobile broadband providers that harms innovation, investment, competition, free expression or the achievement of national broadband goals.”²⁶⁶ The FCC does not intend for the Open Internet rules to expand or contract a broadband provider’s rights under other laws or safety and security regulations, such as “emergency communications and law enforcement, public safety, and national security authorities.”²⁶⁷ The Open Internet rules state:

The purpose of the safety and security provision is first to ensure that open Internet rules do not restrict broadband providers in addressing the needs of law enforcement authorities, and second to ensure that broadband providers do not use the safety and security

259. Preserving the Open Internet, 76 Fed. Reg. 185, 59192-01, 59192.

260. The shutdown prevented all cell phone access and communication, including the ability to communicate on the Internet through mobile devices.

261. See Dunn, *supra* note 6.

262. 47 C.F.R. § 8.5.

263. *Id.* pts. 0 & 8.

264. 47 U.S.C. § 154(g)(2)(i) (2006) (“The Commission may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this chapter, as may be necessary for the execution of its functions.”).

265. 47 C.F.R. § 8.5.

266. *Id.*

267. *Id.*

provision without the imprimatur of the law enforcement authority, as a loophole to the rules. As such, application of the safety and security rule should be tied to invocation by relevant authorities rather than to a broadband provider's independent notion of law enforcement.²⁶⁸

Commentators have argued that the scope of this safety and security rule should be limited so that broadband providers do not abuse the rule by voluntarily using it in ways that are inconsistent with Open Internet principles.²⁶⁹ If the FCC does not limit the safety and security rule, mobile broadband providers may hinder freedom of expression via web sites accessed through mobile networks on cell phones and other devices.

Whether or not BART constitutes a broadband provider, in light of its equipment providing passengers access to the Internet through a cell phone carrier's broadband network, is a factual question. Even if BART is not a broadband provider for the purposes of these rules, the same worries exist because BART may direct the cell phone carrier to turn off the broadband network so as to impede access to certain websites "under the guise of protecting safety and security."²⁷⁰ Because broadband providers would have the ability to avoid the Open Internet rules during times of emergency—or presumably any time it considers preventing access to certain websites necessary to protect safety and security—this rule, which at first glance appears to be protect First Amendment rights, may instead be used to defend hindering access to websites, including social networking sites during times of protests.

BART claims that it turned off its equipment to prevent cell phone communication—which may be done through text messaging or social media websites—due to safety concerns.²⁷¹ Regardless of whether or not BART decided to hinder access to social networking because of safety concerns, it nevertheless discriminated because its goal was to prevent specific speech that would facilitate a protest. If BART or government officials operating broadband networks in the future can claim they prevented users from accessing the Internet because of safety and security reasons, the FCC may consequently be authorizing the squelching of free speech with this carve-out to the rule that purports to prevent the use of broadband networks to hinder free expression.

268. Preserving the Open Internet, 76 Fed. Reg. 185, 59213 (Sept. 23, 2011) (codified at 47 C.F.R. pts. 0 & 8 (2011)) (emphasis added).

269. *Id.*

270. *Id.*

271. Franklin, *supra* note 1.

The FCC has declined to limit the safety exception rule, stating that “it would be a mistake to limit the rule to situations in which broadband providers have an obligation to assist safety and security personnel.”²⁷² The FCC has also declined to require a review process prior to the execution of the broadband provider’s decision because “time may be of the essence in meeting safety and security needs.”²⁷³

IV. IF BART WAS A STATE ACTOR, IT LIKELY VIOLATED CALIFORNIA LAW

California case law prohibits government agencies from disrupting telecommunication networks due to suspicion of illegal activity, as in *People v. Brophy*.²⁷⁴ The court in *Brophy* held that the California Attorney General could not prevent telephone service because the service was used for illegal activity (bookkeeping related to horse races).²⁷⁵ A government agency does not have the authority to disconnect telecommunications service based on its governmental status.²⁷⁶ While the court found that the Attorney General lacked authority to disconnect the telephone because alleging illegal activity is not enough, it also held that the Attorney General did not even have the power to disconnect under its police powers.²⁷⁷ Rather, the court found that this authority belonged to the Railroad Commission, while the power to disconnect telecommunications resides in the California Public Utilities Commission.²⁷⁸

In *Brophy*, the court determined that the government could not legally prevent communications relating to the illegal activity of bookkeeping for horse races.²⁷⁹ BART prevented a wide array of communications, including some that would have allowed some passengers to coordinate a protest together.²⁸⁰ Arguably the protest would have been legal, unless it acted to cause illegal or threatening activity, which is analyzed in Part II, *supra*. Even assuming that a court would have found the protest illegal, under *Brophy*, BART had no authority to disconnect telecommunications.²⁸¹

272. *Id.*

273. *Id.*

274. *People v. Brophy*, 120 P.2d 946, 953–54 (Cal. Ct. App. 1942).

275. *Id.*

276. *See id.*

277. *Id.*

278. *Id.*

279. *Id.*

280. *See Franklin, supra* note 1.

281. *Brophy*, 120 P.2d at 953–54.

While a court would analyze the BART incident under the *Brophy* precedent of California law, other jurisdictions similarly hold that the government cannot disconnect telephones due to suspicion that crimes are taking place over the telephone. For example, under *Shillitani v. Valentine*, New York law provides that telephone companies cannot deny service because of “a mere suspicion or mere belief that they may be or are being used for an illegitimate end.”²⁸² The court in *Shillitani* held that the company “[was] obliged by law to furnish its service and equipment to the public in general, and impartially.”²⁸³

Alabama case law stands for a similar proposition.²⁸⁴ In *Pike v. Southern Bell*, the Supreme Court of Alabama held that telephone companies “ha[d] a duty to serve the general public impartially, and without arbitrary discrimination. [The] right of service extend[ed] to every individual who complie[d] with the reasonable rules of the [Telephone] Company.”²⁸⁵ In *Pike*, the Commissioner of Public Safety of Birmingham wanted the telephone company to disconnect a customer’s phone because it was allegedly operating a lottery.²⁸⁶ The court found that this attempt to exercise police power was not justified because the Commissioner attempted to penalize a person for a crime without undergoing the correct judicial proceedings.²⁸⁷ “The unconstitutional and extra-judicial enlargement of coercive governmental power is a frightening and cancerous growth on our body politic.”²⁸⁸

The fact that Congress’s only explicit authorization for denying telecommunications services relates to alleged gambling implies that government entities do not have the authority to deny services for other reasons.²⁸⁹

BART’s shutting down its cell phone equipment to prevent communication differs from these cases because BART did not target specific individuals who were committing a crime.²⁹⁰ BART sought to

282. *In re Shillitani v. Valentine*, 184 Misc. 77, 81 (N.Y. Sup. Ct. 1945).

283. *Id.* at 80.

284. *Pike v. S. Bell*, 81 So. 2d 254 (Ala. 1955).

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.* at 258.

289. 18 U.S.C. § 1084 (2006).

290. Public Knowledge, Broadband Institute of California, Center for Democracy and Technology, Center for Media Justice, Electronic Frontier Foundation, Media Access Project, Minority Media and Telecommunications Council, National Hispanic Media Coalition, and New America Foundation’s Open Technology Initiative.

290. Feld & Siy, *supra* note 4.

prevent passengers from coordinating protests and demonstrations through messages through the use of cell phones because it assumed there would be safety risks and train delays.²⁹¹ BART's decision prevented any and all passengers from communicating using wireless phones, rather than preventing only communications of those committing a crime. While BART stopped communication between potential protesters, it also prevented passengers from calling family members to explain delays and confirm their whereabouts and impeded emergency service calls.

V. CONCLUSION

BART and subsequent government agencies attempting to hinder access to cell phones will need to overcome many potential violations of the First Amendment and Communications Act to justify its actions. If the regulated forum is not public, it seems the government will have wider latitude to restrict speech. Additionally, § 214(a)(3) of the Communications Act—outlining the acceptable procedure for discontinuing service—may become critical in this debate. If the government, or a government agency, such as BART, can convince the FCC to authorize a shutdown, it may be able to clear one legal hurdle. Similarly, the Commission's new Open Internet rules, although not applicable to all of the restricted services at issue in the BART incident, may result in restrictions of mobile internet use and social networking, despite the fact that these rules are intended to protect freedom of expression.

Despite a history of courts finding that the First Amendment prohibits free speech restrictions and that the Commission prohibits the disconnecting of telecommunication services, the government will likely be able to prevent access to cell phones and social networking without penalties to the extent that it can point to a sufficient threat or emergency. When the FCC publishes its "order" on the BART situation and its subsequent policy for shutting down wireless phone service, Americans may have a better idea of their rights.

In light of the rise of protests throughout the world in 2011 and 2012, specifically the 2011 Arab Spring uprisings and Wall Street protests, the actions that a government may legally undertake to control these movements represent a question that needs answering. The FCC ruling should provide some clarity. However, until a court adjudicates this matter, Americans will not know the true extent of the government's ability to regulate and interfere with technology that may or may not be used in the pursuit of protests.

291. See Franklin, *supra* note 1.

A WAY FORWARD AFTER *WARSHAK*: FOURTH AMENDMENT PROTECTIONS FOR E-MAIL

Courtney M. Bowman[†]

In *United States v. Warshak*,¹ the Sixth Circuit held that the Stored Communications Act (“SCA”), enacted as part of the Electronic Communications Privacy Act (“ECPA”) of 1986,² is unconstitutional.³ The statute’s unconstitutionality arises from two main problems with the SCA as it currently stands. First, the SCA predicates the extent of privacy protection on technological distinctions, mainly pertaining to e-mail storage, that are either insignificant or irrelevant today.⁴ Second, the statute was tailored to meet the needs of businesses in the 1980s and is ill-suited to deal with the modern technological landscape in which the Internet is used largely for personal reasons.⁵ This Note posits that a new or revised version of the SCA must address these important issues and, in so doing, must take into account a number of complicated factors, including the balance between government prosecution of suspected criminals, individuals’ Fourth Amendment right to privacy, and the adaptability of any new law to forthcoming forms of technology.

Most important, however, is that legislators shift their approach from the one they adopted when they first drafted the SCA. Those revising the statute should focus on the *functionality* of email and minimize the unnecessary technological distinctions written into the current version that make the law difficult to apply. This approach will ensure that the amended law will remain applicable in the event of changes to the e-mail technology and to new communications technologies.

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1. 631 F.3d 266 (6th Cir. 2010).

2. Deirdre K. Mulligan, *Reasonable Expectations in Electronic Communications: A Critical Perspective on the Electronic Communications Privacy Act*, 72 GEO. WASH. L. REV. 1557, 1565 (2004).

3. *Warshak*, 631 F.3d at 288.

4. Orin S. Kerr, *A User’s Guide to the Stored Communications Act, and a Legislator’s Guide to Amending It*, 72 GEO. WASH. L. REV. 1208, 1214 (2003–2004) (explaining that the SCA makes distinctions that “freez[e] into the law the understandings of computer network use as of 1986”).

5. Mulligan, *supra* note 2, at 1597.

The goal of this Note is to provide a clear explanation of why the SCA was adopted, highlight the *Warshak* court's reasoning, and suggest a course of action in line with that reasoning that will allow Congress to implement an e-mail privacy protection scheme that makes sense in the context of the modern internet landscape. Part I gives an overview of the privacy concerns that persuaded Congress to adopt the SCA. Part II analyzes the *Warshak* case and highlights the profound implications this case may have on e-mail privacy protection. Part III provides an overview of major problems with the SCA, as well as several key issues Congress should consider in amending the law and recommendations for how the law could be amended effectively.

I. BACKGROUND: THE FOURTH AMENDMENT AS APPLIED TO COMMUNICATIONS PRIVACY

The Fourth Amendment prohibits unreasonable government searches and seizures and is the constitutional provision upon which e-mail privacy is based. It ensures that

[t]he right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.⁶

The Fourth Amendment was adopted in part due to the founders' concerns about the use of general warrants,⁷ which had issued in the colonies in the seventeenth and eighteenth centuries⁸ and did not constrain those executing them in terms of where, when, or what they could search.⁹ Instead, in the words of one commentator, general warrants acted as "legal pass key[s] to all doors" and put "everyone's privacy at the capricious mercy of [their] holder[s]."¹⁰ Accordingly, in stating that a warrant must specify the places, people, or things subject to search and seizure, the language of the Fourth Amendment implies that the wide-ranging searches authorized by general warrants are unreasonable.¹¹

6. U.S. CONST. amend. IV.

7. WILLIAM J. CUDDIHY, *THE FOURTH AMENDMENT: ORIGINS AND ORIGINAL MEANING*, 602-1791, 709 (2009).

8. *Id.* at 241-42.

9. *Id.* at lxv.

10. *Id.*

11. *Id.* at lxiv-lxv.

A. FOURTH AMENDMENT CASE LAW: THE EVOLUTION OF COMMUNICATIONS PRIVACY

For the most part, the Supreme Court has extended Fourth Amendment protections to traditional as well as newer forms of communications technology. In the 1877 case *Ex parte Jackson*, for example, the Court ruled that the Fourth Amendment's warrant requirement applied to mail.¹² The defendant in that case was arrested for mailing a lottery circular in violation of a law that prohibited mailings of that kind.¹³ The Court held that Fourth Amendment protections extended to materials that were "closed against inspection, wherever they may be,"¹⁴ including letters and "sealed packages" in the mail.¹⁵ Furthermore, the Court held that when such materials were in transit, government authorities who wished to open the mail could only do so with a warrant, "as is required when papers are subjected to search in one's own household."¹⁶ The Court thus recognized a privacy interest in the content of people's postal communications.

In *Katz v. United States*,¹⁷ the Court ruled that listening in on private telephone conversations also required a warrant and, in so doing, articulated the modern framework for determining the scope of privacy protection.¹⁸ The defendant in this case was convicted of violating a law against transmitting gambling information over the phone.¹⁹ In the course of the investigation, government authorities had attached an electronic device to the outside of a telephone booth used by the defendant in order to listen in on his telephone conversations.²⁰ The Court held that the defendant could rely on Fourth Amendment privacy protections while using the phone booth because he could not expect that his conversation would be shared with the public and that "[t]o read the Constitution more narrowly is to ignore the vital role that the public telephone has come to play in private communication."²¹ Since the government had not obtained a search warrant before listening in on the call, the Court held that the government had conducted an impermissible search in part because "searches conducted

12. 96 U.S. 727, 733 (1877).

13. *Id.* at 727.

14. *Id.* at 733.

15. *Id.*

16. *Id.*

17. 389 U.S. 347 (1967).

18. *Id.* at 361 (Harlan, J., concurring); Achal Oza, *Amend the ECPA: Fourth Amendment Protection Erodes as E-Mails Get Dusty*, 88 B.U. L. REV. 1043, 1050 (2008).

19. *Katz*, 389 U.S. at 348.

20. *Id.*

21. *Id.* at 352.

outside the judicial process, without prior approval by judge or magistrate, are per se unreasonable under the Fourth Amendment—subject only to a few specifically established and well-delineated exceptions.”²² The Court thus used what is now the modern framework for determining the scope of Fourth Amendment protection.²³ As summarized by Justice Harlan in his concurrence, this framework stipulates that the Fourth Amendment protects one’s communications when (1) a person has a subjective understanding of privacy in a given situation and (2) society would deem such an expectation reasonable.²⁴

However, the Court also has been cautious in extending full Fourth Amendment protection to new forms of communication, at times refraining from making a wide-ranging decision until the societal role of a particular form of communication becomes more apparent.²⁵ For example, in the 2010 case *City of Ontario v. Quon*,²⁶ the Court had to determine whether it was reasonable for the city police department to order transcripts of the text messages Quon sent from an employer-provided device.²⁷ The Court ultimately determined that even if Quon enjoyed a reasonable expectation of privacy in his text messages, the search itself was reasonable and therefore did not violate the Fourth Amendment.²⁸ In so holding, the Court noted that it “must proceed with care when considering the whole concept of privacy expectations in communications made on electronic equipment” because “[t]he judiciary risks error by elaborating too fully on the Fourth Amendment implications of emerging technology before its role in society has become clear.”²⁹ The *Quon* decision therefore illustrates that, although the Court is willing to extend Fourth Amendment protection to newer forms of electronic communication, it is hesitant to do so without a more complete understanding of the potential reverberations of such a decision.³⁰

It is important to note that, although the *Katz* framework has proven very influential in determining the scope of Fourth Amendment privacy protection, it is not the sole determinant of the limits of such protection. In January 2012, the Supreme Court decided *United States v. Jones*³¹ and, in so

22. *Id.* at 357.

23. *Oza*, *supra* note 18.

24. *Katz*, 389 U.S. at 361 (Harlan, J., concurring); *Oza*, *supra* note 18, at 1049–50.

25. *City of Ontario v. Quon*, 130 S. Ct. 2619, 2629 (2010).

26. *Id.* at 2619.

27. *Id.* at 2624–26.

28. *Id.* at 2633.

29. *Id.* at 2629.

30. *Id.*

31. *United States v. Jones*, 132 S. Ct. 945 (2012).

doing, underscored the Amendment's respect for privacy in one's property. Stating that "for most of our history the Fourth Amendment was understood to embody a particular concern for government trespass upon the areas ('persons, houses, papers, and effects') it enumerates,"³² the Court ruled that people have a right to privacy in their physical property.³³ It held that the Fourth Amendment still protects this right and that, despite the Court's articulation of the "reasonable expectation of privacy" test in *Katz*, that test does "not narrow the Fourth Amendment's scope."³⁴

B. THE THIRD PARTY DOCTRINE

Although the Court has recognized that people are entitled to some amount of privacy in their communications, the so-called Third Party Doctrine limits the amount of privacy people can expect and is especially pertinent in analyzing e-mail privacy due to the role third parties play in e-mail communication. The Third Party Doctrine provides that when an individual knowingly supplies information to a third party, his expectation of privacy is diminished because that person is assuming the risk that the third party may reveal the information to government authorities.³⁵ As a result, information imparted to third parties generally falls outside the scope of Fourth Amendment protection and, accordingly, the government can access this information by requesting or subpoenaing it without informing the party under investigation.³⁶ In applying this reasoning in a series of decisions known as the "business records" cases,³⁷ the Court found that the government could subpoena a defendant's account records from his bank (since the bank was a third party to this information)³⁸ and a defendant's telephone dialing records from his telephone provider³⁹ (since the providers

32. *Id.* at 950 (quoting U.S. CONST. amend. IV).

33. *Id.* at 950–51.

34. *Id.* at 951.

35. *See* *United States v. Jacobsen*, 466 U.S. 109, 117 (1984) ("It is well-settled that when an individual reveals private information to another, he assumes the risk that his confidant will reveal that information to the authorities, and if that occurs the Fourth Amendment does not prohibit governmental use of that information.").

36. *See* *Mulligan*, *supra* note 2, at 1562.

37. *Id.*

38. *See* *United States v. Miller*, 425 U.S. 435, 444 (1976). The court here found that Miller had no "legitimate 'expectation of privacy' in [the] contents" of the bank records because they were exclusively comprised of "information voluntarily conveyed to the banks and exposed to their employees in the ordinary course of business." *Id.* at 442. In so doing, a "depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the Government." *Id.* at 443.

39. *See* *Smith v. Maryland*, 442 U.S. 735, 744 (1979).

were acting as third parties).⁴⁰ Given the role of third parties in the process of sending e-mails, which is explained in greater detail in Part I.C.1, *infra*, the Third Party Doctrine proved to be a major concern when e-mail use developed and became more prevalent.⁴¹

C. ECPA BACKGROUND: AN ATTEMPT TO EXTEND FOURTH AMENDMENT PROTECTIONS TO E-MAIL

By the mid-1980s, Congress realized it needed to update existing law in order to protect the privacy of electronic communications.⁴² At the time, Title III of the Omnibus Crime and Safe Streets Act covered communication interception, but the law only applied to voice transmissions by common carriers.⁴³ This meant that the protections the law afforded to voice communications did not apply to data, video, and other electronic communications that were becoming more prevalent, because, at the time of Title III's passage in 1968, "Congress could not appreciate—or in some cases even contemplate—telecommunications and computer technology" advances and, accordingly, did not address such concerns in Title III.⁴⁴ As a result of these gaps in protection, companies in the communications industry began to lobby for legislation that could address their concerns arising from the seeming lack of privacy safeguards for these increasingly popular forms of technology.⁴⁵ One particular worry was that, in light of the business records cases, e-mail would be granted lower standards of privacy protection due to

40. Mulligan, *supra* note 2, at 1562. The court in *Smith* distinguished the case from *Katz* because the pen register device authorities used to obtain the dialing records in *Smith* did not access "the *contents* of communications." *Smith*, 442 U.S. at 741 (emphasis in original). The court then determined that neither *Smith* nor society in general could have an expectation of privacy in phone numbers dialed because these numbers voluntarily and necessarily were imparted to the telephone company in the course of making a phone call, and therefore callers were taking the risk that this dialing information could be given to the police. *Id.* at 742–45. Professor Achal Oza points out that a number of scholars have referred to this determination as the court's distinction between "content information" and "envelope information," in which people may have a recognized right of privacy in the enclosed content of their messages but not in routing information that must remain visible to others in order to send the communication properly. *See* Oza, *supra* note 18, at 1049.

41. Mulligan, *supra* note 2, at 1563.

42. *Electronic Communications Privacy Act: Hearings Before the Subcomm. on Courts, Civil Liberties, and the Administration of Justice of the H. Comm. on the Judiciary on H.R. 3378*, 99th Cong. 1–2 (1986) [hereinafter *1986 ECPA Hearings*] (statement of Rep. Robert W. Kastenmeier, Chairman, S. Comm. on Courts, Civil Liberties, and the Administration of Justice).

43. 132 CONG. REC. S7991 (daily ed. June 19, 1986) (statement of Sen. Leahy).

44. *Id.*

45. *1986 ECPA Hearings*, *supra* note 42, at 1–2 (statement of Rep. Robert W. Kastenmeier, Chairman, S. Comm. on Courts, Civil Liberties, and the Administration of Justice).

the role of third-party servers in transmitting and storing e-mail.⁴⁶ The lack of privacy guarantees had the potential to jeopardize the growth of electronic communications since many people would be hesitant to use new technologies if their messages could not be safeguarded.⁴⁷ Congress subsequently passed ECPA in an effort “to ensure that the new technological equivalents of telephone calls, telegrams, and mail are afforded the same protection provided to conventional communications.”⁴⁸

Despite Congress’s intention to close the gaps in privacy protections in the digital age, the statute, as drafted, created additional confusion about the extent of e-mail privacy. Furthermore, in spite of lawmakers’ stated intent that ECPA provide equal levels of protection to traditional and more modern forms of communication,⁴⁹ the statute instead provided a lower level of protection to e-mail than it did to letters and phone calls. Before analyzing how the structure and language of ECPA led to such a result, however, an explanation of e-mail technology as it existed in the 1980s and a detailed overview of the statute itself is warranted.

1. *E-mail Technology*

An understanding of e-mail technology is important in determining the scope of protection one’s e-mails receive under ECPA since these statutory protections generally hinge on how a user accesses his or her e-mail,⁵⁰ as well as how long and where a given email has been stored.⁵¹ When a user composes an e-mail and clicks the “send” button, a program called Simple Mail Transfer Protocol (“SMTP”) transmits the e-mail from the user’s computer to the server belonging to the user’s e-mail provider.⁵² The server then determines how to route the e-mail and sends it to the server of the recipient’s e-mail provider.⁵³ As the e-mail travels from one server to another, it passes through a network of routers, leaving whole or partial copies of itself on these routers along the way.⁵⁴ Once the e-mail arrives at the

46. Mulligan, *supra* note 2, at 1563.

47. *Id.* at 1565.

48. 1986 ECPA Hearings, *supra* note 42, at 2 (statement of Rep. Robert W. Kastenmeier, Chairman, S. Comm. on Courts, Civil Liberties, and the Administration of Justice).

49. *Id.*

50. Oza, *supra* note 18, at 1050.

51. Mulligan, *supra* note 2, at 1568.

52. Oza, *supra* note 18, at 1051–52.

53. *Id.* at 1052.

54. Mulligan, *supra* note 2, at 1562–63.

receiving e-mail provider's server, it remains there until the recipient opens her e-mail program and retrieves the e-mail.⁵⁵

There are several means by which a user can retrieve her e-mail, depending on whether she uses a Post Office Protocol ("POP"), Internet Message Access Protocol ("IMAP"), or web-based e-mail program. If she is using a POP program, her e-mail will reside on the server until the user tells her e-mail program (such as Microsoft Outlook) to retrieve the e-mail.⁵⁶ The e-mail program then uses POP to transfer the e-mail from the server to the user's computer via download.⁵⁷ Once the message is downloaded to the user's computer, the service provider deletes its copy of the e-mail on its server.⁵⁸

In contrast, both IMAP and web-based programs leave copies of e-mails on the servers even after a user has viewed the e-mails. An IMAP program shows a user the e-mails that are stored on the provider's server, but does not delete these e-mails from the server.⁵⁹ A web-based e-mail service such as Gmail is similar in that it allows a logged-in user to view her e-mails without deleting them from the server.⁶⁰

There are a number of advantages to using an IMAP or web-based service instead of a POP service. One advantage of using an IMAP or web-based e-mail service is that a user can access her e-mail from many different locations since it is stored on a server, rather than downloaded to a single computer.⁶¹ Servers can also serve as storage and backup systems for IMAP and web-based e-mail users. If the user's computer crashes or is infected by a virus, for example, an IMAP user would be able to retrieve backup copies of her e-mail from the server, whereas a POP user who has downloaded copies of her e-mail to her computer and deleted them from the server would not

55. Oza, *supra* note 18, at 1052.

56. *Id.*

57. *Id.*

58. *Id.* Some POP services allow users to leave a copy of a downloaded e-mail on the server instead of deleting the e-mail from the server. See *Using Email*, MEDIATEMPLE, <http://kb.mediatemple.net/questions/272/Using+Email#gs/how-pop-works> (last visited Jan. 22, 2012). Users can instruct their POP clients to store e-mail in this manner. Usually, however, the POP client deletes e-mails from the server once a user downloads them. See Marshall Brain & Tim Crosby, *How E-Mail Works*, HOW STUFF WORKS, <http://communication.howstuffworks.com/email4.htm> (last visited Jan. 22, 2012).

59. Oza, *supra* note 18 at 1053.

60. *Id.* at 1053–54.

61. *IMAP vs. POP: What's the Difference?*, UNIVERSITY OF MINNESOTA E-MAIL AND INTERNET ACCOUNTS GUIDES, <http://www1.umn.edu/adcs/guides/e-mail/imapvspop.html> (last visited Dec. 20, 2011).

have such a backup.⁶² Despite these differences, however, an e-mail sender cannot tell what kind of e-mail retrieving program an intended recipient is using.⁶³

The ability of e-mail to provide such short- and long-term storage capacity was particularly relevant when the statute was drafted in the 1980s.⁶⁴ Before computer spreadsheet programs were adopted widely as efficient number-crunching tools, servers often provided remote storage services that allowed users to copy large amounts of their information to off-site computers in order to process data efficiently.⁶⁵ This type of storage, typically offered at offsite facilities, was known as remote computing service (“RCS”).⁶⁶ Providers also offered electronic communications service (“ECS”), which was the temporary storage required to send or receive e-mails.⁶⁷ Many providers could act as both ECS and RCS providers, so the type of service a provider performed varied depending on the communication at issue.⁶⁸ For example, a service provider acted as an ECS provider for unopened e-mails remaining on the server, while the same service provider acted as an RCS provider when it hosted a document stored at one of its storage sites.⁶⁹ If a user downloaded an e-mail onto his computer and took it off the server (by using a POP program, for example), the service provider no longer served a storage function in regard to that particular e-mail.⁷⁰

The nature of 1980s e-mail technology had several important implications, particularly its susceptibility to the Third Party Doctrine. In the 1980s, businesses began using e-mail on a more regular basis and accordingly became concerned about the privacy the e-mails would receive.⁷¹ The Third Party Doctrine particularly worried e-mail users because e-mail service providers and networks acted as third parties when they transmitted and stored e-mails, meaning that, under the Court’s business records holdings, the government could request or subpoena e-mails from any of the third parties charged with transmitting or storing them.⁷² Congress worried that

62. *Id.*

63. Oza, *supra* note 18, at 1051.

64. Kerr, *supra* note 4, at 1213–14.

65. *Id.*

66. *Id.* at 1214.

67. *Id.*

68. *Id.* at 1215.

69. *Id.* at 1216.

70. *Id.* at 1216–17.

71. Mulligan, *supra* note 2, at 1559–62.

72. *Id.* at 1562–63.

the public would be hesitant to use electronic communications systems if people's privacy could not be safeguarded, and this was one of the concerns that prompted Congress to pass ECPA in 1986.⁷³

Despite these intentions, however, the technical distinctions written into ECPA, particularly its Stored Communications Act ("SCA") provisions, have prevented this legislation from serving this goal satisfactorily. Although the SCA did provide e-mail some protection from the reach of the Third Party Doctrine, its language has been the source of much confusion as e-mail technology has grown more advanced. The next section of this note provides an overview of the structure of ECPA, which serves as a background for an explanation of why the SCA is problematic.

2. *Structure of ECPA*

ECPA is comprised of three statutes: the Wiretap Act at 18 U.S.C. §§ 2511–2522 (Title I), the Pen Register statute at 18 U.S.C. §§ 3121–3127, and the focus of this Note, the Stored Communications Act ("SCA"), at 18 U.S.C. §§ 2701–2711 (Title II).⁷⁴ The Wiretap Act and Pen Register statute apply to electronic communications that are traveling between users. These two acts give electronic communications similar protection to what letters and phone calls receive and prohibit the government from intercepting the content of electronic messages while the messages are in transit, although the Pen Register statute allows for the installation of certain devices in some instances to collect "non-content" data.⁷⁵ Most circuits read the Wiretap Act's text, specifically the word "intercepts"⁷⁶ that is included in the text, to make the statute applicable only to messages that are in transit from one user to another.⁷⁷ Under this theory, if a given message is not in the process of transmission, then it is subject to the protections of the SCA.⁷⁸

73. *Id.* at 1564–65.

74. *Id.* at 1565.

75. *Id.* at 1565–67.

76. 18 U.S.C. § 2511(1) (2006).

77. *A Thinly Veiled Request for Congressional Action on E-Mail Privacy: United States v. Councilman*, 19 HARV. J.L. & TECH. 211, 217–18 (2005).

78. *Id.* Though this is the majority view, the statute is ambiguous as applied to current technology and may be interpreted differently. This is because e-mail messages are temporarily copied and stored on servers as they make their way from one user to another. Therefore, if a message is en route to its final destination but is intercepted while it is in temporary storage on a server (as opposed to traveling between servers), the interception conceivably could be covered by the Stored Communications Act instead of the Wiretap Act because it technically is in storage. *See id.* at 216–17. This ambiguity is another example of the difficulties caused by ECPA's "language of pre-digital-age privacy protections." *Id.* at 217. For an example of how this conundrum has played out in court, see *United States v.*

The SCA, the section of ECPA that regulates communications that are “stored” as opposed to “in transit,” has proven particularly contentious because it mandates different levels of privacy protection based on how long e-mails have been stored on a server after reaching their destinations.⁷⁹ The statute is based on the ECS and RCS distinction, effectively “freezing into the law the understandings of computer network use as of 1986.”⁸⁰ Specifically, § 2703 requires that the government obtain a warrant in order to compel an ECS provider to disclose a particular user’s e-mails if those e-mails have been in temporary storage for 180 days or fewer.⁸¹ In order to obtain a warrant, the government must meet the “probable cause” standard;⁸² that is, the government must demonstrate to a judge that there are sufficient facts for a reasonable person to believe that a search of a specific place will turn up evidence of a crime.⁸³ However, if the government wishes to obtain e-mails that have been in temporary storage for over 180 days, or e-mails that are stored with an RCS provider, the standards the government must meet are lower.⁸⁴ Although the government may seek a search warrant,⁸⁵ it may also compel disclosure with a subpoena or a court order issued upon a showing of “specific and articulable facts”⁸⁶—a standard that is lower than the probable cause required for a warrant⁸⁷—along with prior notice to the subscriber under investigation.⁸⁸ However, prior notice can be delayed for 90 days if notification may produce an “adverse result”⁸⁹ that “jeopardiz[es] an investigation.”⁹⁰ Since any e-mails that a user downloads to his computer and removes from the server (by using a POP program, for example) are no

Councilman, 373 F.3d 197 (1st Cir. 2004), *rev’d on rehearing en banc*, 418 F.3d 67 (1st Cir. 2005), discussed *infra* Section I.D.4.

79. See Mulligan, *supra* note 2, at 1569; Oza, *supra* note 18, at 1044–46 (explaining through a hypothetical how the law creates different expectations of privacy based on storage time).

80. Kerr, *supra* note 4, at 1214.

81. 18 U.S.C. § 2703(a).

82. Fed. R. Crim. P. 41(d)(1).

83. *Search Warrants*, ELECTRONIC FRONTIER FOUNDATION, <https://ssd.eff.org/your-computer/govt/warrants> (last visited Feb. 25, 2012).

84. Kerr, *supra* note 4, at 1218.

85. 18 U.S.C. § 2703(b)(1)(A).

86. *Id.* § 2703(d).

87. Patricia L. Bella & Susan Freiwald, *Fourth Amendment Protection for Stored E-mail*, 2008 U. CHI. LEGAL F. 121, 128 (2008).

88. 18 U.S.C. § 2705 (1986).

89. *Id.* § 2705(a)(1)(B).

90. *Id.* § 2705(a)(2)(E).

longer stored by the server, these downloaded e-mails are subject not to the SCA but to typical Fourth Amendment protections.⁹¹

D. OVERVIEW OF ISSUES WITH THE SCA

Although the SCA—and ECPA as a whole—shielded email from the reach of the Third Party Doctrine to some extent, it raised an assortment of other issues that have compounded as e-mail technology has developed over time. Despite the seemingly clear-cut distinctions made by the statute, changes in e-mail technology and courts' differing statutory interpretations have rendered numerous provisions of the SCA ambiguous and the application of certain privacy standards questionable. Most of these issues relate to e-mail storage, an area that has changed greatly both in terms of technology and people's perceptions since the SCA was adopted.⁹² In evaluating a course of action after *Warshak*, legislators should be aware not only of the SCA's unconstitutionality, but also of the conflicts the SCA has fostered in practice so they can adequately resolve these areas of confusion.

1. *The 180 Day Distinction Mandates Different Levels of Privacy Protection Based on How Long an E-mail Has Been Stored on a Server*

Despite legislators' declared intentions to give e-mail the same protections afforded to letters and phone calls,⁹³ the 180 day distinction mandates a comparatively lower level of privacy protection for e-mails that have been stored for more than 180 days.⁹⁴ Specifically, the government must obtain a warrant under the "probable cause" standard in order to access e-mails that have been stored for 180 days or fewer, while the government need only satisfy the less-stringent "specific and articulable facts" standard required to obtain a subpoena in order to access e-mails that have been stored for more than 180 days.⁹⁵

The reasons Congress implemented this rule remain unclear.⁹⁶ Congress might have viewed any e-mails stored over 180 days as abandoned and

91. Kerr, *supra* note 4, at 1216–17.

92. See Oza, *supra* note 18, at 1045–46 (explaining how e-mail providers' expanded storage capabilities have prompted users to leave their e-mail stored on servers for longer periods of time).

93. See 1986 ECPA Hearings, *supra* note 42, at 2 (statement of Rep. Robert W. Kastenmeier, Chairman, S. Comm. on Courts, Civil Liberties, and the Administration of Justice) ("Congress needs to act to ensure that the new technological equivalents of telephone calls, telegrams, and mail are afforded the same protection provided to conventional communications.").

94. Oza, *supra* note 18, at 1057.

95. 18 U.S.C. §§ 2703(a)–(b); Oza, *supra* note 18, at 1056–57.

96. Bellia & Freiwald, *supra* note 87, at 161.

therefore less deserving of protection.⁹⁷ Furthermore, it is possible that, given the e-mail storage limitations in the 1980s, Congress did not foresee people keeping e-mail in storage for more than 180 days on a regular basis.⁹⁸

Regardless of the reason Congress implemented this rule, the distinction is not a practical one today. People now routinely keep their e-mails for more than 180 days, partly because e-mail providers have the ability to store large amounts of e-mail and make them searchable by users, which encourages a user to store her e-mail indefinitely.⁹⁹ In fact, these “dramatic developments” in e-mail providers’ storage capabilities and customers’ willingness to take advantage of these capabilities recently were cited in Congressional hearings as reasons why Congress needs to consider amending ECPA.¹⁰⁰ Considering these technological changes, e-mails that have been stored for more than 180 days now do not seem any less deserving of the protection provided by the “probable cause” standard, despite that fact that the statute makes this distinction.¹⁰¹

2. *Different Levels of Privacy Protection Depending on How Users Retrieve E-mails*

Under the SCA, e-mails are afforded different amounts of privacy protection based purely on how users choose to retrieve their e-mails.¹⁰² If a person uses a POP program, which downloads e-mails to the user’s computer and deletes them from the server upon retrieval,¹⁰³ these retrieved e-mails are out of the reach of the SCA since the statute only applies to service providers and the government must obtain a warrant in order to gain access to the e-mails, regardless of how long they have been stored because they only reside on the individual’s personal computer.¹⁰⁴ However, if a person uses an IMAP or web-based program, the e-mails remain on the server and therefore are subject to the SCA, including its 180 day

97. Kerr, *supra* note 4, at 1234; Oza, *supra* note 18, at 1045.

98. Bellia & Freiwald, *supra* note 87 at 162; Oza, *supra* note 18, at 1061 n.124.

99. *Electronic Communications Privacy Act Reform: Hearing Before the Subcomm. on the Constitution, Civil Rights, and Civil Liberties of the H. Comm. on the Judiciary*, 111th Cong. 10 (2010) [hereinafter *2010 ECPA Reform Hearing*] (prepared statement of James X. Dempsey, Vice President for Public Policy, Center for Democracy and Technology).

100. *The Electronic Communications Privacy Act: Government Perspectives on Protecting Privacy in the Digital Age: Hearing Before the S. Comm. on the Judiciary*, 112th Cong. 17 (2011) [hereinafter *2011 ECPA Hearing*] (statement of Sen. Coons).

101. Oza, *supra* note 18, at 1068–69.

102. *Id.* at 1054.

103. See *IMAP vs. POP: What’s the Difference?*, *supra* note 61.

104. See Oza, *supra* note 18, at 1059–61.

distinction.¹⁰⁵ Therefore, the level of protection for e-mails varies based on the type of program a person is using, with POP-retrieved e-mails generally remaining subject to the a warrant requirement and IMAP and web-based e-mails subject to the SCA's 180 day distinction.¹⁰⁶

This difference in treatment is significant for a number of reasons. First, IMAP programs generally are considered more advantageous than POP,¹⁰⁷ yet e-mails retrieved using POP receive greater privacy protection than e-mails retrieved with IMAP, potentially counseling against the adoption of the more technologically advanced IMAP standard by users concerned about their privacy. Furthermore, these results seem arbitrary when considered from the perspective of an e-mail sender, who cannot tell whether the recipient of her e-mail is using a POP, IMAP, or web-based program to retrieve e-mail.¹⁰⁸ It even is likely that the recipient is not aware of the type of e-mail retrieval program he is using, thereby making the SCA's distinction seem arbitrary and unjustifiable based on user habits.

3. *Conflicting Statutory Interpretations of "Electronic Storage"*

Further complicating the SCA's storage-based distinction is the conflicting statutory interpretations of the term "electronic storage."¹⁰⁹ The term is a key one in the SCA, since the statute allows for a cause of action against a person who has intentionally gained unauthorized access to an electronic communication when that communication "is in electronic storage."¹¹⁰ Although the statute defines the term "electronic storage" as "temporary, intermediate storage . . . incidental to . . . electronic transmission" or alternatively, "storage . . . for purposes of backup protection,"¹¹¹ the phrase's precise meaning in practice has proven contentious enough to cause a split in interpretation between the federal government and the Ninth Circuit.¹¹² Currently, the government advocates a definition of "electronic storage" that excludes e-mails people have accessed and the Ninth Circuit has held that the definition includes accessed e-mails.¹¹³

105. *Id.*

106. *Id.* at 1060–61.

107. *See IMAP vs. POP: What's the Difference?*, *supra* note 61.

108. *See Oza*, *supra* note 18, at 1051.

109. 18 U.S.C. §§ 2701(a)(1), 2707(a) (2006).

110. *Id.* § 2701(a).

111. *Id.* § 2510(17).

112. OFFICE OF LEGAL EDUCATION, SEARCHING AND SEIZING COMPUTERS 123 (2009), *available at* <http://www.cybercrime.gov/ssmanual/ssmanual2009.pdf>.

113. *Id.* at 123–25.

The origin of this interpretive split was *Theofel v. Farey-Jones*.¹¹⁴ The case arose during discovery in another case between the same parties. The defendant, Farey-Jones, requested that his lawyer subpoena the plaintiffs' ISP so the defendant could access the plaintiffs' e-mails.¹¹⁵ The lawyer drafted a subpoena that was overbroad in violation of the Federal Rules of Civil Procedure.¹¹⁶ However, the defendant was able to read the unlawfully subpoenaed e-mails before a magistrate judge struck down the subpoena.¹¹⁷ The plaintiffs then brought a suit against the defendant alleging, among other things, a violation of the Stored Communications Act.¹¹⁸

The case hinged on the court's statutory interpretation of the term "electronic storage." Defendants maintained that since the messages had been delivered to the intended recipients at the time the defendants accessed them, the e-mails had not been in "electronic storage" and therefore were outside the purview of the SCA.¹¹⁹ However, the court believed that there was "no dispute that messages remaining on NetGate's server after delivery [were] stored 'by an electronic communication service.'"¹²⁰ In contrast to other courts that had limited the "temporary, intermediate storage" classification to e-mails that had not yet been delivered, the *Theofel* court focused instead on whether the messages were stored as a form of "backup."¹²¹ The court concluded through a "plain language" reading of the Act that the ISP's copy of the message served as a "backup" for its subscriber and that, since "nothing in the Act requires that the backup protection be for the benefit of the ISP rather than the user[,] [s]torage under these circumstances thus literally falls within the statutory definition" of electronic storage.¹²² Accordingly, the court reversed the lower court's dismissal of the plaintiffs' SCA claim.¹²³

As a result, the Ninth Circuit construed the category of "electronic storage" in a wider fashion than did the government.¹²⁴ Currently, the Ninth Circuit includes previously accessed e-mail in its definition and thereby affords it the more stringent privacy protection afforded to e-mails in ECS,¹²⁵

114. 359 F.3d 1066 (9th Cir. 2003).

115. *Id.* at 1071.

116. *Id.* at 1071–72.

117. *Id.*

118. *Id.* at 1072.

119. *Id.* at 1075.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 1079.

124. OFFICE OF LEGAL EDUCATION, *supra* note 112.

125. *Id.* at 123–25.

while the government views electronic storage as “temporary storage made in the course of transmission by a service provider and . . . backups of such intermediate communications made by the service provider to ensure system integrity,”¹²⁶ which effectively excludes e-mail that has been accessed by recipients from electronic storage and relegates it to RCS categorization and its less-stringent protections.¹²⁷ The government’s guide to prosecutors seeking guidance on how to deal with such issues advises its readers that prosecutors outside the Ninth Circuit should apply the government’s “traditional interpretation,” while prosecutors within the Ninth Circuit should follow that court’s directives.¹²⁸ This interpretive split, therefore, has profound implications on e-mail security because it creates a significant difference in the amount of privacy protection e-mail users can expect solely based on their geographic locations.

4. *The “In Transit” and “In Storage” Distinctions*

Another significant area of controversy is the distinction between e-mails that are “in transit” and those that have reached their destinations and are “in storage.” This is an important distinction because if an e-mail is intercepted while in transit, the Wiretap Act applies, but an e-mail that is accessed while it is in storage falls under the SCA.¹²⁹ This distinction was at issue in *United States v. Councilman*,¹³⁰ in which Councilman, an ISP operator, was accused of violating the Wiretap Act by writing a program that copied subscribers’ incoming e-mails before the e-mails reached their destinations.¹³¹ A First Circuit panel took a strict textual approach when it looked at the statute and determined that the e-mails at issue were in storage, not transit, when they were copied by the program and therefore fell outside the act.¹³² Despite the fact that the e-mails had not yet reached their intended recipients, the court held that since the messages were within the computer system’s random access memory or hard disks, they had been in temporary storage when Councilman’s employees had accessed them.¹³³ The First Circuit, sitting en

126. *Id.* at 123.

127. *See Theofel*, 359 F.3d at 1077 (stating that the court, unlike the government, does not believe that a user’s having opened an e-mail necessarily relegates that message to storage); Mulligan, *supra* note 2, at 1569 (explaining the implications of the government’s interpretation).

128. OFFICE OF LEGAL EDUCATION, *supra* note 112.

129. *A Thinly Veiled Request for Congressional Action on E-Mail Privacy: United States v. Councilman*, *supra* note 77, at 217–18.

130. 373 F.3d 197 (1st Cir. 2004), *rev’d on rehearing en banc*, 418 F.3d 67 (1st Cir. 2005).

131. *Id.* at 199.

132. *Id.* at 203.

133. *Id.*

banc, then reversed this decision.¹³⁴ After examining the text and legislative history of the Wiretap Act, the court determined that “the term ‘electronic communication’ includes transient electronic storage that is intrinsic to the communication process for such communications.”¹³⁵ Accordingly, the e-mails in question were in transit when Councilman’s employees intercepted them, and Councilman could be prosecuted under the Wiretap Act.¹³⁶ The case demonstrates that even the technological distinctions that seem clear-cut within the SCA can be ambiguous and confusing when applied to technology in practice.

5. *The Internet Has Changed Since ECPA was Adopted in the 1980s*

As a twenty-six-year-old statute in an age of rapid technological change, one of the main sources of problems with ECPA, and the SCA in particular, is the outdated nature of the statute. The Internet itself, as well as the way people use and think about the Internet, has changed dramatically since ECPA was passed in 1986, rendering the original goals of the statute at odds with its current application.¹³⁷ The statute was created with business’ use of the Internet in mind and did not anticipate the personal use that characterizes the Internet today.¹³⁸ The transcripts of the House Judiciary Committee hearings on ECPA reflect this approach, as they contain scant mention of personal privacy issues that should inform a statute such as ECPA—witnesses instead focused on business-related issues such as teleconferencing, the need to protect trade secrets,¹³⁹ and companies’ desire for Congress to implement “clear standards” regarding when the government can access companies’ subscriber data.¹⁴⁰ Significantly, at the time of ECPA’s adoption, there had been very few cases of the government accessing e-mail accounts in the context of criminal investigations.¹⁴¹

134. *United States v. Councilman*, 418 F.3d 67, 84 (1st Cir. 2005) (en banc).

135. *Id.* at 79.

136. Councilman likely was concerned about whether the Wiretap Act or the SCA applied, not because of any differences in the punishment proscribed by the two acts, but because the government had only charged him with violating the Wiretap Act. Therefore, had the court held that Councilman’s actions fell outside the scope of the Wiretap Act, he could not be found guilty of that particular charge. *See Id.* at 69.

137. Mulligan, *supra* note 2, at 1559 (arguing that ECPA was designed for an Internet that was dominated by the business, not personal, uses at the time the statute was adopted and therefore needs to be revised).

138. *Id.* at 1597.

139. *1986 ECPA Hearings*, *supra* note 42, at 4 (statement of Sen. Patrick J. Leahy).

140. *Id.* at 21 (statement of Philip M. Walker, General Regulatory Counsel, GTE Telenet Inc., and Vice Chairman, Electronic Mail Association).

141. *Id.*

However, internet usage has changed dramatically since ECPA was enacted.¹⁴² Today, the Internet is not just a technology used by businesses. Instead, a substantial portion of internet usage is personal in nature. Individuals use the Internet to send personal e-mails, access cloud computing networks, and use social networking websites, among other activities.¹⁴³ This major societal shift suggests that ECPA must be revised so it can better protect individuals as they use the Internet for personal reasons.¹⁴⁴

Despite all these interpretative difficulties and the dynamic nature of technology, the statute has remained unchanged since its inception twenty-six years ago.¹⁴⁵ The *Warshak* case and its constitutional holding, however, may be the catalyst that prompts Congress to revisit the statute.

II. THE WARSHAK DECISION

The importance of *United States v. Warshak*¹⁴⁶ lies not just in its holding that the SCA is unconstitutional, but the manner in which the court approached the decision. Instead of focusing on the technological minutiae relating to e-mail storage set out in the SCA, the court reached its decision by analogizing e-mail to other forms of communication in order to determine the proper extent of protection.¹⁴⁷ In so doing, the court highlighted the best approach to amending the SCA: recognizing that e-mail is an important form of personal communication and affording it privacy protection on that basis, rather than on the basis of its complicated and dynamic underlying technology.

The SCA faced its first constitutional challenge in *Warshak*.¹⁴⁸ The plaintiff in this case, Steven Warshak, was the owner and president of Berkeley Premium Nutraceuticals, which produced a popular supplement called Enzyte. In 2006, Warshak and several of his associates were indicted for mail fraud, bank fraud, money laundering, and additional offenses related to their operation of the company.¹⁴⁹

142. 2010 ECPA Reform Hearing, *supra* note 99, at 1 (statement of Rep. Jerrold Nadler, Chairman, S. Comm. on the Constitution, Civil Rights, and Civil Liberties); Mulligan, *supra* note 2, at 1597.

143. 2010 ECPA Reform Hearing, *supra* note 99, at 1 (statement of Rep. Jerrold Nadler, Chairman, S. Comm. on the Constitution, Civil Rights, and Civil Liberties).

144. *Id.*; Mulligan, *supra* note 2, at 1597.

145. Oza, *supra* note 18, at 1045.

146. 631 F.3d 266 (6th Cir. 2010).

147. *Id.* at 285–86.

148. Susan Freiwald & Patricia L. Bellia, *The Fourth Amendment Status of Stored E-Mail: The Law Professors' Brief in Warshak v. United States*, 41 U.S.F. L. REV. 559, 559 (2007).

149. *Warshak*, 631 F.3d at 281.

The privacy issue in this case involved the way the government authorities investigating Warshak employed the SCA to obtain Warshak's e-mails. During its investigation, the government requested, pursuant to the SCA, that Warshak's ISP, NuVox, start preserving the e-mails Warshak sent and received.¹⁵⁰ NuVox complied, and after the ISP had stored the e-mails for several months, the government compelled NuVox to disclose them.¹⁵¹ Warshak did not find out that the government had compelled the disclosure of his e-mails until a year later.¹⁵² Warshak subsequently accused the government of violating his Fourth Amendment rights by obtaining his private e-mails without a warrant.¹⁵³

In 2010, the Sixth Circuit Court of Appeals held that the government violated Warshak's Fourth Amendment rights by forcing the disclosure of the e-mails without a warrant.¹⁵⁴ The court began its analysis by determining whether the government's actions constituted a "search" under the Fourth Amendment.¹⁵⁵ First, the court used the two-part inquiry from *Katz* to determine whether Warshak had a reasonable expectation of privacy in his emails.¹⁵⁶ Under this standard, the court considered a subjective element—whether Warshak had an expectation of privacy in his e-mails—and an objective element—whether society recognized an expectation of privacy in e-mails.¹⁵⁷ The court quickly determined that the "often sensitive and sometimes damning substance of his e-mails" clearly indicated that Warshak expected his e-mails to remain private since "people seldom unfurl their dirty laundry in plain view."¹⁵⁸

With the subjective element settled, the court moved on to the objective component of the test. The court began by examining the expectations of privacy that accompanied "traditional forms of communication" like letters and phone calls as set out in *Ex parte Jackson* and *Katz*.¹⁵⁹ Based in part on the holdings in these cases, the court determined that both forms of communication carried with them "a reasonable expectation of privacy" that the government would be held to violate if it recorded people's phone calls

150. *Id.* at 283.

151. *Id.*

152. *Id.*

153. *Id.* at 282.

154. *Id.* at 274.

155. *Id.* at 284.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 285.

or intercepted letters in transit without a warrant.¹⁶⁰ As a result, “[g]iven the fundamental similarities between e-mail and traditional forms of communication, it would defy common sense to afford e-mails lesser Fourth Amendment protection” than that afforded to phone calls and mail.¹⁶¹ In so holding, the court dismissed claims that the ability or right of a third party, such as an ISP, to access e-mail contents diminished a subscriber’s reasonable expectation of privacy.¹⁶² While the court did note that an ISP’s intention to “audit, inspect, and monitor” a subscriber’s e-mails as expressed within the context of a subscriber agreement may “render an expectation of privacy unreasonable,” there was no such language in Warshak’s agreement with NuVox.¹⁶³

Having determined that e-mail users, therefore, are afforded a reasonable expectation of privacy in the contents of their e-mails, the court held that since an “ISP is the functional equivalent of a post office or a telephone company” and that e-mail “is the technological scion of tangible mail,”¹⁶⁴ the government’s compelling an ISP to turn over a subscriber’s e-mails constitutes a search under the Fourth Amendment and therefore requires a warrant.¹⁶⁵ Since government agents did not procure a warrant prior to compelling NuVox to turn over Warshak’s e-mails, the agents’ actions violated Warshak’s Fourth Amendment rights.¹⁶⁶ Furthermore, the court ruled that “to the extent that the SCA purports to permit the government to obtain such e-mails warrantlessly, the SCA is unconstitutional.”¹⁶⁷ In so holding, the court stated that depriving e-mail “strong protection under the Fourth Amendment” would render the Fourth Amendment “an ineffective guardian of private communication, an essential purpose it has long been recognized to serve.”¹⁶⁸

The court’s decision carries with it a number of highly significant implications. First, the court declared that the SCA was unconstitutional on its face, not just unconstitutional as applied to Warshak’s case.¹⁶⁹ This aspect of the decision is crucial, since it makes the holding much broader and renders the decision more threatening to the continued existence of the SCA

160. *Id.*

161. *Id.* at 285–86.

162. *Id.* at 286–87.

163. *Id.* at 287.

164. *Id.* at 286.

165. *Id.*

166. *Id.* at 288.

167. *Id.*

168. *Id.* at 286.

169. *Id.* at 288.

as it currently stands.¹⁷⁰ Second, the court's constitutional analysis was not based purely on existing case law such as *Ex parte Jackson* and *Katz*, nor did it rely on any of the technological distinctions written into the SCA, such as those between ECS and RCS. Instead, the court arrived at its conclusion by comparing e-mail to its more traditional communicative counterparts and giving great credence to its important societal role as a communications medium.¹⁷¹ This reasoning is important because it provides a guideline for legislators in amending the law; namely, by focusing on the overall role and functionality of e-mail rather than technological distinctions that could make any amendment quickly outdated or more difficult to apply. The next Part contains a comprehensive analysis of the problems with the SCA and applies the reasoning in *Warshak* to suggest possible amendments to the SCA.

III. AMENDING THE SCA

Now that the *Warshak* court has declared the SCA unconstitutional, it is time to reevaluate the current e-mail privacy protection scheme. *Warshak* is particularly instructive in this regard. Not only did the court declare the SCA unconstitutional,¹⁷² perhaps providing the catalyst needed to encourage Congress to amend the law, but it also set out the best framework for evaluating how to amend the SCA—namely, by focusing on e-mail's role as a communications medium rather than focusing on its underlying technology. However, amending the SCA will be a complicated process due to all the competing interests that must be considered in order for the resulting statute to serve its purpose adequately. This Part presents different factors that Congress should take into account when considering how to amend or replace the SCA in light of the issues discussed above and offers recommendations about how the law should be amended. This Part then analyzes why a legislative, not judicial, approach is the most efficient and effective way to solve these privacy protection issues.

A. ISSUES AND PROPOSED SOLUTIONS

1. Issue: *The Public's Reasonable Expectation of Privacy in E-mail*

The court's reasoning in *Warshak* is important because it may indicate how the public thinks about e-mail, which in turn helps determine the extent of privacy protection e-mail should receive under the Fourth Amendment.

170. In contrast, an "as applied" ruling only applicable to Warshak's case would make the holding more limited (i.e. applying only to cases similar to *Warshak*) and less of a challenge to the statute itself.

171. *Warshak*, 631 F.3d at 286.

172. *Id.* at 288.

According to the test laid out in *Katz*, the Fourth Amendment provides protection to a form of communication when a person has a subjective expectation of privacy and society has an objective interest in privacy in a given communication.¹⁷³ Therefore, what individuals and society as a whole think about e-mail is important in determining the extent of privacy protection it receives.

The *Warshak* court's analysis may be indicative of the way the public thinks about e-mail today and thus is important in determining the scope of privacy protection for e-mail. Rather than focusing on the technical minutiae of how an e-mail winds its way from one user's inbox to another and making its decision based solely on these technicalities, the court emphasized "the fundamental similarities between e-mail and traditional forms of communication," like letters and telephone calls.¹⁷⁴ This analogy served as the basis for the court's ruling that e-mail should be afforded the same protection letters and phone calls receive; namely, that the government should have to obtain a warrant before searching an individual's e-mail.¹⁷⁵ Since this view is less technologically-based and more focused on e-mail's role as a communications service, it is more likely that this view represents the public perception of e-mail, since regardless of any competing public views of how e-mail technology works, the public is likely to think of e-mail primarily as a mode of communication.

The *Warshak* court is not alone in its reasoning, as some scholars have favored an approach that eschews the technical distinctions of the SCA in favor of viewing e-mail as a communications medium and extending Fourth Amendment protections to it accordingly.¹⁷⁶ Since these proposals correspond to the public's likely conception of e-mail as primarily a mode of communication, these views are instructive as to how the public thinks about e-mail and, accordingly, its expectation of privacy in e-mail. For example, Professors Patricia L. Bellia and Susan Freiwald believe that stored e-mail should receive the same Fourth Amendment protection afforded to phone calls and letters because e-mail has replaced these more traditional channels of communication.¹⁷⁷ According to Bellia and Freiwald, e-mail is "at least as important as the telephone" in modern communication and contains the same private information as telephone calls, thereby rendering government

173. *Katz v. United States*, 389 U.S. 347, 361 (1967) (Harlan, J., concurring); *Oza*, *supra* note 18, at 1049–50.

174. *Warshak*, 631 F.3d at 285–86.

175. *Id.* at 286.

176. *See* Bellia & Freiwald, *supra* note 87, at 138; Mulligan, *supra* note 2, at 1579.

177. Bellia & Freiwald, *supra* note 87, at 138.

searches of private e-mail accounts “at least as intrusive as surveillance of other forms of communication.”¹⁷⁸ Stored e-mails, in particular, contain much of this private information and therefore are deserving of full Fourth Amendment protection, instead of the limited protection the SCA currently provides.¹⁷⁹ Professor Mulligan also advocates for more stringent Fourth Amendment protection based on technological displacement, arguing since “e-mail is a replacement for telephone communications as well as postal mail,” it should receive protection similar to that afforded to the other two mediums.¹⁸⁰

Both the *Warshak* opinion and these scholarly proposals illustrate the extent to which e-mail is considered a communications medium in the public eye. Since the public most likely considers e-mail to be a mode of communication and holds a corresponding expectation of privacy in e-mail, e-mail should be protected to the same extent as other forms of communication, rather than being subjected to lesser protection based purely on its storage capabilities, as it currently is under the SCA. Given the constitutional implications of this public perception, Congress needs to keep this perspective in mind when drafting an amended SCA.

a) Solution: A Statute that Corresponds to the Public’s Understanding and Expectations of Privacy

The provisions in the SCA relating to e-mail storage—namely, the 180 day provision and the distinctions the statute makes between ECS and RCS storage—should be eliminated. The bases for these distinctions are outdated and largely irrelevant today¹⁸¹; accordingly, they do not correlate to the public’s understanding of e-mail technology and almost certainly do not figure into the average person’s expectation of privacy in his e-mail account. A statute that eliminates the differing levels of protection for e-mails based on storage type and time and gives e-mail the same protection afforded to phone calls and letters more directly corresponds to the public’s expectation of privacy and understanding of the nature of e-mail communication.

2. *Issue: Maintaining the Privacy Protection-Law Enforcement Balance*

One of legislators’ foremost intentions in passing ECPA involved striking a balance between protecting people’s privacy and allowing the

178. *Id.*

179. *Id.*

180. Mulligan, *supra* note 2, at 1579.

181. *See* Oza, *supra* note 18, at 1045–46 (explaining that at the time the SCA was adopted, the government reasonably could infer that e-mails left on the server after 180 days were abandoned, but that such an inference would not be warranted today).

government reasonable access to communications for law enforcement purposes, and this goal must be kept in mind today.¹⁸² Recently, legislators have acknowledged that “[r]eplicating [this] balance will be the key to any possibility of being successful on proposed legislation” intended to amend ECPA.¹⁸³ On the law enforcement side, the Department of Justice believes that “ECPA has never been more important than it is now” since “criminals, terrorists, and spies” are using more advanced technologies to carry out their plans.¹⁸⁴ On the other hand, legislators recognize that the recent developments such as cloud computing programs and social networking websites require Congress to formulate clear privacy protections in order to safeguard individuals’ personal information and communications in order to promote the growth of these technology-based businesses.¹⁸⁵

a) Solution: E-mail Protections That Place No Greater Burden on Law Enforcement

E-mail should receive the same extent of protection afforded to phone calls and letters. Under an SCA amended pursuant to this Note’s proposal, law enforcement officials who wish to access e-mail from an individual’s account will have to obtain a warrant, regardless of how long the e-mail has been in storage. Although this modification makes it more difficult for law enforcement to obtain e-mails more than 180 days old, it does not afford e-mail any protection greater than that which is deemed appropriate for other functionally similar forms of communication. Indeed, even the Department of Justice recognizes that the 180 day distinction in particular is in need of revisiting and has expressed its willingness to work with legislators in

182. *2011 ECPA Hearing, supra* note 100, at 3 (statement of Sen. Chuck Grassley) (stating that ECPA is “a carefully crafted compromise” that strikes “a balance then between privacy and law enforcement”); *2010 ECPA Reform Hearing, supra* note 99, at 2 (statement of Rep. Jerrold Nadler, Chairman, S. Comm. on the Constitution, Civil Rights, and Civil Liberties) (“[W]e must consider whether ECPA still strikes the right balance between the interests and needs of law enforcement and the privacy interests of the American people.”); 132 CONG. REC. S7991 (daily ed. June 19, 1986) (statement of Sen. Leahy) (“These provisions are designed to protect legitimate law enforcement needs while minimizing intrusions on privacy of system users as well as the business needs of electronic communications system providers.”).

183. *2011 ECPA Hearing, supra* note 100, at 3 (statement of Sen. Chuck Grassley).

184. *Id.* at 5 (statement of James A. Baker, Associate Deputy Att’y Gen., U.S. Dept. of Justice).

185. *Id.* at 14 (statement of Sen. Al Franken) (“[Companies] are losing business because they cannot definitively tell their prospective clients when and how the Government will access their information. Because of this uncertainty, people are not deciding to put their documents on the cloud.”).

addressing this specific provision,¹⁸⁶ thereby suggesting that law enforcement may be amenable to such as solution.

Furthermore, the proposed revisions to the SCA do not interfere with the Third Party Doctrine. While the doctrine as a whole is controversial,¹⁸⁷ eliminating the doctrine entirely likely would allow criminals to use third parties to hide their illegal activity because law enforcement would have to obtain a warrant before gathering evidence about any criminal activity.¹⁸⁸ Therefore, instead of advocating for the wholesale elimination or revision of this doctrine, e-mail should be afforded the same amount of protection as the phone calls and letters to which it is analogous.¹⁸⁹

3. Issue: Applicability to Future Technology

Congress should also consider whether it wants to amend the SCA so it is a technology-specific or technology-neutral law. Congress could adopt a technology-specific statute tailored to the current state of e-mail as we know it, or adopt a more general, technology-neutral statute focused on the communicative role of e-mail, which would result in a statute flexible enough to apply to variations on this current technology. Despite the fact that a technology-specific statute might better address the “subtlety and nuance” of e-mail technology,¹⁹⁰ a technology-neutral statute may prove more enduring and efficient. As explained in Section I.D, *supra*, the SCA’s technological distinctions and definitions have led to significant confusion in interpreting the statute as technology has progressed. This history suggests that legislators charged with revising or replacing the SCA should not tie the language of the Act so strongly to the current state of e-mail infrastructure that the law cannot be adapted to encompass new forms of e-mail and communications technology without substantial legislative revisions. In other words, Congress should strongly consider removing many of the technology-specific

186. *Id.* at 12 (statement of James A. Baker, Associate Deputy Att’y Gen., U.S. Dept. of Justice).

187. See generally Erin Murphy, *The Case Against the Case for Third-Party Doctrine: A Response to Epstein and Kerr*, 24 BERKELEY TECH. L.J. 1239 (2009) (summarizing and evaluating critiques of the Third Party Doctrine).

188. For example, a person could order third parties to commit a crime on his behalf “knowing that the police could not send in undercover agents, record the fact of his phone calls, or watch any aspect of his internet usage without first obtaining a warrant.” A world without a Third Party Doctrine, then, would allow criminals to hide their activities more easily. Orin S. Kerr, *The Case for the Third Party Doctrine*, 107 MICH. L. REV. 561, 576 (2009).

189. *United States v. Warshak*, 631 F.3d 266, 286 (6th Cir. 2010).

190. Paul Ohm, *The Argument Against Technology-Neutral Surveillance Laws*, 88 TEX. L. REV. 1685, 1696 (2010).

provisions from the SCA and instead adopt a technology-neutral statute that could be adapted more easily and efficiently to emerging technologies.

Some scholars believe Congress should adopt technology-specific legislation across the board. Professor Paul Ohm, for example, has highlighted what he believes are a number of advantages of technology-specific laws.¹⁹¹ He believes that technology-specific surveillance laws in particular force Congress to re-evaluate these statutes on a more regular basis due to continuous technological advancements.¹⁹² This in turn increases Congress's role in determining the extent of surveillance and, accordingly, makes surveillance law subject to "more participatory democratic oversight."¹⁹³ He further claims technology-neutral laws may risk being overinclusive if they are applied to new technologies that were not included in the deliberation and research that helped formulate the statute at its time of adoption.¹⁹⁴ The solution he suggests is that Congress should not pass legislation regarding a particular technology until Congress has taken the time to understand that particular technology so as to "tailor" laws that are appropriate for that technology.¹⁹⁵

The legislative history of ECPA, however, shows that a technology-specific approach to e-mail privacy protection would be impractical. Specifically, it shows that, even when Congress knows that it needs to amend a particular statute, the logistics behind drafting or amending a law are onerous and lengthy. For example, the House Judiciary Committee has been holding hearings about amending ECPA since 2010,¹⁹⁶ yet no solution has been reached. Given this legislative history, the more practical option would be to forgo the potentially substantial period that would be required to pass a technology-specific law under Professor Ohm's approach and instead pass a technology-neutral law that regulates e-mail based on its overall communicative function and could be applied regardless of changes in its underlying technology.

a) Solution: Technological Neutrality Accounts for Future Innovation

The SCA, as it currently stands, is an example of how detailed technological distinctions, such as the SCA's storage-based provisions, can

191. See generally Paul Ohm, *The Argument Against Technology-Neutral Surveillance Laws*, 88 TEX. L. REV. 1685 (2010) (describing the benefits of technologically-specific laws).

192. *Id.* at 1686.

193. *Id.*

194. *Id.* at 1697–98.

195. *Id.* at 1695.

196. 2010 ECPA Reform Hearing, *supra* note 99, at 2.

make a law outdated and difficult to apply in a relatively short amount of time.¹⁹⁷ Therefore, Congress should amend the SCA by removing these technology-based distinctions and revising the statute so as to make it technology-neutral. The law often lags behind technology,¹⁹⁸ so a less-specific law that focuses more on a medium's overall function than details likely will guarantee a longer life for the legislation.

B. THE IMPORTANCE OF A LEGISLATIVE SOLUTION

Notwithstanding the logistical difficulties inherent in adopting a legislative amendment to the SCA, a solution in the form of a statute is preferable to relying on judicial interpretation to provide a clear solution. As discussed above, judicial interpretation of the SCA already has led to a circuit split regarding the definition of "electronic storage."¹⁹⁹ The *Warshak* decision only adds to this confusion, as the court's determination that the SCA is unconstitutional currently is law only within the Sixth Circuit.²⁰⁰ Adding to this unevenness is the fact that some courts may be less willing to take on these determinations than others: some, like the *Quon* court, may prefer to wait until the role of a particular technology has solidified,²⁰¹ while others, like the *Warshak* court, may be ready to make significant constitutional interpretations about the law.²⁰² As a result, individuals' privacy protections currently vary from jurisdiction to jurisdiction and more variation could occur in the future. The most effective way to remedy this disparity is for Congress to adopt a statute that resolves these conflicts on a national level rather than to allow courts to make their own, likely conflicting, determinations.

IV. CONCLUSION

Although *Warshak* is currently only the law within the Sixth Circuit, the decision is a significant one and may spell the end of the SCA as we know it. In amending the statute, legislators will have to address a number of interrelated considerations, including public opinion related to e-mail and the balance between law enforcement needs and the public's desire for privacy in

197. See *supra* Section I.D.

198. See *Berger v. State of New York*, 388 U.S. 41, 49 (1967) ("The law, though jealous of individual privacy, has not kept pace with these advances in scientific knowledge.").

199. See *supra* Section I.D.3.

200. 2011 *ECPA Hearing*, *supra* note 100, at 58 (statement of Cameron F. Kerry, General Counsel, U.S. Dept. of Commerce).

201. *City of Ontario v. Quon*, 130 S. Ct. 2619, 2629 (2010).

202. *United States v. Warshak*, 631 F.3d 266, 288 (6th Cir. 2010).

communications. However, by following the spirit of *Warshak* and enacting a statute that correlates to the public's use and conceptions of e-mail, rather than one that is based on the underlying technology, Congress should be able to pass a new law that will regulate e-mail privacy effectively for years to come.

USING SOCIAL NETWORKING TO DISCUSS WORK: NLRB PROTECTION FOR DEROGATORY EMPLOYEE SPEECH AND CONCERTED ACTIVITY

Ariana C. Green[†]

Today's labor lawyers and judges struggle with how to apply 1930s laws to social networking cases. In particular, the "concerted activity" standard has been part of the National Labor Relations Act ("NLRA")¹ since 1935, but using it to assess online activity has led to inconsistent outcomes.² The 800 million active users on Facebook,³ about one-fifth of whom reside in the United States,⁴ engage in more than just friendly banter and picture posting. Along with Twitter,⁵ which has 100 million active monthly visitors,⁶ and other similar sites, Facebook has become a forum where employees complain about work and respond to colleagues' complaints.⁷ Yet most employees do not realize that the particular words they use in a late-night casual comment

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1. National Labor Relations Act, 29 U.S.C. §§ 151–169 (2006).

2. *Compare* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees) *with* Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011) (finding no protection for an employee whose post complained about a manager but did not explicitly ask Facebook friends, many of whom were colleagues, whether or not they agreed with his position).

3. *Facebook Fact Sheet*, FACEBOOK NEWSROOM, <http://newsroom.fb.com/content/default.aspx?NewsAreaId=22> (last visited Feb. 5, 2012). Facebook is a social networking service that allows users to share pictures, information, links, and messages through individually created profiles. It further allows users to join groups and networks, and to express their preferences through the "like" button and by writing comments in response to posts, links, and photos.

4. *Id.*

5. *The fastest, simplest way to stay close to everything you care about*, ABOUT TWITTER, <http://twitter.com/about> (last visited Feb. 5, 2012). Twitter allows users to write and read "tweets," which are posts consisting of up to 140 characters. It facilitates online social networking and micro-blogging.

6. Elizabeth Gannes, *Twitter Finally Discloses How Many Active Users it Has*, ALL THINGS D (Sept. 8, 2011, 9:35 AM), <http://allthingsd.com/20110908/twitter-finally-discloses-how-many-active-users-it-has-100m>.

7. *See* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees).

about an employer may determine whether or not their post⁸ results in a lawful firing, depending upon whether it is found to be “concerted.”⁹

The NLRA gives workers the right to engage in concerted activity,¹⁰ which means that an employer cannot fire an employee solely because she discusses topics such as management or salary with fellow employees, even in a public forum.¹¹ The concerted activity protection also applies when two or more employees act together to change the “terms and conditions” of the group’s employment, or when a single employee brings complaints on behalf of a group.¹² Instances of this protected concerted activity are apt to occur on social media sites.¹³ However, upon accepting a job, an employee likely will not receive a packet notifying her of her right to engage in concerted activity.¹⁴ Indeed, the NLRA has been described as “the best-kept secret in labor law.”¹⁵

In August 2011, the National Labor Relations Board (“NLRB” or “the Board”) mandated that employers post notices about the existence of the NLRA,¹⁶ but the potential efficacy of this mandate remains unclear, because the NLRB postponed the effective date of implementation to April 30,

8. The types of posts on Facebook and Twitter that this note discusses involve users writing original content expressing their views on particular matters, people, or events. Depending on the privacy settings a user selects, the posts could be viewed by a subset of Facebook ‘friends’ or Twitter subscribers, or by all Facebook users or anyone who views a user’s Twitter profile.

9. Memorandum from the Office of the General Counsel of the NLRB, Report of the Acting General Counsel Concerning Social Media Cases (Aug. 18, 2011) [hereinafter General Counsel 2011 Memorandum].

10. The National Labor Relations Act, 29 U.S.C. § 157 (2006).

11. *Employee Rights*, NAT’L LABOR RELATIONS BD., <https://www.nlr.gov/rights-we-protect/employee-rights> (last visited Feb. 5, 2012). If the employee were to act alone in disparaging an employer, she may lose the act’s protection, depending on the extent of her criticism and whether other protections, such as free speech protections, applied in the particular scenario.

12. *Id.*

13. *See, e.g.*, Memorandum from the Office of the General Counsel of the NLRB, Report of the Acting General Counsel Concerning Social Media Cases (Jan. 24, 2012) [hereinafter General Counsel 2012 Memorandum]; General Counsel 2011 Memorandum, *supra* note 9.

14. *See* William R. Corbett, *Waiting for the Labor Law of the Twenty-First Century Waiting for the Labor Law of the Twenty-First Century: Everything Old Is New Again*, 23 BERKELEY J. EMP. & LAB. L. 259, 297–98 (2002).

15. *Id.* at 267.

16. Press Release, NLRB, Board Issues Final Rule to Require Posting of NLRA Rights (Aug. 25, 2011), *available at* <https://www.nlr.gov/news/board-issues-final-rule-require-posting-nlra-rights>.

2012.¹⁷ In the meantime, the ninety-three percent of employees who are not affiliated with a union¹⁸ may not know about these rights¹⁹ or the parameters of what types of statements could get them fired with no legal recourse. Since voicing workplace gripes at union meetings is no longer an option for most people, employees may want to share their grievances online through social networking,²⁰ but rightfully may worry about retaliation. Using social networking websites both shares the posts and maintains them, providing employers with a potentially incriminating record that is often unavailable with in-person conversations.²¹ Further, limited NLRB legal precedent leaves questions unanswered; determining whether a social media post involves concerted activity has become a challenge for the lawyers at the NLRB, which administers the NLRA and adjudicates unfair labor practice cases brought by its General Counsel.²²

17. *Employee Rights Notice Posting*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/poster> (last visited Feb. 5, 2012) (“[As of April 30, 2012] the notice should be posted in a conspicuous place, where other notifications of workplace rights and employer rules and policies are posted. Employers also should publish a link to the notice on an internal or external website if other personnel policies or workplace notices are posted there.”); Arthur T. Carter et al., *Update: NLRB Delays Notice Posting Rule’s Effective Date*, HAYNES & BOONE’S NEWSROOM (Dec. 28, 2011), http://www.haynesboone.com/nlr_delays_notice_posting_rule (noting that this postponement is a response to litigation; various parties are challenging the notice requirements).

18. Jeffrey M. Hirsch, *Making Globalism Work for Employees*, 54 ST. LOUIS U. L.J. 427, 430 (2010) (noting that “among the sharpest drops in union density is in the United States, where private sector union membership declined from 21.7% in 1977 to 7.2% in 2009”).

19. Press Release, American Rights at Work, Statement on Rule to Improve Awareness of NLRA Workplace Rights (Aug. 25, 2011), *available at* <http://www.americanrightsatwork.org/press-center/2011-press-releases/statement-on-rule-to-improve-awareness-of-nlra-workplace-rights-20110825-1036-416.html>. (quoting Kimberly Freeman Brown, Executive Director of American Rights at Work, as stating that “[s]tudies show that many employees are unaware of their rights under the NLRA, which protects union and non-union workers. Employers, even those who strive to act lawfully, are similarly uninformed”).

20. Michael J. Eastman, *A Survey of Social Media Issues Before the NLRB*, LABOR, IMMIGRATION & EMPLOYEE BENEFITS DIVISION, U.S. CHAMBER OF COMMERCE 1 (Aug. 5, 2011), <http://www.uschamber.com/sites/default/files/reports/NLRB%20Social%20Media%20Survey.pdf> (noting that as of Aug. 5, 2011, the U.S. Chamber of Commerce survey of publicly available materials found that the NLRB has reviewed more than 129 cases in some way involving social media).

21. *How to Post and Share*, FACEBOOK, <https://www.facebook.com/help/?page=12512004234100> (last visited Feb. 5, 2012).

22. Telephone interview with Lafe Solomon, Acting General Counsel of the NLRB (Oct. 14, 2011); *see* General Counsel 2011 Memorandum, *supra* note 9; Memorandum from the Office of the General Counsel of the NLRB, Report of the Acting General Counsel Concerning Social Media Cases (Jan. 24, 2012) (showing that the NLRB’s Acting General Counsel continues to issue Memos devoted to the subject of social media).

Recent cases highlight the problems that emerge from an over-reliance on the traditional concerted activity standard. Under these cases, if an employee solicits feedback from colleagues who are her Facebook friends and asks them to join her in some sort of work conditions-related protest, she is much more likely to get to keep her job if it is proven that the termination was in retaliation to the feedback-soliciting post.²³ If she does not explicitly talk about work conditions or directly ask for support, her case is weaker.²⁴ And if an employee's Facebook friends express their shared sentiment instead of just their sympathy in comments, the employee who posted will have a considerably better case for retaliatory firing.²⁵ Apparently, minor variations in language used in a post can have profound consequences.

The casual nature of Facebook posting²⁶ calls into question this approach. Sometimes, people who post simply sympathetic comments in response to a colleague's post may agree that action should be taken and may be willing to help, but may not make that clear with their off-the-cuff online responses. Yet, under the current legal approach, an employee's employment status can hinge on the particular words chosen for spontaneous Facebook posts and follow-up comments.²⁷ Compounding the problem, when NLRB Field Examiners²⁸ investigate cases involving Facebook posts, they

23. *Compare* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees) *with* Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011) (finding no protection for an employee whose post complained about a manager but did not explicitly ask Facebook friends, many of whom were colleagues, whether or not they agreed with his position).

24. *Compare* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 *with* Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503.

25. *Compare* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 *with* Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503. The NLRA concerted activity standard requires that a group of more than one person holds a particular belief in order for an individual who expresses her views to get protection under the Act. For this reason, the details of online responses become central to determinations of wrongful firing.

26. *See, e.g.*, Azedah Aalai, *Think Before You Post: The Perils of Online Intimacy*, PSYCHOLOGY TODAY (Sept. 11, 2011), <http://www.psychologytoday.com/blog/the-first-impression/201109/think-you-post>.

27. *Compare* Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 *with* Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503.

28. *Field Attorney and Field Examiner Positions*, Office of the General Counsel, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/who-we-are/careers/job-descriptions-and-listings/field-attorney-and-field-examiner-positions-office> (last visited Feb. 5, 2012) (explaining that "field examiners act on behalf of the General Counsel by investigating charges of unfair labor practices, recommending appropriate actions or remedies, conducting elections to determine union representation preferences, and acting as hearing officers in contested representation matters").

sometimes miss the context and underlying intent of online comments.²⁹ Context may be easier to determine in offline conversations, where people can respond to each other's comments in real time and where the precise words used constitute just one part of the interaction; much is conveyed through in-person contact and people's recollections of the tenor of a conversation.³⁰ Failing to recognize the differences between online and offline communications has created discordant legal rulings.³¹

In enforcing the NLRA and adjudicating cases involving unfair labor practices, lawyers, judges, and the Board at the NLRB have the power to shape social media policies related to employment situations.³² If no settlement is reached in a meritorious case, attorneys at the NLRB's regional offices bring cases on behalf of employees viewed as unlawfully terminated.³³ If the parties do not settle at the next stage, a case may go to an Administrative Law Judge, and then to several members of the Board on appeal.³⁴ Finally, certain cases will enter the court system on further appeal to a circuit court and then possibly to the Supreme Court.³⁵

The NLRB's Acting General Counsel has said that he endeavors to promote unified legal precedent in this area and has instructed that social

29. See, e.g., JT's Porch Saloon & Eatery, NLRB Adv. Mem., Case No. 13-CA-46689 (Jul. 7, 2011); Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011). These cases will be discussed in Section III.C.3, *supra*, and it will be argued that the context of what led to the posts was overlooked, costing the employees protection under Section 7.

30. ARVID KAPPAS & NICOLE C. KRAMER, FACE-TO-FACE COMMUNICATION OVER THE INTERNET: EMOTIONS IN A WEB OF CULTURE, LANGUAGE, AND TECHNOLOGY 18 (2011) (noting that "many theorists claim that more communication cues are better—that the ability to convey nonverbal communication cues allows communicators to appreciate each other interpersonally and facilitates understanding their messages, or both").

31. Compare Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees) with Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011) (finding no protection for an employee whose post complained about a manager but did not explicitly ask Facebook friends, many of whom were colleagues, whether or not they agreed with his position).

32. Paul Shukovsky, *Employers Must Recognize Federal Labor Act As Source of Social Media Policies Litigation*, 10 PRIVACY & SECURITY LAW REPORT 1629 (Nov. 14, 2011) (citing union attorney Barbara Camens, of Barr & Camens, as saying that the NLRA "is rapidly shaping up to be the biggest source . . . of litigation and legal risk with regard to social media policies").

33. *Investigate Charges*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/what-we-do/investigate-charges> (last visited Feb. 5, 2012).

34. *Id.*

35. OFFICE OF THE EXECUTIVE SECRETARY, GUIDE TO BOARD PROCEDURES, TENTATIVE DRAFT, 55–56 (Dec. 10, 2010).

media cases be brought to his attention.³⁶ His office writes Advice Memos that guide the attorneys in the regional offices as to whether to take a case and how to proceed.³⁷ The General Counsel has issued—and plans to continue to issue—periodic reviews of these social media cases, which further elucidate his office’s views on the contours of the NLRA in the digital space.³⁸ Even though social media cases present novel fact patterns due to the evolving nature of the platforms and social norms, for the most part, the General Counsel has applied existing labor law standards to social media cases, instead of modifying standards to take into account the way in which people use social media.³⁹

This Note considers twelve recent cases before the NLRB involving social media in the workplace. These twelve cases were among the fourteen⁴⁰ cases discussed in the General Counsel’s summer 2011 Social Media Memorandum (“the Memo”), which marked the first time the General Counsel devoted a review memo to social media cases.⁴¹ The cases shed light on what kinds of employee social media behavior receive protection and what kinds of social media policies pass muster with the General Counsel’s office.⁴² Because the Board has not drafted—and likely will not draft⁴³—social media-specific rules, these cases provide important insight into the

36. General Counsel 2012 Memorandum, *supra* note 13. See Memorandum from the Office of the General Counsel of the NLRB, Mandatory Submissions to Advice 11-11 (Apr. 12, 2011), available at <http://mynlrb.nlr.gov/link/document.aspx/09031d458047021e>.

37. *General Counsel Memos*, NAT’L LABOR RELATIONS BD., <https://www.nlr.gov/publications/general-counsel-memos> (last visited Feb. 5, 2012). The Advice Memoranda are addressed to NLRB Region Directors concerning a pending unfair labor practice charge in their specific Region and are binding upon the Region but not upon the NLRB or its ALJs.

38. General Counsel 2012 Memorandum, *supra* note 13.

39. See General Counsel 2012 Memorandum, *supra* note 13; General Counsel 2011 Memorandum, *supra* note 9; Robert Sprague, *Facebook Meets the NLRB: Employee Online Communications and Unfair Labor Practices*, 55 U. PENN. J. BUS. L. (forthcoming 2012), available at <http://ssrn.com/abstract=1982717> (noting that “the fact that employees are using Facebook and other social media tools to discuss work does not alter the basic analysis of what does and does not constitute protected concerted activity”).

40. This Note does not consider a case about a union posting an interrogation video on YouTube or a case about whether or not to allow employees media access. These cases presented issues less relevant to the scope of the undertaken analysis.

41. General Counsel 2012 Memorandum, *supra* note 13.

42. See General Counsel 2011 Memorandum, *supra* note 9.

43. Telephone interview with Lafe Solomon, Acting General Counsel of the NLRB (Jan. 24, 2011) (“[N]either the General Counsel nor the Board issues advisory opinions. Only the Board can do rulemaking, but it does this infrequently. The two rules the Board has issued since the 1980s—rules around elections and notice postings—have led to controversy.”).

General Counsel's nascent views on social media cases.⁴⁴ They also highlight potential inconsistencies with the current approach used by the General Counsel and provide a basis for critique and recommendations.

Part I of this Note summarizes how the NLRB operates, providing a glimpse into its structure, history, and functions. Part II addresses the ways that social media has become relevant to employers and employees. It discusses the challenge of regulating a fast-changing online space that fosters diverse attitudes and usages. It describes the predicament in which employers find themselves—trying to protect their brand and organizational integrity while striving to comply with laws that empower employees to communicate collectively concerning terms and conditions of employment. Many employers also believe that social media provides powerful tools for employers to keep employees informed and in contact.⁴⁵ Employees may even use social media to promote an employer's goods or service.⁴⁶ Meanwhile, employees hoping to keep their jobs in a bad economy may feel pressured to stay silent on issues that they may legally discuss, both offline and online. Without proper guidance from the NLRB General Counsel, employers and employees will continue to operate in an environment of uncertainty. Part III provides a framework for the case analysis and discusses the legal standards used to decide the Memo's social media cases, analyzing how the General Counsel applies the standards to the Memo's cases. Part IV offers recommendations about how to improve consistency among social media rulings.

44. See General Counsel 2011 Memorandum, *supra* note 9; Steven K. Ury, *Working with Social Networks: The Intersection of Labor Law and Ethical Issues Raised by Social Networking* 4–5, 5TH ANNUAL LABOR AND EMPLOYMENT LAW CONFERENCE (Nov. 2–5, 2011) (noting that “the last calendar year has seen proof of the importance of social networking in labor law as a flurry of decisions have come down from the General Counsel of the National Labor Relations Board”).

45. Press Release, Towers Watson, More Companies Worldwide Embracing New Media for Employee Communication, Towers Watson Study Finds (Nov. 17, 2011), available at <http://www.towerswatson.com/press/5879> (finding that “a majority of companies worldwide say they are becoming more knowledgeable about the use of social media tools to connect with and keep their workforces informed”).

46. See Dean Takahashi, *Hearsay Social raises \$18M so your employees won't embarrass you on social media*, VENTURE BEAT (Jul. 28, 2011, 4:30 AM), <http://venturebeat.com/2011/07/28/hearsay-social-raises-18m> (quoting the founder of Hearsay Social as offering to help companies transform their employees into ‘digital brand representatives’).

I. ROLE OF THE NLRB AND THE NLRA

The NLRB—an independent federal agency that administers the NLRA⁴⁷—has exclusive jurisdiction as the first adjudicator of unfair labor practice charges alleging violations of Section 8 of the NLRA,⁴⁸ which makes illegal what Section 7 protects.⁴⁹ Section 7 states:

Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in section 8(a)(3) [section 158(a)(3) of this title].⁵⁰

Currently, the test for concerted activity addresses whether activity is “engaged in with or on the authority of other employees, and not solely by and on behalf of the employee himself.”⁵¹ A district court hears an NLRA-related case only if attorneys bring it forward claiming a violation of a different law.⁵² The NLRB defers to Congress to amend the statute.⁵³

A. NLRB STRUCTURE

The NLRB deals with private sector employees, not government or federal employees.⁵⁴ The NLRB does cover postal service employees, but not agriculture, airline, or railroad employees, which are covered by a separate

47. What We Do, National Labor Relations Board, <https://www.nlr.gov/what-we-do> (last visited Feb. 5, 2012).

48. Telephone interview with Research Department, National Labor Relations Board Washington D.C. Office (Oct. 13, 2011).

49. OFFICE OF THE EXECUTIVE SECRETARY, *supra* note 35, at 55–56.

50. The National Labor Relations Act, 29 U.S.C. § 157 (2006).

51. *Meyers Indus., Inc. (Meyers II)*, 281 N.L.R.B. 882, 885, 889 (1986), *aff’d sub nom., Prill v. NLRB*, 835 F.2d 1481 (D.C. Cir.1987), *cert. denied*, 487 U.S. 1205 (1988).

52. Research Department Interview, *supra* note 48. For example, if a case involves an NLRA violation but the cause of action has mainly to do with some other violation, a lawyer may argue such a case in a district court.

53. *Stillians v. State of Iowa*, 843 F.2d 276, 280 (8th Cir. 1988), *abrogated by Astoria Fed. Sav. & Loan Ass’n v. Solimino*, 501 U.S. 104, 111 S. Ct. 2166, 115 L. Ed. 2d 96 (1991) (stating that “only Congress legislates and only Congress can amend”).

54. *Final Rule for Notification of Employee Rights*, NAT’L LABOR RELATIONS BD., <https://www.nlr.gov/news-media/fact-sheets/final-rule-notification-employee-rights> (last visited Feb. 5, 2012).

Act.⁵⁵ It conducts elections to determine whether employees are in favor of union representation, which is required before employees can form a union.⁵⁶ It also considers bargaining disputes and illegal picketing,⁵⁷ as well as cases involving an employee's right to discuss wages and working conditions.⁵⁸ The NLRB has jurisdiction over labor disputes under the NLRA, while other agencies and the courts have jurisdiction to hear labor-related issues under other federal and state laws.⁵⁹

The President nominates, and the Senate confirms, NLRB Board members.⁶⁰ The Board is supposed to consist of five members, but in recent years, difficulty getting appointees approved has meant that the Board has operated with as few as two members.⁶¹ The presidentially appointed General Counsel, a prosecutor, supervises the NLRB's field offices and cases and operates independently of the Board.⁶² The regional offices docket, investigate, settle, and prosecute unfair labor practice cases, receiving about

55. *Id.* Correspondence with Barry Winograd, Lecturer, Berkeley Law (Mar. 6, 2012) (on file with author) (“[T]he Railway Labor Act (RLA) to cover railroad employees was passed in 1926 and amended and strengthened in 1934, and again amended in 1936 to cover airline employees as well. The statutes reflected the political power of railroad unions, reaching back to the 19th Century. When the NLRA was being considered in 1935 as part of the New Deal, agricultural employees were excluded, in part to satisfy Southern Democrats who were concerned that it would undermine their rural supporters, particularly small farmers.”).

56. OFFICE OF THE EXECUTIVE SECRETARY, *supra* note 35 at 10.

57. *Is it legal to strike or picket an employer?*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/faq/questions/it-legal-strike-or-picket-employer> (last visited Feb. 5, 2012).

58. *Frequently Asked Questions*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/faq/nlr> (last visited Feb. 5, 2012).

59. For example, the U.S. Department of Labor, not the NLRB, hears complaints that directly concern overtime, minimum wage, prevailing wage, pension, worker safety, and child labor. U.S. DEPARTMENT OF LABOR, <http://www.dol.gov/whd> (last visited Feb. 5, 2012). The Equal Employment Opportunity Commission, not the NLRB, deals with cases about discrimination based on race, sex, age, disability, national origin, religion, and color, as well as sexual harassment cases. EQUAL EMPLOYMENT OPPORTUNITY COMMISSION, <http://www.eeoc.gov> (last visited Feb. 5, 2012). In California, the Division of Labor Standards and Enforcement, not the NLRB, hears cases about unpaid wages and vacation pay. DIVISION OF LABOR STANDARDS AND ENFORCEMENT, <http://www.dir.ca.gov/dlse> (last visited Feb. 5, 2012).

60. *Who We Are*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/who-we-are/board> (last visited Feb. 5, 2012).

61. *Background Materials on Two-member Board Decisions*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/news-media/backgrounders/background-materials-two-member-board-decisions> (stating that “from January 2008 to March 2010, the Board operated with three of its five seats vacant”) (last visited Feb. 5, 2012).

62. *The General Counsel*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/who-we-are/general-counsel> (last visited Feb. 5, 2012).

20,000 to 30,000 charges per year.⁶³ The Administrative Law Judges (“ALJs”), who have separate offices and function independently of the regional offices,⁶⁴ hear cases that have not settled.⁶⁵ Charges that employers failed to bargain or that they illegally punished employees for protected activity were the most common complaints brought before the NLRB in recent years.⁶⁶ Each regional office is responsible for issuing complaints, following an investigation, and prosecuting the complaint before the ALJ.⁶⁷

B. NLRB PROCEDURES

Once an employee or a union files a charge alleging a violation of Section 8 of the NLRA, either an NLRB attorney or a Field Examiner is assigned to investigate the charge.⁶⁸ In assigning NLRB personnel to specific cases, the attorneys in the regional office consider the experience of the NLRB lawyers and staff, the complexity of the case, and the existing workloads.⁶⁹ NLRB personnel investigate charges—whether they come from employees, employers, or unions—by collecting evidence and sometimes taking affidavits.⁷⁰ The Regional Director evaluates the findings or, in novel or significant cases, attorneys at the NLRB’s Division of Advice in Washington D.C. do the evaluations.⁷¹ If the D.C. lawyers believe the case has merit, they then send the case back to the regional office to proceed.⁷²

Social media cases are among these rare cases that always go through the D.C. Division of Advice. In an attempt to achieve coherent decision making in an emerging area of the law, the Acting General Counsel has ordered that the regional office lawyers send recommendations on all of the social media cases to the Division of Advice, which makes a suggestion to the General

63. *Investigate Charges*, *supra* note 33.

64. KRISTIN E. HICKMAN & RICHARD J. PIERCE, JR., *FEDERAL ADMINISTRATIVE LAW CASES AND MATERIALS* 293 (2010) (“ALJs are almost as independent of the agencies at which they preside as federal district judges are of the Executive and Legislative branches of government. ALJ salaries are determined by statute; agencies are prohibited from evaluating the performance of ALJs; agencies must use a random assignment method to assign cases to ALJs; and, agencies cannot fire or otherwise discipline an ALJ except for cause, as determined by another agency in a formal adjudication.”).

65. *Investigate Charges*, *supra* note 33.

66. *Id.*

67. OFFICE OF THE EXECUTIVE SECRETARY, *supra* note 35 at 58.

68. Research Department Interview, *supra* note 48; *Field Attorney and Field Examiner Positions*, *supra* note 28.

69. Telephone interview with Joe Frankl, Regional Director, NLRB Region 20, San Francisco (Dec. 8, 2011).

70. *Investigate Charges*, *supra* note 33.

71. *Id.*

72. *Id.*

Counsel, who then decides whether or not to issue a complaint.⁷³ The regional offices send reports and recommendations, but under current procedures, the Division of Advice decides whether social media cases have prosecutive merit before a complaint is issued.⁷⁴

As a general practice, the NLRB encourages parties to settle.⁷⁵ In recent years, over ninety percent of meritorious cases investigated by the NLRB have settled via an NLRB settlement or a private agreement.⁷⁶ Most commonly, regional office lawyers facilitate an Informal Board Settlement, which Regional Directors may be asked to approve.⁷⁷ In an Informal Board Settlement, the General Counsel agrees not to issue a complaint in the case, so long as the respondent takes certain remedial actions to restore the status quo.⁷⁸ In other cases, such as when the charged party has committed unfair labor practices repeatedly, the Board approves a Formal Board Settlement, which leads to the issuance of a Board Order and sometimes a court judgment.⁷⁹ The NLRB closes settled cases only after the parties comply with the terms of the settlement.⁸⁰

When parties do not reach settlement, lawyers in the regional offices can issue a complaint, usually against an employer.⁸¹ In fiscal year 2010, the NLRB lawyers issued 1,243 complaints dealing with such issues as unlawful threats, interrogations, or disciplinary actions and refusals to provide information or to bargain.⁸² Some of these led to hearings before an NLRB ALJ, while others settled prior to reaching a judge.⁸³ NLRB attorneys represent the General Counsel on behalf of charging parties in front of ALJs.⁸⁴ The NLRB attorneys cannot ask for an assessment of penalties.⁸⁵ Rather, under the NLRA, the attorneys can ask for make-whole remedies, including reinstatement and back pay, and other remedies such as requiring

73. Telephone interview with Lafe Solomon, Acting General Counsel of the NLRB (Oct. 14, 2011).

74. Correspondence with Joe Frankl, Regional Director, NLRB Region 20, San Francisco (Jan. 20, 2011).

75. *Facilitate Settlement*, NAT'L LABOR RELATIONS BD., <https://www.nlr.gov/what-we-do/facilitate-settlements> (last visited Feb. 5, 2012).

76. *Id.*

77. *Id.*

78. OFFICE OF THE EXECUTIVE SECRETARY, *supra* note 35, at 58.

79. *Facilitate Settlement*, *supra* note 75.

80. *Id.*

81. *Id.*

82. NAT'L *Investigate Charges*, *supra* note 33.

83. *Id.*

84. *Id.* An individual charging party or a union charging party can have its own attorney participate.

85. *Id.*

notice postings.⁸⁶ NLRB attorneys seeking damages must file civil and criminal contempt actions in the appellate courts.⁸⁷

The NLRB currently has forty ALJs nationwide.⁸⁸ Some were ALJs elsewhere first—for example, with the Social Security Administration—or previously served as labor and employment law attorneys.⁸⁹ In order to maintain independence from the NLRB, ALJs are not subject to agency efficiency ratings, promotions, or demotions, and their salaries depend on the recommendations of an independent agency.⁹⁰ If any party appeals an ALJ decision, which the NLRB calls “filing exceptions,”⁹¹ any three members of the Board can review the ALJ decision.⁹² The Board reviews the case record and issues several hundred decisions per year, which can reverse holdings and change precedent.⁹³ Parties can appeal a Board decision to an appropriate circuit court.⁹⁴

After briefing and oral argument, circuit courts evaluate the factual and legal bases of a Board decision.⁹⁵ If the court agrees with the Board or finds that the responding party had no legal basis to oppose the Board action, or failed to oppose, it enters a judicial decree that requires abiding by the Board Order.⁹⁶ Nearly eighty percent of the approximately sixty-five NLRB cases decided by circuit courts in recent years have affirmed the Board’s ruling.⁹⁷ Either the NLRB or the parties bringing a case can appeal to the U.S. Supreme Court, but the U.S. Solicitor General must grant the NLRB permission before the NLRB can petition for certiorari.⁹⁸

86. *Id.*

87. *Enforce Orders*, NAT’L LABOR RELATIONS BD., <https://www.nlr.gov/what-we-do/enforce-orders> (last visited Feb. 5, 2012).

88. Press Release, Nat’l Labor Relations Bd., Eleanor Laws Appointed NLRB Administrative Law Judge (Sept. 26, 2011), *available at* <https://www.nlr.gov/news/eleanor-laws-appointed-nlr-administrative-law-judge> (last visited Feb. 5, 2012).

89. *E.g., id.*

90. *Who Are ALJs, and How Are They Appointed?*, U.S. DEP’T OF LABOR, <http://www.oalj.dol.gov/FAQ4.HTM> (last visited Feb. 5, 2012).

91. *Decide Cases*, NAT’L LABOR RELATIONS BD., <https://www.nlr.gov/what-we-do/decide-cases> (last visited Feb. 5, 2012).

92. OFFICE OF THE EXECUTIVE SECRETARY, *supra* note 35, at 2, 24.

93. *Who Are ALJs, and How Are They Appointed?*, *supra* note 90.

94. *Enforce Orders*, *supra* note 87.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

Employees or unions primarily file social media cases against an employer under Section 8(a)(1) and (a)(3) of the NLRA.⁹⁹ Section 8(a)(1) makes it illegal for an employer to “interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in Section 7.”¹⁰⁰ Employees or employers can also bring unfair labor practice charges against unions.¹⁰¹ To assess whether an employer’s rules violate Section 8, the NLRB requires an inquiry into “whether the rules would reasonably tend to chill employees in the exercise” of their Section 7 rights.¹⁰² These rights, which protect concerted activity, extend to employees regardless of whether or not they are part of a union.¹⁰³

II. SOCIAL NETWORKING AND THE WORKPLACE

Beyond complying with the NLRA, allowing certain employee speech to transpire through social media may prove beneficial to society at large.¹⁰⁴ Online social networking can facilitate collective action¹⁰⁵ at a time of low employee cohesion due to declining unionization¹⁰⁶ and high employee turnover.¹⁰⁷ Particularly in non-unionized settings and large or otherwise fragmented workplaces, employees have little incentive to act together, since they may free ride off of others’ efforts.¹⁰⁸ According to one scholar, “If the employees could effectively discuss their strategy and gain enough trust so that most of them participate, this collective-action problem could be

99. See General Counsel 2011 Memorandum, *supra* note 9 (presenting examples of cases where employees or unions have claimed that employers violated Sections 8(a)(1) and (a)(3)).

100. The National Labor Relations Act, 29 U.S.C. § 158 (2006).

101. NAT’L LABOR RELATIONS BD., *supra* note 33.

102. Lafayette Park Hotel, 326 N.L.R.B. 824, 825 (1998).

103. 29 U.S.C. § 157; see Republic Aviation Corp. v. NLRB, 324 U.S. 793, 805, (1945).

104. See CLAY SHIRKY, *HERE COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS* (2009).

105. See *id.*

106. Hirsch, *supra* note 18.

107. *MetLife 9th Annual Study of Employee Benefits Trends: A Blueprint for the New Benefits Economy*, METLIFE 9 (Mar. 2011), available at <http://www.metlife.com/assets/institutional/services/insights-and-tools/ebts/Employee-Benefits-Trends-Study.pdf> (“[W]hile employers were focused on dealing with a difficult business climate, the recession has taken a toll on employees. The Study has reported a decline in employee loyalty year over year and that loyalty has now reached a three-year low. But what is disturbing is that employers seem unaware of this downward trend. Employer responses show that they assume employees feel as loyal today as they did three years ago.”).

108. See Jeffrey M. Hirsch, *Communication Breakdown: Reviving the Role of Discourse in the Regulation of Employee Collective Action*, 44 U.C. DAVIS L. REV. 1091, 1095 (discussing how not acting may nonetheless enable employees to reap rewards if a select group acts on behalf of the whole).

overcome. Without substantial discussions, however, group action is unlikely to occur.”¹⁰⁹ Psychological research shows that communication can make groups more productive, improving the quality of group action.¹¹⁰ Indeed, the fact that the vast majority of non-social networking cases brought to the attention of the NLRB involve unions suggests that nonunionized employees often do not know the full extent of their rights¹¹¹ and are therefore less productive as a group. Social media democratizes; it allows otherwise voiceless employees to engage with colleagues and the public to discuss workplace concerns.

A. CONTOURS OF EMPLOYERS’ RIGHTS TO REGULATE SOCIAL MEDIA USE

The prevalence of social media sometimes puts employers in an uncomfortable position.¹¹² What their employees post on social networks could shape their business relationships with customers and other businesses and could affect sales, shareholder confidence, and employee morale.¹¹³ Further, employee posts could reveal trade secrets and expose both employees and employers to litigation.¹¹⁴ Employee posts may also violate privacy laws, including those that prevent disclosure of certain personal

109. *Id.* at 1097.

110. *Id.* at 1100 (“[T]he benefit of communication is not merely as a determinant in whether group action of any kind will exist; communication also influences the amount and quality of group action. In particular, studies have shown that as group members share more of certain types of information, the group becomes more productive.”).

111. *Id.* at 1147 (“[A]lthough no data exist on nonunion employees’ knowledge of their labor rights, it is safe to assume that most are completely unaware of their right to engage in collective action. A rudimentary analysis of the NLRB’s intake data supports the notion that the NLRA is little known outside of the union context. For instance, in Fiscal Year 2008, over 16,000 allegations of employer unfair labor practices were filed with the Board. Of these charges, only 2,781 (17%) did not make allegations that clearly involved a labor organization of some kind, and the actual number of nonunion cases is much smaller because many of these charges still had a union on the scene. Indeed, a search of NLRB decisions during the same period found only two out 389 (0.5%) unfair labor practice cases that did not identify a union. Although the exact number is unclear, these data show that a large majority of charges filed with the NLRB involve employees proximate to a union.”).

112. See Christine Neylon O’Brien, *The First Facebook Firing Case Under Section 7 of the National Labor Relations Act: Exploring the Limits of Labor Law Protection for Concerted Communication on Social Media*, 45 SUFFOLK U. L. REV. 29, 61, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1967637 (noting that “employers and the legal environment need to catch up to the current technological setting of work and socializing on various forms of user-generated content networks”).

113. See, e.g., John L. Hines Jr. et al., *Anonymity, Immunity & Online Defamation: Managing Corporate Exposures to Reputation Injury*, 4 SEDONA CONF. L.J. 97 (2003).

114. See, e.g., DVD Copy Control Ass’n v. Bunner, 116 Cal. App. 4th 241, 255 (2004).

medical information.¹¹⁵ Employers must be vigilant when it comes to social media; if an employer does not take action against posts deemed to create a hostile work environment, for example, the employer could become liable for its inaction or for breaching a duty to prevent discriminatory content or defamation.¹¹⁶ Thus, employers confront great risk around employee social media use.¹¹⁷

Meanwhile, studies have reported that employers increasingly express interest in encouraging employee loyalty through social media.¹¹⁸ One survey found two-thirds of company respondents more knowledgeable about using social media tools than a year earlier and about the same proportion of respondents interested in increasing their use of social media over the next twelve months.¹¹⁹ According to an employment consultant, “Companies that are reluctant to try social media may end up limiting their ability to attract, retain and motivate certain key groups of employees.”¹²⁰ Already, approximately sixty-five percent of Global Fortune 100 companies have a presence on Twitter, and fifty-four percent have a presence on Facebook.¹²¹ Additionally, seventy-four percent of chief marketing officers surveyed consider social media a top business priority.¹²² Certain employee social networking activity can prove to be a boon to employers, so it may not be in an employer’s interest to overly restrict that kind of activity.¹²³

Some start-up companies have garnered considerable venture capital backing with services that help employers enhance their social networking

115. See, e.g., *Health Information Privacy*, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, <http://www.hhs.gov/ocr/privacy/hipaa/understanding/index.html> (last visited Feb. 5, 2012) (noting that “the HIPAA Privacy Rule provides federal protections for personal health information held by covered entities and gives patients an array of rights with respect to that information”).

116. See, e.g., Richard A. Paul & Lisa Hird Chung, *Brave New Cyberworld: The Employer’s Legal Guide to the Interactive Internet*, 24 LAB. L. 109, 120 (2008).

117. Further compounding the difficulty for employers in these instances, questions may arise around preemption and whether federal or state law applies to a particular employment dispute. The presence of a union may also raise preemption questions. See Henry H. Drummonds, *Beyond the Employee Free Choice Act: Unleashing the States in Labor-Management Relations Policy*, 19 CORNELL J.L. & PUB. POL’Y 83 (2009) (noting that “this judge-created preemption law stifles labor relations measures in the states, and leaves labor law smothered in federal orthodoxy”).

118. Towers Watson Press Release, *supra* note 45.

119. *Id.*

120. *Id.*

121. TAKAHASHI, *supra* note 46.

122. *Id.*

123. For example, employees posting about sales events or promoting a product may help a company, particularly if the employee has a large network of Facebook friends.

presence and train employees to assist with those efforts.¹²⁴ One such company, Hearsay Social (“Hearsay”), has raised \$21 million since 2009 and has helped major corporations increase the number of employees using social media for work purposes.¹²⁵ “I tell [companies] you already have 30,000 employees on the internet and they’re already representing you, unofficially,” the Hearsay founder told VentureBeat.¹²⁶ “The brand might be liable for anything that they say. You can change that risk into a number of digital brand representatives.”¹²⁷ Receptivity to such companies suggests that employers are interested in having employees use social media to advance company goals, even if there are risks.

But despite their hopes for social media, employers are caught in the middle legally. While policing workplace misconduct to avoid liability, they must not infringe upon workers’ rights to make certain types of criticisms.¹²⁸ Under the NLRA, overly restrictive rules that could be construed to ban protected NLRA Section 7 activity remain impermissible.¹²⁹ The First Amendment to the United States Constitution prevents Congress from abridging free speech,¹³⁰ and the Fourteenth Amendment applies the restriction to states.¹³¹ Though the First Amendment is inapplicable to private sector employment relationships, courts have interpreted the NLRA to recognize First Amendment-like rights and held that free speech rights apply on the Internet.¹³² Private employees in many jurisdictions get protection from state laws that create a civil right for citizens to exercise free speech.¹³³ Discharged employees may also make viable claims that free speech is a fundamental right, thus enabling them to sue based on the tort of wrongful termination.¹³⁴ Federal and state laws prohibiting discrimination and retaliation, as well as invasion of privacy and whistleblower laws, sometimes form the bases for claims by an employee challenging a

124. *See, e.g.*, TAKAHASHI, *supra* note 46.

125. *Id.*

126. *Id.*

127. *Id.*

128. The National Labor Relations Act, 29 U.S.C. § 158 (2006).

129. *Id.*

130. U.S. CONST. amend. I.

131. U.S. CONST. amend. XIV; *see also* Russo v. Glassner, 279 F. Supp. 2d 136, 142 (D.Conn. 2003); Merritt v. Shuttle, Inc., 13 F. Supp. 2d 371, 382 n.7 (E.D.N.Y. 1998).

132. *See, e.g.*, Reno v. ACLU, 521 U.S. 844, 851 (1997) (noting that First Amendment rights apply to communications over the Internet).

133. *See, e.g.*, CAL. CONST. art. I, § 1.

134. Paul & Chung, *supra* note 116, at 126.

termination based upon her social networking post.¹³⁵ For these reasons, employers must seriously consider their social media policies—at least to avoid costly litigation and public relations problems.

B. RIGHTS AND RESPONSIBILITIES OF EMPLOYEES USING SOCIAL MEDIA

Employees who see social networking as personal, unregulated terrain need to understand that, under the General Counsel's current framework for analysis, "mere gripes" about their places of work could cost them their jobs.¹³⁶ The General Counsel analyzes these cases in reference to "concerted activity," which means that the gripes need to emerge from, include, or incite group action in order to merit protection.¹³⁷ The General Counsel's office engages in a fact-based analysis, looking at the nature of a given conversation in order to ascertain whether or not there is concerted activity.¹³⁸ If, for example, Facebook posts do not elicit supportive comments from fellow workers engaging in conversation and there is no clear evidence of coordinated activity that led up to the posting, the General Counsel is unlikely to find concerted activity.¹³⁹ Unfortunately, the outcome of social media cases appears unpredictable, given the results in recent cases that turn on seemingly trivial factual differences.

Though employees have rights under the NLRA, they still must comply with rules surrounding workplace decorum and other restrictions.¹⁴⁰ Employees, as agents, "must loyally execute the legitimate interests of the principal [or the employer]," and this duty increases in proportion to the employee's level of responsibility.¹⁴¹ Some companies require employees to sign contracts pledging not to disclose confidential company information.¹⁴² Certain jurisdictions have statutes requiring as much, or include the obligation as part of the concept of duty.¹⁴³ Further, employees have a

135. See Robert B. Fitzpatrick, *Social Media: Employer and Employee Concerns*, AMERICAN LAW INSTITUTE (2011).

136. See *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011).

137. The National Labor Relations Act, 29 U.S.C. § 158 (2006); *City Disposal Sys., Inc. v. N.L.R.B.*, 766 F.2d 969, 973–74 (6th Cir. 1985).

138. See General Counsel 2011 Memorandum, *supra* note 9.

139. See *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011); *Wal-Mart*, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011).

140. See RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

141. *Id.*

142. Paul & Chung, *supra* note at 116, at 142.

143. See CAL. LAB. CODE § 2853 (West 2008) (stating that paid employees shall perform the service for which they are hired "with ordinary care and diligence"); *Id.* § 2856 (stating

general duty not to disclose trade secrets¹⁴⁴ or defame, disparage, harass, or intimidate other employees.¹⁴⁵ Given these requirements, the NLRA goes only so far in permitting employees to post what they want.

Today, most employees without union representation are at-will employees, which means that employers can terminate these employees with or without a reason, within certain limitations and exceptions.¹⁴⁶ The primary limitations to an employer's ability to fire an at-will employee are laws prohibiting discrimination and retaliation based upon gender, race, and other similar protected classes under federal and state anti-discrimination laws.¹⁴⁷ But an employer otherwise has a right to discharge an employee at any time if the firing does not violate a contract or employment-related statute.¹⁴⁸ California is one of three states—along with Arizona and Georgia—that has codified the employment-at-will doctrine, though all states and the District of Columbia, excluding Montana, have adopted the doctrine through judicial decisions.¹⁴⁹ The courts in some states have recognized certain exceptions to the at-will doctrine.¹⁵⁰ These exceptions stem from implied contract, public policy, promissory estoppels, the covenant of good faith and fair dealing, intentional infliction of emotional distress, and privacy.¹⁵¹ Still, employees have less recourse than they would if at-will employment were not so pervasive.

Employers and employees have various competing interests when it comes to social networking. Employers seek to protect their image,¹⁵² while

that an employee “shall substantially comply with all the directions of his employer concerning the service on which he is engaged, except where such obedience is impossible or unlawful, or would impose new and unreasonable burdens upon the employee”).

144. See MARK A. ROTHSTEIN & LANCE LIEBMAN, ROTHSTEIN & LIEBMAN'S EMPLOYMENT LAW CASES AND MATERIALS 1049 (4th ed. 1998).

145. See California Fair Employment and Housing Act, CAL. GOV'T CODE § 12940(j)(1), § 12940(j)(3) (West 2008).

146. Robert Sprague, *Fired for Blogging: Are There Legal Protections for Employees Who Blog?*, 9 U. PA. J. LAB. & EMP. L. 355, 359 (2007).

147. See *Wage and Hour Division*, U.S. DEPARTMENT OF LABOR, <http://www.dol.gov/whd> (last visited Feb. 5, 2012); U.S. EQUAL EMPLOYMENT OPPORTUNITY COMMISSION, <http://www.eeoc.gov> (last visited Feb. 5, 2012).

148. Sprague, *supra* note 146.

149. *Id.* at 387 n. 26 (citing CAL. LAB. CODE § 2922 (West 2003) (“California’s statute provides, in part, that ‘[a]n employment, having no specified term, may be terminated at the will of either party on notice to the other.’ . . . ‘There has been an ongoing effort to codify the employment-at-will doctrine in a uniform act through the Model Employment Termination Act, produced by the National Conference of Commissioners on Uniform State Laws. To date, no state has adopted the model act.’”).

150. *Id.* at 361.

151. *Id.*

152. See Takahashi, *supra* note 46.

employees may feel that they should be able to express their views freely.¹⁵³ Some employers want employees to help promote their brand.¹⁵⁴ However, even employees willing to tout their employer's wares online may worry about employers in any way monitoring their online activity, which they may have reason to keep separate from their workplace identity to avoid adverse workplace consequences.¹⁵⁵ At-will employment only makes employees more vulnerable,¹⁵⁶ and the NLRA, while providing protections, has limits due to other duties employees owe employers.¹⁵⁷

III. APPROACH AND ANALYSIS OF THE SOCIAL MEDIA CASES BEFORE THE NLRB

The analysis throughout this Note stems from NLRB precedent and how that precedent has been applied in case-specific Advice Memos, ALJ decisions involving social media, and the year-end Acting General Counsel's Memo.¹⁵⁸ For some of the cases considered, only the year-end Memo provided guidance; this happened if, at the time of writing, a case was still open or documents were not available. For other cases, the availability of ALJ reasoning and case-specific Memos guided discussion. None of the cases addressed in the year-end Memo was before the Board at the time of this Note's writing.

The cases considered implicate issues relating to employee privacy; when laws protect online posts, an employee's right to privacy expands. This Note does not focus on privacy law, however. Instead, it considers employee social media use and NLRB decisions as a cyberlaw and labor law issue, which has consequences for various aspects of people's virtual and actual lives. Moreover, although the rulings and analyses may prove relevant to more than

153. *See Reno v. ACLU*, 521 U.S. 844, 851 (1997).

154. *See Takahashi*, *supra* note 46 (citing statistics from Burston-Marsteller Communications). Receptivity to such companies suggests that employers are interested in having employees use social media to advance company goals, even if there are risks.

155. *See* General Counsel 2011 Memorandum, *supra* note 9. Findings of unprotected activity suggest that employees must be wary of what they say online because employers may retaliate without violating the law.

156. Sprague, *supra* note 146, at 359.

157. *See* Restatement (Second) of Agency § 387 (1958).

158. Due to backlogs and certain NLRB policies, documents related to cases are not always posted to the NLRB website for researchers to use. In some instances, the author of this Note was able to file Freedom of Information Act (FOIA) requests to gain access to Advice Memos pertaining to particular cases. In other instances, particularly when a case remained open due to one party having filed exceptions or the settlement occurring fewer than six months prior, certain documents remained inaccessible.

social networking activities alone, this Note tailors its discussion to social networking.

A. APPROACH TO LEGAL PRINCIPLES AND PROPOSAL FOR MORE FLEXIBLE ANALYSIS

Although this Note argues that the legal standard used to decide social media cases needs to evolve, it does not suggest an expansion of current doctrine. Rather, it urges the General Counsel and ALJs to acknowledge the limitations of applying the traditional concerted activity standard in all social media cases, as concert is not necessarily expressed in the same way online as offline. Short of changing the approach taken by the NLRB attorneys, General Counsel, and ALJs, if and when a social media case gets to the Board, the Board should reject the limited approach.

Currently, the General Counsel looks to the facts of a case and will find concert “[w]hen the record evidence demonstrates group activities, whether ‘specifically authorized’ in a formal agency sense, or otherwise.”¹⁵⁹ Accordingly, individual activities that are the “logical outgrowth of concerns expressed by the employees collectively” are characterized as concerted.¹⁶⁰ Concerted activity further includes “circumstances where individual employees seek to initiate or to induce or to prepare for group action” and where individual employees bring “truly group complaints” to management’s attention.¹⁶¹ However, activity that does not anticipate group action, and therefore does not go beyond “mere griping,” is not concerted.¹⁶²

Because an individual employee’s actions may constitute protected concerted activity if the actions stem from conversations with other employees,¹⁶³ this Note argues that the General Counsel should more systematically consider evidence of concert outside of the actual posts, even

159. *Meyers II*, 281 N.L.R.B. 882, 886 (1986), *aff’d sub nom.*, *Prill v. NLRB*, 835 F.2d 1481 (D.C. Cir.1987), *cert. denied*, 487 U.S. 1205 (1988).

160. *See* *Five Star Transportation*, 349 N.L.R.B. 42, 43–44, 59 (2007), *enfd*, 522 F.3d 46 (1st Cir. 2008) (holding that drivers’ letters to school committee raising individual concerns over a change in bus contractors were logical outgrowth of concerns expressed at a group meeting).

161. *Meyers II*, 281 N.L.R.B. at 887.

162. *See* *Mushroom Transp. v. NLRB*, 330 F.2d 683, 685 (3d Cir. 1964) (noting that “[a]ctivity which consists of mere talk must, in order to be protected, be talk looking toward group action . . . and, if it looks forward to no action at all, it is more than likely to be mere ‘griping’ ”); *Holling Press*, 343 N.L.R.B. 301, 302 (2004) (noting that activity that involves only a speaker and a listener may be concerted “so long as what is being articulated goes beyond mere griping”).

163. *See* *Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452 (Sept. 28, 2011).

in the absence of clear, organized meetings or other obvious signals. As it stands now, the General Counsel's application of the concerted activity standard seems to ignore the fact that people communicate on multiple platforms and through different media simultaneously and fluidly.¹⁶⁴ The NLRB Memo cases appear at odds, because in some instances, the General Counsel focuses mostly on a Facebook post itself and pays minimal attention to other forms of communication pertaining to the same conversation.¹⁶⁵

This Note supports the use of the "opprobrious conduct" standard,¹⁶⁶ which gives employers recourse when their employees make truly outlandish comments.¹⁶⁷ That standard provides a mechanism for ensuring that the concerted activity standard will not permit outrageous speech.¹⁶⁸ Thus, even if the General Counsel adopts a more flexible approach in line with what this Note suggests, the "opprobrious conduct" analysis will provide a check that limits protection on posts that go beyond reasonable, permissible speech.

B. CASES CONSIDERED IN THIS NOTE

The Table below lists the twelve cases considered in this Note, their status in the NLRB process, and the outcomes related to whether or not the posts constituted protected concerted activity and whether or not the social media policies were legal. The Acting General Counsel and NLRB attorneys have issued complaints, dismissed, settled, and in some instances, prosecuted these cases before an ALJ. This Note contends that the ALJ may have incorrectly decided two of the cases considered in the Memo—*JT's Porch Saloon & Eatery*¹⁶⁹ and *Wal-Mart*¹⁷⁰—because of the General Counsel's

164. See General Counsel 2011 Memorandum, *supra* note 9.

165. Compare *Hispanics United of Buffalo*, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees) with *Wal-Mart*, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011) (finding no protection for an employee whose post complained about a manager but did not explicitly ask Facebook friends, many of whom were colleagues, whether or not they agreed with his position). This Note contends that in order to thoroughly analyze whether or not a social media post represents concerted activity, NLRB lawyers must look for evidence of concert before the post. This is done in some cases, such as in *Hispanics United*, but not in others, such as *Wal-Mart* and *JT's Porch Saloon & Eatery*.

166. *Atl. Steel Co.*, 245 N.L.R.B. 814 (1979) (stating that "even an employee who is engaged in concerted protected activity can, by opprobrious conduct, lose the protection of the Act"); see discussion *infra* Section III.D.

167. *Id.*

168. *Opprobrium Definition*, DICTIONARY.COM, <http://dictionary.reference.com/browse/opprobrium> (last visited Feb. 5, 2012) (defining 'opprobrium' as "the disgrace or the reproach incurred by conduct considered outrageously shameful").

169. *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011).

seeming unwillingness to adapt the concerted activity standard to the nuances of social media. This Note urges the General Counsel to engage in more dexterous analysis of social media cases.

Table 1: Cases Considered

CASE NAME	STATUS	OUTCOME
1. <i>Hispanics United</i>	Open	Concerted activity under <i>Meyers</i>
2. <i>American Medical Response</i>	Closed	Concerted activity under <i>Meyers</i>
3. <i>Karl Knauz Motors Inc.</i>	Open	NOT protected concerted activity
4. <i>Triple Play Sports Bar</i>	Open	Concerted activity under <i>Meyers</i>
5. <i>Arizona Daily Star</i>	Open	NOT protected concerted activity
6. <i>JT's Porch Saloon</i>	Closed	NOT protected concerted activity <i>Note questions outcome of this case</i>
7. <i>Rural Metro</i>	Closed	NOT protected concerted activity
8. <i>Martin House Inc.</i>	Closed	NOT protected concerted activity
9. <i>Wal-Mart</i>	Closed	NOT protected concerted activity <i>Note questions outcome of this case</i>
10. <i>Flagler Hospital</i>	Closed	Overly broad social media policy
11. <i>Parks and Sons</i>	Open	Overly broad social media policy
12. <i>Giant Eagle Inc.</i>	Closed	Partially okay social media policy

C. CONCERTED ACTIVITY FOR MUTUAL AID OR PROTECTION

1. *History of the Concerted Activity Standard*

A review of the concerted activity standard's history sheds light on its current scope. The Norris-Laguardia Act of 1931, which included an early mention of "concert"¹⁷¹ without focusing on it, prevented the federal courts from enjoining labor disputes engaged in "singly or in concert."¹⁷² The Board intended Section 7(a) of the National Industrial Recovery Act of 1933 to allow laborers to associate in order to improve working conditions.¹⁷³ But it was not until the passage of Section 7 of the NLRA in 1935 that concerted

170. Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011).

171. Norris-Laguardia Act, Ch. 90, § 2, 47 Stat. 70, 70 (1932).

172. *Id.*

173. *Meyers Indus., Inc. (Meyers I)*, 268 N.L.R.B. 493 (1984).

activity became a protected right.¹⁷⁴ According to one scholar's analysis, however, until 1967, the circuit courts and the NLRB were "reluctant to find that concerted activity existed when an individual employee, acting alone to complain about working conditions, sought protection under Section 7 of the Act."¹⁷⁵ This changed when the Board for the first time gave protection to an employee acting alone in an effort to enforce a collective bargaining agreement.¹⁷⁶ In *Interboro Contractors*, a steamfitter complained to management to furnish safe labor conditions, which the employer and the steamfitter agreed to as part of a collective bargaining agreement.¹⁷⁷ On appeal, the Second Circuit upheld the Board's decision to protect the employee.¹⁷⁸ In the years that followed, NLRB rulings adhered to the *Interboro* decision, though circuits were split during that period.¹⁷⁹

In 1975, the NLRB further expanded the scope of protection by finding that activities unrelated to collective bargaining agreements could also warrant protection.¹⁸⁰ In *Alleluia Cushion*, an employer discharged a single employee after the employee sent a letter to the Occupational Safety and Health Administration ("OSHA").¹⁸¹ The employee was dissatisfied with how the employer handled his complaint about workplace safety, and the letter the employee wrote led to an inspector's visit.¹⁸² The Board ruled in the employee's favor, without a showing that the employee had solicited support from colleagues.¹⁸³ The Board found "an implied consent" from colleagues enough for concerted activity.¹⁸⁴ In addition to acting for a group of employees' interests, activity on behalf of the public—such as raising concerns related to safety—could trigger "mutual aid or protection."¹⁸⁵

174. The National Labor Relations Act, 29 U.S.C. § 157 (2006).

175. Lori A. Ciarrocca, *The Struggle to Define Section 7 Concerted Activity: A Literal Definition Emerges*, 44 WASH. & LEE L. REV. 1277, 1283 (1987).

176. *Interboro Contractors*, 157 N.L.R.B. 1295 (1966).

177. *Id.*

178. *National Labor Relations Board v. Interboro Contractors*, 388 F.2d 495 (1967).

179. *See, e.g.*, *NLRB v. City Disposal Sys., Inc.*, 465 U.S. 822, 831 (1984), *aff'g* *Interboro Contractors*, 157 N.L.R.B. 1295 (1966); Ciarrocca, *supra* note 175, at n. 51; *NLRB v. Ben Peking Corp.*, 452 F.2d 205, 207 (7th Cir. 1971); *NLRB v. Selwyn Shoe Mfg. Corp.*, 428 F.2d 217, 221 (8th Cir. 1970).

180. *See Alleluia Cushion*, 221 N.L.R.B. 999, 1007 (1975), *overruled by* *Prill v. NLRB*, 755 F.2d 941 (D.C. Cir. 1985).

181. *Id.* at 999.

182. *Id.*

183. *Id.* at 1007.

184. *Id.* at 1000.

185. ROBERT A. GORMAN, *BASIC TEXT ON LABOR LAW* 302 (1976).

Nine years later, in 1984, the *Meyers* cases¹⁸⁶ overruled the *Alleluia Cushion* standard, which for a limited time had significantly broadened the scope of concerted activity protection. The *Meyers* cases guide the interpretation of social media cases today.¹⁸⁷ The cases involved a truck driver who complained to his employer about safety problems involving the truck he drove for the company.¹⁸⁸ When his employer failed to take action, and after he got into an accident because of malfunctioning brakes, the employee called the Public Service Commission to inspect the vehicle.¹⁸⁹ The Commission then issued a citation and put the vehicle out of service.¹⁹⁰ After the employer fired the employee,¹⁹¹ and NLRB attorneys took the case. The ALJ and the Board ruled in favor of the employer's dismissal of the employee, finding it did not violate Section 8(a)(1) of the Act because the employee acted alone in refusing to drive the vehicle and in contacting the Commission.¹⁹²

The D.C. Circuit remanded *Meyers I* in order to give the Board the chance to reconsider in light of the 1984 Supreme Court decision in *NLRB v. City Disposal Systems*,¹⁹³ which suggested that the NLRB had substantial authority to define the scope of Section 7 of the NLRA.¹⁹⁴ The D.C. Circuit Court did not disclose whether it agreed or disagreed with the ruling in *NLRB v. City Disposal Systems*.¹⁹⁵ On remand in *Meyers II*, the Board reaffirmed its rule from *Meyers I*, holding that concerted activity is "engaged in with or on the authority of other employees, and not solely by and on behalf of the employee himself."¹⁹⁶ Though today the NLRA makes the distinction between concerted activity for mutual aid or protection and individual gripes, questions remain about what actually does and should constitute concerted

186. *Meyers I*, 268 N.L.R.B. 493 (1984); *Meyers II*, 281 N.L.R.B. 882 (1986) (reaffirming the rule from *Meyers I*, holding that concerted activity is "engaged in with or on the authority of other employees, and not solely by and on behalf of the employee himself").

187. See General Counsel 2011 Memorandum, *supra* note 9.

188. *Meyers I*, 268 N.L.R.B. 493.

189. *Id.*

190. *Id.* at 505.

191. *Id.* at 506.

192. *Id.* at 493.

193. *NLRB v. City Disposal Sys., Inc.*, 465 U.S. 822 (1984).

194. *Id.* at 830 (noting that the court has "not hesitated to defer to the Board's interpretation of the Act in the context of issues substantially similar to that presented here").

195. See *Meyers II*, 281 N.L.R.B. 882 (1986).

196. *Id.* at 885.

activity.¹⁹⁷ The uncertainties affect employers and employees seeking predictability in an online context.¹⁹⁸ Given that courts and NLRB Board members under several administrations have not pushed for a return to the *Alleluia Cushion* standard,¹⁹⁹ this Note proposes a more feasible middle-ground that allows for consideration of social media norms.

2. *Cases Considering Concerted Activity*

Nine of the twelve cases discussed in this Note turned on an analysis of whether or not the employees engaged in concerted activity. In the first six cases reviewed below, the General Counsel or ALJs found no concerted activity and therefore did not need to analyze whether or not bad faith existed.²⁰⁰ In the next three cases considered, the General Counsel or ALJs found concerted activity.²⁰¹ After establishing concerted activity, the case's evaluator must find no bad faith or opprobrious conduct in order for the employee to get protection.²⁰² This Note therefore goes on to consider the analysis of Bad Faith and Opprobrious Conduct in Section III.D, *infra*. Ultimately, the decision-makers found that none of the employees' activities included bad faith or opprobrious conduct in the three concerted activity cases.

197. See Corbett, *supra* note 14, at 268 (“[I]f broadly interpreted and vigorously enforced, Section 7 could obviate the need for some additional individual rights statutes. It could give employees a far-reaching protection that individual rights laws cannot.”).

198. See General Counsel 2011 Memorandum, *supra* note 9. The rulings in the General Counsel's Memo do not seem consistent, as is argued in this Note, making it difficult to draw conclusions from NLRB case precedent.

199. *Alleluia Cushion Co.*, 221 N.L.R.B. 1099 (1975), *overruled by* *Prill v. NLRB*, 755 F.2d 941 (D.C. Cir. 1985) (finding “an implied consent” from colleagues enough for concerted activity).

200. *Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452 (Sept. 28, 2011); *Martin House*, NLRB Adv. Mem., Case No. 34-CA-12950 (July 19, 2011); *Wal-Mart*, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011); *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011); *Rural Metro*, NLRB Adv. Mem., Case No. 25-CA-31802 (June 29, 2011); *Arizona Daily Star*, NLRB Adv. Mem., Case No. 28-CA-23267 (Apr. 21, 2011).

201. *Triple Play Sports Bar & Grille*, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915 (Jan. 3, 2012); *Am. Med. Response of Conn.*, Adv. Mem., Case No. 34-CA-12576 (Oct. 5, 2010); *Hispanics United of Buffalo*, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011).

202. *Atl. Steel Co.*, 245 N.L.R.B. 814, 816 (1979) (stating at “even an employee who is engaged in concerted protected activity can, by opprobrious conduct, lose the protection of the Act”).

In the first case under review, *Karl Knauz Motors*,²⁰³ an ALJ held that the employer appropriately terminated its employee because his posts did not reflect concert.²⁰⁴ The employee had posted on Facebook critical comments and pictures related to a car wreck that took place at a nearby car dealership that the employer also owned.²⁰⁵ The car wreck involved another salesperson and a customer during a test drive.²⁰⁶ Under a photo of the accident, the salesman wrote: “This is your car: This is your car on drugs.”²⁰⁷ Another photo of the car submerged in a pond had the caption:

This is what happens when a sales Person sitting in the front passenger seat (Former Sales Person, actually) allows a 13 year old boy to get behind the wheel of a 6000 lb. truck built and designed to pretty much drive over anything. The kid drives over his father’s foot and into the pond in all about 4 seconds and destroys a \$50,000 truck. OOOPS!²⁰⁸

The complaint alleged that the employer fired the employee for different Facebook posts criticizing how his company had served cheap food to potential customers at a high-end car sales event, but the ALJ found that those particular postings did not spur the discharge.²⁰⁹ The employee removed those posts when asked to do so by management.²¹⁰ The ALJ characterized the postings related to the sales event as concerted activity, because the salesman was expressing sentiments that coworkers had vocalized during a previous staff meeting, when employees complained that the cheap refreshments could affect sales.²¹¹ The ALJ found the company

203. *Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452 (Sept. 28, 2011). This case is still open, currently pending a Board decision on the ALJ decision.

204. *Id.* at 12. At the time of the Acting General Counsel’s Social Media Memo in August, this case, filed May 20, 2011, had not been before the ALJ, and the General Counsel analyzed the issues based on the case-specific Advice Memo, which argued for protecting the employee’s Facebook postings related to the car wreck and a separate sales event. The ALJ disagreed with that advice. It remains to be seen whether the Board will agree with the ALJ.

205. *Id.* at 3.

206. *Id.* at 4.

207. *Id.*

208. *Id.*

209. *Id.* at 9.

210. *Id.* at 4.

211. *Id.* at 8. Under *Meyers II*, 281 N.L.R.B. 882, 887 (1986), concerted activities included individual activity when “individual employees seek to initiate or to induce or to prepare for group action, as well as individual employees bringing truly group complaints to the attention of management.” In *Owens-Corning Fiberglass Corp. v. NLRB*, 407 F.2d 1357, 1365 (4th Cir. 1969), the court stated that the “activity of a single employee in enlisting the

policy pertaining to social media to be overbroad and ordered that it make changes, in line with recommendations described in Section III.E, *infra*.²¹² Karl Knauz Motors highlights the importance of establishing concert. Because the car wreck postings, unlike the sales event postings, did not build on group sentiment or push for something specific that a group of employees would likely endorse, the ALJ found no reason to protect the posts under Section 7 of the NLRA.²¹³

Because of a similar finding in *Arizona Daily Star*,²¹⁴ the General Counsel did not even suggest issuing a complaint; he found legal the employer's decision to fire its employee for tactless social media posts.²¹⁵ First, a reporter employee posted on Twitter criticism of another news organization's television coverage.²¹⁶ After the television station contacted the newspaper, the reporter apologized for his disparaging tweet, the term for a Twitter post.²¹⁷ He then continued to tweet disrespectfully about homicides, even though the editors had told him in a formal meeting that he was prohibited from discussing the newspaper in any public forum.²¹⁸ Over the course of several weeks, the employee tweeted:

August 27—"You stay homicidal, Tucson. See Star Net for the bloody deets."

support of his fellow employees for their mutual aid and protection is as much 'concerted activity' as is ordinary group activity." In *NLRB v. Mike Yurosek & Son*, 53 F.3d 261, 265 (9th Cir. 1995), the court stated that

[t]he fact that there was no express discussion of a group protest or 'common cause' is not dispositive . . . their individual actions were concerted to the extent they involved a 'logical outgrowth' of prior concerted activity. The lone act of a single employee is concerted if it 'stems from' or 'logically grew' out of prior concerted activity.

212. Karl Knauz Motors, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452, 7 (Sept. 28, 2011).

213. *Id.* at 9 ("I find that Becker's posting of the Land Rover accident on his Facebook account was neither protected nor concerted activities, and Counsel for the General Counsel does not appear to argue otherwise. It was posted solely by Becker, apparently as a lark, without any discussion with any other employee of the Respondent, and had no connection to any of the employees' terms and conditions of employment. It is so obviously unprotected that it is unnecessary to discuss whether the mocking tone of the posting further affects the nature of the posting.").

214. *Arizona Daily Star*, NLRB Adv. Mem., Case No. 28-CA-23267 (Apr. 21, 2011). In this case, a special Appeal to the Board on November 22, 2011 was dismissed for Non-Merit on April 28, 2011.

215. *Id.* at 1.

216. *Id.* at 4.

217. *Id.*

218. *Id.* at 6.

August 30—“What?!?!? No overnight homicide? WTF? You’re slacking Tucson.”

September 10—“Suggestion for new Tucson-area theme song: Droening [sic] pool’s ‘let the bodies hit the floor.’”

September 10—“I’d root for daily death if it always happened in close proximity to Gus Balon’s.”

September 10—“Hope everyone’s having a good Homicide Friday, as one Tucson police officer called it.”²¹⁹

The General Counsel did not find concert because the tweets did not relate to the terms and conditions of employment, and the employee did not attempt to involve other employees.²²⁰ Had he in his tweets, or prior to his tweets, asked colleagues whether they wanted to join him in making criticisms, and had the General Counsel found enough evidence of group sentiment, he may have had protection. To get coverage from the NLRA, he may have needed to more clearly criticize his employer, instead of making somewhat random observations and criticisms about his city. This case seems to have come out correctly in that Section 7 of the NLRA²²¹ does not protect comments that harm an employer’s reputation and do not express a commonly felt workplace gripe.²²²

In *Martin House, Inc.*, the NLRB’s Division of Advice in Washington opined that there was no protection for an employee who posted insensitively about the mental patients she oversaw.²²³ She made the posts while at work,²²⁴ so her employer had more leeway in setting limits on what she could express while on the job.²²⁵ The employee, a full-time recovery specialist working for Martin House, a nonprofit residential facility for

219. *Id.* at 3.

220. *Id.* at 6.

221. The National Labor Relations Act, 29 U.S.C. § 157 (2006).

222. *See Meyers II*, 281 N.L.R.B. 882 (1986).

223. *Martin House*, NLRB Adv. Mem., Case No. 34-CA-12950, 1 (July 19, 2011). The General Counsel dismissed the case on Non-Merit on Jul. 8, 2011, and the case was closed on Jul. 26, 2011.

224. *Id.*

225. *Id.* at 2. This notion that employers can regulate work time more than leisure time is a principle of labor law. *See, e.g.*, *Republic Aviation Corp. v. NLRB*, 324 U.S. 793, 803 (1945) (noting that “the Board has held that, while it was ‘within the province of an employer to promulgate and enforce a rule prohibiting union solicitation during working hours,’ it was ‘not within the province of an employer to promulgate and enforce a rule prohibiting union solicitation by an employee outside of working hours, although on company property,’ the latter restriction being deemed an unreasonable impediment to the exercise of the right to self-organization”).

homeless people, many of whom suffered from mental illness and substance abuse, wrote on her Facebook wall:

Charging Party: Spooky is overnight, third floor, alone in a mental institution, btw Im not a client, not yet anyway.

Friend 1: Then who will you tell when you hear the voices?

Charging Party: me, myself and I, one of us had to be right, either way we'll just pop meds until they go away! Ya baby!

Charging Party: My dear client ms 1 is cracking up at my post, I don't know if shes laughing at me, with me or at her voices, not that it matters, good to laugh

Friend 1: That's right but, if she gets out of hand, restrain her.

Charging Party: I don't need to restrain anyone, we have a great rapport, im beginning to detect when people start to decompensate and she is the sweetest, most of our peeps are angels, just a couple got some issues, Im on guard don't worry bout a thing!

Friend 2: I think you'd look cute in a straitjacket, heh heh heh.²²⁶

The employee did not discuss her posts with colleagues, no colleagues responded, and no evidence existed of preparation for group action or a response to collective concerns.²²⁷ A Facebook friend of the employee, a former client of Martin House, reported the postings to Martin House.²²⁸ The termination letter cited a confidentiality breach and the fact that the posts were made at work, when the employee should have been working.²²⁹ Had the employee expressed legitimate complaints about her working environment, complaints that others shared, she may have had recourse. However, the details of the case led the NLRB Washington D.C. attorneys to correctly conclude that Section 7 did not provide protection.

The Division of Advice also recommended dismissal in *Rural Metro* for non-merit because an employee's posts did not ask for particular relief and did not clearly show concert.²³⁰ In this case, an employee medical transportation and fire protection dispatcher, whose husband was an Emergency Medical Technician, posted a comment on a senator's Facebook

226. Martin House, NLRB Adv. Mem., Case No. 34-CA-12950, 1–2.

227. *Id.* at 3.

228. *Id.* at 2.

229. *Id.*

230. *Rural Metro*, NLRB Adv. Mem., Case No. 25-CA-31802, 1 (June 29, 2011). The General Counsel dismissed on Non-Merit on July 8, 2011, and the case was closed on July 28, 2011.

wall.²³¹ The senator had just announced that four Indiana fire departments had received grants.²³² The employee's post read:

My husband and I work for Rural Metro, me as a [redacted] and he as an [redacted]. Rural Metro has contracts w/several fire departments to provide EMS. The reason they contract out to us? BECAUSE WE'RE THE CHEAPEST SERVICE IN TOWN! How do we manage that? BY PAYING OUR EMPLOYEES \$2 LESS THAN THE NATIONAL AVERAGE! We both make less than \$10 an hr. And he's worked for them 3.5 yrs! . . . the fact that we're employees of a cheap contract company instead of government employees hurts us. Maybe some of that grant money could be used toward hiring personnel to run the new equipment too. Unfortunately the state is going the other way and looking for more cheap companies to farm the jobs out to. Privatization hard at work

And the 20 year old that died in township, he was a friend of mines family member. Rural Metro provides coverage for that area, but we only have 2 trucks for all of county and they're stationed near Hospital nearly 15–20 minutes from township driving emergen[cy]. Furthermore one of our crews showed up on a scene of a cardiac arrest where the volunteer fire fighters/first responders didn't even know how to perform CPR! I get that it only saves 1–2% of people, but we'll never know in this case if it would have helped. It's going to take a lot more grant money to fix all of the problems w/IN's EMS!²³³

Rural Metro discharged the employee based on the disparaging remarks she made about her employer, the fact that she shared confidential information, and her violation of the company's Code of Ethics and Business Conduct policy.²³⁴ The Division of Advice found no possible concerted activity, claiming that the dispatcher did not talk about her posts with colleagues and that the post did not seek relief for employment circumstances.²³⁵

Given that concerted activity includes "circumstances where individual employees seek to initiate or to induce or to prepare for group action" and where individual employees bring "truly group complaints" to management's attention,²³⁶ it seems feasible that a judge could find concert based on this

231. *Id.*

232. *Id.*

233. *Id.* at 1–2.

234. *Id.* at 2.

235. *Id.* at 3.

236. *Meyers II*, 281 N.L.R.B. 882, 887 (1986).

employee's post. In *Rural Metro*, as in *JT's Porch Saloon & Eatery*,²³⁷ the Washington NLRB attorneys deemed the employee's earlier related conversations—lamenting wages with colleagues—as separate from the post.²³⁸ This approach seems too limited; evidence of concert from earlier offline situations deserves more weight. Though the facts could cut either way, the NLRB agent may have failed to fully investigate the implications of the circumstances leading up to the post in *Rural Metro*.

The outcomes in the first three cases—*Karl Knauz Motors*, *Arizona Daily Star*, and *Martin House*²³⁹—seem reasonable; however, the employee in *Rural Metro* may have deserved a chance to make her case. The next two cases under consideration more seriously call into question the NLRB's current usage of the concerted activity standard.

3. *Limitations of the Concerted Activity Standard*

The narrowly applied concerted activity standard led to unfair outcomes in *JT's Porch Saloon & Eatery*²⁴⁰ and *Wal-Mart*.²⁴¹ In looking for proof of concerted activity, the NLRB attorneys and the General Counsel relied too much on actual online responses from Facebook friends, which were either lacking or phrased in a way that did not explicitly show concert.²⁴² Most Facebook posts are by their nature directed towards a community.²⁴³ Unless an individual sets her privacy settings to be unusually restrictive, the individual who posts is “speaking” to a group of people. Whether or not colleagues reply to Facebook threads may depend mostly on the time of the

237. *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011).

238. *Rural Metro*, NLRB Adv. Mem., Case No. 25-CA-31802, 2 (June 29, 2011).

239. *Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452 (Sept. 28, 2011); *Martin House*, NLRB Adv. Mem., Case No. 34-CA-12950 (July 19, 2011); *Arizona Daily Star*, NLRB Adv. Mem., Case No. 28-CA-23267 (Apr. 21, 2011).

240. *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011).

241. *Wal-Mart*, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011).

242. *Compare* *Hispanics United of Buffalo*, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011) (finding protected activity when employee Facebook posts criticizing a colleague solicit feedback from fellow employees) *with* *Wal-Mart*, NLRB Adv. Mem., Case No. 17-CA-2503 (July 19, 2011) (finding no protection for an employee whose post complained about a manager but did not explicitly ask Facebook friends, many of whom were colleagues, whether or not they agreed with his position) *and* *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011) (finding no protection for an employee whose previous, related offline conversation were deemed separate from his Facebook postings).

243. *How to Post and Share*, FACEBOOK HELP CENTER, <https://www.facebook.com/help/sharing> (explaining how to share status updates to make statements, in various forms, visible to Facebook friends or a designated community).

posting or other matters that seem too dependent on contingency²⁴⁴ for them to reasonably drive the outcome of the case. It is the intent of the “speaker” that should matter. For these reasons and others, social media posts merit a unique, tailored analysis.

In *JT's Porch Saloon & Eatery*, the Division of Advice dismissed an employee's charge that his firing violated Section 7 of the NLRA.²⁴⁵ The employee's Facebook post complained about the restaurant and bar's unwritten policy wherein waitresses kept all of a table's tips, despite the serving help they received from bartenders.²⁴⁶ He also complained that his employer had not given him a raise in five years and called the restaurant's customers “rednecks,” writing that he hoped they would choke on glass when they drove home drunk.²⁴⁷ None of his colleagues responded to his post.²⁴⁸ When the employee had earlier complained about the tipping policy offline, a fellow bartender agreed that it “sucked,” but they did not raise the issue with management.²⁴⁹ In other cases, including *Karl Knauz Motors*, the NLRB considered offline conversations in a sales meeting as proof of concert for those particular online posts.²⁵⁰

So why did this offline conversation not help the employee here? The Advice Memo suggested that the employee's previous offline conversation, during which he discussed the issue he later posted about with a colleague,

244. For example, whether or not someone responds to a Facebook post could have to do with whether or not she happened to check status updates close to the time her colleague posted, such that the update would appear in her feed. Alternatively, a decision to post could depend on whether a user logs in using a computer or a smartphone; some people find that it takes too long to type responses on smart phones and thus refrain from commenting on posts they would respond to were they at a computer. Additionally, whether or not someone responds could depend on her fear of legal or reputational repercussions. Were the colleagues engaging in an offline, private conversation, it is possible that a colleague would express support and even agree to complain to a manager, whereas that same colleague may worry that a public Facebook post endorsing a colleague's post leaves her too exposed. Perhaps for some of the reasons discussed, the General Counsel has, in some instances, considered offline conversations relevant to an analysis of concert. When finding protection for posts related to an employee's complaints about a work sales event, it mattered more that the individual intended to express a group lament than how Facebook friends happened to respond. *See Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452, 8 (Sept. 28, 2011).

245. *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689, 1 (July 7, 2011).

246. *Id.*

247. *Id.* at 1–2.

248. *Id.* at 3.

249. *Id.* at 1.

250. *Karl Knauz Motors*, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452, 8 (Sept. 28, 2011).

was separate from his Facebook posts.²⁵¹ This seems at odds with the approach in *Karl Knauz Motors*, where the ALJ considered the sales event posts protected because of earlier offline conversations.²⁵² Here, the bartender's post directly criticized the terms and conditions of his employment, and the employee had earlier commiserated about his complaints with a colleague offline.

Whereas the lack of concert seemed clear for the car wreck posts in *Karl Knauz Motors*, the random, offensive tweets in *Arizona Daily Star*, and the insensitive posts in *Martin House*, the outcome of *Wal-Mart*, like that of *JT's Porch Saloon & Eatery*, seems less reasonable. The Division of Advice in *Wal-Mart* suggested dismissal of the case because it found that an employee's posts represented a mere "gripe" and were not intended to induce group action.²⁵³ The Wal-Mart employee wrote: "Wuck Falmart! I swear if this tyranny doesn't end in this store they are about to get a wakeup call because lots are about to quit!"²⁵⁴ Responses ensued:

[Employee 1]: bahaha like! :)

[Employee 2]: What the hell happens after four that gets u so wound up??? Lol

[Charging Party]: You have no clue [Employee 1] . . . [Assistant Manager] is being a super mega puta! Its retarded I get chewed out cuz we got people putting stuff in the wrong spot and then the customer wanting it for that price . . . that's false advertisement if you don't sell it for that price . . . I'm talking to [Store Manager] about this shit cuz if it don't change Wal-Mart can kiss my royal white ass!²⁵⁵

After a meeting with the Store Manager, who received a printout of the posts, the employee removed the thread.²⁵⁶ Most of the employee's Facebook friends were colleagues,²⁵⁷ but this did not help because of the way he phrased his post and the words his friends used to respond. The employee claimed that two other coworkers posted comments of support; one of those

251. JT's Porch Saloon & Eatery, NLRB Adv. Mem., Case No. 13-CA-46689, 3 (July 7, 2011).

252. Karl Knauz Motors, NLRB Administrative Law Judge Decision, Case No. 13-CA-46452, 8 (Sept. 28, 2011).

253. Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-25030, 3 (July 19, 2011). Case Closed Jul. 25, 2011.

254. *Id.* at 1.

255. *Id.* at 1–2.

256. *Id.* at 2.

257. *Id.* at 1.

coworkers said that she made a “hang in there” sort of remark.²⁵⁸ Given that the post in this case specifically addressed working conditions and that the employee got support from Facebook friends who were colleagues, his disciplining does not seem fair when compared with the other cases. This Note contends that the case should have at least proceeded to an ALJ for a more comprehensive review.

In some instances, the concerted activity standard gives employees more protection than employees might imagine the concerted activity standard would have. But in other cases, interpreting it rigidly in social networking cases prevents it from providing protection in a uniform way, because trivial factors could remove certain activity from the realm of protection. The NLRB’s approach of using the existing concerted activity standard for social media cases, without taking into account how social media is used, leads to some problematic outcomes.

D. BAD FAITH AND OPPROBRIOUS CONDUCT

1. *The Standard for Bad Faith and Opprobrious Conduct*

Even where concerted activity exists, when the Board finds activity to be in bad faith and opprobrious because of its nature or purpose, the activity may not warrant protection under Section 7 of the NLRA.²⁵⁹ Opprobrium is defined as “the disgrace or the reproach incurred by conduct considered outrageously shameful.”²⁶⁰ However, perhaps because the United States has from the start been committed to supporting expression of diverse viewpoints,²⁶¹ the Board has not considered all offensive speech opprobrious.²⁶² In one case, the Board found that calling a supervisor a “liar and a bitch” and a “fucking son of a bitch” was not so opprobrious as to cost the employee the protection of the Act.²⁶³ In another case, when an employee called a supervisor an “egotistical fuck,” the employee did not lose Section 7 protection.²⁶⁴ Meanwhile, the Board has held that communication

258. *Id.* at 2.

259. *Atl. Steel*, 245 NLRB 814, 816 (1979) (stating at “even an employee who is engaged in concerted protected activity can, by opprobrious conduct, lose the protection of the Act”).

260. *Opprobrium definition*, DICTIONARY.COM, <http://dictionary.reference.com/browse/opprobrium> (last visited Feb. 5, 2012).

261. U.S. CONST. amend. I (“Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the government for a redress of grievances”).

262. *See* General Counsel 2011 Memorandum, *supra* note 9.

263. *See* *Stanford Hotel*, 344 N.L.R.B. 558, 564 (2005).

264. *See* *Alcoa*, 352 N.L.R.B. 1222, 1226 (2008).

“so disloyal, reckless or maliciously untrue” can lose the Act’s protection and justify terminating an employee for cause.²⁶⁵ Case law suggests that findings of opprobrious conduct depend more on the nature, content, and veracity of the communication than on whether or not employees use epithets.²⁶⁶

NLRB attorneys and judges use a test for opprobrious conduct that comes from the Supreme Court ruling in *Jefferson Broadcasting*.²⁶⁷ In that case, the Supreme Court remanded to a court of appeals with instructions to reinstate the Board’s decision that the employees’ activity did not merit Section 7 protection.²⁶⁸ The case involved striking television technicians.²⁶⁹ Their peaceful picketing turned into a series of “vitriolic attacks on the quality of the company’s television broadcasts” and then technicians distributed thousands of handbills at local businesses impugning the television station.²⁷⁰ The technicians distributed on the picket line, on the public square several blocks from the company’s premises, on buses, and in barber shops and restaurants.²⁷¹ They mailed handbills to local business people.²⁷² The handbills read:

Is Charlotte A Second-Class City?

You might think so from the kind of Television programs being presented by the Jefferson Standard Broadcasting Co. over WBTV. Have you seen one of their television programs lately? Did you know that all the programs presented over WBTV are on film and may be from one day to five years old. There are no local programs presented by WBTV. You cannot receive the local baseball games, football games or other local events because WBTV does not have the proper equipment to make these pickups. Cities like New York, Boston, Philadelphia, Washington receive such programs nightly. Why doesn’t the Jefferson Standard Broadcasting Company purchase the needed equipment to bring you the same type of programs enjoyed by other leading American cities? Could it be

265. *Endicott Interconnect Tech. v. NLRB*, 453 F.3d 532, 537 (D.C. Cir. 2006) (citing *Am. Golf Corp.*, 330 N.L.R.B. 1238, 1240 (2000); *see also Cincinnati Suburban Press*, 289 N.L.R.B. 966, 967–68 (1988); *Emarco, Inc.*, 284 N.L.R.B. 832, 833 (1987); *Richboro Cmty. Mental Health Council*, 242 N.L.R.B. 1267 (1979)).

266. *Id.*; *see Stanford Hotel*, 344 N.L.R.B. 558, 564 (2005); *Alcoa*, 352 N.L.R.B. 1222, 1226 (2008).

267. *NLRB v. Local Union No. 1229, Int’l Bhd. of Elec. Workers*, 346 U.S. 464 (1953).

268. *Id.* at 477–78.

269. *Id.* at 464.

270. *Id.* at 468–71.

271. *Id.* at 468.

272. *Id.*

that they consider Charlotte a second-class community and only entitled to the pictures now being presented to them?²⁷³

Jefferson Standard fired the ten technicians who sponsored or distributed the handbills.²⁷⁴

The Court in *Jefferson* clarified the link between opprobrious conduct and disloyalty.²⁷⁵ If concerted activity is significantly disloyal, and therefore opprobrious, it loses protection.²⁷⁶ The technicians' decision not to refer to the collective action activity in its handbills could have misled the handbill's recipients and seemed to make the Court less willing to protect the activity based on concert.²⁷⁷ Indeed, the Court noted that the attack

related itself to no labor practice of the company. It made no reference to wages, hours or working conditions. The policies attacked were those of finance and public relations for which management, not technicians, must be responsible. The attack asked for no public sympathy or support. It was a continuing attack, initiated while off duty, upon the very interests which the attackers were being paid to conserve and develop.²⁷⁸

The *Jefferson* Court employed a now commonly used test for determining when conduct by an employee reaches this threshold of disloyal opprobrium.²⁷⁹ It requires that the Board look at whether communication is (1) related to an ongoing labor dispute and (2) not so disloyal, reckless, or maliciously untrue to make it lose the Act's protection.²⁸⁰ In *Jefferson*, the Court looked for additional evidence of disloyalty.²⁸¹ It noted that the technicians distributed the handbills at a "critical time" in the company's business and that the handbills reflected a "sharp, public, disparaging attack upon the quality of the company's product and its business policies, in a manner reasonably calculated to harm the company's reputation and reduce its income."²⁸² A finding of opprobrium requires consideration of context because disloyalty depends on the specifics surrounding the activity.

273. *Id.*

274. *Id.*

275. *Id.* at 472.

276. *Id.*

277. *Id.* at 468.

278. *Id.* at 476.

279. *Id.* at 477-78.

280. *Id.*

281. *See id.*

282. *Id.* at 464.

Building upon the *Jefferson* standard, a quarter century later the Board articulated more factors to consider before finding opprobrium.²⁸³ In *Atlantic Steel*, the Board agreed with an arbiter's initial finding that an employer lawfully discharged a foreman for inappropriate conduct, which included poor work performance and cursing.²⁸⁴ Upholding precedent,²⁸⁵ the Board decided that even concerted activity loses protection if it is deemed opprobrious.²⁸⁶ Adjudicators must balance the following factors: (1) the place of the discussion; (2) the subject matter of the discussion; (3) the nature of the employee's outburst; and (4) whether the outburst was, in any way, provoked by an employer's unfair labor practice.²⁸⁷ The Acting General Counsel's Social Media Memo includes various mentions of the *Atlantic Steel* test, showing its continued importance in NLRB decision-making.²⁸⁸

2. Cases Considering Opprobrious Conduct

In the three Memo cases in which the Division of Advice found concerted activity, it had to consider whether the social networking activity lost protection due to opprobrium.²⁸⁹ In all three of these cases, the NLRB attorneys found that the conduct did not lose protection and that the employers inappropriately punished the employees.²⁹⁰ None of the three cases showed sufficient disloyalty on the part of employees in proportions close to *Jefferson* disloyalty. Further, in all of the cases, the subject matter affected the terms and conditions of employment. In addition, employer practices, or practices by employees for whom the employer was responsible, provoked the posts—an *Atlantic Steel* factor that cuts in favor of a discharged employee.

In *American Medical Response of Connecticut*, a terminated employee accepted a settlement agreement that had the employer agreeing to change its rules so that it did not overly restrict employee conversations about working conditions.²⁹¹ The employee of the emergency medical services provider

283. See *Atl. Steel*, 245 N.L.R.B. 814 (1979).

284. *Id.* at 814.

285. See *Hawaiian Hauling Service, Ltd.*, 219 N.L.R.B. 765, 766 (1975).

286. *Atl. Steel*, 245 N.L.R.B. at 816.

287. *Id.*

288. See General Counsel 2011 Memorandum, *supra* note 9.

289. See *Triple Play Sports Bar & Grille*, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915 (Jan. 3, 2012); *Am. Med. Response of Conn., Adv. Mem.*, Case No. 34-CA-12576 (Oct. 5, 2010); *Hispanics United of Buffalo*, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011).

290. See *id.*

291. NLRB complaint based upon Facebook posts as 'concerted activity' is settled prior to hearing, EMPLOYMENT LAW MATTERS (Feb 8, 2011), <http://www.employmentlawmatters.net/2011/>

belonged to a union and had served the company for eleven years as a paramedic.²⁹² She demanded union representation before filling out an incident report ordered by her boss; he had received a client complaint about her handling of a medical situation.²⁹³ When the boss denied her request for union representation, she referred to him on Facebook as a “17” (AMR code for psychiatric patient), “dick,” and “scumbag.”²⁹⁴ Despite her harsh language, however, the case’s Advice Memo stated that the opprobrium standard does not necessarily forbid distasteful speech.²⁹⁵

The Advice Memo, which came out before the settlement, found that the employee engaged in protected activity that did not reach opprobrious proportions.²⁹⁶ It found that the employer violated Section 8(a)(1) of the Act by denying the employee a union representative and by threatening to discipline her for invoking her rights.²⁹⁷ The employer violated Section 8(a)(1) and (3) of the Act by firing her for engaging in such activity and violated Section 8(a)(1) of the Act by maintaining a blogging and Internet posting and standards-of-conduct policies that could chill Section 7 protected activity.²⁹⁸

The NLRB attorneys used the *Atlantic Steel* factors to show that the employer erred in firing the employee. Under factor (1) of *Atlantic Steel*, the place of the posting gave her more protection because the employee posted outside the workplace and the posts did not interrupt the work of other employees.²⁹⁹ Under factor (2), subject matter, the posts dealt with supervisory action, which constitutes protected subject matter.³⁰⁰ As to factor (3), the nature of the outburst, no verbal or physical threats accompanied the name-calling, and the Board protects more egregious name-calling than was present here.³⁰¹ Factor (4), whether the employer provoked the outburst,

02/articles/nlra/nlrb-complaint-based-upon-facebook-posts-as-concerted-activity-is-settled-prior-to-hearing (“[T]he company’s position throughout this matter has been that the individual who authored the Facebook postings was fired ‘based on multiple, serious complaints about her behavior,’ and not simply because of the postings. The settlement of this matter includes a separate, private settlement between the company and the individual employee, the terms of which have not been made public.”).

292. Am. Med. Response of Conn., Adv. Mem., Case No. 34-CA-12576, 3 (Oct. 5, 2010). Case closed July 7, 2011.

293. *Id.* at 3.

294. *Id.* at 3–4.

295. *Id.* at 3.

296. *Id.* at 9.

297. *Id.* at 8.

298. *Id.* at 6.

299. *Id.* at 9.

300. *Id.* at 10.

301. *Id.*

avored the employee, who responded directly to an employer's inappropriate threat.³⁰²

American Medical Response of Connecticut proved significant because it spawned considerable press attention in marking the first case in which the General Counsel claimed that an employee's Facebook posts should be protected.³⁰³ A November 2010 *New York Times* article generated buzz about the case³⁰⁴ and may have contributed to the considerable increase in the number of charges filed by employees fired for similar actions, as employees became aware that legal protections for social media posts existed.³⁰⁵

Using similar reasoning as the NLRB attorneys used in *American Medical Response of Connecticut*, an ALJ, in *Hispanics United of Buffalo*, held that a nonprofit organization inappropriately discharged five employees for complaining on Facebook about working conditions.³⁰⁶ The General Counsel's year-end Memo called it a "textbook example of concerted activity" and found no opprobrium.³⁰⁷ Anticipating a meeting with management, an employee named Mariana Cole-Rivera posted on her Facebook page about a coworker's criticisms of Cole-Rivera's work.³⁰⁸ Other employees responded, defending Cole-Rivera and themselves against what they described as unfair criticism from their colleague.³⁰⁹ Below is the contested Facebook thread:

Mariana Cole-Rivera: Lydia Cruz, a coworker feels that we don't help our clients enough at HUB I about had it! My fellow coworkers how do u feel?

302. *Id.*

303. *E.g.*, Steven Greenhouse, *Company Accused of Firing over Facebook Post*, N.Y. TIMES (Nov. 8, 2010), <http://www.nytimes.com/2010/11/09/business/09facebook.html> (reporting that "in what labor officials and lawyers view as a ground-breaking case involving workers and social media, the National Labor Relations Board has accused a company of illegally firing an employee after she criticized her supervisor on her Facebook page"); Sam Hananel, *Facebook Post Firing of Conn. Woman Illegal: Feds*, CHRISTIAN SCIENCE MONITOR, Nov. 10, 2010, available at <http://www.csmonitor.com/USA/Latest-News-Wires/2010/1110/Facebook-post-firing-of-Conn.-woman-illegal-Feds>.

304. Greenhouse, *supra* note 303.

305. Lafe Solomon Interview, *supra* note 73.

306. Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872, 7 (Sept. 6, 2011). Currently pending a Board decision on the ALJ Decision. The case is open as of February 5, 2012.

307. General Counsel 2011 Memorandum, *supra* note 9, at 4.

308. Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872, 4 (Sept. 6, 2011).

309. *Id.* at 4-6.

Damicela Rodriguez: What the f. . . Try doing my job I have 5 programs

Ludimar Rodriguez: What the Hell, we don't have a life as is, What else can we do???

Yaritza (M Ntal) Campos: Tell her to come do [my] fucking job n c if I don't do enough, this is just dum

Carlos Ortiz de Jesus: I think we should give our paychecks to our clients so they can "pay" the rent, also we can take them to their Dr's appts, and served as translators (oh! We do that). Also we can clean their houses, we can go to DSS for them and we can run all their errands and they can spend their day in their house watching tv, and also we can go to do their grocery shop and organized the food in their house pantries . . . (insert sarcasm here now)

Mariana Cole-Rivera again: Lol. I know! I think it is difficult for someone that its not at HUB 24-7 to really grasp and understand what we do. . . I will give her that. Clients will complain especially when they ask for services we don't provide, like washer, dryers stove and refrigerators, I'm proud to work at HUB and you are all my family and I see what you do and yes, some things may fall thru the cracks, but we are all human :) love ya guys

Nannette Dorrios, a member of the Board of Directors: Who is Lydia Cruz?

Yaritza Campos again: Luv ya too boo

Mariana Cole-Rivera: She's from the dv program works at the FJC [Family Justice Center] at hub once a week.

Jessica Rivera, the Secretary to HUD Director Iglesias: Is it not overwhelming enough over there?

Lydia Cruz-Moore: Marianna stop with ur lies about me. I'll b at HUB Tuesday..

Cole-Rivera: Lies? Ok. In any case Lydia, Magalie [Lomax, HUB'S Business Manager] is inviting us over to her house today after 6:00 pm and wanted to invite you but does not have your number i'll inbox you her phone number if you wish.

Carlos Ortiz: Bueno el martes llevo el pop corn [Good, Tuesday, I'll bring the popcorn].³¹⁰

Management, which the opinion suggests may have been keen on finding an excuse to reduce staff, termed the behavior online harassment against the other employee and used it to justify the firing of all five Facebook posters.³¹¹

Ultimately, the employees got their jobs back because the judge found concerted activity under the *Meyers* cases and no opprobrium.³¹² According to the General Counsel's Memo, the activity was deemed concerted because:

The discussion was initiated by the one coworker in an appeal to her coworkers for assistance. Through Facebook, she surveyed her coworkers on the issue of job performance to prepare for an anticipated meeting with the Executive Director, planned at the suggestion of another employee. The resulting conversation among coworkers about job performance and staffing level issues was therefore concerted activity.³¹³

The ALJ concluded that a single employee can be considered to be engaging in concerted activity if she is enlisting support from colleagues for mutual aid and protection with the goal of initiating or inducing group action.³¹⁴ Had the employee in *Wal-Mart*³¹⁵ used language that more explicitly suggested this motive, he may have received protection. The ALJ found for the employees despite finding that the employees were not necessarily trying to change their working conditions.³¹⁶ Though attempts to change working conditions are more likely to be protected activity, other activity can also be protected, especially if it clearly calls for colleagues' participation.³¹⁷

Upon finding concert and no violation of the employer's zero tolerance or discrimination policy, the ALJ applied the *Atlantic Steel* factors to show that the employees did not lose protection based on opprobrious conduct.³¹⁸ With regard to factor (1), place, the Facebook posts were not made at work and were not made during working hours.³¹⁹ As to (2), the subject matter, the Facebook posts had to do with a coworker's criticisms of employee job

311. *Id.* at 10.

312. *Id.* at 7, 9, 10.

313. General Counsel 2011 Memorandum, *supra* note 9, at 4.

314. Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872, 7 (Sept. 6, 2011); *see* NLRB v. Mushroom Transportation Co., 330 F.2d 683, 685 (3d Cir. 1964) (noting that "the object of inducing group action need not be express"); Whittaker Corp., 289 N.L.R.B. 933 (1988).

315. Wal-Mart, NLRB Adv. Mem., Case No. 17-CA-25030 (July 19, 2011).

316. Hispanics United of Buffalo, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872, 8 (Sept. 6, 2011);

317. *Id.*

318. *Id.* at 9.

319. *Id.*

performance, which the employees had a protected right to discuss.³²⁰ As to factor (3), there were no “outbursts” against the nonprofit and several posts did not even mention Cruz-Moore, the coworker who criticized Cole-Rivera’s work; none of the employees criticized the employer in their posts.³²¹ With regard to factor (4), the ALJ found irrelevant the fact that the employer did not provoke the Facebook comments.³²² *Hispanics United of Buffalo* provides an example against which to measure *JT’s Porch Saloon & Eatery* and *Wal-Mart* and highlights inconsistencies as to how the General Counsel analyzes social media posts.

In *Triple Play Sports Bar & Grille*, an ALJ found protected concerted activity with no opprobrious conduct.³²³ After several of the employer’s former and current employees discovered that they owed additional state income taxes related to the employer’s earnings, the employer arranged a staff meeting with the accountant and payroll company to discuss concerns.³²⁴ A former employee subsequently posted on her Facebook page a comment expressing dissatisfaction with the fact that she owed more money.³²⁵ Her wall post and the responses it generated read as follows:

LaFrance (former employee): Maybe someone should do the owners of Triple Play a favor and buy it from them. They can’t even do the tax paperwork correctly!!! Now I OWE money . . . Wtf!!!!

Ken DeSantis (customer): You owe them money . . . that’s fucked up.

Danielle Marie Parent (employee): I FUCKING OWE MONEY TOO!

LaFrance: The state. Not Triple Play. I would never give that place a penny of my money. Ralph fucked up the paperwork . . . as per usual.

De Santis: Yeah I really don’t go to that place anymore.

320. *Id.*

321. *Id.*

322. *Id.*

323. *Triple Play Sports Bar & Grille*, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915, 22 (Jan. 3, 2012). Currently pending whether Board will grant review. At the time of the General Counsel’s year-end Memo, the ALJ had not issued a decision. No case-specific Advice Memo was available at the time of this Note’s writing.

324. *Id.* at 3.

325. *Id.*

LaFrance: It's all Ralph's fault. He didn't do the paperwork right. I'm calling the labor board to look into it because he still owes me about 2000 in paychecks.

LaFrance: We shouldn't have to pay it. It's every employee there that it's happening to.

DeSantis: You better get that money . . . that's bullshit if that's the case I'm sure he did it to other people too.

Parent: Let me know what the board says because I owe \$323 and I've never owed.

LaFrance: I'm already getting my 2000 after writing to the labor board and them [sic] investigating but now I find out he fucked up my taxes and I owe the state a bunch. Grrr.

Parent: I mentioned it to him and he said that we should want to owe.

LaFrance: Hahahaha he's such a shady little man. He probably pocketed it all from all our paychecks. I've never owed a penny in my life till I worked for him. That [sic] goodness I got outta there.

Sanzone: I owe too. Such an asshole.

Parent: Yeah me neither, I told him we will be discussing it at the meeting.

Sarah Baumbach (employee): I have never had to owe money at any jobs . . . I hope I won't have to at TP . . . probably will have to seeing as everyone else does!

LaFrance: Well discuss good because I won't be there to hear it. And let me know what his excuse is.

Jonathan Feeley (customer): And they're way too expensive.³²⁶

According to the ALJ, the comments were protected under Section 7, in part because the discussion was part of a "sequences of events" that included face-to-face conversations lamenting the tax problems.³²⁷

In finding that the employer violated Section 8, the ALJ cited precedent stating that concerted activity "encompasses those circumstances where individual employees seek to initiate or to induce or to prepare for group action."³²⁸ Applying *Atlantic Steel*, the ALJ found that the employees'

326. *Id.* at 3–4.

327. *Id.* at 8.

328. *Id.* (quoting *Meyers II*, 281 N.L.R.B. 883, 887 (1986); see also *KNTV, Inc.*, 319 N.L.R.B. 447, 450 (1995) (noting that "concerted activity encompasses activity which begins

concerted activity did not lose protection for opprobrium.³²⁹ The place of the comments, under factor (1), did not interfere with the workplace because the employees commented outside the workplace during nonworking time so did not disrupt the work environment.³³⁰ The subject, under factor (2), had to do with a core concern that Section 7 protected.³³¹ Under factor (3), the outbursts did not include offensive language worthy of removing protection and did not include “threats, insubordination, or physically intimidating conduct.”³³² The ALJ found that it did not matter that comments were not provoked, under factor (4), by unlawful tax practices on the part of the employer.³³³ The employer alleged defamation, but that failed because the comments were not made with a “malicious motive.”³³⁴ Had the comments been less clearly supportive of the original post, it is possible that this case could have come out like *JT’s Porch Saloon & Eatery*³³⁵ and *Wal-Mart*.³³⁶ Fortunately for the employees, however, they used language that made concert clear.

In *American Medical Response of Connecticut*,³³⁷ *Hispanics United of Buffalo*,³³⁸ and *Triple Play Sports Bar & Grille*,³³⁹ applying the *Atlantic Steel* test to the facts of each case enabled the employees to get the protections that concerted activity provided.³⁴⁰ As the *Jefferson* standard shows, opprobrious conduct includes evidence of malice and disloyalty, but the NLRB attorneys did not find such behavior in the three concerted activity cases considered in the Social Media Memo.³⁴¹ Thus, the employees in those cases prevailed.³⁴²

with only a speaker and listener, if that activity appears calculated to induce, prepare for, or otherwise relate to some kind of group action”).

329. *Triple Play Sports Bar & Grille*, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915, 9–13 (Jan. 3, 2012).

330. *Id.* at 10.

331. *Id.* at 10–11.

332. *Id.* at 11.

333. *Id.* at 14.

334. *Id.* at 11.

335. *JT’s Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689 (July 7, 2011).

336. *Wal-Mart*, NLRB Adv. Mem, Case No. 17-CA-25030 (July 19, 2011).

337. *Am. Med. Response of Conn.*, Adv. Mem., Case No. 34-CA-12576 (Oct. 5, 2010).

338. *Hispanics United of Buffalo*, NLRB Administrative Law Judge Decision, Case No. 3-CA-27872 (Sept. 6, 2011).

339. *Triple Play Sports Bar and Grille*, NLRB Administrative Law Judge Decision, Case No. 34-CA-12915 (Jan. 3, 2012).

340. *See* General Counsel 2011 Memorandum, *supra* note 9.

341. *See id.*

342. *See id.*

E. LEGALITY OF SOCIAL MEDIA POLICIES

If Field Examiners, the Division of Advice attorneys, the General Counsel, the ALJ, and the Board would acknowledge the unique ways in which people engage with social networking, both employers and employees would benefit from more predictable rulings that could also enable employers to write better social media policies. These policies should go beyond merely quoting the NLRA and should have examples that employees can understand, such that they can reasonably interpret the limitations described. The policies should spell out, for example, that people can be critical and talk to fellow employees about confidential information and wages offline and online. Employers have some flexibility as to what they want to permit, but they must not forbid activities that are protected by the NLRA.

1. *The Standards for Evaluating Employers' Social Media Policies*

In determining the outcome of cases involving social media, the General Counsel strives to ensure that employers do not have inappropriately restrictive policies.³⁴³ In addition to looking at the *Lafayette Park* standard, which asks whether an employer's "rules would reasonably tend to chill employees in the exercise of their Section 7 rights,"³⁴⁴ the General Counsel uses *Lutheran Heritage*.³⁴⁵ The standard that emerged from that case states that a rule is unlawful if it explicitly restricts Section 7 activities, or if it is shown that (1) employees would reasonably construe the language to prohibit Section 7 activity; (2) the rule was promulgated in response to union activity; or (3) the rule has been applied to restrict the exercise of Section 7 rights.³⁴⁶ The *Lafayette Park* and *Lutheran Heritage* standards together give employees additional protection.

2. *Cases Considering Social Media Policies*

Three of the cases analyzed in the General Counsel's Social Media Memo focus on the legality of an employer's social media policy. In all three, the General Counsel found overly broad policies. In *Flagler Hospital*, the NLRB attorneys advocated protecting an employee's Facebook criticisms of a fellow nurse and finding the hospital's social media policy too broad.³⁴⁷ Prior to the

343. Lafe Solomon Interview, *supra* note 73.

344. *Lafayette Park Hotel*, 326 N.L.R.B. 824, 825 (1998).

345. *Lutheran Heritage Village-Livonia*, 343 N.L.R.B. 646 (2004).

346. *Id.* at 647.

347. *Flagler Hospital*, Adv. Mem., Case No. 12-CA-27031, 1 (Oct. 19, 2011). Case was closed on August 24, 2011.

posting, several nurses had complained to the manager about their colleague's frequent absences.³⁴⁸ The post, written several days after the nurse had again called in sick, discussed the nurse's "history" of absences, which "totally disrupted" and "really screwed" the operating room.³⁴⁹ The policy, which the Memo found violated Section 8(a)(1) by potentially chilling Section 7 protected activity,³⁵⁰ included the following provisions:

4. No 'tweet,' blog or social networking page or site may in any way violate, compromise, or disregard the privacy or confidentiality rights or privileges of any Hospital patient; the confidentiality or protections granted or provided to personal health information or other protected information or data; or rights and reasonable expectations as to privacy or confidentiality of any person or entity.

5. Any communication or post which constitutes embarrassment, harassment or defamation of the Hospital or of any Hospital employee, officer, board member, representative or staff member, including members of the medical staff, is strictly prohibited.

6. Any conduct, behavior or form of expression which, under the law, is or may be impermissible if expressed in another form or forum is likewise impermissible if expressed through any social networking media, blog or social networking site or page. This includes any statements which lack or are reckless as to truthfulness or which might cause damage to or does damage the reputation or goodwill of the Hospital, its staff or employees in the community or otherwise.³⁵¹

The NLRB attorneys found the policy unlawful³⁵² under the second part of the *Lutheran Heritage* test—which prohibits promulgating a rule in response to union activity.³⁵³ The policy did not contain guidance as to what the employer meant by "private" and could lead employees to believe that they could not discuss wages or other legally permissible topics.³⁵⁴

Further, the General Counsel explicitly criticized the inclusion in the Flagler Hospital policy of a deceptive "savings clause" in Rule 6, which used the phrase "under the law" to avoid liability.³⁵⁵ Citing *McDonnell Douglas Corp.*,

348. *Id.* at 2.

349. *Id.*

350. *Id.* at 1.

351. *Id.* at 1–2.

352. *Id.* at 3.

353. *Lutheran Heritage Village-Livonia*, 343 N.L.R.B. 646, 647 (2004).

354. *Flagler Hospital*, Adv. Mem., Case No. 12-CA-27031, 3 (Oct. 19, 2011). Case was closed on August 24, 2011.

355. *Id.* at 5.

the General Counsel explained the rationale for criticizing such clauses: “[I]t can reasonably be foreseen that employees would not know what conduct is protected by the National Labor Relations Act and, rather than take the trouble to get reliable information on the subject, would elect to refrain from engaging in conduct that is in fact protected by the Act.”³⁵⁶ The NLRB does not look highly upon savings clauses intended to prevent employees from questioning unlawful policies.³⁵⁷

Similarly, in *Parks & Sons of Sun City*, the General Counsel viewed the employer’s social media policy as overly broad.³⁵⁸ The policy forbade employees from discussing company business online and from posting content that they would not show their supervisors or that could be deemed inappropriate.³⁵⁹ It went so far as to prohibit employees from using the company name or other identifying information on personal profile pages.³⁶⁰ Here, too, the NLRB relied on the *Lutheran Heritage* factors in finding that the policy could reasonably be construed to prohibit Section 7 protected behavior, such as discussing wages or other terms and conditions of employment and that the employer provided no rationale for prohibiting listing the company name on a person’s social networking profile page.³⁶¹ Some sort of rationale related to confidentiality and safety seems reasonable, but absent that, employees should have a right to display their employer’s name.

In *Giant Eagle Inc.*, the regional office attorneys found two parts of a supermarket chain’s social media policy too broad.³⁶² The Advice Memo accepted the first of three parts under review but not the remaining parts.³⁶³ The sections at issue included:

3. No Team Member is required to participate in any social media or social networking site (unless required as a part of the job), and no Team Member should ever be pressured to ‘friend,’ ‘connect,’

356. *Id.* (citing McDonnell Douglas Corp., 240 N.L.R.B. 794, 802 (1979)).

357. McDonnell Douglas Corp., 240 N.L.R.B. 794, 802 (1979).

358. General Counsel 2011 Memorandum, *supra* note 9, at 20-1. The General Counsel’s Memo does not include the name of the case, but through conversations with NLRB staff, the author was able to find the name of the case: *Parks & Sons of Sun City, Inc.*, Case No. 28-CA-23350 (filed Jan. 28, 2011), no documents available due to open status of case and the protocol/decision of NLRB personnel.

359. *Id.* at 21.

360. *Id.*

361. *Id.*

362. Giant Eagle Inc., Case No. 6-CA-37260, Adv. Mem., 1 (Oct. 19, 2011). Case was closed on July 28, 2011.

363. *Id.*

or otherwise communicate with another Team Member via a social media outlet.

....

5. Team Members may not reference (including through use of photographs), cite, or reveal personal information regarding fellow Team Members, company clients, partners, or customers without their express consent.

6. Use of Company logos, photographs of any Company store, brand, or product, or use of any other intellectual property is not permitted without written proper authorization from the Company.³⁶⁴

The General Counsel agreed that the rule against pressuring was sufficiently narrowly tailored in its attempts to prevent harassment.³⁶⁵ However, the rule against revealing personal information could squelch discussion of wages, and the rule against using company logos or photographs could unlawfully prohibit posting pictures of peaceful union organizing or other work protests.³⁶⁶

This Note commends the NLRB attorneys and the General Counsel for pushing employers to draft more specific social media policies. Going forward, the more precise the General Counsel can be about what does not pass muster and why, the more likely employers will have the ability to comply. The General Counsel has more steps to take in order to communicate the limits of protection with greater clarity. The *Lafayette Park* standard, prohibiting policies with a tendency to “chill employees in the exercise of their Section 7 rights,”³⁶⁷ provides a useful floor for scrutiny. The *Lutheran Heritage* standard, which adds steps to the inquiry, looking at the origin of the policy and its actual application,³⁶⁸ can further guide employers. The Board should encourage employers to draft model guidelines for employees. Since these can help employers avoid lawsuits, employers have an interest in directing resources and consideration towards such efforts.

364. *Id.* at 2.

365. *Id.* at 3.

366. *Id.* at 3–4.

367. *Lafayette Park Hotel*, 326 N.L.R.B. 824, 825 (1998).

368. *Lutheran Heritage Village-Livonia*, 343 N.L.R.B. 646, 647 (2004).

IV. RECOMMENDATIONS FOR ADDRESSING SOCIAL MEDIA CASES

Whether through future rulemaking or through new approaches to social media cases, NLRB attorneys, the General Counsel, ALJs, and the Board should adopt an approach that is flexible enough to adequately address social media cases instead of operating under the false assumption that online activity mirrors offline activity. Further, the General Counsel should provide guidelines and a range of sample social media policies—targeted at various types of businesses—to assist employers. The General Counsel should directly address the issue of whether Facebook friends’ responses, and the subtleties in diction of a particular post, should actually be the basis for determining protection.

Because employees often do not know that they have rights under the NLRA,³⁶⁹ the NLRB’s recent decision to require employers to post NLRA rights marks a step in the right direction.³⁷⁰ Next, the NLRB must confront the challenge of seeing this policy through and making sure the notice actually reaches employees. Employers could avoid costs associated with complaints and litigation by crafting specific social media policies that are not too limiting, and the NLRB should make templates readily available. As rules become further delineated, employees will be more likely to comply and also to accept discharges when the law permits them. But policies alone are generally not sufficient. Workplace training would likely help.

To avoid misleading employees, some scholars suggest that employers should add the following language to their policies: “Nothing in this policy should be interpreted to prevent, interfere with, or otherwise restrain an individual’s legitimate exercise of his or her Section 7 activities under the National Labor Relations Act.”³⁷¹ This approach appears to protect the

369. Corbett, *supra* note 14, at 297–98.

370. *Employee Rights Notice Posting*, *supra* note 17 (“[T]he notice should be posted in a conspicuous place, where other notifications of workplace rights and employer rules and policies are posted. Employers also should publish a link to the notice on an internal or external website if other personnel policies or workplace notices are posted there.”); Press Release, American Rights at Work, Statement on Rule to Improve Awareness of NLRA Workplace Rights (Aug. 25, 2011), available at <http://www.americanrightsatwork.org/press-center/2011-press-releases/statement-on-rule-to-improveawareness-of-nlra-workplace-rights-20110825-1036-416.html> (mentioning that American Rights at Work Executive Director Kimberly Freeman Brown issued a statement including the following endorsement: “This rule is a step in the right direction toward giving more men and women a fair vote in the workplace to help rebalance our economy, and rebuild the middle class”).

371. Jeffrey S. Klein & Nicholas J. Pappas, *Do Social Media Policies Violate NLRA Section 7 Rights?*, NEW YORK L.J. (Oct. 11, 2011), <http://www.law.com/jsp/lawtechnologynews/PubArticleLTN.jsp?id=1202518441906&slreturn=1>.

employer from possible claims that its policy is overbroad. But as the General Counsel articulated in *Flagler Hospital*, a savings clause alone cannot shield an employer from liability.³⁷² Further, the law should do more than encourage litigation avoidance. That clause should be accompanied by a clear explanation of the NLRA, with examples of its common applications, tailored to the particular workplace. That will make it much more useful to employees.

Of the cases considered in this Note, *JT's Porch Saloon & Eatery* and *Wal-Mart* are the most troubling because employee posts that appear just as concerted as protected posts in other cases did not receive protection—mostly because of the NLRB's unwillingness to consider the realities of social networking. In *JT's Porch Saloon & Eatery*, the employee had discussed his discontent with terms and conditions of work prior to posting his Facebook grievance.³⁷³ If he had more colleagues as Facebook friends, it is possible that somebody would have responded and agreed with him. And had he been more explicit about asking others to join him, he may have fared better. Considering reasoning employed in the other cases, it is likely that NLRB attorneys or an ALJ could have found concert in this situation. It seems unjust that this sort of contingency is the *sine qua non* of whether or not behavior is deemed protected.

Clarifying what types of posts will give the employee protection could enable employees to act more strategically. For example, in the offline world, the Board overruled an ALJ decision in a case in which nurses called a hotline to complain about the high temperature of a nursing home and how it affected patients.³⁷⁴ The Board ruled that because the nurses only mentioned the well-being of patients in their phone call—not their own well-being—this did not constitute a complaint about the terms and conditions of employment and therefore did not merit Section 7 protection.³⁷⁵ Had the nurses instead stated that they were worried about their patients' health and their own health, it is likely that they would have been able to keep their jobs.³⁷⁶ This example illustrates how, with more information, employees could tailor their gripes in a way that would give them legal recourse.

372. *Flagler Hospital*, Adv. Mem., Case No. 12-CA-27031, 5 (Oct. 19, 2011).

373. *JT's Porch Saloon & Eatery*, NLRB Adv. Mem., Case No. 13-CA-46689, 1 (July 7, 2011).

374. Chairman Battista, Decisions and Orders of the NLRB, Case 3-CA-23704 (Apr. 30, 2004).

375. *Id.* at 645.

376. *See id.*

On the flip side, in the social media context, there may be a downside to giving employees too much information. Perhaps one could imagine that if an employee knows that her Facebook post will be permissible if it encourages group action, she will carefully craft a gripe that disparages the employer considerably, without going so far as to be considered opprobrious. If she adds a line asking for her colleagues to support her in complaining about a manager, whom she has harshly criticized, she may find that she is protected. The employee in *Wal-Mart*,³⁷⁷ had he known more about the NLRA, probably could have done this and kept his job. But do we as a society want to encourage these sorts of workarounds? Would this dilute the concerted activity standard, rendering it easily manipulated?

In *Wal-Mart*, a case in which the employee did have Facebook friend colleagues responding to his post, the nature of the responses—specifically, the wording used—informed the outcome of the case.³⁷⁸ Given how casually people engage on Facebook, this result also seems arbitrary.³⁷⁹ Had a colleague written something in a different way, showing just a touch more “concert,” Section 7 of the NLRA may have protected this employee’s postings. Fact patterns matter and should determine how law gets applied, online and offline. But the slight variations in facts in the above cases should not lead to such different outcomes. Because the NLRB attorneys had to comply with the strict *Meyers* standard and did not take into account the unique characteristics of Facebook, these holdings inappropriately punished employees. In an age of at-will employment and decreasing unionization, when an employee loses her job, she may find herself unable to find another one quickly.

Accordingly, the General Counsel should rethink the NLRB’s approach to social networking cases in order to create fairness and standardization. A just society demands at least that much.

377. *Wal-Mart*, NLRB Adv. Mem, Case No. 17-CA-25030 (July 19, 2011).

378. *Id.* at 3 (“[T]he Charging Party’s Facebook postings were an expression of an individual gripe. They contain no language suggesting the Charging Party sought to initiate or induce coworkers to engage in group action; rather they express only his frustration regarding his individual dispute with the Assistant Manager over mispriced or misplaced sale items. Moreover, none of the coworkers’ Facebook responses indicate that they otherwise interpreted the Charging Party’s postings.”).

379. The standard analysis employed by the NLRB now does not seem to take into account norms surrounding social media. One of the few scholars to look at the recent social media cases before the NLRB concluded that social networking does not change the analysis at all. Sprague, *supra* note 39 (noting that “the fact that employees are using Facebook and other social media tools to discuss work does not alter the basic analysis of what does and does not constitute protected concerted activity”).

V. CONCLUSION

Many employees are not aware that the NLRA gives them important rights that extend to social networking posts.³⁸⁰ It allows them to complain, so long as their complaints are of a certain nature and do not violate other laws.³⁸¹ Knowing the details of these rights can help employees keep their jobs. Ideally, employees would think before they post, but the nature of social networking and the casual way in which many people utilize it suggest that future cases will continue to push the limits of protected online activity. If we accept that younger generations, who are growing up with pervasive technology, are particularly accustomed to digitally sharing many aspects of their lives,³⁸² then it seems appropriate for the General Counsel and the Board to develop standards that can provide guidance for current and future generations. Employees should push their employers to craft social media policies and should make sure to consult these policies. Employees should also consult their NLRA rights so that when they casually post, they have a sense, at least in the back of their minds, as to what sort of behavior is protected against an employer's retaliation.

The Board, in turn, should push for successful implementation of the newly mandated notification system³⁸³ through which employers must inform employees of their NLRA rights. Meanwhile, the General Counsel should allow NLRB attorneys more leeway in interpreting when online speech is protected on social networks. Precedent based on standards of concerted activity and opprobrious behavior serve in some cases, but in others, the attorneys should display more agility in considering the context of social networking posts. If the aim is to offer timely guidance and rulings, the

380. Press Release, American Rights at Work, Statement on Rule to Improve Awareness of NLRA Workplace Rights, (Aug. 25, 2011), *available at* <http://www.americanrightsatwork.org/press-center/2011-press-releases/statement-on-rule-to-improve-awareness-of-nlra-workplace-rights-20110825-1036-416.html>. (“[Kimberly Freeman Brown stated:] Studies show that many employees are unaware of their rights under the NLRA, which protects union and non-union works. Employers, even those who strive to act lawfully, are similarly uninformed.”).

381. The National Labor Relations Act, 29 U.S.C. §§ 151–169 (2006).

382. See JOHN PALFREY, BORN DIGITAL: UNDERSTANDING THE FIRST GENERATION OF DIGITAL NATIVES 1–2 (2010) (“You see [Digital Natives] everywhere. . . . They were all born after 1980, when social digital technologies, such as Usenet and bulletin board systems, came online. They all have access to networked digital technologies. . . . Major aspects of their lives—social interactions, friendships, civic activities—are mediated by digital technologies. And they’ve never known any other way of life.”).

383. *Employee Rights Notice Posting*, *supra* note 17 (noting that the date the notice requirement goes into effect was postponed to April 30, 2012).

General Counsel must develop a more technologically cognizant approach to social networking cases.

WYETH AND PLIVA: THE LAW OF INADEQUATE DRUG LABELING

Daniel Kazhdan[†]

In *Wyeth v. Levine*, decided in 2009, the U.S. Supreme Court held that consumers *could* sue brand-name drug manufacturers under state tort laws for inadequately labeling a drug (where the drug's label did not warn, or warn sufficiently, of side effects that the drug company knew or should have known of).¹ Just two years later, the Supreme Court held in *PLIVA Inc. v. Mensing* that consumers *could not* sue generic drug manufacturers for inadequately labeling a drug.² The result in *PLIVA*, viewed in light of *Wyeth*, seems unfair for two reasons. First, why should a consumer's right to compensation depend on whether he purchased a brand-name or generic drug? Second, and this happened in *PLIVA*, sometimes plaintiffs are prescribed a brand-name drug, but, because of state drug substitution laws, their pharmacists dispense the generic equivalent.³ The result is that state-sanctioned (and in some states even mandated) substitution causes the plaintiffs to lose their compensation.⁴

The Court itself noted that its distinction between lawsuits against brand-name drug manufacturers and lawsuits against generic drug manufacturers from the perspective of the plaintiffs "makes little sense."⁵ Nonetheless, the majority felt compelled to make the distinction because the Food and Drug Administration's ("FDA's") regulations distinguish between brand-name drug companies and generics. Generic drug companies cannot change their labels without prior FDA approval, while brand-name companies may do so unilaterally.⁶ Since federal law forbids generic drug companies from unilaterally changing their labels, allowing state tort suits for inadequate labeling would put generics in an impossible situation: state tort law would

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1. *Wyeth v. Levine*, 555 U.S. 555, 573 (2009).

2. *PLIVA Inc. v. Mensing*, 131 S. Ct. 2567 (2011).

3. *Id.* at 2581.

4. *Id.* For discussion of these substitution laws, see *infra* Part III.

5. *PLIVA*, 131 S. Ct. at 2581.

6. *Id.* at 2575. The explanation for this distinction is that the FDA does not want generic drug companies to have labels that differ in any substantive way from those of their brand-name equivalents. See *infra* note 160 and accompanying text.

require generics to label their drugs in a manner that federal law forbids.⁷ The Court therefore held that federal law preempted state tort suits against generic drug companies for inadequate labeling.⁸

This Note argues that the Court was right that the distinction between *Wyeth* and *PLIVA* “makes little sense.” A plaintiff’s right to compensation now depends on the vagaries of state drug substitution laws.⁹ Worse yet, as this Note will explain, under *Wyeth* and *PLIVA* only some generics will be preempted from suit. Authorized generics, those produced by the brand-name company, will still be suable. This makes even less sense.

To be fair, the Court is not the only government institution responsible for this state of affairs. The FDA—by permitting brand-name drug companies to unilaterally alter their label,¹⁰ while forbidding generic drug companies from changing their label under identical circumstances¹¹—created the distinction between generic drugs and brand-name drugs. The Courts in *Wyeth* and *PLIVA* merely took this distinction one step further, tying liability to the right to alter labels unilaterally.

There is a danger that the combination of these two decisions, *Wyeth* and *PLIVA*, will create public pressure on states, doctors, and pharmacists to avoid generic drug substitutions. This could result in states weakening or repealing their substitution laws, doctors prescribing brand-name drugs and prohibiting drug substitutions, pharmacists refusing to substitute drugs, or patients insisting on receiving the brand-name drug.

A backlash against generic drug substitution would be harmful. Generic drug substitutions save society billions of dollars a year and patients who are prescribed generic drugs, which are cheaper, are more likely to comply with their drug regimen.¹² Importantly, this backlash would come from the inequivalence of the legal status of brand-name and generic drugs. Which substantive law is to be applied (whether both should or should not be suable) is not the concern of this Note.

There are a number of ways (aside from the Court reversing either *Wyeth* or *PLIVA*) that patients who take generic drugs could have the same legal

7. *Id.* at 2574–75.

8. *Id.* at 2582.

9. *Id.* at 2581.

10. *Wyeth v. Levine*, 555 U.S. 555, 568–71 (2009) (citing 21 C.F.R. § 314.70(c)(6)(iii)(A), (C) (2008); 73 Fed. Reg. 49,604–07 (Aug. 22, 2008)).

11. *PLIVA*, 131 S. Ct. at 2574–75 (citing Brief for the U.S. as Amicus Curiae Supporting Respondents at 16, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 741927 [hereinafter SG Brief]).

12. *See infra* Part III.

rights as those who take brand-name drugs: the FDA, Congress, and states all have means of effecting such a change. The FDA could either permit generic drug companies to change their labels if they learn of new adverse side effects (thus changing the result in *PLIVA*) or it could forbid brand-name drug companies from unilaterally changing the label in similar situations (thus changing the result in *Wyeth*). It is also possible that the FDA, using proper procedures, could create preemption even against brand-name drugs (changing *Wyeth*). Alternatively, Congress could either explicitly preempt suits against brand-name companies (abrogating *Wyeth*) or explicitly permit suits against generic drug companies (abrogating *PLIVA*). Finally, states could allow plaintiffs who are harmed by inadequately labeled generics to sue the brand-name drug that determined the label, or states may require that generic drug companies waive their preemption defense before the state substitutes the generic for a brand-name prescription.

Part I of this Note reviews the facts of *Wyeth* and *PLIVA*. Part II notes that situations like that in *PLIVA*, where adverse side effects are discovered after the generic enters the market are not rare. It also shows that after *Wyeth* and *PLIVA* authorized generics should be treated differently than other generics. Part III argues that the Court's decisions may create a backlash against generic drugs. Finally, Part IV proposes ways that drug companies, the FDA, Congress, and the states could remedy the harmful effects of the Court's distinction between brand-name drugs and generic drugs.

I. THE TWO CASES

A. *WYETH V. LEVINE*: CONSUMERS CAN SUE THE BRAND-NAME MANUFACTURER

In *Wyeth v. Levine*, the Supreme Court held that consumers can sue brand-name drug companies for inadequate drug-labeling, despite the fact that the FDA approved the label of the drug.¹³ The case arose when Levine, who had been treated with Wyeth's drug, sued Wyeth for not adequately labeling the method of delivery of the drug Phenergan.¹⁴ The label did not make clear that Phenergan should be delivered via an IV-drip method (where the drug is mixed with saline solution and dripped through a catheter into the patient's vein) as opposed to an IV-push method (where it is introduced directly into

13. *Wyeth*, 555 U.S. 555.

14. *Id.* at 559–60.

the vein).¹⁵ As a result, a physician's assistant¹⁶ used the IV-push method and Levine developed gangrene, eventually requiring that her arm be amputated.¹⁷ After Levine settled her case against the health center and clinician, she brought a state law tort action in Vermont, alleging that the inadequate labeling caused her injury.¹⁸ Wyeth argued that the FDA's approval of the Phenergan label should preempt the state law cause of action,¹⁹ and supported its argument with the FDA's explicit statement, in the preamble to one of its regulations, that FDA approval preempts state suits.²⁰ The Vermont Supreme Court, however, sided with the plaintiffs.²¹

The Supreme Court, in a majority opinion by Justice Stevens, joined by Justices Kennedy, Souter, Ginsburg, and Breyer, affirmed the Vermont Supreme Court, holding that since Wyeth could have modified its label unilaterally (i.e. without FDA approval) there was no conflict between the FDA's approval of Wyeth's label and Levine's suit against Wyeth.²² The Court bolstered its decision by noting that the Food, Drug, and Cosmetic Act ("FDCA") explicitly stated that it did not preempt state tort suits for actions that did not involve a "direct and positive conflict" with the federal law.²³ Moreover, given that the FDCA preempted state tort law suits for medical devices but made no similar provision for drugs, it seemed reasonable to rule that state tort law should not be preempted.²⁴ Justice Thomas, in concurrence, agreed with the Court that Wyeth should not be immune to a state tort suit.²⁵ However, he thought this was so solely because Wyeth could have changed its label unilaterally.²⁶

15. *Id.* at 560. As a result of the risk of developing gangrene, Phenergan is now delivered via deep intramuscular injection. *Phenergan Injection*, DRUGS.COM, <http://www.drugs.com/pro/phenergan-injection.html> (last revised Feb. 29, 2012).

16. The physician's assistant was also clearly at fault. She "administered a greater dose than the label prescribed, . . . may have inadvertently injected the drug into an artery rather than a vein, and . . . continued to inject the drug after Levine complained of pain." *Wyeth*, 555 U.S. at 564. The dissent argued that on this ground the Court should have found for Wyeth. *Id.* at 605 (Alito, J., dissenting). The majority argued that this issue was no longer on appeal. *Id.* at 564 n.2.

17. *Id.* at 558.

18. *See id.* at 559.

19. *Id.* at 563–64.

20. *Id.* at 575.

21. *Id.* at 563 (citing 183 Vt. 76, 84 (2006), *aff'd*, 555 U.S. 555).

22. *Id.* at 575–77 (disagreeing with the FDA); *id.* at 569–71 (holding Wyeth could unilaterally modify its label); *id.* at 574–75 (reasoning that there was no conflict).

23. *Id.* at 568 (citing 21 U.S.C. §§ 301–399d (2010)).

24. *Id.* at 567.

25. *Id.* at 582–83 (Thomas, J., concurring).

26. *Id.* at 583.

B. *PLIVA v. MENSING*: CONSUMERS CANNOT SUE THE GENERIC MANUFACTURER

PLIVA also involved a suit for inadequate drug labeling, but this time for a generic drug.²⁷ The plaintiffs, Mensing and Demahy, were prescribed Reglan, a brand-name drug, and their pharmacists dispensed metoclopramide, a generic version of the same drug, some of which was produced by PLIVA.²⁸ Additionally, Mensing's pharmacists dispensed a generic drug produced by the brand-name company, Wyeth.²⁹ As a result of taking metoclopramide, the plaintiffs developed tardive dyskinesia,³⁰ a disease characterized by involuntary movements.³¹

The pharmacists who substituted the prescribed brand-name drug for its generic alternative acted pursuant to state law.³² Specifically, in Minnesota, where Mensing received metoclopramide, a pharmacist *must* substitute a brand-name drug with a generic drug unless the patient objects.³³ In Louisiana, where Demahy received metoclopramide, it is unclear whether a pharmacist may or must substitute a generic drug—so long as the patient does not object.³⁴

The plaintiffs sued the generic drug manufacturers of metoclopramide, including PLIVA, for not listing tardive dyskinesia as a potential side effect.³⁵ The cause of action was a state law tort claim for inadequate labeling. The

27. *PLIVA Inc. v. Mensing*, 131 S. Ct. 2567 (2011).

28. *See id.* at 2573.

29. *Mensing v. Wyeth, Inc.*, 588 F.3d 603, 605 n.1 (8th Cir. 2009), *rev'd sub nom. PLIVA*, 131 S. Ct. 2567.

30. *PLIVA*, 131 S. Ct. at 2573.

31. Jeffrey M. Karp et al., *Metoclopramide Treatment of Tardive Dyskinesia*, 246 J. AM. MED. ASS'N 1934, 1934 (1981).

32. *PLIVA*, 131 S. Ct. at 2581.

33. MINN. STAT. § 151.21 (2011).

34. *See* LA. REV. STAT. ANN. § 37:1241 (2007 & Supp. 2012) (“The board may [punish a person who] (17)(a) Has knowingly selected an equivalent drug product if the practitioner or authorized prescriber instructs otherwise by either of the following: (i) On a written prescription drug order, handwriting a mark in a check-off box labeled with ‘Dispense as Written’, or the abbreviation ‘DAW’, or both, and personally handwriting his signature on a printed-single-signature line. . . . (ii) On an oral prescription, verbally indicating that a specific brand-name drug or product is ordered by the practitioner or authorized prescriber or his agent. The pharmacist shall note such information on the file copy of the prescription. (b) The patient shall be informed of, and consent to, the equivalent drug product interchange when the practitioner or authorized prescriber permits the equivalent drug product interchange.”).

35. *Demahy v. Actavis, Inc.*, 593 F.3d 428, 430 (5th Cir. 2010), *rev'd sub nom., PLIVA*, 131 S. Ct. 2567 (stating that Demahy sued the generic drug company, Actavis); *Mensing v. Wyeth, Inc.*, 588 F.3d 603, 605 (8th Cir. 2009), *rev'd sub nom., PLIVA*, 131 S. Ct. 2567 (stating that Mensing sued Actavis Elizabeth, Pliva, Teva, Wyeth, and UDL Laboratories).

Minnesota Supreme Court (where Mensing sued), in a 1977 case,³⁶ and the Louisiana Supreme Court (where Demahy sued), in a 1994 case,³⁷ held that state law required a manufacturer to warn prospective buyers of potential dangers. Explaining why preemption was inapplicable, the plaintiffs argued that generic drug companies could have legally effectuated a warning to the buyers in one of three ways.³⁸ First, the defendants could have unilaterally changed their label to add warnings about potential side effects.³⁹ Second, the generic drug manufacturers could have unilaterally sent “Dear Doctor” letters warning doctors of the potentially adverse side effects.⁴⁰ Finally, the defendants should have petitioned the FDA to require that both the generic and the brand-name drugs add warnings to their labels.⁴¹

PLIVA argued that the Hatch-Waxman Act, which sets forth general labeling laws, preempted state tort laws.⁴² The Act states that a generic drug application must contain “information to show that the labeling proposed for the new drug is the same as the labeling approved for the [brand-name] drug.”⁴³ PLIVA argued that the Hatch-Waxman Act required the generic label to be identical to the brand-drug label.⁴⁴ FDA regulations also stressed that the generic label had to be “the same as” the brand label.⁴⁵ Thus, PLIVA claimed that it could not both maintain the same label as the brand-name drug—which did not adequately state the risk of developing tardive dyskinesia—while also changing the label to comply with state law.⁴⁶ Similarly, PLIVA argued that “Dear Doctor” letters would constitute

36. *Frey v. Montgomery Ward & Co.*, 258 N.W.2d 782, 788 (Minn. 1977) (cited in *PLIVA*, 131 S. Ct. at 2573).

37. *Hines v. Remington Arms Co., Inc.*, 648 So. 2d 331, 337 (La. 1994) (cited in *Stahl v. Novartis Pharm. Corp.*, 283 F.3d 254, 270 (5th Cir. 2002) (applying Louisiana law) (cited in *PLIVA*, 131 S. Ct. at 2573)).

38. Interestingly, the Eighth Circuit suggested that if there were no way for generic drug companies to warn customers of potential dangers then the generic drug companies should have just left the market. *Mensing v. Wyeth, Inc.*, 588 F.3d 603, 611 (8th Cir. 2009), *rev'd sub nom. PLIVA*, 131 S. Ct. at 2567 (“The generic defendants were not compelled to market metoclopramide. If they realized their label was insufficient but did not believe they could even propose a label change, they could have simply stopped selling the product.”).

39. *PLIVA*, 131 S. Ct. at 2574–55.

40. *Id.* at 2576.

41. Brief for Respondents Gladys Mensing and Julie Demahy at 28–30, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 686400. *See PLIVA*, 131 S. Ct. at 2576–77.

42. Brief for Respondents, *supra* note 41, at 28–30 (citing 21 U.S.C. § 355 (2010)).

43. § 355(j)(2)(A)(v).

44. *PLIVA*, 131 S. Ct. at 2574–76.

45. 21 C.F.R. §§ 314.94(a)(8)(iv), 314.127(a)(7) (2011); *see PLIVA*, 131 S. Ct. at 2574.

46. *PLIVA*, 131 S. Ct. at 2574–76.

unauthorized labeling and therefore were also prohibited.⁴⁷ Finally, PLIVA argued that they had no duty to petition the FDA for a label change, and, in any event, state tort law should be preempted given the tenuousness of PLIVA's ability to change the label: PLIVA would have to convince the FDA, an independent actor, that a label change was necessary, and then the FDA would need to convince the brand-name manufacturer to change the label before PLIVA could change its own label.⁴⁸

The FDA, through an amicus brief filed by the Solicitor General, agreed with PLIVA that generic drug companies could not change their labels or send "Dear Doctor" letters without FDA approval, but it nevertheless agreed with the plaintiffs that suits against generic drug companies should not be preempted.⁴⁹ It argued that PLIVA was required to petition for broader warnings⁵⁰ and that this requirement made PLIVA liable for plaintiffs' injuries in cases where it did not petition for a label change.⁵¹ Congressman Waxman, an author of the Hatch-Waxman Act, agreed with the plaintiffs that the Hatch-Waxman Act should not be read to preempt state tort suits.⁵²

The Supreme Court, in an opinion by Justice Thomas, ruled in favor of PLIVA. First, the Court granted *Auer*⁵³ deference to the FDA's interpretations that generic drug companies cannot unilaterally change their

47. Brief of Petitioners PLIVA, Inc.; TEVA Pharms. USA Inc.; and UDL Labs, Inc. at 46–47, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 219554; see *PLIVA*, 131 S. Ct. at 2576.

48. Brief of Petitioners, *supra* note 47, at 47–55; see *PLIVA*, 131 S. Ct. at 2577.

49. *PLIVA*, 131 S. Ct. at 2574–76 (citing the SG Brief, *supra* note 11).

50. *Id.*

51. SG Brief, *supra* note 11, at 25–29.

52. Brief of Rep. Henry A. Waxman as Amicus Curiae in Support of Respondents Urging Affirmance, *PLIVA v. Mensing*, 131 S. Ct. 2567 (2011) (Nos. 09-993, 09-1039, 09-1501), 2011 WL 794113, at 2.

53. *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (opinion by Scalia, J.) (discussing deference to the interpretation of the Secretary of Labor described in an amicus brief and stating, "[b]ecause the . . . test is a creature of the Secretary's own regulations, his interpretation of it is, under our jurisprudence, controlling unless plainly erroneous or inconsistent with the regulation") (internal citations omitted). Although Justice Scalia signed onto the majority opinion in *PLIVA*, he questioned the validity of *Auer* deference in a decision published two weeks before *PLIVA*. *Talk America, Inc. v. Michigan Bell Telephone Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring) ("It is comforting to know that I would reach the Court's result even without *Auer*. For while I have in the past uncritically accepted that rule, I have become increasingly doubtful of its validity."). Of course, Justice Scalia was part of the dissent in *Wyeth* that thought that even suits against brand-names drug companies should be preempted. *Wyeth v. Levine*, 555 U.S. 555, 604 (2009) (Alito, J., dissenting). So he did not need to defer to the FDA's interpretations to find preemption.

labels or send “Dear Doctor” letters.⁵⁴ Under *Auer*, since the FDA’s interpretations were reasonable interpretations of its own regulations, the FDA’s position was upheld.⁵⁵

Given that generic drug companies could not unilaterally change their label or send “Dear Doctor” letters, the Court found that the Hatch-Waxman Act preempted suits against generic drug companies. The Court began by noting that since the Act did not discuss preemption, the task of inferring any such preemption fell to the courts.⁵⁶ The Court quickly dismissed the FDA brief as deserving little deference.⁵⁷ It then noted that even had PLIVA requested that the FDA change the label, the FDA would still have discretion whether to change the label.⁵⁸ Moreover, until 2007, when the plaintiffs’ injuries occurred, even if the FDA thought the label should be changed, it would need the brand-name to agree to a label change.⁵⁹ Thus, PLIVA, on its own, could not have changed its label and, therefore, it was impossible for PLIVA, without the assistance of the FDA, to both fulfill its state law and federal law obligations.⁶⁰ Since a label change would require decisions by a third party, the Court found it difficult to believe that Congress in enacting the federal law, which can preempt state law, did not intend to do so.⁶¹

54. *PLIVA*, 131 S. Ct. at 2576.

55. *Id.* at 2575–76

56. *Id.* at 2577 n.5.

57. *Id.* at 2575 n.1. Presumably, the reason the Court did not defer to the FDA’s claim of preemption is that preemption is a question of statutory interpretation (as opposed to the questions of label changes and “Dear Doctor” letters that are questions of the agency interpreting its own regulations) and statutory interpretation questions receive only strong deference (what is commonly known as *Chevron* deference, a reference to *Chevron, U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)) if the agency used extensive procedures. *United States v. Mead Corp.*, 533 U.S. 218, 227, 235–38 (2001). Because the FDA did not promulgate its brief based on extensive procedures, it received only a low level of deference which was ultimately overcome. *See Riegel v. Medtronic*, 555 U.S. 312, 326–27 (2008) (opinion by Scalia, J., for a unanimous Court). However, Scalia’s opinion on this question has not been consistent. *See Christensen v. Harris Cnty.*, 529 U.S. 576, 589 (2000) (Scalia, J., concurring in part and concurring in judgment) (arguing that a Solicitor General’s brief deserved *Chevron* deference).

58. *Id.* at 2578–79.

59. Food and Drug Administration Amendments Act of 2007 (“FDAAA”), Pub. L. No. 110-85, § 355, 121 Stat. 823, 925 (2007); *see also Wyeth v. Levine*, 555 U.S. 555, 567 (2009) (“In 2007, for the first time, [Congress] granted the FDA statutory authority to require a manufacturer to change its drug label based on safety information that becomes available after a drug’s initial approval.”).

60. *PLIVA*, 131 S. Ct. at 2579.

61. U.S. CONST. art. VI, cl. 2.

C. DISTINGUISHING *PLIVA* FROM *WYETH*

The decisions in *Wyeth* and *PLIVA*, allowing state tort suits against brand-name drug companies but not against generics, are in tension because they are founded on opposing assumptions about the role of the FDA. *Wyeth's* foundation is that the FDA cannot, on its own, effectively monitor drug labels, and therefore it allows state tort suits as a private means of enforcement.⁶² By contrast, the result in *PLIVA* implies that the FDA's seal of approval is sufficient assurance of drug safety, and therefore private tort suits would be redundant. Indeed, only Justices Thomas and Kennedy saw the two cases as legally distinguishable.⁶³

Justice Thomas, in keeping with his concurrence in *Wyeth*, distinguished *Wyeth* from *PLIVA* on the grounds that brand-name manufacturers could unilaterally change drug labels, whereas generic drug companies still needed FDA approval before they could change their labels.⁶⁴ Although Justice Kennedy did not join Justice Thomas's concurrence in *Wyeth*, that Kennedy joined both the *Wyeth* and the *PLIVA* majorities indicates that he too thought this distinction was meaningful.⁶⁵

The majority in *PLIVA* recognized that, from a policy perspective, its decision led to a strange, and in some ways unfair, result because the patients lost their right to compensation as a result of state substitution laws.

Had Mensing and Demahy taken Reglan, the brand-name drug prescribed by their doctors, *Wyeth* would control and their lawsuits

62. See *Wyeth*, 555 U.S. at 578–79 (“The FDA has limited resources to monitor the 11,000 drugs on the market, and manufacturers have superior access to information about their drugs, especially in the postmarketing phase as new risks emerge. State tort suits uncover unknown drug hazards and provide incentives for drug manufacturers to disclose safety risks promptly. They also serve a distinct compensatory function that may motivate injured persons to come forward with information.”).

63. This case is an example of a situation where many justices (seven of nine) thought two cases (*Wyeth* and *PLIVA*) were analogous and should be decided in the same manner, but a minority of justices (Thomas and Kennedy) saw the cases as meaningfully distinguishable. As a result, a new doctrine emerged that distinguished between the two cases in a fashion that most justices thought was irrelevant. A more famous example of this is the combination of affirmative action cases, *Gratz v. Bollinger*, 539 U.S. 244 (2003) (6–3), and *Grutter v. Bollinger*, 539 U.S. 306 (2003) (5–4), where a distinction that only Justices O'Connor and Breyer thought was meaningful carried the day. Other tribunals avoid this problem by joining several questions in a way that judges have to vote on them all together. See, e.g., *Case Concerning Oil Platforms (Iran v. U.S.)*, 2003 I.C.J. 161, 387 (Nov. 6) (separate opinion of Judge *ad hoc* Rigaux) (noting that he voted as he did because two issues were tied in the vote, so he either had to vote for both or neither).

64. *PLIVA*, 131 S. Ct. at 2579.

65. Only Justices Thomas and Kennedy were in the majority in both *Wyeth* and *PLIVA*.

would not be pre-empted. But because pharmacists, acting in full accord with state law, substituted generic metoclopramide instead, federal law pre-empts these lawsuits. We acknowledge the unfortunate hand that federal drug regulation has dealt Mensing, Demahy, and others similarly situated.⁶⁶

However, they argued that the absurdity should not be overstated, since it is uncommon for “genuinely new information” to surface about drugs that have been in use for a long time.⁶⁷

In dissent, Justice Sotomayor, joined by Justices Ginsburg, Breyer, and Kagan, disagreed.⁶⁸ They argued that preemption should only apply if PLIVA could show that it could not have obtained a label change.⁶⁹ Here, PLIVA could have requested a label change.⁷⁰ Thus, the burden should have been on PLIVA to show that such a request would have been ineffective.⁷¹ Since PLIVA had not met this burden, the dissent would not have found PLIVA’s state tort liability preempted.⁷²

The dissent argued that the result in *PLIVA* was problematic for several reasons. First, once generic drug manufacturers enter a drug market, the brand-name drug often leaves the market.⁷³ Indeed, approximately a quarter of drugs on the market no longer have brand-name equivalents.⁷⁴ Based on *PLIVA*, no private entity has the incentive to discover new harmful side effects: the brand-name no longer exists on the market and the generic manufacturers are immune from suit.⁷⁵ Second, while the first-order effect of *PLIVA* helps generic drug companies by immunizing them from inadequate labeling suits, the long term effect may be to reduce consumer trust in generics.⁷⁶ This, in turn, may lead states to revoke their drug substitution laws

66. *Id.* at 2581 (internal citations omitted).

67. *Id.* at 2581 n.9.

68. *Id.* at 2582 (Sotomayor, J., dissenting).

69. *Id.*

70. *Id.* at 2587.

71. *Id.* at 2588–89.

72. *Id.* at 2593.

73. *Id.* at 2592–93 (citing sources).

74. Brief for Marc T. Law et al. as Amici Curiae in Support of Respondents at 18, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 794111 (cited in *PLIVA*, 131 S. Ct. at 2584) (stating that 22–32% of drugs are available only as generics). One specific example of this is Phenergan, the drug at issue in *Wyeth*, where the brand-name is no longer available. *Generic Phenergan*, EMEDTV, <http://drugs.emedtv.com/phenergan/generic-phenergan.html> (last updated June 17, 2009).

75. *PLIVA*, 131 S. Ct. at 2592–93. All the generic drug companies have to do is pass along information about reported adverse side effects to the FDA, 21 C.F.R. § 314.80 (2009), but they need not analyze this information themselves.

76. *PLIVA*, 131 S. Ct. at 2593.

(laws that either require or permit pharmacists to replace prescriptions for brand drugs with generic drugs),⁷⁷ which would severely harm generic drug companies and more broadly deter consumer use of generic drugs.

II. THE SEVERITY OF THE PROBLEM

This Part details the severity of the problem created by the combination of *Wyeth* and *PLIVA* on two dimensions. First, it notes that it not rare to discover new side effects for generic drugs. Additionally, applying the holdings of *Wyeth* and *PLIVA* to cases of authorized generics, where brand-name companies produce generics of their own drug, leads to truly bizarre results.

A. *PLIVA* IS NOT UNCOMMON

The *PLIVA* majority reasoned that situations where newly discovered adverse side effects emerge after generics have entered the market are “rare.”⁷⁸ The Court’s rationale was that “patent protections ordinarily prevent generic drugs from arriving on the market for a number of years after the brand-name drug appears.”⁷⁹

The Court’s assertion that generics should not enter the market for a number of years is logically appealing. While generic drug companies often challenge the patents of brand-name drugs, they challenge first-generation patents (patents on the compound itself) less frequently,⁸⁰ so the brand-name drug presumably has some years of exclusivity. Moreover, even independent of patents, a company that successfully brings to market a drug that has not been previously approved by the FDA gets five years of exclusivity.⁸¹ Drugs

77. *E.g.*, MINN. STAT. § 151.21(3) (2011) (“When a pharmacist receives a paper or hard copy prescription on which the prescriber has not personally written in handwriting ‘dispense as written’ . . . and there is available in the pharmacist’s stock a less expensive generically equivalent drug that, in the pharmacist’s professional judgment, is safely interchangeable with the prescribed drug, then the pharmacist *shall*, after disclosing the substitution to the purchaser, dispense the generic drug, unless the purchaser objects.”) (emphasis added). Indeed, “all States have some form of generic substitution law [and] [s]ome States require generic substitution in certain circumstances.” *PLIVA*, 131 S. Ct. at 2583 (Sotomayor, J., concurring) (citations omitted). Presumably in part due to the mandatory substitution laws, “[n]inety percent of drugs for which a generic version is available are now filled with generics.” *PLIVA*, 131 S. Ct. at 2584 (Sotomayor, J., concurring) (citing DEPT. OF HEALTH AND HUMAN SERVS., ASPE ISSUE BRIEF: EXPANDING THE USE OF GENERIC DRUGS 3–4 (2010)).

78. *PLIVA*, 131 S. Ct. at 2582 n.9.

79. *Id.*

80. C. Scott Hemphill & Bhaven N. Sampat, *When Do Generics Challenge Drug Patents?*, 8 J. EMPIRICAL & LEGAL STUD. 613, 621 (2011).

81. 21 U.S.C. § 355(c)(3)(E) (2010).

are thus likely to have been on the market for some time before generics begin producing them, and therefore the label at the end of that period, when the generics can step in, should be fairly accurate and stable.

However, the Court understated the relevance of *PLIVA*. A 2002 study published in the Journal of the American Medical Association showed that of drugs approved for sale between 1975 and 1999, 10.2% acquired a new black box warning (the most serious warning the FDA can require) or were withdrawn from the market after entering the market.⁸² Of those, only half were documented within the first seven years after drug approval.⁸³ As noted by the amicus brief of Public Citizen in *PLIVA*, there are more recent examples of new adverse effects being discovered for old drugs.⁸⁴ For instance, in 2010, the FDA removed propoxyphene from the market because of cardiac risks after it had been on the market for fifty-three years.⁸⁵ In 2008, the FDA added a black-box warning to fluoroquinone antibiotics after they had been on the market for twenty-six years.⁸⁶ The frequent appearance of major label changes more than seven years after drug approval must be considered in light of the fact that the average drug patent is valid for only nine years following FDA approval of the drug, and that average time of validity has been dropping.⁸⁷ In other words, it is increasingly likely that new and severe adverse side effects will be discovered on generic drugs.

82. Karen E. Lasser et al., *Timing of New Black Box Warnings and Withdrawal for Prescription Medications*, 287 J. AM. MED. ASS'N. 2215, 2216 (2002).

83. *Id.* at 2218.

84. Brief of Public Citizen and AARP as Amici Curiae in Support of Respondents at 11–12, *PLIVA v. Mensing*, 131 S. Ct. 2567 (2011) (Nos. 09-993, 09-1039, 09-1501), 2011 WL 741928.

85. FDA, *Propoxyphene-Containing Products*, FDA, <http://www.fda.gov/Drugs/DrugSafety/PostmarketDrugSafetyInformationforPatientsandProviders/ucm233800.htm> (last updated Dec. 6, 2010).

86. FDA, *Information for Healthcare Professionals: Fluoroquinolone Antimicrobial Drugs*, FDA (July 8, 2008), <http://www.fda.gov/Drugs/DrugSafety/PostmarketDrugSafetyInformationforPatientsandProviders/ucm126085.htm>. Other examples abound. *See* Brief of the Am. Med. Ass'n et al. as Amici Curiae in Support of Respondents at 12–17, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 794118. Terbutaline sulfate received a black-box label in 2011. FDA, *FDA Warns Against Certain Uses of Asthma Drug Terbutaline for Preterm Labor: Certain Uses Could Lead to Maternal Heart Problems and Death*, FDA (Feb. 17, 2011), <http://www.fda.gov/NewsEvents/Newsroom/PressAnnouncements/ucm243840.htm>. Non-steroidal, anti-inflammatory drugs, like ibuprofen and naproxen, have been on the market since the 1970s. They received black-box warnings in 2005. FDA, *COX-2 Selective (Includes Bextra, Celebrex, and Vioxx) and Non-Selective Non-Steroidal Anti-Inflammatory Drugs (NSAIDs)*, FDA (Apr. 7, 2005), <http://www.fda.gov/Drugs/DrugSafety/PostmarketDrugSafetyInformationforPatientsandProviders/ucm103420.htm>.

87. Kate S. Gaudry, *Evergreening: A Common Practice To Protect New Drugs*, 29 NATURE BIOTECHNOLOGY 876, 876 (2011).

Other evidence for the frequency of the *PLIVA* situation is the attention the case received. In the first four months since *PLIVA* was decided, courts cited *PLIVA* twenty-three times.⁸⁸ Of those, fifteen were cases that similarly involved claims that generic drug companies had provided inadequate labeling.⁸⁹ If *PLIVA* were a rare situation, then it should not be relevant to so many cases. Even if, from this point forward, cases rarely cite *PLIVA*, it will likely be because the only cases that need to cite *PLIVA* are cases where the plaintiff claimed that the generic drug was inadequately labeled. After *PLIVA*, educated plaintiffs' lawyers will not make this claim anymore. A final indication of the importance of *PLIVA* is that twenty-one amicus briefs were filed in the case.⁹⁰ This is more than the average 14.7 amicus briefs the Supreme Court received for decisions published within a week of *PLIVA*.⁹¹

88. Purcell v. Bank of America, 659 F.3d 622, 624 (7th Cir. 2011); Smith v. Wyeth, Inc., 657 F.3d 420, 423 (6th Cir. 2011); Tarrant Reg'l Water Dist. v. Herrmann, 656 F.3d 1222, 1242 (10th Cir. 2011); Metz v. Wyeth, LLC, No. 8:10-CV-2658-T-27AEP, 2011 WL 5024448, *1 (M.D. Fla. Oct. 20, 2011); Morris v. Wyeth, Inc., No. 3:09-CV-854, 2011 WL 4975317, *1 (W.D. La. Oct. 19, 2011); Morris v. Wyeth, Inc., No. 3:09-CV-854, 2011 WL 4973839, at *1 (W.D. La. Oct. 19, 2011); Guilbeau v. Wyeth Inc., No. 09-1652, 2011 WL 4948996, at *1 (W.D. La. Oct. 14, 2011); Cline v. Bank of Am., N.A., No. 2:10-1295, 2011 WL 4857934, at *4 (S.D. W. Va. Oct. 13, 2011); Fisher v. Pelstring, 817 F. Supp. 2d 791, 791 (D.S.C. Sept. 30, 2011); Schork v. Baxter Healthcare Corp., No. 4:10-cv-00005-RLY-WGH, 2011 WL 4402602, at *3 (S.D. Ind. Sept. 22, 2011); Beck v. Teva Pharm. Indus., No. 10-1901, 2011 WL 4062219, at *1 (E.D. La. Sept. 13, 2011); Brasley-Thrash v. Teva Pharm. USA, Inc., No. 10-00031-KD-N, 2011 WL 4025734, at *1 (S.D. Ala. Sept. 12, 2011); Scott v. Baxter Healthcare Corp., No. 10-0186-CG-N, 2011 WL 4007675, at *1 (S.D. Ala. Sept. 09, 2011); Gross v. Pfizer, Inc., No. 10-CV-00110-AW, 2011 WL 4005266, at *1 (D. Md. Sept. 07, 2011); Paisley v. Darwin, No. CV-10-1253-PHX-DGC, 2011 WL 3875992, at *4 (D. Ariz. Sept. 02, 2011); Henderson v. Sun Pharm. Indus., 809 F. Supp. 2d 1373, 1373 (N.D. Ga. 2011); Schedin v. Ortho-McNeil-Janssen Pharm., Inc., 808 F. Supp. 2d 1125, 1125 (D. Minn. 2011); Keck v. Endoscopy Ctr. of S. Nev., LLC, (Nos. A575837, A579660, A5824922011), 2011 WL 3921690, at *1 (Trial Order) (D. Nev. Aug. 19, 2011); Sacks v. Endoscopy Ctr. of S. Nev., LLC, (Nos. 08A572315 (LEAD), 08A576071, 09A583058), 2011 WL 4915174, *1 (Trial Order) (D. Nev. July 28, 2011); Suarez v. Castrillo, No. 11-cv-01762-MSK, 2011 WL 2729074, at *1 (D. Colo. July 13, 2011); Produce Alliance v. Let-Us Produce, No. 2:10cv198, 2011 WL 2634238, *5 (E.D. Va. July 01, 2011); Tohono O'odham Nation v. City of Glendale, No. CV-11-279-PHX-DGC, 2011 WL 2650205, *4 (D. Ariz. June 30, 2011); *In re Dunlap*, 458 B.R. 301, 327 (Bankr. E.D. Va. 2011).

89. *Smith*, 657 F.3d at 423; *Metz*, 2011 WL 5024448; *Morris*, 2011 WL 4973839; *Morris*, 2011 WL 4975317; *Guilbeau*, 2011 WL 4948996; *Fisher*, 817 F. Supp. 2d 791; *Schork*, 2011 WL 4402602; *Beck*, 2011 WL 4062219; *Brasley-Thrash* 2011 WL 4025734; *Scott*, 2011 WL 4007675; *Gross*, 2011 WL 4005266; *Henderson*, 809 F. Supp. 2d 1373; *Schedin*, 808 F. Supp. 2d 1125; *Keck*, 2011 WL 3921690; *Sacks*, 2011 WL 4915174.

90. See Helen W. Nies, *Dissents at the Federal Circuit and Supreme Court Review*, 45 AM. U. L. REV. 1519, 1524 (1996) ("The importance of a case is often gauged by the number of amicus briefs filed.").

91. *PLIVA* was decided on June 23, 2011. Of the eighteen cases decided within a week of *PLIVA*, five had more amici and thirteen had fewer. Goodyear Dunlop Tires Operations,

B. THE EFFECT OF *WYETH* AND *PLIVA* ON AUTHORIZED GENERICS IS TRULY BIZARRE

Wyeth and *PLIVA* together mean that the law explicitly distinguishes, for the purposes of preemption, between brand-name drugs and generic drugs. If the Court's argument is taken to its logical conclusion, then the Court should distinguish further between brands of generics: generics produced by the brand-name manufacturer should be liable for suit, while other generics should be preempted. To understand this, a brief explanation of drug approval is necessary.

When a brand-name company seeks FDA approval of a new drug, it files a New Drug Application ("NDA") with the FDA.⁹² The NDA must show, among other things, that the drug is safe, effective, and appropriately labeled.⁹³ Once an NDA has been granted, other companies can file an Abbreviated New Drug Application ("ANDA") for the right to produce a generic version of the brand-name drug. The ANDA does not need to reprove that the drug is safe.⁹⁴ It only needs to only show that the drug is bioequivalent to an existing drug that the FDA has already approved.⁹⁵ Sometimes, once generics have already entered the market, the brand-name company produces a generic version of its own drug—which are known as authorized generics.⁹⁶ The authorized generic does not require the filing of an

S.A. v. Brown, 131 S. Ct. 2846 (2011) (6 amici); Arizona Free Enter. Club's Freedom Club PAC v. Bennett, 131 S. Ct. 2806 (2011) (28 amici); J. McIntyre Mach., Ltd. v. Nicastro, 131 S. Ct. 2780 (2011) (9 amici); Brown v. Entm't Merch. Ass'n, 131 S. Ct. 2729 (2011) (34 amici); Bullcoming v. New Mexico, 131 S. Ct. 2705 (2011) (8 amici); Freeman v. United States, 131 S. Ct. 2685 (2011) (0 amici); Sorrell v. IMS Health Inc., 131 S. Ct. 2653 (2011) (27 amici); CSX Transp., Inc. v. McBride, 131 S. Ct. 2630 (2011) (7 amici); Stern v. Marshall, 131 S. Ct. 2594 (2011) (7 amici); *PLIVA Inc. v. Mensing*, 131 S. Ct. 2567, 2567 (21 amici); *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (39 amici); *Am. Elec. Power Co. v. Connecticut*, 131 S. Ct. 2527 (2011) (48 amici); *Turner v. Rogers*, 131 S. Ct. 2507 (2011) (13 amici); *Borough of Duryea, Pa. v. Guarnieri*, 131 S. Ct. 2488 (2011) (8 amici); *Davis v. United States*, 131 S. Ct. 2419 (2011) (4 amici); *J.D.B. v. North Carolina*, 131 S. Ct. 2394 (2011) (10 amici); *Tapia v. United States*, 131 S. Ct. 2382 (2011) (1 amicus); *Smith v. Bayer Corp.*, 131 S. Ct. 2368 (2011) (4 amici); *Bond v. United States*, 131 S. Ct. 2355 (2011) (5 amici). The average number of amici for those cases is 14.7.

92. 21 U.S.C. § 355(b) (2010).

93. *Id.*

94. § 355(j).

95. *Id.*

96. See, e.g., FTC, *FTC Report Examines How Authorized Generics Affect the Pharmaceutical Market, Propoxyphene-Containing Products*, FDA, (Aug. 31, 2011) <http://www.ftc.gov/opa/2011/08/genericdrugs.shtm>.

ANDA; instead the brand-name company produces it under the original NDA.⁹⁷

The FDA regulations cited in *Wyeth*, distinguish between the NDA holder, who can unilaterally change the label, and the ANDA holders, who cannot.⁹⁸ Since the authorized generic is produced under the NDA (not an ANDA) it should have the right to change its label unilaterally. This makes sense since ultimately it is the brand-name company that dictates how and when the authorized generic is produced and it is the brand-name company producing the authorized generic. If so, authorized generics would not be preempted from suits.⁹⁹

But allowing inadequate drug-labeling suits against authorized generics but not other generics creates a far stranger result than does the direct application of *Wyeth* and *PLIVA*. Even once generics enter a market for a drug, the brand-name can sell for a higher price than do the generics¹⁰⁰—perhaps because people believe that the brand-name has better quality control or because the brand is just more familiar to them.¹⁰¹ Thus, brand-name drug makers are not in exactly the same market as generics. On the other hand, authorized generics and regular generics are selling the same product. If authorized generics are not preempted from state tort suits, but regular generics are, then it will be difficult for authorized generics to remain competitive once generics enter the market (since authorized generics will be subject to suit while their direct competitors will not).

97. 42 C.F.R. § 447.506(a) (2010).

98. 57 Fed. Reg. 17,950, 17,961 (1992) (cited in *PLIVA v. Mensing*, 131 S. Ct. 2567, 2575 (2011)); SG Brief, *supra* note 11, at 16–17).

99. Although the amicus brief for forty-two states assumes (without any argument) that authorized generics would be treated like all other generics, the brief's assumption seems incorrect given the way the Court framed its opinion in *PLIVA*. See Brief of Amici Curiae States of Minnesota, Louisiana, Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, Wyoming, and The District of Columbia in Support of Respondents at 24, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 805229.

100. *Brand-Name vs. Generic Drug Costs*, BLUE CROSS BLUE SHIELD MICH. (Feb. 2011), http://www.bcbsm.com/pdf/ps_generic.pdf; *Generic Drugs: The Same Medicine for Less Money*, CONSUMER REP., <http://www.consumerreports.org/health/resources/pdf/best-buy-drugs/money-saving-guides/english/GenericDrugs-FINAL.pdf> (last visited Feb. 19, 2012).

101. *In re Brand Name Prescription Drugs Antitrust Litigation*, 186 F.3d 781, 787 (7th Cir. 1999).

Indeed, in *PLIVA*, Mensing received generic metoclopramide from, amongst others, the brand-name producer of the drug, Wyeth.¹⁰² By the time the case reached the Supreme Court, Mensing settled with Wyeth,¹⁰³ and therefore she left Wyeth off the list of defendants at the Supreme Court level,¹⁰⁴ even though she listed them in her district court complaint and Eighth Circuit appeal.¹⁰⁵ In the future, however, plaintiffs similarly situated will likely sue manufacturers of authorized generics, arguing that the logic of *PLIVA* does not preempt suits against authorized generics.

III. POTENTIAL SECONDARY EFFECTS OF *WYETH* AND *PLIVA*

Particularly troubling in *PLIVA* is the fact that the doctor prescribed Reglan, the brand-name drug, but because of state substitution laws the pharmacist dispensed the generic.¹⁰⁶ It was this substitution that caused the plaintiffs to lose their right to sue. As the dissent in *PLIVA* notes, it is possible that the case's holding will cause patients to push back on generic drug substitutions for prescriptions for brand-name drugs.¹⁰⁷ To understand this possibility, one must first look at the form of drug substitution laws.

A. DRUG SUBSTITUTION LAWS

With the rising cost of healthcare, states have implemented policies to substitute prescriptions for more expensive brand-name drugs with cheaper generic equivalents.¹⁰⁸ When a medical practitioner prescribes a brand-name drug, and she might do so for any number of reasons,¹⁰⁹ she can put on the

102. *Mensing v. Wyeth, Inc.*, 588 F.3d 603, 605 n.1 (8th Cir. 2009), *rev'd sub nom.*, *PLIVA* 131 S. Ct. at 2567.

103. E-mail from Louis M. Bograd, Counsel for Mensing, to author (Mar. 19, 2012) (on file with author).

104. *Mensing and Demahy Brief*, *supra* note 41.

105. Complaint for Damages Demand for Jury Trial ¶ 53, *Mensing v. Wyeth, Inc.*, 562 F. Supp. 2d 1056 (D. Minn. 2008), 2007 WL 4675340; Appellant Gladys Mensing's Opening Brief at 18, *Mensing v. Wyeth, Inc.*, 588 F.3d 603 (8th Cir. 2009) (No. 08-3850), 2008 WL 5707474.

106. *PLIVA*, 131 S. Ct. at 2581; *id.* at 2592 (Sotomayor, J., dissenting).

107. *Id.* at 2592–93 (Sotomayor, J., dissenting).

108. William H. Shrank et al., *State Generic Substitution Laws Can Lower Drug Outlays Under Medicaid*, 29 HEALTH AFFAIRS 1383, 1383 (2010).

109. Practitioners may require that the brand-name drug be prescribed for a number of reasons, some legitimate and others less so. For instance, practitioners might require that the brand-name drug be dispensed because the patient has had an adverse reaction to the generic or the generic is ineffective. *See, e.g.*, TENN. CODE ANN. § 53-10-204(a) (2008 & Supp. 2011). On the other hand, they sometimes do so because of financial incentives offered by the brand-name drug company. *See* Ben Hirschler, *AstraZeneca Pulls Plug on Free*

prescription “brand medically necessary” or another equivalent term indicating that the brand-name drug, and not a generic, should be dispensed. If the prescriber does so—and this occurs in an estimated 2.7% of prescriptions¹¹⁰—all states (with the possible exception of Oklahoma¹¹¹) agree that pharmacists must dispense the brand-name drug and cannot substitute a generic version.¹¹²

Trips for Doctors, REUTERS, May 27, 2011, available at <http://www.reuters.com/article/2011/05/27/astrazeneca-junkets-idUSLDE74P1YI20110527>. It is also possible that practitioners do so out of habit, since the brand-name drug came to the market first. See Mark A. Hurwitz & Richard E. Caves, *Persuasion or Information? Promotion and the Shares of Brand Name and Generic Pharmaceuticals*, 31 J.L. & ECON. 299, 305 (1988).

110. See, *infra*, note 137 and accompanying text.

111. See OKLA. STAT. tit. 59, § 353.13(D) (2010 & Supp. 2011) (“No pharmacist being requested to sell, furnish or compound any drug, medicine, chemical or other pharmaceutical preparation, by prescription or otherwise, shall substitute or cause to be substituted therefor, without authority of the prescriber or purchaser, any like drug, medicine, chemical or pharmaceutical preparation.”). The statute seems to imply that the purchaser’s authority alone, even without the prescriber’s approval, permits a pharmacist to substitute a generic drug.

112. ALA. CODE § 34-23-8 (LexisNexis 2010); ALASKA STAT. § 08.80.295(a) (2010); ARIZ. REV. STAT. ANN. § 32-1963.01(D) (2008); ARK. CODE ANN. § 17-92-503(b)(1) (2010); CAL. BUS. & PROF. CODE §§ 4052.5(b), 4073(b) (West 2011 & Supp. 2012); COLO. REV. STAT. § 12-22-124(1) (2011); CONN. GEN. STAT. § 20-619(b) (2008); DEL. CODE ANN. tit. 24, § 2549(a) (2011); FLA. STAT. § 465.025(2) (2007); GA. CODE ANN. § 26-4-81(g) (2003 & Supp. 2011); HAW. REV. STAT. ANN. § 328-92(b) (LexisNexis 2008); RULES OF THE IDAHO BOARD OF PHARMACY § 180(01) (2011), <http://adminrules.idaho.gov/rules/current/27/0101.pdf>; 225 ILL. COMP. STAT. ANN. 85/25 (West 2005 & Supp. 2011); IND. CODE ANN. § 16-42-22-8(a)(1) (West 2007); IOWA CODE § 155A.32(2)(a) (2005 & Supp. 2011); KAN. STAT. ANN. § 65-1637(a)(1) (2002 & Supp. 2009); KY. REV. STAT. ANN. § 217.822(1) (LexisNexis 2007 & Supp. 2010); LA. REV. STAT. ANN. § 37:1241(A)(17)(a) (2007 & Supp. 2012); ME. REV. STAT. tit. 32, § 13781 (1999 & Supp. 2011); MD. CODE ANN. HEALTH-GEN. § 15-118(a)(1) (West 2009 & Supp. 2011); MASS. GEN. LAWS. ch. 112, § 12D (2003 & Supp. 2012); MICH. COMP. LAWS § 333.17755(3) (2008 & Supp. 2011); MINN. STAT. § 151.21(2) (2011); MISS. CODE ANN. § 73-21-117(2)(b) (2008 & Supp. 2011); MO. REV. STAT. § 338.056(2)(1) (2001 & Supp. 2011); MONT. CODE ANN. § 37-7-505(2) (2011); NEB. REV. STAT. § 71-5403(1)(a) (2009); NEV. REV. STAT. § 639.2583(5) (2004 & Supp. 2007); N.H. REV. STAT. ANN. § 146-B:2(I) (LexisNexis 2005 & Supp. 2010); N.J. STAT. ANN. § 24:6E-7 (West 1997 & Supp. 2011); N.M. STAT. ANN. § 26-3-3(C) (2004); N.Y. EDUC. LAW § 6816-a(1)(a) (McKinney 2010 & Supp. 2011); N.C. GEN. STAT. § 90-85.28(b) (2011); N.D. CENT. CODE § 19-02.1-14.1(3) (2009 & Supp. 2011); OHIO REV. CODE ANN. § 4729.38(A)(1) (LexisNexis 2003 & Supp. 2011); OR. REV. STAT. § 689.515(3) (2011); 35 PA. STAT. ANN. § 960.3(a) (West 2003 & Supp. 2011); R.I. GEN. LAWS § 5-19.1-19 (2009 & Supp. 2011); S.C. CODE ANN. § 39-24-40 (1983 & Supp. 2010); S.D. CODIFIED LAWS § 36-11-46.2 (2004 & Supp. 2011); TENN. CODE ANN. § 53-10-204(b) (2008 & Supp. 2011); TEX. OCC. CODE ANN. § 562.008(a) (West 2003 & Supp. 2009); UTAH CODE ANN. § 58-17b-605(5) (West 2007 & Supp. 2011); VT. STAT. ANN. tit. 18, § 4605(a) (2002 & Supp. 2011); VA. CODE ANN. § 54.1-3408.03(A) (2009 & Supp. 2011); WASH. REV. CODE ANN. § 69.41.120 (West 2007 & Supp. 2012); W. VA. CODE ANN. § 30-5-12b(b) (LexisNexis 2007

However, in the absence of a prescriber's explicit order forbidding substitution, state laws vary in regards to when and how substitution of generic drugs is permitted. Eleven states require the prescriber to expressly permit substitution, although they do so in three different ways: Oklahoma forbids generic drug substitution "without authority of the prescriber";¹¹³ seven states require all prescription pads to have one line that says substitution is permissible and one that says substitution is forbidden and by signing on one of the two lines the prescriber either permits or forbids substitutions;¹¹⁴ and finally, Maine, New York, and Pennsylvania require that all prescription forms say that substitution is permitted, so the doctor has to override the boilerplate language to prevent substitution.¹¹⁵ The remaining thirty-nine states permit substitution unless the prescriber expressly forbids it.¹¹⁶

& Supp. 2011); WIS. STAT. ANN. § 450.13(2) (West 1998 & Supp. 2010); WYO. STAT. ANN. § 33-24-148(b) (2011); accord D.C. CODE § 48-803.03(2) (2001 & Supp. 2011); 5 GUAM CODE ANN. § 5271(b) (2011); P.R. LAWS ANN. tit. 20, § 410b(b)(1) (2009); V.I. CODE ANN. tit. 19, § 753(c) (1995 & Supp. 2011); see *PLIVA*, 131 S. Ct. at 2583 (Sotomayor, J., dissenting) ("[A]ll States 'allow the physician to specify that the brand name must be prescribed, although with different levels of effort from the physician.'").

113. OKLA. STAT. tit. 59, § 353.13(D) (2010 & Supp. 2011).

114. ALA. CODE § 34-23-8(4); DEL. CODE ANN. tit. 24, § 2549(a)(1), (c); IND. CODE ANN. §§ 16-42-22-6, 16-42-22-8(a)(1); MO. REV. STAT. § 338.056; S.C. CODE ANN. § 39-24-40(b); UTAH CODE ANN. § 58-17b-605(1); WASH. REV. CODE ANN. § 69.41.120; accord V.I. CODE ANN. tit. 19, § 753(a).

115. ME. REV. STAT. tit. 32, § 13781 (requiring all Maine prescription forms to contain this text: "Any drug which is the generic and therapeutic equivalent of the drug specified above in this prescription must be dispensed, provided that no check mark () has been handwritten in the box in the lower right-hand corner"); N.Y. EDUC. LAW § 6810 ("Imprinted conspicuously on every prescription written in this state in eight point upper case type immediately below the signature line shall be the words: 'THIS PRESCRIPTION WILL BE FILLED GENERICALLY UNLESS PRESCRIBER WRITES 'd a w' IN THE BOX BELOW.'"); 35 PA. STAT. ANN. § 960.3(a) (requiring prescription forms to contain the following language: "In order for a brand name product to be dispensed, the prescriber must handwrite 'brand necessary' or 'brand medically necessary' in the space below.").

116. ALASKA STAT. § 08.80.295(a); ARIZ. REV. STAT. ANN. § 32-1963.01(A); ARK. CODE ANN. § 17-92-503(b); CAL. BUS. & PROF. CODE § 4052.5(b); COLO. REV. STAT. § 12-22-124; CONN. GEN. STAT. § 20-619(b); FLA. STAT. § 465.025(2); GA. CODE ANN. § 26-4-81; HAW. REV. STAT. ANN. § 328-92; RULES OF THE IDAHO BOARD OF PHARMACY § 180(01); 225 ILL. COMP. STAT. ANN. 85/25; IOWA CODE § 155A.32(1); KAN. STAT. ANN. § 65-1637(a); KY. REV. STAT. ANN. § 217.822; LA. REV. STAT. ANN. § 37:1241(17); MD. CODE ANN. HEALTH-GEN. § 15-118(a)(1); MASS. GEN. LAWS. ch. 112, § 12D; MICH. COMP. LAWS § 333.17755(3)(a); MINN. STAT. § 151.21(3); MISS. CODE ANN. § 73-21-117(1); MONT. CODE ANN. § 37-7-505; NEB. REV. STAT. § 71-5403; NEV. REV. STAT. § 639.2583(3); N.H. REV. STAT. ANN. § 146-B:2; N.J. STAT. ANN. § 24:6E-7; N.M. STAT. ANN. § 26-3-3; N.C. GEN. STAT. § 90-85.28; N.D. CENT. CODE § 19-02.1-14.1(3); OHIO REV. CODE ANN. § 4729.38(A); OR. REV. STAT. § 689.515; R.I. GEN. LAWS § 5-19.1-19; S.D. CODIFIED LAWS

Additionally, states differ about whether, if substitution is permitted, pharmacists are obligated to substitute a generic drug or are merely permitted to do so.¹¹⁷ Fifteen states require pharmacists to dispense a generic drug if they are allowed to,¹¹⁸ while thirty-two states merely permit them to do so.¹¹⁹ The laws of Idaho,¹²⁰ Louisiana,¹²¹ and Oklahoma¹²² are unclear on this point.

§ 36-11-46.1; TENN. CODE ANN. § 53-10-204; TEX. OCC. CODE ANN. § 562.008(a); VT. STAT. ANN. tit. 18, § 4605; VA. CODE ANN. § 54.1-3408.03(A); W. VA. CODE ANN. § 30-5-12b(b); WIS. STAT. ANN. § 450.13(2); WYO. STAT. ANN. § 33-24-148(b); *accord* D.C. CODE § 48-803.03; 5 GUAM CODE ANN. § 5271(b) (at least if the drug is being partially paid for by public funds); P.R. LAWS ANN. tit. 20, § 410b(b)(1).

117. Christensen et al., *Drug Product Selection: Legal Issues*, 41 J. AM. PHARM. ASS'N 868, 870 (2001) (cited in *PLIVA v. Mensing*, 131 S. Ct. 2567, 2583 (2011)) tabulates the distinctions between the states on this ground. Since some of their data is not accurate (at least not anymore), I redo this data. The states that Christensen et al. have incorrectly represented are: Hawaii (actually mandates substitution); Maine (actually mandates substitution); Maryland (actually mandates substitution); Mississippi (actually permits substitution); Tennessee (actually mandates substitution); Vermont (actually mandates substitution); Washington (actually permits substitution). *See infra* notes 118, 119.

118. FLA. STAT. § 465.025(2); HAW. REV. STAT. ANN. § 328-92(a); KY. REV. STAT. ANN. § 217.822(1); ME. REV. STAT. tit. 32, § 13781(1); MD. CODE ANN. HEALTH-GEN. § 15-118(a)(1); MASS. GEN. LAWS. ch. 112, § 12D; MINN. STAT. § 151.21(3) (though the Statute requires that the generic drug be “in the pharmacist’s professional judgment . . . safely interchangeable with the prescribed drug”); NEV. REV. STAT. § 639.2583(1); N.J. STAT. ANN. § 24:6E-7; N.Y. EDUC. LAW § 6816-a(1); 35 PA. STAT. ANN. § 960.3(a); R.I. GEN. LAWS § 5-19.1-19; TENN. CODE ANN. § 53-10-205(a); VT. STAT. ANN. tit. 18, § 4605(a); W. VA. CODE ANN. § 30-5-12b(b); *accord*, P.R. LAWS ANN. tit. 20, § 410b(b)(1); V.I. CODE ANN. tit. 19, § 753(c).

119. ALA. CODE § 34-23-8(1); ALASKA STAT. § 08.80.295(a); ARIZ. REV. STAT. ANN. § 32-1963.01(D); ARK. CODE ANN. § 17-92-503(b)(1); CAL. BUS. & PROF. CODE §§ 4052.5(a), 4073(a); COLO. REV. STAT. § 12-22-124(1); CONN. GEN. STAT. § 20-619(b); DEL. CODE ANN. tit. 24, § 2549(a); GA. CODE ANN. § 26-4-81(a); ILL. COMP. STAT. ANN. 85/25; IND. CODE ANN. § 16-42-22-8(a)(1) (though the statute is not entirely clear); IOWA CODE § 155A.32(1) (though if the drug is being even partially paid for by public funds, substitution is mandatory); KAN. STAT. ANN. § 65-1637(a); MICH. COMP. LAWS § 333.17755(1) (though if the purchaser requests the generic drug the pharmacist must substitute); MISS. CODE ANN. § 73-21-117(1); MO. REV. STAT. § 338.056(1); MONT. CODE ANN. § 37-7-505(1); NEB. REV. STAT. § 71-5403(1)(a); N.H. REV. STAT. ANN. § 146-B:2(I); N.M. STAT. ANN. § 26-3-3(A); N.C. GEN. STAT. § 90-85.28(a); N.D. CENT. CODE § 19-02.1-14.1(3); OHIO REV. CODE ANN. § 4729.38(A); OR. REV. STAT. § 689.515(5); S.C. CODE ANN. § 39-24-40(b) (though the statute is not entirely clear); S.D. CODIFIED LAWS § 36-11-46.1; TEX. OCC. CODE ANN. § 562.008(b); UTAH CODE ANN. § 58-17b-605(5); VA. CODE ANN. § 54.1-3408.03(A); WASH. REV. CODE ANN. § 69.41.120; WIS. STAT. ANN. § 450.13(2) (though the statute is not entirely clear); WYO. STAT. ANN. § 33-24-148(b); *accord*, D.C. CODE § 48-803.02(a); 5 GUAM CODE ANN. § 5271(d).

120. *See* RULES OF THE IDAHO BOARD OF PHARMACY § 180(01) (2011), <http://adminrules.idaho.gov/rules/current/27/0101.pdf>.

121. *See* LA. REV. STAT. ANN. § 37:1241(A)(17) (2007 & Supp. 2012).

122. *See* OKLA. STAT. tit. 59, § 353.13(D) (2010 & Supp. 2011).

States also diverge on what say a patient has in the substitution process. Ten states do not require a pharmacist to inform the patient before substituting a generic drug.¹²³ In Arizona, if a third party (generally an insurance company) reimburses the drug then the pharmacist does not have to inform the patient; if not, she does.¹²⁴ In Iowa and Ohio, if the drug is being reimbursed by public funds then the pharmacist does not have to inform the patient; if not, she does.¹²⁵ Five states require the pharmacist to inform the patient of the substitution, but do not say the patient has the right to refuse the substitution.¹²⁶ Maine, Tennessee, and Vermont say the pharmacist must inform the patient who can then refuse the substitution, but if he refuses, then he must pay the additional cost out-of-pocket.¹²⁷ Finally, twenty-seven states allow the purchaser to refuse a substitution and the laws do not say that the purchaser must pay the extra-cost out-of-pocket.¹²⁸

123. ALA. CODE § 34-23-8(4); ILL. COMP. STAT. ANN. 85/25; KAN. STAT. ANN. § 65-1637; MD. CODE ANN. HEALTH-GEN. § 15-118(a); MASS. GEN. LAWS. ch. 112, § 12D; MICH. COMP. LAWS § 333.17755; N.M. STAT. ANN. § 26-3-3; N.Y. EDUC. LAW § 6816-a; N.C. GEN. STAT. § 90-85.28; WYO. STAT. ANN. § 33-24-148; *accord* 5 GUAM CODE ANN. § 5271 (at least if the drug is being partially paid for by public funds).

124. ARIZ. REV. STAT. ANN. § 32-1963.01(B).

125. IOWA CODE § 155A.32(2)(b) (2005 & Supp. 2011); OHIO REV. CODE ANN. § 4729.38 (LexisNexis 2003 & Supp. 2011).

126. CAL. BUS. & PROF. CODE §§ 4052.5(e), 4073(e) (West 2011 & Supp. 2012); COLO. REV. STAT. § 12-22-124(3) (2011); DEL. CODE ANN. tit. 24, § 2549(a)(2) (2011); IND. CODE ANN. § 16-42-22-8(a)(2) (West 2007); VA. CODE ANN. § 54.1-3408.03 (2009 & Supp. 2011).

127. ME. REV. STAT. tit. 32, § 13781 (1999 & Supp. 2011); TENN. CODE ANN. § 53-10-205(d) (2008 & Supp. 2011); VT. STAT. ANN. tit. 18, § 4605 (2002 & Supp. 2011).

128. ALASKA STAT. § 08.80.295(a) (2010); ARK. CODE ANN. § 17-92-503(b)(3) (2010); CONN. GEN. STAT. § 20-619(b) (2008); FLA. STAT. § 465.025(2)-(3) (2007); GA. CODE ANN. § 26-4-81(f) (2003 & Supp. 2011); HAW. REV. STAT. ANN. § 328-92(a) (LexisNexis 2008); RULES OF THE IDAHO BOARD OF PHARMACY § 180(01) (2011), <http://adminrules.idaho.gov/rules/current/27/0101.pdf>; KY. REV. STAT. ANN. § 217.822 (LexisNexis 2007 & Supp. 2010); LA. REV. STAT. ANN. § 37:1241(A)(17)(b) (2007 & Supp. 2012); MINN. STAT. § 151.21(3) (2011); MISS. CODE ANN. § 73-21-117(3) (2008 & Supp. 2011); MO. REV. STAT. § 338.056 (2001 & Supp. 2011); MONT. CODE ANN. § 37-7-505 (2011); NEB. REV. STAT. § 71-5403(1)(b) (2009); NEV. REV. STAT. § 639.2583(3)(b) (2004 & Supp. 2007) (forbidding substitution, however, if the government is paying the difference. This suggests that if the payer is a third party other than the government, then the patient can refuse the substitution and the insurance would have to foot the difference); N.H. REV. STAT. ANN. § 146-B:2(I) (LexisNexis 2005 & Supp. 2010); N.J. STAT. ANN. § 24:6E-7 (West 1997 & Supp. 2011); N.D. CENT. CODE § 19-02.1-14.1(3) (2009 & Supp. 2011); OKLA. STAT. tit. 59, § 353.13(D) (2010 & Supp. 2011); OR. REV. STAT. § 689.515(4) (2011); 35 PA. STAT. ANN. § 960.3(b) (West 2003 & Supp. 2011); R.I. GEN. LAWS § 5-19.1-19 (2009 & Supp. 2011); S.C. CODE ANN. § 39-24-40(e) (1983 & Supp. 2010); S.D. CODIFIED LAWS § 36-11-46.3 (2004 & Supp. 2011); TEX. OCC. CODE ANN. § 562.009(a) (West 2003 & Supp. 2009); UTAH CODE ANN. § 58-17b-605(1)(b) (West 2007 & Supp. 2011); WASH. REV. CODE ANN. § 69.41.130 (West 2007 & Supp. 2012); W. VA. CODE ANN. § 30-5-12b(n) (LexisNexis 2007 & Supp. 2011);

B. ADVANTAGES OF DRUG SUBSTITUTION LAWS

In a study of 5.6 million prescriptions, Shrank et al. showed two reasons why drug substitution is generally good for healthcare.¹²⁹ First, drug substitution lowers the cost of healthcare for society generally whether it is public insurance, private insurance, or the patients themselves who are paying for the drugs. In their sample, patients and their insurance plans paid, respectively, an average of \$17.90 and \$26.67 for generic drugs, but an average of \$44.50 and \$135.26 for brand-name drugs where a generic existed.¹³⁰ The FDA's data indicates a similar price reduction. The price for generic drugs is, on average, 15% of the price of the brand-name drug before generic entry.¹³¹ Shrank et al. estimate that if substitution occurred in all feasible situations, "patient charges could be reduced by as much as \$1.2 billion annually and health system costs could be reduced by as much as \$7.7 billion."¹³²

Additionally, when generic drugs are not substituted, patients are less likely to comply with their drug regimen. When substitution is forbidden, the chance that patients will not purchase a drug at all increase by 42% and the chances that a patient will not refill a prescription increase by 61% as compared with prescriptions where substitution is permitted.¹³³ Presumably this is due to the fact that generic drugs are cheaper. In short, generic substitution for brand-name drugs is extremely efficient and important for society as a whole.¹³⁴

C. PLIVA MAY RESULT IN A DECREASE IN DRUG SUBSTITUTION

Ironically, while the generic drug company won the preemption battle in *PLIVA*, it is possible that generics' preemption from suit will lead to a

WIS. STAT. ANN. § 450.13(1) (West 1998 & Supp. 2010); *accord*, D.C. CODE § 48-803.03(1) (2001 & Supp. 2011); P.R. LAWS ANN. tit. 20, § 410b(b)(1) (2009); V.I. CODE ANN. tit. 19, § 753(c) (1995 & Supp. 2011).

129. William H. Shrank et al., *The Consequences of Requesting "Dispense as Written,"* 124 AM. J. MED. 309 (2011).

130. *Id.* at 311.

131. FDA, *Facts and Myths About Generic Drugs*, FDA, <http://www.fda.gov/Drugs/ResourcesForYou/Consumers/BuyingUsingMedicineSafely/UnderstandingGenericDrugs/cm167991.htm> (last updated Oct. 13, 2009).

132. Shrank et al., *supra* note 129, at 314.

133. *Id.* at 313.

134. It is true, however, that those who believe that medical patent terms are too short would likely consider any way to extend the effective life of a patent, including limiting generic drug substitutions, to be a boon to society. See Richard A. Epstein, *Branded Versus Generic Competition? A Kind Word for the Branded Drugs*, 3 HASTINGS SCI. & TECH. L.J. 459, 470 (2011).

backlash against generic drug companies that will decrease the number of generic substitutions for brand-name prescriptions. This could happen on a local level because doctors might stop permitting drug substitutions, pharmacists might stop dispensing generic substitutes, and patients may start requesting the brand-name drug. This could also happen on a broader level if states changed their drug substitution laws to prevent or limit situations where generic drugs are substituted.

1. *Doctors, Pharmacists, or Patients May Prevent Substitutions*

Fear of what happened in *PLIVA* may cause doctors, pharmacists, and patients to avoid generic drug substitutions altogether. This is a particularly potent concern in the case of doctors, since their discretion to prevent generic substitutions is virtually unchecked.¹³⁵ Thus, if doctors fear that patients will not be compensated for harms arising from newly-discovered side effects, then, as the dissent in *PLIVA* notes, doctors might start prohibiting substitutions more frequently.¹³⁶ A recent study by Shrank et al., conducted before the Court's decision in *PLIVA*, showed that of 5.6 million prescriptions, 2.7% had a prescriber's order preventing substitution.¹³⁷ This percentage will likely rise if doctors feel that patients may be harmed by taking generic drugs.

Doctors' motivation for preventing substitutions could be altruistic. By requiring pharmacies to dispense the brand-name drug, the doctor ensures that if it later turns out that the drug was inadequately labeled the consumer can be compensated. Weighing against this, however, is the fact that brand-name drugs cost more than their generic equivalents, though insurance often absorbs some portion of the cost of patient prescriptions.¹³⁸

However, self-interest may also lead doctors to prevent substitutions. Injured patients can sue multiple sources for their injury. For example, in *Wyeth*, Levine sued both Wyeth, for inadequate labeling, and the physician's assistant who dispensed Phenergan, for doing so negligently.¹³⁹ However, once plaintiffs have been made whole by suing the drug company, they can no longer sue the doctor for the same injury; if they receive only partial or no

135. Only Tennessee expressly limits the situations where doctors can declare that a brand-name drug is medically necessary, TENN. CODE ANN. § 53-10-204(a)(1) (2008 & Supp. 2011), and even Tennessee has a broad exception for "clinically based prescriber determined need[s]." § 53-10-204(a)(1)(C).

136. *PLIVA v. Mengin*, 131 S. Ct. 2567, 2593 (2011) (Sotomayor, J., dissenting).

137. Shrank et al., *supra* note 129, at 311.

138. See Elizabeth Mendes, *More Americans Uninsured in 2011*, GALLUP WELLBEING (Jan. 24, 2012), <http://www.gallup.com/poll/152162/Americans-Uninsured-2011.aspx>.

139. *Wyeth v. Levine*, 555 U.S. 555, 559 (2009).

compensation from the drug company then they can sue the doctor for only some of the damage.¹⁴⁰ Thus, forcing patients to take brand-name drugs may help doctors avoid, or at least reduce, medical malpractice claims.

Like doctors, pharmacists, in states where they have discretion (and that is most states),¹⁴¹ may dispense brand-name drugs to leave open the possibility of suit for patients who may be hurt by inadequate labeling. Pharmacists may also dispense brand-name drugs so that, in case of later suit, the plaintiff might seek recovery from the brand-name drug company to shoulder some or all of the liability.¹⁴² Individual pharmacists, or entire pharmacies more broadly, may implement such a policy.

Finally, patients may prevent substitution of generic drugs. As noted above, in most states a patient may prevent a drug substitution, perhaps without having to pay for the difference in price between the brand-name and the generic drug.¹⁴³ Even before *PLIVA*, Shrank et al. showed that 2.0% of patients requested that their prescriptions be filled with the brand-name drug.¹⁴⁴ With the Court's decision, patients have one more reason to try and prevent a drug substitution since receiving the brand-name drug maintains their ability to sue.

2. States May Change Their Substitution Laws

Among states that have changed their drug substitution laws within the last ten years, the trend has been nearly uniform towards promoting drug substitution.¹⁴⁵ However, the same pressures that may lead doctors,

140. See, e.g., *Monroe v. Standard Oil Co.*, 452 U.S. 549, 562 & n.13 (1981) (assuming that double compensation should not be granted).

141. See *supra* notes 118, 119 and accompanying text.

142. As they do sometimes. See, e.g., *Griffith v. Blatt*, 51 P.3d 1256 (Or. 2002).

143. See *supra* notes 123–128.

144. Shrank et al., *supra* note 129, at 311.

145. Compare ARIZ. REV. STAT. ANN. § 32-1963.01(D) (2001); 225 ILL. COMP. STAT. ANN. 85/25 (West 2001); KAN. STAT. ANN. § 65-1637(a)(1) (State 2001); ME. REV. STAT. tit. 32, § 13781 (2001); MD. CODE ANN. HEALTH-GEN. § 15-118(a)(1) (West 2001); MASS. GEN. LAWS ANN. ch. 112, § 12D (2001); N.J. STAT. ANN. § 24:6E-7 (West 2001); N.C. GEN. STAT. ANN. § 90-85.28(b) (West 2001); TENN. CODE ANN. § 53-10-204 (West 2001) with the modern versions of the statutes. Virginia actually changed its statutes in two ways: on the one hand, the earlier version of the statute required the doctor to explicitly permit substitution by signing under a line that says substitution is permitted, whereas the modern version assumes substitution is permissible unless the doctor explicitly forbids it. Compare VA. CODE ANN. § 54.1-3408.03(A) (2001) with the modern version of the statute. On the other hand, in 2001, when that condition was met, substitution was mandatory, whereas now substitution is in the discretion of the pharmacist. Compare VA. CODE ANN. § 54.1-3408.03(A) (2001) with the modern version of the statute. Only Wisconsin made substitution uniformly less likely. See WIS. STAT. ANN. § 450.13(2) (West 2001), amended by WIS. STAT. ANN. § 450.13(2) (Supp. 2011) (requiring substitution where it is permitted).

pharmacists, and patients to attempt to avoid substitutions may also lead states in the future to choose not to strengthen, and perhaps even weaken, their substitution laws. Indeed, Maine (but so far, only Maine) already limits substitution of generic drugs to drugs manufactured by companies “doing business in the United States that [are] subject to suit and the service of legal process in the United States.”¹⁴⁶ Thus, Maine already considers the generic’s potential to be sued a prerequisite for substitutions.

As a result of *PLIVA*, other states may change their laws to make drug substitution more difficult. For instance, as noted above, states vary as to the ability they give a patient to choose or prevent drug substitutions.¹⁴⁷ Ten states do not even require the patient to be informed of the substitution.¹⁴⁸ After *PLIVA*, these states might consider it unfair to force patients to take the generic version of the drug and thereby lose their right to compensation. Shrank et al. have shown that requiring patient consent strongly correlates with a decrease in the frequency of drug substitutions made.¹⁴⁹ Specifically, in a study of prescriptions for the brand-name drug Zocor and its generic equivalent simvastatin, the results of the study showed that requiring patient consent prior to substitution led to an approximately 25% decrease in generic drug substitution.¹⁵⁰ This disproportionately affected less-educated patients, since they were the most likely to disfavor generic drugs.¹⁵¹

Similarly, states may require prescription pads to explicitly state whether a doctor is permitting generic drug substitution—instead of permitting substitution by default. It stands to reason that some doctors who now simply fill a prescription without thinking about substitution (thus defaulting to substitution in many states), might instead prohibit substitution if they were explicitly required to consider the question.¹⁵² Finally, states may require pharmacists to inform patients that if they take the generic drug the patient will not be able to sue the manufacturer for compensation in case of harm.

To summarize, states have laws that permit the substitution of a generic drug for a brand-name drug. These substitutions are important, both financially and as a matter of patient compliance with drug regimens. But *PLIVA* and *Wyeth* in combination may decrease the use of substitution over

146. ME. REV. STAT. tit. 32, § 13781 (1999 & Supp. 2011).

147. See *supra* notes 123–128 and accompanying text.

148. See *supra* note 123.

149. Shrank et al., *supra* note 108.

150. *Id.*

151. *Id.*

152. See *Mosley v. Wyeth*, 719 F. Supp. 2d 1340, 1347 n.6 (2010) (arguing that generic drug substitution “is less likely to occur . . . in Alabama” where explicit doctor’s permission is required).

the long run. This combination of the two cases, therefore, is harmful to society. The next Part examines several institution that can make patients taking brand-name drugs and patients taking generics be treated equivalently.

IV. FIXING THE PROBLEMS CREATED BY THE COURT

Any of several different actors could independently harmonize the treatment of patients harmed by brand-name and generic drugs. First, the Court could reverse or limit either *Wyeth* or *PLIVA*. Though it is unlikely that the Court would do so *sua sponte*, a change by the FDA may cause the Court to reconsider its decisions, since a fundamental ingredient in the Court's decisions in *PLIVA* (and maybe *Wyeth* as well) was the FDA's own regulations and interpretations.

Additionally, generic drug companies could themselves waive their preemption defense, or states could force generic drug companies to do so. States could also permit plaintiffs, even those harmed by *generic* drugs, to sue the brand-name company. Finally, Congress could step in and statutorily overrule either of the two decisions.

A. JUDICIAL REVERSAL OR LIMITATION OF THE DECISIONS

It is always possible that the Court might reverse or limit the holdings in *PLIVA* or in *Wyeth*. The majority in *PLIVA* makes a cryptic comment that, perhaps, is meant to imply that for injuries sustained after 2007, the result in *PLIVA* may be different. The Court says “[a]ll relevant events in these cases predate the Food and Drug Administration Amendments Act of 2007. We therefore refer exclusively to the pre-2007 statutes and regulations and express no view on the impact of the 2007 Act.”¹⁵³

What the Court means by that comment is unclear, but several possibilities emerge. One possibility is that the Court believes that the 2007 amendment's grant to the FDA of the power to require post-market studies¹⁵⁴ would affect the decision in *PLIVA*. The rationale is this: if generic drug companies are required to conduct post-market studies, then the FDA can trust that those companies will have sufficient information about potential side effects so that the FDA should allow them to amend their

153. *PLIVA Inc. v. Mensing*, 131 S. Ct. 2567, 2574 n.1 (2011) (internal citations omitted).

154. FDAAA, Pub. L. No. 110-85, § 901(a), 121 Stat. 823, 923 (2007) (amending 21 U.S.C. § 355(o)(3) (2010)) (“[T]he Secretary may . . . require a responsible person for a drug to conduct a postapproval study or studies of the drug, or a postapproval clinical trial or trials of the drug . . .”). See generally *id.* at 923–26 (laying out the FDA's new powers to require post-market studies).

labels first and ask the FDA later (just as brand-name drugs can). If that is so, then the generic drug manufacturers are not in an impossible situation where the FDA forbids label changes but state tort law requires it. Therefore, state tort law would not be preempted.

Another possibility is that the Court is referring to the Act's granting the FDA the ability to mandate a label change.¹⁵⁵ Before 2007, the FDA could only suggest to a brand-name drug company that they should change their label, but the manufacturer could refuse to change the label (although the FDA could then withdraw approval of the drug).¹⁵⁶ The plaintiff's claim against *PLIVA* was particularly attenuated because it was brought under the pre-2007 Act. *PLIVA* would have had to convince the FDA that a label change was warranted and the FDA would have had to convince the brand to change the label.¹⁵⁷ The 2007 amendments erode this difficulty, since the FDA would not need to convince the brand-name company. Thus, one could argue, that for injuries that occur post-2007, suits against generic drug companies would not be preempted, even under *PLIVA*. However, the Court's focus on *PLIVA*'s ability to "independently" change its label¹⁵⁸ makes it unlikely that its preemption reasoning depended on the FDA's inability to mandate a label change, given that either way the generics could not "independently" effect a label change.

B. NEW FDA REGULATIONS

The most likely candidate to change the result created by *PLIVA* is the FDA. The reason the Court distinguished between generic drug companies and brand-name companies was because the FDA did the same.¹⁵⁹ The FDA argued that it forbade generics from unilaterally updating their label because it wanted brand-name and generic drugs to be equivalent.

[T]he fundamental premise of the [generic drug approval process is] that a generic drug can be relied upon as a therapeutic equivalent of its [brand-name equivalent]. Accordingly, FDA places a very high priority on assuring consistency in labeling, so as to minimize any cause for confusion among health care professionals and

155. *Id.* § 901(a), 121 Stat. at 924 (amending 21 U.S.C. § 355(o)(4)).

156. *Wyeth v. Levine*, 555 U.S. 555, 571 (2009).

157. *See PLIVA*, 131 S. Ct. at 2578 (describing the chain of events as a game of "Mouse Trap").

158. *PLIVA*, 131 S. Ct. at 2579 ("The question for 'impossibility' is whether the private party could independently do under federal law what state law requires of it.").

159. *PLIVA*, 131 S. Ct. at 2575–79.

consumers as well as to preclude a basis for lack of confidence in the equivalency of generic versus brand name products.¹⁶⁰

Importantly, the FDA believed that even with its regulations, the plaintiffs' suit against the generic drug companies in *PLIVA* should prevail. Finding preemption would "deprive injured parties of a long available form of compensation and . . . do so in . . . an inconsistent manner."¹⁶¹ The Court disagreed. The FDA is therefore on the horns of dilemma. It must either allow generic drugs unilaterally to update their labels—thus potentially causing consumers to believe there is a difference between brand-name and generic drugs—or must allow state tort suits against brand-name but not generic drugs—with the same effect.

However, even without the result in *PLIVA*, the advantages of allowing generic drug companies to add extra warnings unilaterally when they discover that there are potential new side effects itself outweighs the benefit of insuring identical labeling between generics and brand-name companies.¹⁶² After all, if the FDA agrees with the proposed change, then the brand-name company will also have to change its label, and if the FDA does not agree, then the generic drug company will revert to the brand-name label. Moreover, it is already possible that brand-name drugs and their generic drug equivalents will have differing labels. If a brand-name company discovers new adverse side effects it must change its label to reflect these new adverse side effects even before the FDA reviews the label change.¹⁶³ It will take the generics time to change their label, and, during this period of time, the brand-name and generic labels will differ. Given the bizarre result in *PLIVA*, the argument that generics should be allowed to unilaterally change their labels is all the more compelling.¹⁶⁴

It thus seems likely that the FDA will change its position and allow generics to change their labels in light of newly discovered adverse side effects.¹⁶⁵ That the FDA can change its regulations, and therefore the result

160. SG Brief, *supra* note 11, at 4.

161. *Id.* at 26–27.

162. *But see* *PLIVA et al. Brief*, *supra* note 47, at 37–38 (arguing that while brand-name companies should be required to revise their labels when they learn of new side effects, generics should not, since brand-name companies have access to more information).

163. *Wyeth v. Levine*, 555 U.S. 555, 570–71 (2009).

164. *See* Brian Wolfman & Dena Feldman, *PLIVA v. Mensing and Its Implications*, BNA INSIGHTS: HEALTH LAW RESOURCE CENTER, http://healthlawrc.bna.com/hlrc/4203/split_display.adp?fedfid=22851209&vname=hllifenotallissues&split=0 (last visited Feb. 21, 2012).

165. *See* Petition from Sidney M. Wolfe et al. to Food and Drug Admin., Dep't of Health and Human Servs. 1, 6 (Aug. 29, 2011), *available at* <http://www.citizen.org/documents/Citizen-Petition-8-26.pdf> (requesting that the FDA change its regulations to

in *PLIVA*, is clear. The Court itself admits, “[a]s always, Congress and the FDA retain the authority to change the law and regulations if they so desire.”¹⁶⁶

However, administrative law may throw a hurdle in the way of the FDA. Though the FDA’s interpretation (in its brief) of its regulations—prohibiting generic drug companies from unilaterally altering their labels—was an interpretive rule and therefore did not require notice-and-comment,¹⁶⁷ according to the D.C., Third, Fifth, and Sixth Circuits (and perhaps the Second Circuit as well)¹⁶⁸ the FDA would have to use notice-and-comment to alter its interpretation; the First and Ninth Circuits disagree.¹⁶⁹ Nonetheless, the FDA could clearly change its regulations (at least through notice-and-comment) to explicitly permit generic drug companies to unilaterally change their labels.

Finally, it is possible that the FDA could change the result in *Wyeth*. In *Wyeth* the Court did not defer to the FDA’s assertion that federal law should preempt state tort suits for several reasons. First, the Court noted that the FDA did not use notice-and-comment.¹⁷⁰ Second, the FDA’s position that state tort suits should be preempted was “at odds with what evidence we have of Congress’s purposes,” and third, the FDA’s position “reverse[d] the

allow generic drug companies to unilaterally alter their label in the case of newly-discovered adverse side effects, in part to avoid the result in *PLIVA*).

166. *PLIVA v. Mensing*, 131 S. Ct. 2567, 2582 (2011).

167. *See Shalala v. Guernsey Mem’l Hosp.*, 514 U.S. 87, 99 (1995). Notice-and-comment is where an agency notifies the public of a proposed interpretation and requests public comment. *See* 5 U.S.C. § 553 (2011).

168. *See Visiting Nurse Ass’n of Brooklyn v. Thompson*, 378 F. Supp. 2d 75, 90 (E.D.N.Y. 2004) (“The Second Circuit . . . has hinted on at least one occasion that it would . . . requir[e] administrative agencies to employ notice and comment in altering established interpretations of applicable regulations.”).

169. *See generally United States v. Magnesium Corp. of Am.*, 616 F.3d 1129, 1139 (10th Cir. 2010) (“[T]he issue whether an agency may alter its interpretation of its own regulation without notice and comment is the subject of a circuit split, with the Third, Fifth, and Sixth Circuits apparently adopting the D.C. Circuit’s view [that it cannot] and the First and Ninth Circuits seemingly taking the contrary position.”). These courts are talking about cases where the agency interpretation is set out in a regulation, not in a brief. However, at least the stated logic of the Sixth Circuit would apply equally well to opinions stated in briefs. *See Dismas Charities, Inc. v. U.S. Dept. of Justice*, 401 F.3d 666, 682 (6th Cir. 2005) (“It is true that once an agency gives a regulation an interpretation, notice and comment will often be required before the interpretation of that regulation can be changed. This is because once an agency has promulgated its own regulation, a change in the interpretation of that regulation is likely to reflect the agency’s reassessment of wise policy rather than a reassessment of what the agency itself originally meant. The determination of wise policy—unlike legal interpretation—is the kind of determination for which notice and comment procedures are particularly appropriate.”) (internal citations omitted).

170. *Wyeth v. Levine*, 555 U.S. 555, 577 (2009).

FDA's own longstanding position without providing a reasoned explanation."¹⁷¹ The first and third of the Court's criticisms are within the FDA's power to fix: the FDA could use notice-and-comment to promulgate a decision to preempt all state tort suits, even against brand-name companies, and it could explain in detail why it thinks this is necessary. The FDA cannot, however, legally do anything about the Court's understanding of Congress's purposes. It is therefore possible, though not certain, that the FDA could convince the Court to overrule *Wyeth* by using proper procedures to promulgate its understanding. However, it is possible that even if before *Wyeth* it was ambiguous whether the FDCA intended to preempt lawsuits against brand-name drug manufacturers, the very fact that the Supreme Court ruled on the issue makes the statute legally unambiguous.¹⁷²

C. MANUFACTURER WAIVER OF THE PREEMPTION DEFENSE

If the number of generic drug substitutions were to decrease as a result of the Court's decision in *PLIVA*, generic drug companies—the very companies that argued for federal preemption from suit in *PLIVA*¹⁷³—might find it worthwhile as a business matter to waive their preemption defense. That generic drug companies can waive their defense at trial is clear. With exceptions not relevant here, preemption is a waivable affirmative defense.¹⁷⁴

However, generic drug companies attempting to waive their *PLIVA* rights face a collective action problem. Generic drug companies are, on the whole, indistinguishable; consumers normally identify the generic drug based on the generic's chemical name, which is identical for all generic equivalents

171. *Id.*

172. An agency can interpret an ambiguous statute even after a Court of appeals has interpreted the statute differently. *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005). Whether this also applies to Supreme Court decisions is debated. *Compare id.* at 1003 (Stevens, J., concurring) (“a decision by this Court that would presumably remove any pre-existing ambiguity [in an ambiguous statute]”) with *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1247 (10th Cir. 2008) (disagreeing).

173. Reply Brief of Petitioners Actavis and Actavis Elizabeth, *PLIVA Inc. v. Mensing*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 1059615, at *3; Reply Brief of Petitioners *PLIVA*; Teva Pharm. USA; and UDL Labs at 4, *PLIVA*, 131 S. Ct. 2567 (2011) (Nos. 09-993, 09-1039, 09-1501), 2011 WL 1059616; Brief of Apotex, Inc. as Amicus Curiae in Support of Petitioners at 14, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 288894; Brief of the Generic Pharm. Ass'n as Amicus Curiae in Support of Petitioners at 19, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 343069; Brief for Morton Grove Pharm., Inc. and Impax Lab., Inc. as Amici Curiae in Support of Petitioners at 13, *PLIVA*, 131 S. Ct. 2567 (Nos. 09-993, 09-1039, 09-1501), 2011 WL 343070.

174. *See Int'l Longshoremens Ass'n, AFL-CIO v. Davis*, 476 U.S. 380 (1986). The only type of preemption that is not waivable is preemption that removes subject matter jurisdiction. *Id.* at 385.

of a single drug.¹⁷⁵ As a result, generics do not advertise their products because any advertisements they invest in will benefit all generics that have the same chemical name.¹⁷⁶ This same problem exists if legislative limits on drug substitution laws cause a generic drug manufacturer, or even all generic drug manufacturers, to recognize that *PLIVA* harms their interest. If a generic drug company permits consumers to sue, this permission will either be diluted by all the other drug companies that do not waive their federal preemption defense or all the other companies will get to free-ride on consumers' positive association from the first company's waiver (even if the other companies themselves refuse to waive liability). It may therefore prove difficult for generic drug companies to avoid the result in *PLIVA*, even if, in the long run, the result is harmful to their interests.

D. STATE ACTION

Since the decision in *PLIVA* rests on federal preemption, and thus on the Supremacy Clause,¹⁷⁷ states cannot statutorily overrule *PLIVA* directly. They do, however, have a number of potential options.

1. Required Waiver

One model for improvement is Maine's drug substitution statute. Maine limits substitution of generic drugs to companies "doing business in the United States that [are] subject to suit and the service of legal process in the United States."¹⁷⁸ Other states could extend Maine's approach and limit drug substitution to generic drugs provided by manufacturers that have waived their preemption defense.¹⁷⁹ The state would create a list of generic drug companies that have waived their preemption defense, allowing substitutions of their drugs only. Thus, generic companies would face a Hobson's choice: they could refuse to waive their tort liability, in which case they would not be substituted for brand-name prescriptions—and therefore they would be sold far less frequently¹⁸⁰—or they could waive their preemption defense. If the state required waiver is legally enforceable, such a scheme could effectively overrule *PLIVA*.

175. RICHARD A. EPSTEIN, *OVERDOSE: HOW EXCESSIVE GOVERNMENT REGULATION STIFLES PHARMACEUTICAL INNOVATION* 153 (2006); Adam R. Young, *Generic Pharmaceutical Regulation in the United States with Comparison to Europe: Innovation and Competition*, 8 WASH. U. GLOBAL STUD. L. REV. 165, 178 (2009).

176. EPSTEIN, *supra* note 175, at 153; Young, *supra* note 175, at 178 (2009).

177. U.S. CONST. art VI, cl. 2.

178. ME. REV. STAT. tit. 32, § 13781 (1999 & Supp. 2011).

179. Which can be waived. *See supra* Section IV.C.

180. *See* Karolina Anderson et al., *Impact of a Generic Substitution Reform on Patients' and Society's Expenditure for Pharmaceuticals*, 81 HEALTH POL'Y 376 (2007).

What is unclear, though, is whether a contractual waiver of a preemption defense is judicially enforceable.¹⁸¹ The First Circuit has held that a preemption defense may not be contractually waived if it “do[es] violence to the public policy underlying the legislative enactment.”¹⁸² Whether a state mandated waiver of liability does violence to the public policy expressed in *PLIVA* is closely related to a second question.

It is possible that federal law may preempt a state’s demand for a waiver of liability. Most justices consider any state law that is “an obstacle to the accomplishment and execution of the full purposes and objectives of Congress”¹⁸³ preempted by federal law (obstacle preemption). If, as the majority in *PLIVA* holds, allowing state tort suits for inadequate labeling conflicts with the requirements of the Hatch-Waxman Act, then state laws effectively forcing generic manufacturers to waive their right to such a defense likely would be invalidated under obstacle preemption.

What makes this more confusing is that Justice Thomas does not accept obstacle preemption since he believes that attempting to intuit Congress’s goals is too speculative.¹⁸⁴ Since *PLIVA* was a 5–4 decision, with Justice Thomas in the majority, this might be crucial. Whether a state requirement for waiver was constitutional would therefore depend on whether at least one of the dissenting justices in *PLIVA* would follow *stare decisis*, upholding the result in *PLIVA* from which they dissented, in which case the generics would be preempted and the waiver of liability would be impermissible since all the justices except for Justice Thomas accept obstacle preemption.¹⁸⁵ If the four liberal justices continue resisting preemption for generic drug manufacturers, Justice Thomas would likely join them—agreeing only in result, since he would uphold the waiver of liability—thereby creating a plurality upholding liability against generic drug manufacturers. Perhaps the First Circuit’s “violence to the public policy” test is similar to the obstacle

181. *See* *Tompkins v. United Healthcare of New Eng.*, 203 F.3d 90, 97 (1st Cir. 2000) (“Although in some circumstances contractual waiver of statutory rights is permissible, we find no case holding that parties may contractually waive the right to assert ERISA preemption. Our decision in *Wolf v. Reliance Standard Life Ins. Co.*, 71 F.3d 444, 449 (1st Cir.1995), relied upon by the *Tompkinses*, merely holds that ERISA preemption, as an affirmative defense rather than as an element of the court’s jurisdiction, is waived if not timely raised. But *Wolf*, which addresses only procedural waiver, offers no support for the *Tompkinses’* contractual waiver argument.”) (internal citations omitted).

182. *Id.* (citing sources).

183. *Crosby v. Nat’l Foreign Trade Council*, 530 U.S. 363, 373 (2000).

184. *Williamson v. Mazda Motor of Am., Inc.*, 131 S. Ct. 1131, 1142 (2011) (Thomas, J., concurring); *Haywood v. Drown*, 129 S. Ct. 2108, 2133 (2009) (Thomas, J., dissenting); *Wyeth v. Levine*, 555 U.S. 555, 604 (2009) (Thomas, J., concurring).

185. *See supra* note 184.

preemption test and Justice Thomas would likewise reject is as being too speculative. In that case, depending on the liberal justices' application of *stare decisis*, such a waiver might garner a majority.

2. *Allow Suits Against Brand-Name Drug Companies*

A different potential solution is to grant patients harmed by generic drugs the right to sue the brand-name drug company that makes the equivalent brand-name drug. The logic is simple. Had the brand-name changed its label, the FDA would have considered whether to update the labeling requirements on the drug.¹⁸⁶ If the FDA had updated the label then the generic label would have had to follow suit¹⁸⁷ and therefore the generic label would have been more accurate. Though a couple of courts have accepted this argument and held that brand-name drug companies can be liable for harm from the generic equivalents of a drug,¹⁸⁸ those decisions are the exception.¹⁸⁹ Courts, as a matter of state tort law, almost uniformly require that a plaintiff be injured by ingesting the defendant's drug.¹⁹⁰

Importantly, a number of the courts that ruled in favor of the brand-name manufacturers reasoned that consumers should just sue the generic drug company.¹⁹¹ However, given that *PLIVA* forecloses this option, perhaps state courts or legislatures will permit suits against brand-name drug companies for harm from their generic equivalents.¹⁹² One caveat is that in cases where the brand-name drug company has left the market, it seems very unfair to force the brand-name drug to continue monitoring the safety of the drug or else be liable for suits for inadequate labeling of a drug they no longer produce.¹⁹³

186. *See Wyeth*, 555 U.S. at 571.

187. *PLIVA v. Mensing*, 131 S. Ct. 2567, 2576–77 (2011).

188. *Conte v. Wyeth, Inc.*, 168 Cal. App. 4th 89, 109–11 (2008); *Kellogg v. Wyeth*, 762 F. Supp. 2d 694, 708–09 (D. Vt. 2010).

189. *See* Kenneth Sills, *Liability of Name Brand Drug Manufacturer for Injury or Death Resulting from Use of Prescription Drug's Generic Equivalent*, 56 A.L.R. 6th 161 (2010).

190. *Id.* (collecting cases).

191. *E.g.*, *Foster v. Am. Home Prods. Corp.*, 29 F.3d 165, 169 (4th Cir. 1994); *Bartlett v. Mutual Pharm. Co.*, 659 F. Supp. 2d 279, 308–09 n.40 (D.N.H. 2009); *Schrock v. Wyeth*, 601 F. Supp. 2d 1262, 1267 (W.D. Okla. 2009); *Fields v. Wyeth*, 613 F. Supp. 2d 1056, 1061 (W.D. Ark. 2009); *Swicegood v. PLIVA*, 543 F. Supp. 2d 1351, 1358 (N.D. Ga. 2008).

192. *Cf.* Allen Rostron, *Prescription for Fairness: A New Approach to Tort Liability of Brand-Name and Generic Manufacturers*, 60 DUKE L.J. 1123, 1177–78 (2011) (arguing for brand-name manufacturer liability in light of the possibility that the then pending *PLIVA* decision would turn out as it did).

193. *See* Lars Noah, *Adding Insult to Injury: Paying for Harms Caused by a Competitor's Copycat Product*, 45 TORT TRIAL & INS. PRAC. L.J. 673, 691–92 (2010) (questioning whether courts

E. CONGRESSIONAL ACTION

A final possibility is that Congress could explicitly make uniform the preemption laws for generic and brand-name drugs: either both are preempted or both are not.¹⁹⁴ After all, both *Wyeth*¹⁹⁵ and *PLIVA*¹⁹⁶ imply that, had Congress been explicit about wanting or not wanting preemption, then the Court would have acquiesced to that decision. The Supreme Court, in other cases, makes this point explicitly.¹⁹⁷ Additionally, like the FDA, Congress could permit generic drug companies to unilaterally change drug labels upon learning of new adverse side effects and this would effectively reverse *PLIVA*, or it could forbid brand-name drug companies from unilaterally changing their labels, thus reversing the result in *Wyeth*.¹⁹⁸ Obviously getting specific Congressional action is never a simple task, but given the importance of the drug industry, it might be possible.¹⁹⁹

V. CONCLUSION

There is significant tension between the Court's 2009 decision in *Wyeth v. Levine* and its 2011 decision in *PLIVA v. Mensing*. The result of the combination of the two cases is that brand-name drug companies can be sued for inadequate labeling, whereas generic drug companies cannot.²⁰⁰ In

that permit plaintiffs harmed by generic drugs to sue the brand-name drug would extend this to cases where the brand-name drug has left the market).

194. Nothing in the Health Care and Education Reconciliation Act of 2010 touches on these questions. See Pub. L. No. 111-152, 124 Stat. 1029 (2010).

195. 555 U.S. at 574–75.

196. *PLIVA v. Mensing*, 131 S. Ct. 2567, 2577 n.5, 2579 (2011).

197. *E.g.*, *Cipollone v. Liggett Grp. Inc.*, 505 U.S. 504, 516 (1992) (“Accordingly, the purpose of Congress is the ultimate touchstone of pre-emption analysis.”) (internal citations and alterations removed); see also Katie Stewart, *Should Congress Seek To Alter the Preemption Schism Established by Wyeth v. Levine and PLIVA v. Mensing*, 1 FDLPS FOOD & DRUG POLY FORUM, Oct. 26, 2011, at 5–6 (arguing that Congress should always say whether they intend for state law to be preempted, but especially in the context of food and drug law). The argument that Congress should generally specify whether a federal law preempts state law is debatable. In many instances, *a priori* it may be difficult to determine how state and federal law will interact. Thus, it may be better to let a court determine *ex post* whether preemption applies.

198. See Stewart, *supra* note 197, at 6–7.

199. As this Note was going to press, the *New York Times* reported that Congressman Waxman “was exploring ways to address [*PLIVA*], either through legislation or a rule change.” Katie Thomas, *Generic Drug Proving Resistant to Damage Suits*, N.Y. TIMES, Mar. 12, 2012, at A1.

200. Lest one worry that the Court was advantaging generic drug manufacturers against brand-name manufacturers, on the same day *PLIVA* was decided the Court also decided *Sorrell v. IMS Health Inc.*, 131 S. Ct. 2653 (2011), ruling in favor of brand-name drug companies that states cannot prohibit doctors from releasing pharmacy records that detail

the case of authorized generics, it may be that one generic can be sued while the rest cannot. The potentially unfortunate result could be a decrease in the number of generic drugs dispensed. This is harmful both because it wastes resources and because patients who have to take brand-name drugs are less likely to comply with their drug regimen.²⁰¹

While it is unlikely that the Court will reverse either of its decisions without prompting, the FDA might change its regulations, and this would in turn change the law. Additionally, it is possible that Congress might get involved and abrogate either *Wyeth* or *PLIVA*. Finally, while states cannot abrogate *PLIVA*, since it is based on the Constitutional Supremacy Clause, they can allow patients harmed by generic drugs to sue brand-name drug companies. This is not as unfair as it may seem, since the brand-name company is the company that set the label in the first place. States may also be able to force generic drug companies to waive their preemption defense before the generic is substituted. Hopefully, the numerous potential fixes mean that the broader benefits of generic drug substitution will not be harmed.

the prescribing practices of individual doctors. *See id.* at 2670 (explaining why such a law harms the brand-name manufacturer's interests). So, on the whole, it breaks even.

201. *See supra* Section III.B.

COMPENSATED INJUNCTIONS: A MORE EQUITABLE SOLUTION TO THE PROBLEM OF INEVITABLE DISCLOSURE

Sonya P. Passi[†]

A trade secret is as “any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others.”¹ By their very definition, trade secrets hold great value, and employers often invest significant resources in their development and subsequent protection.² Nevertheless, the theft of trade secrets costs companies as much as \$300 billion per year,³ and it is estimated that in over 85% of cases, the alleged misappropriator was either an employee or a business partner of the trade secret owner.⁴ Thus, employers face great risks when an employee, equipped with knowledge of and access to the company’s trade secrets, decides to leave the company in order to work for one of the employer’s competitors. The most troubling scenario arises when the departing employee’s general knowledge and experience—both understood to be assets rightfully belonging to her—are unalterably tied to the former employer’s trade secret information, such that disclosure of these trade secrets is inevitable in the course of her subsequent employment with a competing company.⁵ This is the problem of inevitable disclosure.

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1. RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 (1995).

2. Susan Street Whaley, *The Inevitable Disaster of Inevitable Disclosure*, 67 U. CIN. L. REV. 809, 816 (1999).

3. Almeling, Snyder, et al., *A Statistical Analysis of Trade Secret Litigation in Federal Courts*, 45 GONZ. L. REV. 291, 292 (2010) (citing OFFICE OF THE NAT’L COUNTERINTELLIGENCE EXECUTIVE, ANNUAL REPORT TO CONGRESS ON FOREIGN ECONOMIC COLLECTION AND INDUSTRIAL ESPIONAGE—2002 vii (Feb. 2003), available at <http://www.fas.org/irp/ops/ci/docs/2002.pdf>).

4. *Id.* at 294.

5. *See, e.g.*, *Carborundum Co. v. Williams*, 468 F. Supp. 38, 40 (E.D. Tenn. 1978), *aff’d mem.*, 590 F.2d 334 (6th Cir. 1978) (explaining that where the employee’s general knowledge was permeated with the former employer’s trade secret information, it would “require an exhibition of the highest personal and industrial integrity” for the employee not to disclose this information to his new employer).

The Uniform Trade Secrets Act (“UTSA”),⁶ which guides states’ trade secret law, only protects employers in cases of actual or threatened trade secret misappropriation.⁷ Actual misappropriation means that the trade secrets have already been divulged.⁸ Threatened misappropriation occurs when the departing employee has demonstrated a bad-faith intent to divulge trade secret information.⁹ However, these two available causes of actions under the UTSA, alone, fail to provide employers with adequate protection. The value of the trade secret is lost by the time an employer can bring a claim of actual misappropriation.¹⁰ Consequently, such claims are considered a last resort for employers who prefer to protect their trade secrets by preventing trade secret disclosure in the first place.¹¹ Under the UTSA, an employer’s only other option is to seek an injunction for threatened misappropriation by a departing employee.¹² However, it is typically understood that to meet the burden of proof in a claim for threatened misappropriation, the employer must show evidence of bad faith or ill-intent on the part of the departing employee.¹³ Not only is bad faith very difficult for employers to prove, but also, the employee may in fact have no malicious intent or indeed any intent whatsoever to disclose the trade secrets.

The doctrine of inevitable disclosure evolved as a judicial response to the perceived need to fill the void in the UTSA not covered by the causes of action for actual and threatened misappropriation of trade secrets. The

6. The theory of trade secret protection evolved under the common law, guided by the Restatement (First) of Torts (1934). Confusion and disparity between states was prevalent. Thus, in 1979, the National Conference of Commissioners on Uniform State Laws approved the UTSA. The adoption of UTSA by the majority of jurisdictions in some form or another provided some uniformity in trade secret protection. John H. Matheson, *Employee Beware: The Irreparable Damage of the Inevitable Disclosure Doctrine*, 10 LOY. CONSUMER L. REV. 145, 147 (1998).

7. UNIF. TRADE SECRETS ACT § 2(a) (amended 1985) (“[a]ctual or threatened misappropriation may be enjoined”).

8. *See, e.g., Ecolab, Inc. v. Paolo*, 753 F. Supp. 1100 (E.D.N.Y. 1991); *Surgidev Corp. v. Eye Tech., Inc.*, 648 F. Supp. 661 (D. Minn. 1986).

9. *See, e.g., Clorox Co. v. S.C. Johnson & Son, Inc.*, 627 F. Supp. 2d 954 (E.D. Wis. 2009).

10. STEVEN WILLBORN ET AL., *EMPLOYMENT LAW: CASES AND MATERIALS* 352–53 (4th ed. 2007).

11. *Id.*

12. UNIF. TRADE SECRETS ACT § 2(a) (“[a]ctual or threatened misappropriation may be enjoined”).

13. *See, e.g., Clorox*, 627 F. Supp. 2d at 968 (“Threatened misappropriation may be demonstrated by showing either that the defendant possesses trade secrets and has misused or disclosed those secrets in the past, that the defendant intends to misuse or disclose those secrets, or that the defendant possesses trade secrets and wrongfully refuses to return them.”).

doctrine protects trade secrets not only before they have been disclosed but also in the absence of bad faith or ill intent on the part of the departing employee.¹⁴ In cases where the employer's trade secrets cannot be separated from the departing employee's general knowledge, such that disclosure of the trade secret information is "inevitable" in the course of future employment for a competing company, the doctrine of inevitable disclosure allows a court to enjoin the employee from working for the employer's competitors for a certain length of time.¹⁵

However, although the doctrine of inevitable disclosure fills an important role neglected by the UTSA, it does not, as it stands, produce just results. By giving employers a tool to perpetually prevent employees from working for competitors, the doctrine protects trade secrets at the cost of severely shackling job mobility.¹⁶ Indeed, most foreign countries refuse to recognize any version of the inevitable disclosure doctrine on the grounds that it constitutes an "unreasonable restraint of trade."¹⁷ Moreover, by forcing courts to choose between the interests of the employer and the interests of the employee, with no room for compromise, the doctrine is a source of much discomfort for judges.¹⁸ If a court grants an injunction, it risks significantly destroying the employee's job prospects; if a court does not grant an injunction, it risks allowing great economic damage to the employer's business. As a result, judges struggle with the potential consequences of their decisions, resulting in inconsistent rulings.¹⁹ Thus, the doctrine's current failure to recognize the interests of employees is not only unfair, but it is also problematic from a judicial decision-making standpoint.

This Note proposes that, as a solution to the problem with the doctrine of inevitable disclosure, courts should make it mandatory for employers to

14. Jennifer L. Saulino, *Locating Inevitable Disclosure's Place in Trade Secret Analysis*, 100 MICH. L. REV. 1184, 1186 (2002). Some courts conceptualize the doctrine of inevitable disclosure as one form of threatened misappropriation. *See, e.g.*, *Interbake Foods, LLC v. Tomasiello*, 461 F. Supp. 2d 943 (N.D. Iowa 2006). However, the author of this Note joins other courts in conceptualizing the doctrine of inevitable disclosure as an alternative to actual or threatened misappropriation. *See, e.g.*, *Cent. Valley Gen. Hosp. v. Smith*, 162 Cal. App. 4th 501, 525 (Ct. App. 2008). Thus it provides relief even in instances of good faith or unintentional disclosure.

15. *See, e.g.*, *La Calhene, Inc. v. Spoylar*, 938 F. Supp. 523 (W.D. Wis. 1996).

16. Whaley, *supra* note 2, at 841.

17. *See* 1 RESTRICTIVE COVENANTS AND TRADE SECRETS IN EMPLOYMENT LAW: AN INTERNATIONAL SURVEY (Wendi S. Lazar & Gary R. Siniscalco eds., 2010) [hereinafter RESTRICTIVE COVENANTS] (Canada, the United Kingdom, Germany, France, Japan and Hong Kong have all rejected the doctrine).

18. *See, e.g.*, Suellen Lowrey, *Inevitable Disclosure Trade Secret Disputes: Dissolutions of Concurrent Property Interests*, 40 STAN. L. REV. 519, 520 (1998).

19. *Id.*

adequately compensate employees for the entire time period that the employees are enjoined from working for a competitor under the doctrine of inevitable disclosure. This would ensure that both the employer's and the employee's interests are accounted for. Additionally, an equitable system of injunctive relief and compensation serves to promote the true value of trade secrets. The trade secret is not only worth protecting, but it is worth paying to protect. Finally, a compensated injunction offers many practical benefits. It would force employers to evaluate the necessity of such an injunction, reduce instances of frivolous litigation, and make judicial decision-making easier, by offering judges a compromise. Given that there are no real "wrongdoers" in cases of inevitable disclosure, this is an area of law where courts and state legislatures can and should be proactive in tailoring remedies to individual cases in order to ensure fairness.

This Note proceeds in three parts. Part I summarizes the conflicting policy interests at stake in cases of inevitable disclosure. Part II then surveys the doctrine of inevitable disclosure in more detail. Although the majority of states recognize this doctrine,²⁰ albeit with varying understandings of "inevitability,"²¹ a small minority of states have taken different approaches to the problem of inevitable disclosure. For example, the Third Circuit recently proposed a standard that provides even greater protection to employers than the doctrine of inevitable disclosure.²² Instead of requiring employers to show that disclosure of their trade secrets is *inevitable*, it simply requires that there be a *substantial likelihood* of disclosure.²³ Meanwhile, California and a small minority of other states have refused to protect employers from the inevitable disclosure of their trade secrets.²⁴ These alternative standards will also be discussed in Part II.

Part III argues that, in light of the important policy concerns on both sides of an inevitable disclosure dispute, the doctrine of inevitable disclosure, which sacrifices one set of interests for the other, is unacceptable in its current form. However, both the Third Circuit's substantial likelihood test and California's rejection of the doctrine of inevitable disclosure are similarly inequitable. Thus neither provides an adequate alternative. Rather, the most effective and equitable solution would be a system of compensated injunctions. Courts should provide employers with injunctive relief in cases of inevitable disclosure but should require that employers compensate

20. *See infra* Part II.A.

21. *See infra* Part II.B.

22. *Bimbo Bakeries USA, Inc. v. Botticella*, 613 F.3d 102, 110 (3d Cir. 2010).

23. *Id.*

24. *See infra* Part II.C.

former employees for the entire duration of the injunction. Part III will not only offer a conceptual framework within which to understand this proposed solution, but will also consider the mechanics of how this solution could operate in practice. It is the author's hope that this Note will be read not only by interested commentators, but also by judges and state legislators. It will take a concerted effort by both groups to implement compensated injunctions as state practice.

I. CONFLICTING POLICY INTERESTS IN INEVITABLE DISCLOSURE CASES

The competing interests involved in inevitable disclosure situations "are as easy to state as they are difficult to protect."²⁵ On the one hand, employers have invested a great deal of time and resources into developing their trade secrets and stand to incur substantial losses if their competitors gain access to these secrets.²⁶ If they could not protect their trade secrets in cases of inevitable disclosure, employers would either not invest as much in innovation, or they would be forced to take "inefficient steps to protect the information," such as dividing tasks between many employees such that no individual employee has complete knowledge of the trade secret information.²⁷ Thus, the doctrine of inevitable disclosure not only serves the interest of economic efficiency but it also promotes the broad societal goal of investment in innovation.²⁸ Moreover, society has a strong interest in preserving commercial morality and one company's purposeful hiring of a competitor's employee who has knowledge of the competitor's trade secrets offends our understanding of fair and ethical business practices.²⁹

On the other hand, serious questions of fairness also arise on the employee's side, given that the only way to protect trade secrets in these cases is by restraining a departing employee from working for the former employer's competitor entirely.³⁰ If a court enjoins an employee from working for companies in the same competitive area as their current

25. *E.I. duPont de Nemours & Co. v. Am. Potash & Chem. Corp.*, 200 A.2d 428, 437 (Del. Ch. 1964).

26. WILLBORN, *supra* note 10, at 326.

27. *Id.*

28. Lowrey, *supra* note 18, at 526.

29. *Id.* at 525.

30. By definition, it is not possible to enjoin a departing employee from disclosing a trade secret subject to inevitable disclosure. The point is that the trade secret is inseparable from the employee's general knowledge and experience such that disclosure is inevitable. The only way to prevent disclosure, then, is to enjoin the departing employee from working for a competitor entirely.

employment, that employee's options for alternative employment are significantly restricted and economic hardship may well result.³¹ Employees may face additional restrictions when, in order to avoid hindrances on their future employment prospects, they shy away from increasing their expertise through access to and involvement in the development of company trade secrets.³² Moreover, in a free society, jobs not only ensure financial stability but are also "central to [an individual's] . . . status, and perhaps to their definition of themselves as persons."³³ Thus, restrictions on employment mobility can do great damage to one's sense of self. Furthermore, litigation can be both draining and potentially damaging to an employee's reputation and as a result, may even "have a chilling effect" on an employee's desire to leave her current employment.³⁴ From a contractual standpoint, an employee may be unaware of potential restrictions on her future mobility at the time of negotiating the employment contract, thus not bargaining for that restriction in the resulting agreement.³⁵ This is particularly unfair given that employers have "both the legal means and the comparative information advantage to protect themselves" in advance through non-compete clauses in the employment contract.³⁶

At the same time, society stands to benefit from the disclosure of trade secrets. The spread of ideas allows other innovators to develop and build on the ideas of their competitors at a lower cost, thus resulting in cheaper goods and services in the marketplace. Moreover, there may be instances where companies choose to protect their intellectual property through trade secrets rather than patent protection because of the potentially greater length of protection, all the while knowing the risks of this decision.³⁷ It does not seem fair, then, to punish employees for the cost-benefit analysis of their employers.

31. Whaley, *supra* note 2, at 844.

32. Johanna L. Edelstein, *Intellectual Slavery?: The Doctrine of Inevitable Disclosure of Trade Secrets*, 26 GOLDEN GATE U. L. REV. 717, 733 (1996).

33. Lowrey, *supra* note 18, at 538.

34. *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 310 (S.D.N.Y. 1999).

35. Adam Gill, *The Inevitable Disclosure Doctrine: Inequitable Results Are Threatened But Not Inevitable*, 24 HASTINGS COMM. & ENT. L.J. 403, 424 (2002).

36. Matheson, *supra* note 6, at 146. Non-compete agreements come into operation after the employment relationship ends and usually prevent the former employee "from engaging in business activity competitive with the former employer for a period of time in a specified geographical area." *Id.* at 154.

37. Matthew J.S. Graham, *Leveraging Your Intellectual Property: Trade Secret vs. Patent Protection*, FREDRIKSON AND BYRON P.A. (July 2006), http://www.fredlaw.com/articles/ip/inte_0607_mjsg.html.

As explained above, economic interests exist on both sides of the debate, as do societal interests and moral concerns. Courts are forced to grapple with these competing interests and the difficulty of this task helps explain the well-criticized problem of inconsistent judicial outcomes.³⁸

II. RESPONSES TO THE INEVITABLE DISCLOSURE PROBLEM

There have been three main responses to the problem of inevitable disclosure. The majority of jurisdictions have protected trade secrets in these cases by enjoining the employee from working for a competing company if the trade secret owner can demonstrate that disclosure of the trade secret in the course of employment for a competitor is “inevitable.”³⁹ This is the doctrine of inevitable disclosure. Recently, the Third Circuit espoused a variation of this test, which allows for trade secret protection in cases where there is a “substantial likelihood” of disclosure in the course of future employment.⁴⁰ It is yet to be seen whether other jurisdictions will adopt this approach. The third approach is to provide no trade secret protection in cases of inevitable disclosure. California and a minority of other states have adopted this approach in the name of employee mobility.⁴¹ This Part considers each approach in turn.

A. THE DOCTRINE OF INEVITABLE DISCLOSURE

1. *Historical Development of the Doctrine*

Courts created the doctrine of inevitable disclosure as a response to the perceived need for trade secret protection in cases where a former employer’s trade secrets are inextricably linked to a departing employee’s general knowledge and experience, such that disclosure of these trade secrets is inevitable in the course of subsequent employment with a competing company.⁴²

In the early 1960s, B.F. Goodrich Co. (“Goodrich”), a manufacturing and research company, brought suit to permanently enjoin a former employee, Donald Wohlgemuth, from working for any of its competitors.⁴³

38. *See, e.g.*, Whaley, *supra* note 2, at 841 (“the doctrine has been developed and applied inconsistently”).

39. *See, e.g.*, PepsiCo, Inc. v. Redmond, 54 F.3d 1262 (7th Cir. 1995).

40. Bimbo Bakeries USA, Inc. v. Botticella, 613 F.3d 102, 110 (3d Cir. 2010).

41. *See, e.g.*, Bayer Corp. v. Roche Molecular Sys., Inc., 72 F. Supp. 2d 1111 (N.D. Cal. 1999).

42. Saulino, *supra* note 14, at 1185.

43. B.F. Goodrich Co. v. Wohlgemuth, 192 N.E.2d 99, 101 (Ohio Ct. App. 1963).

Wohlgemuth was one of only a few top executives and developers at Goodrich and spent most of his time as part of a team of engineers and scientists that designed space suits.⁴⁴ He had “full knowledge” of many of Goodrich’s trade secrets.⁴⁵ When Wohlgemuth resigned and accepted a higher-paying job managing International Latex Corporation’s (Latex) space suit business, Goodrich feared that he would divulge its trade secrets to Latex.⁴⁶ Indeed, Wohlgemuth, by his own admission, expected to “use all of the knowledge that he had to [Latex’s] benefit.”⁴⁷ Although Wohlgemuth did not explicitly threaten to disclose Goodrich’s trade secrets, the Court of Appeals of Ohio nevertheless found that there was a “substantial threat of disclosure” by virtue of his working at Latex.⁴⁸ Stressing the values of “commercial morality” and “the American doctrine of free enterprise,” the court concluded that Goodrich was entitled to protection of its trade secrets.⁴⁹ Thus, the court enjoined Wohlgemuth from working for Latex.⁵⁰

A year later, in *E.I. duPont de Nemours & Co. v. American Potash & Chemical Corp.*, a chemical manufacturer sought to enjoin a departing employee with intimate knowledge of one of its unique chemical processes from working for a competitor who wanted access to the secret process.⁵¹ A Delaware trial court held that “where there is a finding that a threat of use or disclosure exists which the court concludes will, if effectuated, constitute a breach of confidence,” a court may enjoin a departing employee from working for a competitor.⁵² Just as the *B.F. Goodrich* court talked about “commercial morality,”⁵³ so too did the *E.I. DuPont* court emphasize an employee’s “fiduciary duty” to his former employer.⁵⁴

Two years later, these principles were reiterated in *Allis-Chalmers Manufacturing Co. v. Continental Aviation & Engineering Corp.* A Michigan district court granted the plaintiff company an injunction preventing a former employee with knowledge of the company’s engineering trade secrets from working for a competitor.⁵⁵

44. *Id.* at 102.

45. *Id.*

46. *Id.* at 103.

47. *Id.* at 104.

48. *Id.* at 105.

49. *B.F. Goodrich Co.*, 192 N.E.2d at 105.

50. *Id.*

51. 200 A.2d 428, 430–32 (Del. Ch. 1964).

52. *Id.* at 546.

53. *B.F. Goodrich Co.*, 192 N.E.2d at 105.

54. *E.I. duPont de Nemours*, 200 A.2d at 428.

55. *Allis-Chalmers Mfg. Co. v. Cont’l Aviation & Eng’g Corp.*, 255 F. Supp. 645 (E.D. Mich. 1966).

These three cases first established the doctrine of inevitable disclosure, although none mentioned the doctrine explicitly.⁵⁶ All three cases recognized that a court can enjoin an employee from working for a competitor even in the absence of a covenant not to compete or any explicit intent on the part of the employee to misappropriate her former employer's trade secrets.⁵⁷ However, the circumstances of these cases were narrow and unusual, as they all involved companies engaged in scientific, technological or engineering industries. Moreover, at issue in each case was the potential disclosure of the very trade secrets that had led to the former employers' dominance in their respective industries.⁵⁸

2. *Present State of the Doctrine*

It was not until the Seventh Circuit's opinion in *PepsiCo, Inc. v. Redmond* that the doctrine of inevitable disclosure was explicitly established and expanded to cover a broader range of cases.⁵⁹ In that case, a soft drink manufacturer brought an action to enjoin a former high-level managerial employee from working for a competitor in a similar capacity.⁶⁰ The court found that the employee had access to the plaintiff's trade secrets, and that he would inevitably disclose them in the course of employment with the competitor if he assumed duties relating to beverage pricing, marketing, and distribution.⁶¹ Moreover, the court noted that "fierce beverage-industry competition" existed between the two companies,⁶² and that the new company would "achieve a substantial advantage" by knowing the plaintiff's trade secret information.⁶³ Thus, the court affirmed the district court's holding enjoining the employee from working for the former employer's competitors for six months.⁶⁴

The *PepsiCo* court broadened the situations in which employers can employ the doctrine of inevitable disclosure by affirming an injunction to protect trade secrets unrelated to science, technology, or engineering, but

56. Jonathan O. Harris, *The Doctrine of Inevitable Disclosure: A Proposal To Balance Employer And Employee Interests*, 78 WASH. U. L.Q. 325, 331–32 (2000).

57. *Allis-Chalmers*, 255 F. Supp. at 645; *E.I. duPont de Nemours*, 200 A.2d at 428; *B.F. Goodrich Co.*, 192 N.E.2d at 105.

58. *Id.* at 337.

59. *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995); Harris, *supra* note 56, at 339.

60. *PepsiCo*, 54 F.3d at 1263.

61. *Id.*

62. *Id.* at 1263–64.

63. *Id.* at 1270.

64. *Id.* at 1272.

instead involved pricing, distribution, packaging, and marketing.⁶⁵ The court also highlighted the relevant factors that courts should consider in applying the doctrine of inevitable disclosure: (1) whether the former employee has knowledge of the first employer's trade secrets; (2) whether the employee's new job duties are so similar or related to those in the former position that it would be extremely difficult not to rely on or use the first employer's trade secrets; (3) whether the former employee and the new employer can be depended upon to avoid using the trade secret information;⁶⁶ and (4) whether the level of competition between the former and new employer is such that the former employer would suffer irreparable harm if its trade secrets were disclosed.⁶⁷ This doctrine, then, requires courts to engage in a fact-intensive analysis.

While many jurisdictions apply the doctrine of inevitable disclosure as espoused by the *PepsiCo* court,⁶⁸ others jurisdictions took issue with it.⁶⁹ For example, New York courts have sought to limit use of the doctrine to "only the rarest of cases" because "in cases that do not involve the actual theft of trade secrets, the court is essentially asked to bind the employee to an implied-in-fact restrictive covenant based on a finding of inevitable disclosure."⁷⁰ Another common complaint about the doctrine of inevitable disclosure is that it produces inconsistent results because it demands such a vigorous factual analysis of each individual case. A New York district court even referred to the problem as the "nebulous standard of 'inevitability.'" ⁷¹

B. THE SUBSTANTIAL LIKELIHOOD TEST

In *Bimbo Bakeries USA, Inc. v. Botticella*, the Third Circuit created an alternative standard to be applied in cases of inevitable disclosure.⁷² Like the doctrine of inevitable disclosure, the Third Circuit's standard grants

65. Harris, *supra* note 56, at 339.

66. See 2 RESTRICTIVE COVENANTS, *supra* note 17, VOL. II, 55–15; *PepsiCo, Inc.*, 54 F.3d at 1268–71.

67. Harris, *supra* note 56, at 330.

68. See, e.g., *Barilla Am., Inc. v. Wright*, No. 4-02-CV-90267, 2002 WL 31165069 (S.D. Iowa 2002); *Branson Ultrasonics Corp. v. Stratman*, 921 F. Supp. 909 (D. Conn. 1996); *Merck & Co. Inc. v. Lyon*, 941 F. Supp. 1443 (M.D.N.C. 1996); *Procter & Gamble Co. v. Stoneham*, 747 N.E.2d 268 (Ohio Ct. App. 2000).

69. See, e.g., *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 310 (S.D.N.Y. 1999).

70. *Id.* (noting, further, that "[t]his runs counter to New York's strong public policy against such agreements and circumvents the strict judicial scrutiny they have traditionally required").

71. *EarthWeb*, 71 F. Supp. 2d at 311.

72. *Bimbo Bakeries USA, Inc. v. Botticella*, 613 F.3d 102, 114 (3d Cir. 2010) ("sufficient likelihood or substantial threat of disclosure") (citations omitted).

employers injunctive relief when a departing employee has knowledge of her employer's trade secrets. However, while the doctrine of inevitable disclosure test, by definition, requires that disclosure be "inevitable," the Third Circuit's test requires only that there be a "substantial likelihood" that the trade secret will be misappropriated if the departing employee is allowed to work for a competitor.⁷³ This more relaxed standard appears to be much more pro-employer than the doctrine of inevitable disclosure.

In *Bimbo Bakeries*, the plaintiff, Bimbo Bakeries USA, Inc. ("Bimbo"), one of the four largest companies in the United States baking industry, filed an action against its former Vice President of Operations for California, Chris Botticella, to protect its trade secrets from misappropriation.⁷⁴ As one of Bimbo's senior executives for ten years, Botticella worked closely with a broad range of confidential information regarding the company, its products, and its business strategy.⁷⁵ Among other things, he had access to Bimbo's codebook and knowledge of Bimbo's strategy for increasing profitability.⁷⁶ Additionally, Botticella was one of only seven people who knew how to replicate Bimbo's popular line of Thomas' English Muffins, which generate approximately half a billion dollars in revenue annually.⁷⁷

The district court entered a preliminary injunction enjoining Botticella from working for Hostess, Bimbo's competitor, until the merits of the case could be reached, on the grounds that there was a "substantial likelihood" that Botticella would disclose Bimbo's trade secrets in the course of his employment with Hostess.⁷⁸ The Third Circuit affirmed this holding and upheld the preliminary injunction.⁷⁹

The substantial likelihood test is not new. Courts have frequently applied it, or a similar standard, in cases of inevitable disclosure. For example, in *Procter & Gamble Co. v. Stoneham*, the Ohio Court of Appeals held that an injunction was an appropriate remedy where the threat of misappropriation "was not only possible or speculative, but was substantially likely to result."⁸⁰ Moreover, Minnesota's federal and state courts have repeatedly

73. *Id.* at 112, 114.

74. *Id.* at 105.

75. *Id.*

76. *Id.*

77. *Id.* at 105, 110.

78. *Bimbo Bakeries USA, Inc.*, 613 F.3d. at 108; *Bimbo Bakeries USA, Inc. v. Botticella*, No. 10-0194, 2010 WL 571774, at *14 (E.D. Pa. 2010), *aff'd*, 613 F.3d 102 (3d. Cir. 2010).

79. *Bimbo Bakeries*, 613 F.3d at 111.

80. *Procter & Gamble Co. v. Stoneham*, 747 N.E.2d 268, 280 (Ohio Ct. App. 2000).

acknowledged a “high degree of probability” standard.⁸¹ The standards applied by these courts are not surprising: “inevitability” is a difficult concept to understand and apply. However, the Third Circuit is the first court to conceptualize this test as separate and distinct from the inevitable disclosure test.⁸² *Bimbo Bakeries*, then, marks a potential shift towards even stronger protections for employers and, concomitantly, weaker protections for employees.

C. CALIFORNIA’S PRO EMPLOYEE APPROACH: NO RESTRICTIONS ON EMPLOYMENT MOBILITY

California emphatically rejected the doctrine of inevitable disclosure because it contradicts the state’s public policy in favor of employment mobility.⁸³ California Business and Profession Code Section 16600 provides that “[e]very contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”⁸⁴ Interpreting this code section “as broadly as its language reads,” California courts consistently reject non-competition agreements as counter to public policy.⁸⁵ Thus, it follows that the state similarly refuses to recognize the doctrine of inevitable disclosure, which essentially sanctions judicially created non-competes.⁸⁶ Indeed, in *Bayer Corp. v. Roche Molecular Systems, Inc.*, a federal district court declared that “[t]he theory of ‘inevitable disclosure’ is not the

81. See, e.g., *Lexis-Nexis v. Beer*, 41 F. Supp. 2d 950, 958 (D. Minn. 1999); *ReliaStar Life Ins. Co. v. KMG Am. Corp.*, No. A052079, 2006 WL 2529760, at *4 (Minn. Ct. App. 2006).

82. *Bimbo Bakeries*, 613 F.3d at 111. Previously, courts simply worked within the rubric of the doctrine of inevitable disclosure.

83. See, e.g., *Bayer Corp. v. Roche Molecular Sys., Inc.*, 72 F. Supp. 2d 1111 (N.D. Cal. 1999); *Whyte v. Schlage Lock Co.*, 125 Cal. Rptr. 2d 277 (Cal. Ct. App. 2002). Maryland has a policy in favor of employee mobility similar to that of California, and thus similarly refuses to adopt the doctrine of inevitable disclosure. See *LeJeune v. Coin Acceptors, Inc.*, 381 Md. 288, 322 (Ct. App. 2004).

84. CAL. BUS. & PROF. CODE § 16600 (Deering 1992). This code section is “the longest-standing prohibition against non-compete enforcement.” Matt Marx et al., *Regional Disadvantage? Non-Compete Agreements and Brain Drain* 13 (MIT Sloan School of Management, Working Paper, Sept. 22, 2010), available at <http://www.hbs.edu/units/tom/seminars/docs/braindrain100925.pdf>.

85. Ronald J. Gilson, *The Legal Infrastructure Of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not To Compete*, 74 N.Y.U. L. REV. 575, 607 (1999). This policy dates from nineteenth century codification and was not adopted with any reference to high technology. Alan Hyde, *Trade Secrets Practice in Silicon Valley* in WILLBORN, *supra* note 10, at 327.

86. *Bayer*, 72 F. Supp. 2d at 1120 (explaining that a court should not allow a plaintiff to use inevitable disclosure as an after-the-fact non-compete agreement to enjoin an employee from working for the employer of his or her choice).

law in California” in light of “the [state’s] policy favoring employee mobility free of encumbering restriction.”⁸⁷

Some commentators attribute the success of Silicon Valley—“the most entrepreneurial and technologically successful region in the world today”—to the mobility of California employees.⁸⁸ Most notably, Ronald Gilson, a prominent scholar, argues that the lack of restrictions on employment in California resulted in the development of a “job-hopping” culture in Silicon Valley, which in turn permitted the occurrence of knowledge “spill-overs” between established technology firms and start-ups, encouraging both growth and innovation.⁸⁹ Meanwhile, others, including AnnaLee Saxenian, another prominent scholar in the field, attribute Silicon Valley’s success not to California’s legal structure but to the Silicon Valley’s organic and unique business culture.⁹⁰ She explains that an open culture of communication, information sharing across firms, and collaboration are the key to its success.⁹¹

III. A MORE EQUITABLE SOLUTION: COMPENSATED INJUNCTIONS

Without some form of protection for trade secrets in cases of inevitable disclosure, trade secret law is weak at best. In cases of actual misappropriation, the damage to the employer’s business has already been done.⁹² No amount of monetary damages can restore the value of the trade secret.⁹³ Thus, for trade secret protection to be effective, it must come prior to misappropriation. In cases of threatened misappropriation, courts typically grant injunctions to prevent disclosure.⁹⁴ However, the employer must demonstrate bad faith or ill-intent on the part of the employee.⁹⁵ A future employer or smart employee is not likely to make her intentions known and may in fact formally disavow any such intention.⁹⁶ Therefore, the former

87. *Id.*

88. *See* Marx et al., *supra* note 84, at 1; Gilson, *supra* note 85.

89. Gilson, *supra* note 85, at 578.

90. ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE ix (1994).

91. *Id.*

92. Saulino, *supra* note 14, at 1191.

93. *Id.*

94. *Id.* at 1193.

95. *Id.* at 1194.

96. *See, e.g.*, *Bimbo Bakeries USA, Inc. v. Botticella*, 613 F.3d 102, 106 (3d Cir. 2010) (directing Botticella “to execute an ‘Acknowledgment and Representation Form,’ which essentially indicated that Hostess was not interested in any confidential information, trade secrets, or other proprietary information that Botticella had acquired from Bimbo, and that

employer very often has a difficult time meeting its burden.⁹⁷ Thus, cases of both actual and threatened misappropriation offer limited recovery. The inadequacy of these remedies is exacerbated by the fact that in many trade secret disputes, the employee has not yet misappropriated the secret and has no intention of doing so. Instead, the former employer's trade secrets are so enmeshed in the employee's acquired skills and knowledge that disclosure is inevitable. Thus, the doctrine of inevitable disclosure fills a large gap in the protection of trade secrets left open by the existing causes of action for actual and threatened misappropriation.⁹⁸

At the same time, however, the doctrine of inevitable disclosure is highly inequitable, as are the Third Circuit's substantial likelihood test and California's rejection of any protection for employers in cases of inevitable disclosure. All three approaches focus exclusively and somewhat simplistically on protecting either the employer's interest or the employee's interest. One interest is sacrificed for the sake of protecting the other.⁹⁹ However, both interests are worthy of protection. Injunctive relief recognizes the rights of employers to protect their trade secrets, and subsequently incentivizes them to invest in innovation and in the skills and knowledge of their employees.¹⁰⁰ Additionally, injunctive relief in these situations serves to preserve a broader societal interest in commercial morality.¹⁰¹ On the other hand, protecting employees' right to fully market their skills and to work for whomever they choose recognizes their right to be financially secure. Furthermore, the free movement of information and ideas allows companies to build upon the innovations of their competitors and reduces the overall cost of goods and services to society. Particularly because there is no real wrongdoer in cases of inevitable disclosure, courts can and should adopt a more balanced approach.

Botticella would not disclose such information to Hostess"). It is perhaps for this reason courts often consider ill-intent or bad faith in cases of inevitable disclosure: There is insufficient evidence to reach the burden of showing such intent, but enough to meet the weaker standard of inevitable disclosure.

97. *See, e.g.*, *Edifecs, Inc. v. Tibco Software, Inc.*, 756 F. Supp. 2d. 1313 (W.D. Wash 2010) (holding that evidence of threatened misappropriation was speculative and therefore insufficient because the employer failed to provide concrete evidence of words or conduct indicating misuse by the departing employee).

98. *See supra* notes 8–10.

99. Both the doctrine of inevitable disclosure and the substantial likelihood test require the court to either grant an injunction, thus protecting only the employer's interests, or to refuse to grant an injunction, thus protecting only the employee's interests. Meanwhile, California's policy always favors the employee's interests.

100. Lowrey, *supra* note 18, at 526.

101. Edelstein, *supra* note 32, at 733–34.

A. INTERNATIONAL APPROACHES

In the search for a new approach, it is useful to look abroad at how other countries address this problem, and compare these approaches to those of the United States. Although other countries do not recognize the doctrine of inevitable disclosure, many allow employers to contractually restrict post-employment misappropriation of trade secrets if they provide employees adequate monetary compensation for restricting the latter's employment options. The United Kingdom ("UK"), Germany, and China provide examples of this approach.

UK employers adopted a system known as "garden leave" to protect their trade secrets.¹⁰² A garden leave clause, written into an employment contract, requires the employee to provide the employer with a relatively long period of notice before she may terminate the employment relationship.¹⁰³ During this notice period, employees are paid their full salary and benefits, but the employer cannot force them to do any work.¹⁰⁴ This system is called "garden leave" because it is expected that the employee will stay home and tend to his garden during this period in which he is out of work but financially secure.¹⁰⁵ A garden leave clause not only protects employees from financial hardship but, by extending their status as an employee, it also sustains their contractual obligations of fidelity by preventing them from engaging in competitive activity from the moment of notice of their departure to the end of the garden leave period. Because employees are not required to work during this period, employers can restrict the amount of up-to-date confidential information the employee can take with them to their new job. The proper time length of a garden leave clause is a question of reasonableness.¹⁰⁶

Germany's approach to preventing trade secret misappropriation similarly incorporates a system of compensation for employees. The crucial difference is that while the UK conceptualizes the employee as a *current* employee, Germany treats the employee as a *former* employee.¹⁰⁷ Germany

102. Greg T. Lembrich, *Garden Leave: A Possible Solution To The Uncertain Enforceability Of Restrictive Enforcement Covenants*, 102 COLUM. L. REV. 2291, 2291 (2002).

103. *Id.* at 2292.

104. *Id.*

105. *Id.* at 2305.

106. *See, e.g.*, *Tullet Prebon plc v. BGC Brokers LP*, [2010] 1 EWHC 484 (Q.B.) (finding that a 12 month garden leave period was appropriate for certain employees while 8 months was appropriate for others).

107. *Compare* Lembrich, *supra* note 101 at 2292 (explaining that a garden leave clause provides protection by extending the employment contract) *with* 1 RESTRICTIVE

uses a system of compensated restrictive covenants. Specifically, the German Commercial Code requires that an employer compensate the employee for the complete duration of time that the covenant is in effect.¹⁰⁸ The maximum term of a restrictive covenant is two years.¹⁰⁹ Compensation, which is set at no less than half of the employee's pay during the last twelve months of employment, includes any extra benefits previously received, including Christmas bonuses, vacation allowance, and commission.¹¹⁰ Total compensation need not exceed 110% of the contractual payments last received by the employee, unless the geographical restrictions of the non-compete covenant forced the employee to relocate.¹¹¹ In these circumstances, total compensation need not exceed 125% of the last received payment.¹¹²

Beginning in 2008, China also implemented a system of compensated restrictive covenants under its Labor Contract Law.¹¹³ If the employee is a senior technician, is in senior management, or otherwise has access to the employer's trade secrets, the employer may include a non-compete restriction in the employment contract.¹¹⁴ However, the non-compete agreement may not last more than two years, and the employer must compensate the employee on a monthly basis throughout the post-employment non-compete period.¹¹⁵ The law does not stipulate how much compensation is required.¹¹⁶ Some commentators suggest that compensation should match the employee's former salary, while others suggest that compensation need only meet the minimum wage requirements of the relevant jurisdiction.¹¹⁷

Neither the UK's garden leave system nor the compensated restrictive covenant regimes in Germany and China are foreign to employers in the United States. The UK's garden leave system appears to be gaining traction in the United States financial services industry.¹¹⁸ Unlike the generous notice

COVENANTS, *supra* note 17, 17-5 (explaining that german restrictive covenant provides protection after employment has terminated).

108. 1 RESTRICTIVE COVENANTS, *supra* note 17, 17-5.

109. *Id.* (citing HANDELSGESETZBUCH [HGB] (COMMERCIAL CODE) 1979 § 74(a)(1)).

110. *Id.*

111. *Id.* 17-6.

112. *Id.* Some Japanese courts also held that compensation is a "requirement" in the context of post-employment restrictions. *Id.*

113. *See* PRC LABOR CONTRACT LAW, art. 23–24 (Jan. 2008).

114. *See id.*

115. *See id.*

116. *See id.*

117. Steve Dickinson, *Employee Non-Compete Agreements In China. It's Complicated*, CHINA L. BLOG (Jan. 31, 2012, 2:38 PM), http://www.chinalawblog.com/2010/01/employee_noncompete_agreements.html.

118. 2 RESTRICTIVE COVENANTS, *supra* note 17, 55-30.

period under the British system, US employers that included a garden leave clause in their employment contracts limited the notice period to 30 to 90 days.¹¹⁹ However, US courts have yet to uphold the legitimacy of such provisions. For example, in *Bear, Stearns & Co. v. Sharon*, a Massachusetts district court held that the employer's garden leave clause was unenforceable because it required the departing employee "to continue an at-will employment relationship against his will."¹²⁰ The continuance of the employment relationship is a key characteristic of the garden leave system, because the prolonging of both the employee's duty of loyalty to the former employer and the employer's duty to compensate the departing employee forms the basis of the system's justification.¹²¹ However, given the tradition of at-will employment in the United States,¹²² it is unclear whether courts will ever recognize the validity of garden leave clauses.

By contrast, American courts have a long history of recognizing restrictive covenants. Although American courts are generally skeptical about restrictive covenants—both because of the restrictions that they impose on employment mobility and because employees lack bargaining power when they are required to sign such agreements¹²³—they usually uphold such agreements if they are reasonable.¹²⁴ There is no requirement that employers compensate their employees for the time that they are restricted from working elsewhere,¹²⁵ but many courts do require that there be adequate consideration to support a restrictive covenant. In cases where the initial employment contract included a non-compete agreement, "the employer's initial promise of employment provides sufficient consideration to support the covenant not to compete."¹²⁶ However, in cases where the employee signed a non-compete agreement during the course of their employment, courts require additional consideration.¹²⁷ Sufficient additional consideration may be in the form of "a raise, a new position, or an increased employment

119. *Id.*

120. *Bear, Stearns & Co., Inc. v. Sharon*, 550 F. Supp. 2d 174, 178 (D. Mass. 2008).

121. *See supra* Part III.A.

122. *See, e.g.*, Restatement (Second) of Contracts § 367 (1981).

123. Elizabeth A. Rowe, *When Trade Secrets Become Shackles: Fairness and the Inevitable Disclosure Doctrine*, 7 TUL. J. TECH. & INTEL. PROP. 167, 208 (2005).

124. Lowrey, *supra* note 18, at 523–24.

125. *But see* 2 RESTRICTIVE COVENANTS, *supra* note 17, 55-31/32 (explaining that US courts are more likely to enforce a restrictive covenant that provides the employee with adequate compensation, as this factor tends to shift the equity to the employer).

126. Harris, *supra* note 56, at 327–28.

127. *Id.*

term.”¹²⁸ Nevertheless, courts view non-competes very favorably in “the rare cases where employees are explicitly compensated for signing them.”¹²⁹

B. COMPENSATION AS A BALANCING MECHANISM

The basic premise in the UK, Germany, and China, is that if an employer wants to protect its trade secrets, it must be willing to pay the price to do so. The result safeguards both the employer’s interest in maintaining the value of its trade secret and the employee’s interest in financial security. Compensation, then, provides the balancing force that is lacking in American trade secret law. Applying this requirement to cases of inevitable disclosure, courts should enjoin employees from working for competitors when the former employer’s trade secrets are so entangled in the employee’s skills, knowledge, and experience that disclosure is inevitable. However, courts should grant the injunction on the condition that employers adequately compensate employees. That way, employers would have peace of mind that their trade secrets will not be disclosed, and employees would retain their financial security. Additionally, an equitable system of injunctive relief and compensation serves to promote the true value of trade secrets. The trade secret is not only worth protecting, but it is worth paying to protect.

This compensation requirement offers several practical benefits. It would transform injunctive relief into a cost-intensive option for employers by forcing them to seriously contemplate the need for an injunction, and thus limit litigation to cases of real necessity. Given the debilitating effect that such litigation can have on the career and professional reputation of an employee, this limiting factor serves to protect employees from unnecessary hindrances. Moreover, if courts enforce injunctions in inevitable disclosure cases on the condition that the employer compensate the employee for the duration of the injunction, it may increase the number of restrictive covenants that include compensation clauses. If courts will only enforce compensated injunctions, it probably follows that they will only enforce compensated restrictive covenants. Thus, employers are put on notice of what constitutes an enforceable covenant not to compete, and employees will have notice of when it is worth bringing suit.¹³⁰ The net effect, then, is a reduction in the amount of litigation on this issue. Additionally, this

128. *Id.*

129. Lowrey, *supra* note 18, at 524; *see, e.g.*, *Gillette Co. v. Williams*, 360 F. Supp. 1171, 1177 (D. Conn. 1973) (finding a non-compete agreement that provided employees with two years’ worth of compensation “more than reasonable”).

130. *See EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299, 311 (S.D.N.Y. 1999) (“Clearly, a written agreement that contains a non-compete clause is the best way of promoting predictability during the employment relationship and afterwards.”).

approach benefits employees by ensuring that they receive more than adequate consideration in non-compete clauses, a contractual area where they traditionally have had very little bargaining power.¹³¹

Finally, this balanced approach makes judicial decision-making easier, benefiting both judges and private parties. Suellen Lowrey, a prominent scholar, argues that inconsistent decisions in this area of law are the result of court's discomfort with a regime that must protect either the employer's interests or the employee's interests.¹³² There is currently too much at stake, and courts struggle with the potential consequences of their decisions. Thus, this balanced approach is likely to appeal to both judges and private parties by helping to streamline judicial decision-making in cases of inevitable disclosure.¹³³

C. THE THEORETICAL BASIS FOR A STANDARD OF COMPENSATED INJUNCTIONS

There are several possible frameworks in which to conceptualize and rationalize compensated injunctions. One option is to understand both the employer and employee as having a mutual property right at stake. In the employer's case this is the trade secret. In the employee's case this is the general knowledge and experience that is inseparable from the trade secret. Another option is to understand inevitable disclosure cases under contract theory. If inevitable disclosure injunctions are de facto covenants not to compete, then they should be subject to the same consideration requirements. The employee must receive some benefit in return for agreeing not to compete. The final alternative, which, as discussed below,¹³⁴ seems most appropriate for conceptualizing compensated injunctions is the Calabresi-Melamed framework.

1. *A Concurrent Property Framework*

One framework under which to understand this proposed standard is the doctrine of concurrent property.¹³⁵ Under this framework, both the employer and employee are understood to have a property right in the trade secret at issue.¹³⁶ Given that the trade secret is enmeshed in the employee's skills, knowledge, and experience, and that possession of this information makes the employee more valuable, it is not entirely far-fetched to assume that the

131. Lowrey, *supra* note 18, at 520.

132. *Id.*

133. *See id.* at 532.

134. *See infra* Part III.C.3.

135. *Id.* at 520.

136. *Id.*

employee has a property interest in the trade secret. Suellen Lowrey argues that “once courts and legislatures characterize . . . inevitable disclosure conflicts as disputes over property rights, they will be able to draw and expand on established law in this field to fashion a better process for resolving inevitable disclosure battles.”¹³⁷ For example, in cases of joint property ownership where it is not possible to divide the real property equitably through partition-in-kind, the unjustly enriched co-tenants are required to pay a premium to the other co-tenants.¹³⁸ Alternatively, in these cases, courts resort to judicial sales, thus recognizing the parties’ interests through monetary compensation.¹³⁹ Building on these principles, it is possible to view compensated injunctions as a way of recognizing the proprietary interests of both parties by reimbursing the employee for her lost use of the trade secret information.¹⁴⁰

A concurrent property framework would not only “reflect . . . the partial nature of employer ownership of the workplace,” but it would also recognize “the increasing importance of occupation to [an employee’s] wealth, status, and personhood.”¹⁴¹ However, there are also problems with applying concurrent property doctrine to inevitable disclosure cases.¹⁴² In particular, issues of valuation arise. If courts view both the employer and employee as having a property interest in the trade secret, then what portions does each own? Additionally, this framework would disrupt the current ownership system for trade secrets¹⁴³ and as a result potentially dissuade employers from investing as heavily in trade secrets.

2. *A Contractual Framework*

An alternative framework under which to understand the compensated injunction proposal is contract theory. An inevitable disclosure injunction is essentially a de facto covenant not to compete.¹⁴⁴ Since a covenant not to compete constitutes a contract, it must be validated by consideration.¹⁴⁵ In cases where the initial employment agreement contains a non-compete

137. *Id.* at 535.

138. *See, e.g.*, *Delfino v. Vealencis*, 436 A.2d 27, 33 (Conn. 1980).

139. *See, e.g.*, *Johnson v. Hendrickson*, 24 N.W.2d 914, 918 (S.D. 1946).

140. Lowrey, *supra* note 18, at 541.

141. *Id.* at 544.

142. Jay L. Koh, *From Hoops to Hard Drives: An Accession Law Approach to the Inevitable Misappropriation of Trade Secrets*, 48 AM. U. L. REV. 271, 274 (1998).

143. *See id.*

144. *Bayer Corp. v. Roche Molecular Sys., Inc.*, 72 F. Supp. 2d 1111, 1120 (N.D. Cal. 1999).

145. RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (“the formulation of a contract requires . . . a consideration”).

clause, courts generally hold that the employer's promise of employment provides the necessary consideration.¹⁴⁶ However, when an employee enters into a non-compete after the initial employment contract, courts require additional consideration.¹⁴⁷ Courts have held that a raise, a new position, or an increased employment term amounts to sufficient additional consideration.¹⁴⁸ However, none of these alternatives are available after the termination of the employment relationship. It follows, then, that an inevitable disclosure injunction must be validated by additional consideration in the form of compensation.¹⁴⁹ While a contractual framework is logically sound, an employee in an inevitable disclosure case is entering the de facto contract against their will. This violates basic principles of contract law,¹⁵⁰ and thus there are limits to this framework.

3. *A Calabresi-Melamed Framework for Inevitable Disclosure*

In 1972, Guido Calabresi and Douglas Melamed, pioneers in the field of law and economics, developed a legal framework within which to resolve situations where uses of assets conflict.¹⁵¹ Their principles have since been distilled into four rules used to explain nuisance law. These principles are laid out below in Table 1.

146. Harris, *supra* note 56, at 327–28.

147. *Id.*

148. *Id.*

149. *Id.* at 344.

150. See RESTATEMENT (SECOND) OF CONTRACTS § 367(2) (1981).

151. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

Table 1: The Calabresi-Melamed Framework¹⁵²

	Property Rule	Liability Rule
Property Owner	The property owner has a right to be free of pollution under the protection of a property right. The property owner can secure an injunction against the polluting neighbor.	The property owner again has a right to operate free of pollution but under the weaker protection of a liability rule. The neighbor may continue to pollute but if it did, it would have to pay the property owner a court estimated amount for the harm caused to them.
Polluting Neighbor	The polluting neighbor has the right to pollute, protected by a property right.	The polluting neighbor again has the right to pollute but under the weaker protection of a liability rule. The property owner may prevent the polluting neighbor from polluting via an injunction if it pays the polluting neighbor damages in an amount that equals the court-estimated harm caused to the polluting neighbor as a result.

Although scholars most commonly use the framework espoused by Calabresi and Melamed to resolve disputes between property owners and polluting neighbors under nuisance law, the principles were intended to apply more generally to cases of conflicting assets.¹⁵³ Thus, this framework can be applied to cases of inevitable disclosure. The employer is the “property owner” seeking to protect his trade secret. The employee is the “polluting neighbor,” whose intended employment with a competing company threatens to destroy the property owner’s trade secret.

152. Lucian Ayre Bebchuk, *Property Rights and Liability Rules: The Ex Ante View of the Cathedral*, 100 MICH. L. REV. 601, 609 (2001).

153. Calabresi, *supra* note 151, at 1090.

**Table 2: The Calabresi-Melamed Framework
as applied to the problem of inevitable disclosure**

	Property Rule	Liability Rule
Employer	<p>The employer has the right to protect its trade secret under the protection of a property right. The employer can secure an injunction against the departing employee, preventing her from working for a competitor.</p> <p>Doctrine of inevitable disclosure and the substantial likelihood test</p>	
Departing Employee	<p>The departing employee has the right to work for a competitor, protected by a property right.</p> <p>The rule in California</p>	<p>The departing employee has the right to work for a competitor but under the weaker protection of a liability rule. The employer may enjoin the employee from working for a competitor but it must pay the employee in damages for the harm caused by the injunction.</p> <p>The proposed standard: compensated injunction</p>

This is arguably the most effective—but perhaps the least obvious—framework under which to understand the compensated injunction approach. It is the least obvious because, despite the widespread acceptance of the framework set out by Calabresi and Melamed, the concept of a compensated injunction has only been applied once in *Spur Industries v. Del. E. Webb Development Co.*¹⁵⁴ In that case, the developer of a retirement community in rural Arizona sought to enjoin the owner of a livestock feedlot from continuing his business, on the grounds that the stench coming from the manure and infestation of flies from the feedlot were affecting residents of the retirement community and the developer’s future sales.¹⁵⁵ The court granted the injunction.¹⁵⁶ However, given that the developer had moved to the area knowing that the livestock feedlot was situated there—essentially “coming to the nuisance”—the court held that it would be inequitable to grant an injunction without requiring the developer to compensate the

154. *Spur Indus. v. Del. E. Webb Dev. Co.*, 108 Ariz. 178, 186 (1972).

155. *Id.* at 183.

156. *Id.* at 186.

feedlot owner for the cost of uprooting.¹⁵⁷ Although this is the only case in which a court issued a compensated injunction, it nevertheless demonstrates the ability of this equitable remedy to fairly balance competing and equally important interests.

This framework of analysis is arguably the most effective because it does not blur the interests of the employer and employee into a concurrent property interest; rather it recognizes two separate interests in two separate assets, thus avoiding the problem of determining who owns what portion of the property interest. Additionally, the framework advocates for more than adequate consideration; it allows courts to fashion individualized relief by estimating the cost to the employee of having her employment mobility restricted. This allows courts to tackle head on the risk of economic hardship to the employee resulting from injunctive relief. Finally, this framework is particularly effective because it facilitates an understanding of the proposed compensated injunction standard in relation to the current alternatives,¹⁵⁸ thus providing a more complete picture of the inevitable disclosure problem than other frameworks.

D. THE MECHANICS OF THE PROPOSED STANDARD

There are a number of ways that courts can craft the proposed compensated injunction remedy. Rather than lay out a definitive approach, this section provides a number of suggestions for the main aspects of this standard.

1. *An Immutable Rule*

There are two distinct classes of contractual rules: (1) default rules that can be waived by prior agreement; and (2) immutable rules, such as the duty to act in good faith, which cannot be contracted around.¹⁵⁹ For the proposed standard to have any effect, it must be adopted as an immutable rule. States have to make clear in their laws governing trade secrets that only compensated non-compete agreements—whether contract-based or judicially created in cases of inevitable disclosure—are enforceable. Otherwise, employers will simply contract around the need to compensate employees for inevitable disclosure injunctions.

157. *Id.* at 184–85.

158. *See supra* Table 2.

159. Ian Ayres & Robert Gertner, *Filling Gaps In Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989).

2. *Amount of Compensation*

One goal of the proposed system of compensating employees when they are enjoined from working for a competitor in cases of inevitable disclosure is to prevent economic hardship. Because there are no real wrongdoers in these cases, it is intuitively wrong to completely sacrifice the interests of one party in order to protect another. Under the Calabresi-Melamed framework, courts are supposed to estimate damages in cases of compensated injunctions by valuing the harm that the injunction will cause to the plaintiff.¹⁶⁰ In inevitable disclosure cases, the harm to the employee is the value of her salary for the time that she is enjoined from working, as well as other employment benefits, such as health insurance. Thus, courts should require employers to compensate employees both for the loss of their former salary and the fair value of benefits. This mirrors the compensation level set by the garden leave system in the UK and is perhaps more generous than many restrictive covenants in Germany, where employers need only set the compensation level at half of the employee's pay during the last twelve months of employment.¹⁶¹

3. *Length of Injunction*

Questions of duration should be answered on a case-by-case basis. In cases involving the financial services industry, for example, employers have been satisfied to employ a garden leave provision lasting no more than 90 days.¹⁶² This likely reflects the adequacy of such a limited time window in an industry where confidential data and information change rapidly. Other “fluid industr[ies],” such as the computer software industry, may also be subject to such rapid change that only short injunctions are necessary to protect trade secrets.¹⁶³ In contrast, an employer like Bimbo Bakeries would likely require a much longer injunction to protect its half-a-billion-dollar English muffin recipe.¹⁶⁴

There are several ways in which courts might determine how long an injunction should last. If a court is able to quantify the useful life of the trade secret under consideration, it could set a corresponding time limit.¹⁶⁵ Where the useful life of the trade secret is unknown and unavailable, courts could

160. See, e.g., *Spur Indus.*, 108 Ariz. at 178.

161. 1 RESTRICTIVE COVENANTS, *supra* note 17, 17-5.

162. *Id.* at Vol. II, 55-30.

163. See, e.g., *Novell Inc. v. Timpanogos Research Grp.*, 46 U.S.P.Q.2d 1197, 1218 (D. Utah 1998) (holding that only a nine-month injunction was necessary).

164. See *Bimbo Bakeries USA, Inc. v. Botticella*, 613 F.3d 102, 105, 110 (3d Cir. 2010).

165. See *Novell*, 46 U.S.P.Q.2d at 1218 (holding that only a nine-month injunction was necessary).

also look to the amount of time necessary to reverse engineer the trade secret or develop it independently.¹⁶⁶ States could also adopt a maximum time limit, such as the two-year rule written into non-competition laws in Germany and China.¹⁶⁷ This standard would undoubtedly be easier for courts to apply and would provide fair notice to employers and employees alike. Alternatively, states could reject any time limitations, instead embracing the need to give the trade secret its due value.

4. *Preventing Abuse: The Duty to Mitigate*

If states adopt a two-year limit on compensated injunctions in inevitable disclosure cases, the risk of abuse will not be a large concern. However, where no time limit exists, courts might enforce permanent injunctions. For example, although the court in *Bimbo Bakeries* was only asked to impose a preliminary injunction, one can imagine that the only way to truly keep Bimbo's half-a-billion-dollar English muffin recipe secret would be to impose a permanent injunction upon the departing employee such that he would never be able to work for a competing English muffin company.¹⁶⁸ The court would have the discretion to conclude that the potential harm to Bimbo far exceeds the harm to the employee that would result from a permanent injunction, and grant the permanent injunction.

In such cases, where permanent injunctions are at stake, it is at least plausible that opportunistic employees might try to abuse the system in search of early retirement. States could prevent such abuses by imposing a duty to mitigate on the employee. The duty to mitigate in the employment context frequently arises in Title VII cases of employment discrimination and wrongful discharge where employees seek back pay.¹⁶⁹ The basic principles of the duty to mitigate may be applied to cases of inevitable disclosure.

The Supreme Court has stated that the duty to mitigate in the employment context "requires the [employee] to use reasonable diligence in finding other suitable employment."¹⁷⁰ "Reasonable diligence" means an "honest, good faith effort" to find new employment; the employee is not

166. Lowrey, *supra* note 18, at 524.

167. See 1 RESTRICTIVE COVENANTS, *supra* note 17, 17-5 (citing HANDELSGESETZBUCH [HGB] (COMMERCIAL CODE) 1979 § 74(a)(1)).

168. *Bimbo Bakeries*, 613 F.3d at 105, 110.

169. Richard J. Gonzalez, *Satisfying the Duty to Mitigate in Employment Cases: A Survey and Guide*, 69 Miss. L.J. 749, 750 (1999).

170. *Ford Motor Co. v. EEOC*, 458 U.S. 219, 231 (1982) (failure to hire context); Gonzalez, *supra* note 169, at 749 (noting applicability of the Supreme Court's standard to Title VII cases).

held to “the highest standard of diligence.”¹⁷¹ Suitable employment is defined as “substantially equivalent employment.”¹⁷² Under this standard, the employee is not required to “accept a demotion, or take a demeaning position.”¹⁷³ Nor must an employee enter “another line of work”¹⁷⁴ or “seek employment which is not consonant with his particular skills, background, and experience.”¹⁷⁵ The burden lies with the former employer to demonstrate that the employee did not exercise reasonable efforts to find suitable employment.¹⁷⁶

Whether or not an employee is expected to take a job in a different geographic location depends on the nature of the work.¹⁷⁷ If the new job requires an arduous commute, courts are generally sympathetic to the employee.¹⁷⁸ However, if relocation is typical in the employee’s line of work, or if the employee previously declared her flexibility or an interest in relocating, courts may well expect the employee to take a comparable job in another location.¹⁷⁹

An employee in an employment discrimination or wrongful discharge case may reasonably choose to leave the job market temporarily and pursue formal educational opportunities, either to acquire new skills or update their existing ones. However, courts usually deny back pay in these cases unless the employee makes reasonable attempts to mitigate his employment before entering an educational program.¹⁸⁰

171. *Id.* at 753–54 (citing *NLRB v. Arduini Mfg. Corp.*, 394 F.2d 420, 422–23 (1st Cir. 1968)).

172. *Rasimas v. Michigan Dep’t of Mental Health*, 714 F.2d 614, 624 (6th Cir. 1983).

173. *Ford Motor Co.*, 458 U.S. at 231.

174. *Id.*

175. *NLRB v. Madison Courier, Inc.*, 472 F.2d 1307, 1320–21 (D.C. Cir. 1972).

176. *Gonzalez*, *supra* note 169, at 750.

177. *Id.* at 767.

178. *See, e.g.*, *NLRB v. Westin Hotel*, 758 F.2d 1126, 1130 (6th Cir. 1985) (holding that an employee without adequate means of transportation was not required to accept employment twenty-five miles from their home); *Madison Courier, Inc.*, 472 F.2d at 1314 (holding that employees were not required to accept a job fifty miles from their homes).

179. *See, e.g.*, *Ford v. Nicks*, 866 F.2d 865, 874–75 (6th Cir. 1989) (holding that it was unreasonable for an academic to turn down a job position seventy miles from her home, given that she had previously searched for jobs on a nationwide scale); *Cowan v. Standard Brands*, 572 F. Supp. 1576, 1581–82 (N.D. Ala. 1983) (holding that an employee who had moved several times in his career was required to take a comparable job in another city).

180. *Compare* *Miller v. Marsh*, 766 F.2d 490, 492–93 (11th Cir. 1985) (holding that employee who enrolled in law school without first pursuing alternative employment had not met his duty to mitigate), *with* *Dailey v. Societe Generale*, 108 F.3d 451, 456–57 (2d Cir. 1997) (holding that employee who searched for suitable employment for six months before enrolling in training to be a physician’s assistant had satisfied her duty to mitigate).

Courts that impose a duty to mitigate in cases of inevitable disclosure should follow most of the principles outlined above, which seem to be governed by fairness considerations. The burden should lie with the former employer to prove that the employee has not exercised reasonable efforts to find suitable alternative employment. Courts should not expect employees to take a demeaning position, and, instead, should consider the nature of the employment in determining whether employees need to accept work in a different geographic location. However, it is problematic to hold that an employee in an inevitable disclosure case need not enter “another line of work.”¹⁸¹ An inevitable disclosure injunction prevents the employee from working for the former employer’s competitors.¹⁸² Thus, employees might find themselves restricted from working in the same line of work without taking a demeaning position. Courts should perhaps expect employees to enter another line of work if it requires a similar skill set.¹⁸³ For example, the employees in *PepsiCo* might not be able to work in the beverage industry anymore but they may well be able to transfer their management skills to a comparable job in another industry.¹⁸⁴ Similarly, given that employees are prevented from working for competitors and may have no option but to enter another line of work, it is reasonable to expect that they would enroll in an education program during the period of the injunction. Thus, unlike in many employment discrimination cases,¹⁸⁵ courts should not impose restraints on this practice in cases of inevitable disclosure.

IV. CONCLUSION

While the compensated injunction standard proposed in this Note is not perfect, it provides a compromise for courts that are currently forced to choose between only recognizing the rights of employers and only recognizing the rights of employees. The proposed standard protects employees from forced economic hardship, but it does not alleviate the potential negative effects that unemployment, however temporary, may have

181. *Ford Motor Co. v. EEOC*, 458 U.S. 219, 231 (1982).

182. *See, e.g., PepsiCo, Inc. v. Redmond*, 54 F.3d 1262, 1267 (7th Cir. 1995).

183. *But see* Matt Marx, *Good Work If You Can Get It . . . Again: Post-employment Restraints and the Inalienability of Expertise* 3 (MIT Sloan School of Management, Working Paper, 2009), available at <http://ssrn.com/abstract=1456748> (using research on non-compete enforcement to suggest that many employees subject to non-competes “take occupational detours in that they change fields for at least the duration of the agreement, losing touch with their professional networks and experiencing the atrophy of their specialized skills” as a result).

184. *PepsiCo*, 54 F.3d at 1262.

185. *See, e.g., Ford*, 866 F.2d at 874–75; *Cowan*, 572 F. Supp. at 1581–82.

on an individual's status and personhood.¹⁸⁶ Arguably, only the California model of free mobility provides this protection. However, completely favoring one side's interests at the expense of the other is particularly unfair given that there are no real wrongdoers in cases of inevitable disclosure. The proposed compensated injunction protects both sides, and in doing so not only evens out the balance of power between employers and employees in the trade secret context, but also recognizes the true value of the trade secret at issue. Moreover, by attaching a cost to trade secret protection, this standard would likely filter out unnecessary litigation. If an employer does not find a trade secret worth paying to protect, a court should not protect the trade secret and restrict the departing employee's mobility. The concept of a compensated injunction is not new. As this Note explains, a similar standard is used in Europe and Asia. Moreover, the idea is theoretically recognized in American law. Thus, there is nothing radical about this balanced approach, which promises to benefit employers, employees, and judges alike.

186. See Lowrey, *supra* note 18, at 538.

STILL AN ALTERNATIVE WAY TO PROTECT TRADITIONAL NEWS: WHY *BARCLAYS* DID NOT KILL THE “HOT NEWS” TORT

Luis Zambrano[†]

The news industry is in trouble. Among other setbacks, advertisement revenues and print circulation for American newspapers have fallen precipitously, leading to significant staff layoffs and, some contend, to a reduction in the quality of the news product.¹ Although one argument is that this is a result of the economic recession, Judge Richard Posner blames the newspaper industry’s continual financial troubles on the permanent shift in consumer behavior “from the paid to the free medium.”² He notes that “[n]ews, as well as other information found in newspapers, is available online for nothing, including at the websites of the newspapers themselves, who thus are giving away content.”³ Hence, consumers no longer pay—or expect to pay—for access to the day’s news in print if they can access the same or similar content online. One study found that as of January 2010, close to sixty-one percent of Americans received their news from online sources on an average day.⁴ Another study found that print newspapers’ total advertising revenue has fallen significantly every year since 2006.⁵

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1. See Richard Posner, *The Future of Newspapers*, THE BECKER-POSNER BLOG (July 23, 2009, 7:37 PM), <http://www.becker-posner-blog.com/2009/06/the-future-of-newspapers--posner.html>. For a more complete explanation of why the loss of traditional newspapers may be detrimental to the news dissemination process as a whole, see Elaine Stoll, Note, *Hot News Misappropriation: More Than Nine Decades After INS v. AP, Still an Important Remedy for News Piracy*, 79 U. CIN. L. REV. 1239 (2011). Stoll argues that the fall of the traditional newspaper industry means a decline in original news reporting, which leads to the disappearance of substantial information even while online content sites increase in number. Eventually (and ironically) these online blogs, social media, and other internet sites that provide free access to news content will themselves suffer due to a lack of original information to propagate. *Id.* at 1284–88.

2. Posner, *supra* note 1.

3. *Id.*

4. Kimberley Isbell, *The Rise of the News Aggregator: Legal Implications and Best Practices* 1 (Berkman Ctr. For Internet & Soc’y, Res. Publ’n Working Paper No. 2010-10, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670339.

5. *Advertising Expenditures (Annual)*, NEWSPAPER ASS’N OF AM., <http://www.naa.org/Trends-and-Numbers/Advertising-Expenditures/Annual-All-Categories.aspx> (last updated

Posner proposes that Congress expand copyright law to bar online access to copyrighted material or to prevent linking or paraphrasing of copyrighted material without the copyright holder's consent.⁶ His proposal for broader protections has strong roots in the history of American intellectual property theory; for example, one archetypal view is that intellectual property protection is essential to create the economic incentives necessary to invent and innovate.⁷

Although this is a popular understanding of the benefits of intellectual property, it has not gone unchallenged in copyright literature. Thirty years ago, for example, Stephen Breyer, now a Supreme Court Justice, challenged the notion that the economic incentives copyright law affords are absolutely necessary to incentivize invention and innovation.⁸ Furthermore, as caselaw has recognized⁹—and as this Note will illustrate—copyright protection “has not mattered much” historically in protecting the news industry's products, in part because “news moves too quickly to make exclusive rights protected by copyright law useful.”¹⁰

This Note will argue that aside from expanding copyright law, there exists another long-standing legal claim that the newspaper industry can employ in certain instances to protect its work product: the “hot news” misappropriation tort, a cause of action developed in a 1918 Supreme Court case that sought to protect the value of uncopyrightable facts in news stories.¹¹ Part I of this Note defines the “hot news” tort, its origin as a method to protect certain uncopyrightable aspects in informational works of value, and the evolution of the doctrine up to the present day. Part II then

Mar. 1, 2011). This dataset also presents the revenue that newspapers earn from online advertising through their websites. Although online advertising revenue increased between 2003 and 2007 (and in 2010), the total combined revenue from print and online advertising has fallen since 2006 from almost fifty billion to about twenty-six billion dollars. *Id.*

6. Posner, *supra* note 1.

7. See Edmund W. Kitch, *Property Rights in Inventions, Writings, and Marks*, 13 HARV. J.L. & PUB. POL'Y 119, 123 (1990) (noting that intellectual property rights are part of a “subtle and complex system of private empowerment” that exists to “enable private parties to engage in the activity of investment in innovation, authorship, and development of positive relationships with customers”); see also Frank H. Easterbrook, *Intellectual Property is Still Property*, 13 HARV. J.L. & PUB. POL'Y 108, 118 (1990) (“Except in the rarest case, we should treat intellectual and physical property identically in the law.”).

8. See Stephen Breyer, *The Uneasy Case for Copyright: A Study of Copyright in Books, Photocopies, and Computer Programs*, 84 HARV. L. REV. 281, 282 (1970).

9. See, e.g., *Int'l News Serv. v. Associated Press*, 248 U.S. 215, 233 (1918). The “hot news” tort originated *International News Service*, which is discussed *infra* Section I.

10. See Minjeong Kim, *Show Me the Money: The Economics of Copyright in Online News*, 58 J. COPYRIGHT SOC'Y U.S. AM. 301, 305 (2011).

11. *Int'l News Serv.*, 248 U.S. 215.

shifts the Note's focus to the Second Circuit Court of Appeals's recent decision in *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*.¹² The Second Circuit is the highest court that has attempted to define the parameters of what constitutes a viable "hot news" cause of action in the modern era. Finally, Part III argues that although the Second Circuit and several district courts have systematically limited the scope of what constitutes a "hot news" claim, the tort nonetheless remains a viable cause of action for those who seek to protect the traditional newspaper industry from the challenges presented by the world of online aggregation.¹³ However, Part III also notes that the Second Circuit's decision in *Barclays II* does not represent a sure win for traditional newspaper businesses and outlines certain detrimental problems that the court created, but did not address.

I. INTRODUCTION TO "HOT NEWS" MISAPPROPRIATION

The "hot news" misappropriation claim originated in the Supreme Court case *International News Service v. Associated Press*.¹⁴ Both International News Service ("INS") and Associated Press ("AP") were powerful news-gathering services that provided stories of a national and international scope to local newspapers throughout the United States that subscribed to their respective wire services.¹⁵ William Randolph Hearst, INS's owner, had been critical of U.S. entry into World War I on the side of Great Britain.¹⁶ In response, Great Britain prohibited INS reporters from sending cable telegrams to the United States.¹⁷ INS thus was not as well-positioned as AP to provide the latest war

12. *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, 650 F.3d 876 (2d Cir. 2011), *rev'g* *Barclays Capital, Inc. v. Theflyonthewall.com. (Barclays I)*, 700 F. Supp. 2d 310 (S.D.N.Y. 2010).

13. Whether the traditional news industry should be protected, however, is beyond the scope of this Note.

14. *Int'l News Serv.*, 248 U.S. 215. Though this is when the U.S. Supreme Court first recognized a "hot news" interest, the nature of property rights in the news had been contested in American courts since at least the latter part of the nineteenth century. *See, e.g.*, *Kiernan v. The Manhattan Quotation Tel. Co.*, 50 How. Pr. 194 (N.Y. Sup. Ct. 1876); *see generally* Eric R. Claeys, *Intellectual Usufructs: Trade Secrets, Hot News, and the Usufructuary Paradigm at Common Law*, in *INTELLECTUAL PROPERTY AND THE COMMON LAW* (Shyamkrishna Balganesh ed., forthcoming 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1889231 (describing "hot news" and the tort's relation to the concept of property rights).

15. Isbell, *supra* note 4, at 14.

16. *See id.*

17. *See id.*

news to its subscribers.¹⁸ INS then engaged in various “questionable practices”¹⁹ to ensure its access to AP’s pre-publication materials.²⁰

The issue before the Court was INS’s practice of acquiring information about war developments from copies of AP newspapers on the East Coast and rewriting the stories to send to INS’s subscriber newspapers throughout the United States, especially those on the West Coast.²¹ The time-lag involved in this practice sometimes led to INS-subscriber papers publishing stories before AP-subscriber papers, even though only AP had spent money on the news-gathering resources and manpower to document the event(s) at issue.²² The Court had to decide whether INS could be lawfully enjoined from appropriating AP’s “news” to sell as a product to INS’s clients.²³ AP claimed that INS’s actions were a violation of AP’s “property right in the news” and constituted “unfair competition in business.”²⁴

AP, however, did not bring a copyright claim against INS; copyright law did not apply because AP’s “news matter [was] not copyrighted” and was practically uncopyrightable “because of the large number of dispatches that [were] sent daily, and, according to [AP]’s contention, news [was] not within the operation of the copyright act [of 1909].”²⁵ Furthermore, the Supreme Court noted that although news articles could be copyrighted, the “news elements” within them—the information respecting current events contained in the literary production” (i.e. the facts)—could not.²⁶ For its side, INS argued that AP would be granted a “despotic monopoly” if the Court agreed with AP that news had property value.²⁷ INS said that permitting an

18. *See id.*; *see also* Douglas G. Baird, *Common Law Intellectual Property and the Legacy of International News v. Associated Press*, 50 U. CHI. L. REV. 411, 412 (1983) (describing INS’s actions).

19. *See* Isbell, *supra* note 4, at 14.

20. *See id.* The “questionable practices” included bribing AP employees and employees who worked for AP subscriber papers. *Id.*; *see also* Case Comment, *Injunction to Protect the Right of Property in News*, 18 COLUM. L. REV. 257, 257–61 (1918) (describing the *International News Service* case).

21. *Int’l News Serv. v. Associated Press*, 248 U.S. 215, 229–32 (1918); *see also* Baird, *supra* note 18, at 412–15 (providing background history).

22. *Int’l News Serv.*, 248 U.S. at 238–39.

23. *Id.* at 232.

24. *Id.*

25. *Id.* at 233.

26. *Id.* at 234.

27. *News Pirating Case in Supreme Court*, N.Y. TIMES (May 3, 1918), <http://query.nytimes.com/mem/archive-free/pdf?res=f50d1ff6345b11738dddaa0894dd405b888df1d3>.

injunction against its practices would grant AP a “general” or “absolute property” right in the news.²⁸

Instead of deciding whether a property right existed in news facts, the Supreme Court instead recognized a “quasi-property” interest in the news information that AP gathered and distributed.²⁹ The Court distinguished between an absolute property right in the news against the public and a property right against a direct competitor, and ruled that AP had the latter but not necessarily the former.³⁰ The AP could not, for example, sue an individual newspaper purchaser who spread the factual content of a news article “for any legitimate purpose not unreasonably interfering with [AP]’s right to make merchandise of it.”³¹ However, when the facts in news taken from AP were transmitted for commercial use, in direct competition against AP, and within a certain period of time, this practice amounted to unfair competition,³² and a time-based injunction against INS was proper.³³

Thus, while the Supreme Court denied copyright protection for facts, in its decision it sought to devise a way to reward AP for its news-gathering efforts. It chose, in the words of one scholar, “to steer a middle path [between an absolute property right and none at all,] and in the process articulated a framework that has since remained as novel as it was

28. *Id.*

29. *See Int’l News Serv.*, 248 U.S. at 236.

30. *Id.* at 236–40.

31. *Id.* at 239–40.

32. *Id.* The court describes misappropriation in this context as:

[T]aking material that has been acquired by [AP] as the result of organization and the expenditure of labor, skill, and money, and which is salable by complainant for money, and that [INS] in appropriating it and selling it as its own is endeavoring to reap where it has not sown, and by disposing of it to newspapers that are competitors of [AP]’s members is appropriating to itself the harvest of those who have sown. Stripped of all disguises, the process amounts to an unauthorized interference with the normal operation of [AP]’s legitimate business precisely at the point where the profit is to be reaped, in order to divert a material portion of the profit from those who have earned it to those who have not; with special advantage to defendant in competition [INS] because of the fact that it is not burdened with any part of the expense of gathering the news. The transaction speaks for itself and a court of equity ought not to hesitate long in characterizing it as unfair competition in business.

Id.

33. Although the majority in *International News Service* did not specifically outline the time length of this injunction, Justice Holmes in his concurrence saw it as a matter of hours. The key is to figure how long a particular news item has value because it has not yet been disseminated to the public. *See id.* at 247–48 (Holmes, J., concurring).

controversial.”³⁴ In doing so, the Court shaped the common law tort of misappropriation to attempt to address the instance when “one competitor free rides on another competitor’s work at the precise moment when the party whose work is being misappropriated was expecting to reap rewards for that work.”³⁵ This cause of action became known as a “hot news” misappropriation claim due to the subject matter at issue and time-sensitive nature of the information appropriated.³⁶

A. FROM *INTERNATIONAL NEWS SERVICE* TO THE 1976 COPYRIGHT ACT

In the decades following *International News Service*, courts were ambivalent about the scope and applicability of “hot news” misappropriation. In 1929, the Second Circuit in *Cheney Bros. v. Doris Silk Corp.* limited the tort’s applicability.³⁷ Plaintiff, a silk manufacturer, relied on *International News Service* to ask the court to grant a temporary injunction to prevent Defendant from copying Plaintiff’s designs that were produced every season.³⁸ The court refused to apply *International News Service*, noting that the holding in the case applied specifically to “situations substantially similar” to that case (that is, in the news industry) and did not create a federal common-law patent or copyright doctrine.³⁹ Judge Learned Hand noted that ruling otherwise “would flagrantly conflict with the scheme which Congress has for more than a century devised to cover the subject-matter” at issue—federal statutory

34. Shyamkrishna Balganesh, “Hot News”: *The Enduring Myth of Property in News*, 111 COLUM L. REV. 419, 422 (2011). Balganesh argues that in the years since *International News Service*, most courts, including the Second Circuit, have adopted a “propertarian rhetoric” that the majority’s decision claimed to have avoided. *Id.* at 423.

35. Isbell, *supra* note 4, at 14.

36. *See, e.g.*, Balganesh, *supra* note 34, at 422.

37. 35 F.2d 279 (2d Cir. 1929) (declining to extend “hot news” misappropriation protection to silk designs, which change frequently), *cert. denied*, 281 U.S. 728 (1930). New York courts, however, did allow other fashion designers to use misappropriation to protect their products. *See, e.g.*, *Doir v. Milton*, 155 N.Y.S.2d 443 (N.Y. Sup. Ct. 1956); *Margolis v. Nat’l Bellas Hess Co.*, 245 N.Y.S. 175 (N.Y. Sup. Ct. 1931). The broadening of *International News Services* at the state level also occurred in other industries. *See, e.g.*, *Metropolitan Opera Ass’n v. Wagner-Nichols Recorder Corp.*, 101 N.Y.S.2d 483 (N.Y. Sup. Ct. 1950) (preliminary injunction against the recording, copying, and sale of certain musical performances); *Mut. Broad. Sys., Inc. v. Muzak Corp.*, 30 N.Y.S.2d 419 (N.Y. Sup. Ct. 1941) (temporary injunction barring defendant from simultaneously transmitting baseball game broadcasts). The Second Circuit would address this seeming discord between it and state courts and decisively limit the reach of misappropriation in *National Basketball Ass’n v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997). *See infra* note 57.

38. *Id.* at 279–80.

39. *Id.* at 280.

intellectual property laws.⁴⁰ After *Erie Railroad Co. v. Tompkins*⁴¹ abolished federal common law in diversity of citizenship cases (the basis for federal jurisdiction under *International News Service*), some commentators argued that *Erie* had killed the “hot news” misappropriation doctrine *International News Service* had created at the federal level.⁴²

The kernel of the misappropriation tort, however, survived.⁴³ Indeed, when federal copyright law was overhauled in 1976, Congress explicitly recognized the persistence of misappropriation as a cause of action separate from intellectual property law that would not be preempted in all instances. Federal preemption was codified in the Copyright Act of 1976 as follows:

(a) [A]ll legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106 in works of authorship that . . . come within the subject matter of copyright as specified by sections 102 and 103 . . . are governed exclusively by this title. *Thereafter, no person is entitled to any such right or equivalent right in any such work under the common law or statutes of any State.*⁴⁴

Yet Congress did not seek to eliminate state common law or statutes that protect rights other than those mentioned in the Act; the Act does not limit rights or remedies respecting “subject matter that does not come within the subject matter of copyright as specified by sections 102 and 103”⁴⁵ and “activities violating legal or equitable rights that are not equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106.”⁴⁶ The legislative history of the 1976 Act mentions that § 301 does not completely preempt misappropriation under the federal intellectual property regime, and the legislative history specifically cites the *International News Service* case as a scenario where misappropriation could survive such preemption:

“Misappropriation” is not necessarily synonymous with copyright, and thus a cause of action labeled as “misappropriation” is not preempted if it is in fact based neither on a right within the general scope of copyright as specified by section 106 nor on a right

40. *See id.*

41. 304 U.S. 64 (1938).

42. *See* ROBERT P. MERGES ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE* 974 (5th ed. 2009) (citing James Treece, *Patent Policy and Pre-emption: The Stiffel and Compco Cases*, 32 U. CHI. L. REV. 80 (1964)); Balganes, *supra* note 34, at 422.

43. *See* RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 38(b) (1995).

44. 17 U.S.C. § 301(a) (2006) (emphasis added).

45. *Id.* § 301(b)(1).

46. *Id.* § 301(b)(3).

equivalent thereto. For example, state law should have the flexibility to afford a remedy (under traditional principles of equity) against a consistent pattern of unauthorized appropriation by a competitor of the facts (i.e., not the literary expression) constituting ‘hot’ news, whether in the traditional mold of [*International News Service*], or in the newer form of data updates from scientific, business, or financial data bases.⁴⁷

Therefore, the 1976 Copyright Act did not eliminate the possibility of state misappropriation claims, and *International News Service*-like “hot news” misappropriation claims have seemingly resurged in cases where parties seek to defend what they argue constitutes “property”⁴⁸ that cannot be protected under federal intellectual property laws (or bring hot news misappropriation claims addition to regular intellectual property claims).⁴⁹

47. See H.R. REP. NO. 94-1476, at 132 (1976), reprinted in 1976 U.S.C.C.A.N. 5659, 5748. This part of the legislative history contemplates an expansion of “hot news” into other fields, but, as this Note indicates, courts, in particular the Second Circuit, have decidedly limited the scope of the tort to the news industry. See *infra* Sections I.B, II.C.

48. The scholarly literature has struggled in interpreting whether *International News Service* created a property right in the news. Richard Epstein, for example, argues that *International News Service* definitively decided the issue of property in the news, holding that such a right does exist. Richard A. Epstein, *International News Service v. Associated Press: Custom and Law as Sources of Property Rights in the News*, 78 VA. L. REV. 85, 112–13 (1992). On the other hand, Balganesh notes that the Supreme Court explicitly rejected that its decision created a property right in the news because such a scheme would not have addressed the problems in the news industry, see *infra* note 107, and the Court instead established an alternative framework based on unfair competition and unjust enrichment. Balganesh, *supra* note 34, at 448–51. But see Richard A. Epstein, *The Protection of “Hot News”: Putting Balganesh’s “Enduring Myth” About International News Services v. Associated Press in Perspective*, 111 COLUM. L. REV. SIDEBAR 79, 80 (2011) [hereinafter Epstein, *Protection of “Hot News”*] (arguing that “[t]here is no myth [of property rights in the news] to dispel” since Epstein’s original piece did not refer to “property” in the conventional sense—i.e. as holding an exclusive right against the world). Although *International News Service* did not seek to create a property right in the news, however, “hot news” claimants in the news industry have adopted, and the Second Circuit has interpreted in the modern era, a “propertarian rhetoric” when discussing *International News Service*. See Balganesh, *supra* note 34, at 423–25. Treating factual information as a form of property gives a news industry claimant three consequential benefits: “(1) the recognition and validation of an ex ante licensing market for time sensitive news; (2) the increased emphasis on the in rem or nonrelational nature of the entitlement in misappropriation; and (3) the use of injunctive relief as the default remedy in hot news cases.” *Id.* at 431.

49. See, e.g., *Standard & Poor’s Corp. v. Commodity Exch., Inc.*, 683 F.2d 704 (2d Cir. 1982); *Bd. of Trade v. Dow Jones & Co.*, 439 N.E.2d 526 (Ill. App. Ct. 1982); *Columbia Broad. Sys., Inc. v. Melody Recordings, Inc.*, 341 A.2d 348 (N.J. Super. Ct. App. Div. 1975); see also Edmund J. Sease, *Misappropriation is Seventy-Five Years Old; Should We Bury It or Revive It?*, 70 N.D. L. REV. 781, 801–02 (1994) (noting that fourteen states have a similar cause of action while only two, Massachusetts and Hawaii, have directly repudiated it).

B. “HOT NEWS” IN THE SECOND CIRCUIT POST-1976 AND BEFORE
BARCLAYS II

The Second Circuit Court of Appeals is the highest court in the United States to address the viability and parameters of a “hot news” cause of action in the modern era.⁵⁰ In 1997, the court in *National Basketball Ass’n v. Motorola, Inc.*⁵¹ held that, although limited, an *International News Service*-like claim could be a valid cause of action not subject to § 301 preemption.⁵²

In the case, Defendant Motorola created and sold a pager called the SportsTrax that would continually update its users about NBA games.⁵³ Motorola employed people who would gather information about NBA games either by watching or listening to the game, and then these employees would upload the information for SportsTrax subscribers.⁵⁴ The NBA offered a similar service, Gamestats, to its customers.⁵⁵ The District Court for the Southern District of New York found that Motorola was liable under the state-law “hot news” misappropriation claim because Motorola “had unlawfully misappropriated the NBA’s property rights in its games.”⁵⁶ Motorola then appealed to the Second Circuit, which had to decide if federal copyright law preempted NBA’s “hot news” claim or whether it survived as a separate claim.

The Second Circuit found that an *International News Service*-like “hot news” misappropriation claim still existed in the modern era and would survive federal copyright preemption whenever an “extra element” existed in the claim that dealt with a right the federal intellectual property laws did not cover.⁵⁷ However, the Second Circuit suggested that this “extra element” exists only when:

50. See Balganes, *supra* note 34, at 422. Of the states that have adopted a “hot news” cause of action, New York is the most pertinent since the Second Circuit has chosen to define just what *International News Service* means in the modern era. *Id.* at 422. See, e.g., *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, 650 F.3d 876, 907 (2d Cir. 2011); *Nat’l Basketball Ass’n v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997).

51. *Nat’l Basketball Ass’n*, 105 F.3d 841 (2d Cir. 1997).

52. See *id.* at 852 (“Our conclusion, therefore, is that only a narrow ‘hot-news’ misappropriation claims survives preemption for actions concerning material within the realm of copyright.”).

53. *Id.* at 841–45.

54. *Id.*

55. *Id.*

56. *Id.* at 848.

57. See *id.* at 852. In establishing that “hot news” misappropriation survives post-1976, however, the Second Circuit directly rejected previous theories of misappropriation that had been advanced at the New York state level and had expanded the reach of *International News Services* to include activities which the courts now saw as under the scope of copyright law.

(i) a plaintiff generates or gathers information at a cost; (ii) the information is time-sensitive; (iii) a defendant's use of the information constitutes free-riding on the plaintiff's efforts; (iv) the defendant is in direct competition with a product or service offered by the plaintiff; and (v) the ability of other parties to free-ride on the efforts of the plaintiff or others would so reduce the incentive to produce the product that its existence or quality would be substantially threatened.⁵⁸

Under these factors, the Second Circuit overturned the district court's decision and held that the NBA did not present a valid "hot news" claim because it did not show "any damage to any of its products based on free-riding by Motorola."⁵⁹ In other words, Motorola's alleged misappropriation "did not undermine the financial incentive to continue promoting, marketing, and selling professional basketball games."⁶⁰ Although the tort remained alive, according to one scholar, "the modern form of the [hot news] misappropriation doctrine thus affords plaintiffs some limited copyright-like protection for facts under narrowly defined circumstances."⁶¹

II. *BARCLAYS II*: THE "HOT NEWS" KILLER?

The Second Circuit Court of Appeals, in 2011, ruled on whether the "hot news" misappropriation tort could be applied in instances when the suing party creates news. In *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, the Second Circuit held that an online financial news aggregator did not

See id. at 851–52. ("The broad misappropriation doctrine relied upon by the district court [based on concepts such as commercial immorality or society's ethics] is, therefore, the equivalent of exclusive rights in copyright law" because "[s]uch concepts are virtually synonymous with wrongful copying and are in no meaningful fashion distinguishable from infringement of a copyright."). Thus, in practice, the Second Circuit's decision limited the application of "hot news" misappropriation in industries that at the state level had been successful in using the tort to protect their products through temporary injunctions. *See id.* (noting that state cases such as *Metropolitan Opera Ass'n* and *Mut. Broad. Sys.*, highlighted *supra* note 37, would not have been able to proceed under misappropriation after the enactment of the 1976 Copyright Act). However, the Second Circuit in 2011 would make clear that "hot news" misappropriation still protects the traditional news industry. *See infra* Sections II.C, III; *see also* Frank C. Gomez, Note, *Misappropriation: Washington Post v. Total News, Inc.*, 13 BERKELEY TECH. L.J. 21, 28–29 (1998) (illustrating how "hot news" misappropriation might still protect the traditional news industry after *National Basketball Ass'n*).

58. *See Nat'l Basketball Ass'n*, 105 F.3d at 850. *But see, infra* Section II.C (explaining that in *Barclays II* the Second Circuit would say that this supposed "test" is only one a series of tests presented in *NBA* that has no precedential value in deciding the existence of an "extra element").

59. *Nat'l Basketball Ass'n*, 105 F.3d at 854.

60. Isbell, *supra* note 4, at 17.

61. *Id.*

engage in “hot news” misappropriation when it published, on its website for a profit, the confidential financial recommendations that several financial firms had created for their select actual or potential subscribers.⁶² At first glance, this Second Circuit decision presumably limits the reach of the already-weakened “hot news” tort because it appears to present a parallel *International News Service*-like factual scenario, but one in which the court does not find misappropriation. Accordingly, the tort could not be used in place of, or in addition to, Posner’s copyright extension proposal to protect the traditional news industries from the threats of the online world.⁶³

However, as this Part will argue, the Second Circuit decision in *Barclays II* actually does away with the precedential constraints of the *NBA* “tests”⁶⁴ and instead attempts to develop a more streamlined way to distinguish who can make a valid “hot news” claim. The Second Circuit formulates a “make versus break” distinction to analyze direct competition and free-riding between two industries.⁶⁵ In doing so, the court draws a line between information makers and information gatherers.⁶⁶ The Second Circuit notes that “creating”/“making” news is not the same as “acquiring”/“breaking” news; the financial firms do the former while the online news aggregator does the latter.⁶⁷ Thus, if Company A creates valuable information and Company B reports Company A’s information, Company A cannot claim its creation is news in order to make a tortious claim because the *International News Service* decision only protects “acquired” and not “created” information.⁶⁸ Though the Second Circuit’s “make versus break” distinction is not without its problems, discussed *infra* Part III, the decision at least re-emphasizes the one point that has not been lost in “hot news” jurisprudence since the *International News Service* decision: that traditional news industries can still bring a “hot news” misappropriation claim that may survive federal copyright preemption.⁶⁹

62. See *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, 650 F.3d 876, 907 (2d Cir. 2011), *rev’g* *Barclays Capital, Inc. v. Theflyonthewall.com. (Barclays I)*, 700 F. Supp. 2d 310 (S.D.N.Y. 2010).

63. Posner, *supra* note 1.

64. As the *Barclays II* court explains in its decision, the *National Basketball Ass’n* court actually outlined two five-part tests and one three-extra element test that are inconsistent with each other, a point discussed *infra* Section II.C.

65. See *Barclays II*, 650 F.3d at 903–06.

66. See *id.*

67. See *id.* at 903–04.

68. See *id.*

69. See *id.* at 905–06.

A. THE PARTIES AND FACTUAL BACKGROUND

In *Barclays Capital Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, Plaintiffs-Appellees were several prominent financial firms (Firms) that provide securities brokerage services to their customers.⁷⁰ In connection with their businesses, the Firms produce daily research reports and recommendations to be distributed to their clients or prospective clients before major trading markets open.⁷¹ These items give recipients an “informational advantage,”⁷² and they are an integral part of the Firms’ business models insofar as recipients pay the Firms a brokerage commission fee to execute a trade based on the Firms’ information.⁷³ In particular, the Firms’ recommendations are “likely to spur any investor into making an immediate trading decision.”⁷⁴

Defendant-Appellant, Theflyonthewall.com (Fly), is an online financial “news aggregator”⁷⁵ that charges twenty-five to fifty dollars a month for access to its website.⁷⁶ Through its online news feeds and circulation to third-party distributors,⁷⁷ Fly provides its paid subscribers with access to the Firms’ recommendations—access that would otherwise only be available to the Firms’ clients, which primarily entail “hedge funds, private equity firms, pension funds, endowments, and wealthy investors.”⁷⁸ The recommendations

70. *See id.* at 878.

71. *See id.* at 879.

72. *Id.* This advantage has two parts: learning the contents of the report before most people, and, more importantly, having knowledge of *the fact* that the Firms make certain recommendations, which “is likely to result in purchases or sales of the securities in question . . . and a corresponding short-term increase or decrease in the securities’ markets price.” *Id.* The Second Circuit recognized that these firms have market-moving capacity at least in the short term simply by virtue of giving *any* kind of information, a point which becomes important in the distinction the court creates between those entities that “make” news and those that “break” it. *See infra* Section II.C.

73. *Barclays II*, 650 F.3d at 881–82. The value of the reports and recommendations are directly connected to their “informational advantage.” As a result, most of the trading based on this information happens in the early hours of the business day when the information is held only by a relative few and therefore is more valuable. *Id.*

74. *Id.* at 881 (citing *Barclays Capital, Inc. v. Theflyonthewall.com (Barclays I)*, 700 F. Supp. 2d 310, 316 (S.D.N.Y. 2010), *rev’d*, *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, 650 F.3d 876 (2d Cir. 2011)).

75. A rough definition of a “news aggregator” is as “a website that collects headlines and snippets of news stories from other websites. Examples include Google News and the Huffington Post.” *Barclays II*, 650 F.3d at 882. However, not all “news aggregators” are created or function in the same way, a point analyzed *infra* Part III.

76. *Barclays II*, 650 F.3d at 883.

77. These include trading platforms such as Bloomberg and Thomson Reuters. As the court notes, these services “also separately provide authorized dissemination of the Firms’ Recommendations.” *Id.* at 882.

78. *Id.* at 880.

typically become available in the form of one-line headlines each business day before the New York Stock Exchange opens at 9:30 A.M. Eastern Standard Time.⁷⁹ During the time period covered by this lawsuit, the excerpts from the research reports that underlie these recommendations would sometimes accompany them.⁸⁰ After the Firms informed Fly in March and April 2005 that their practice allegedly infringed on the Firms' copyrights and was tortious under New York's doctrine of "hot news" misappropriation, Fly removed the detailed excerpts from the research papers, but continued to post the Firms' recommendations on its website.⁸¹

B. LEGAL ALLEGATIONS AND THE DISTRICT COURT DECISION

The Firms then sued Fly in the District Court for the Southern District of New York based on two causes of action: copyright infringement due to Fly's excerpting of seventeen research reports in February and March of 2005, and a "hot news" misappropriation claim based on Fly's continual publication of the Firms' recommendations on its website.⁸² Before the trial, Fly agreed to drop its First Amendment defense claim, and it also abandoned its fair use claim.⁸³ For the copyright infringement claim, the district court awarded the Firms statutory damages (with prejudgment interest), attorney's fees, and a permanent injunction to restrain Fly from further infringement of the copyrighted material.⁸⁴ For the misappropriation claim, the district court found Fly liable and enjoined it from publishing the Firms' recommendations for a period ranging from thirty minutes to several hours after their release.⁸⁵ Fly appealed the ruling only as to the misappropriation claim,⁸⁶ arguing in

79. *Id.* at 881.

80. *Id.* at 885.

81. *Id.*

82. *Id.*

83. *Id.* at 886–87.

84. *Barclays Capital, Inc. v. Theflyonthewall.com (Barclays I)*, 700 F. Supp. 2d 310, 328–31 (S.D.N.Y. 2010), *rev'd on other grounds*, *Barclays Capital, Inc. v. Theflyonthewall.com, Inc. (Barclays II)*, 650 F.3d 876 (2d Cir. 2011).

85. *Barclays II*, 650 F.3d at 887.

86. Fly conceded infringement on the copyright of the seventeen reports at issue. *Id.* at 886. In order to successfully create an argument for copyright infringement, however, the Firms had gone to the lengths of registering all seventeen reports with the Copyright Office and adjoining copies of the certificates of registration to the original district court complaint for the purpose of being able to hold Fly liable. *See Barclays I*, 700 F. Supp. 2d at 328; Complaint at Ex. A, *Barclays I*, 700 F. Supp. 2d 310 (S.D.N.Y. 2010) (No. 1:06-CV-04908). As Part I of this Note indicates, this method is impractical for traditional news outlet for two reasons: (1) the news industry is fast-paced, and (2) there are uncopyrightable aspects of the news—the facts—that nonetheless have been gathered through some expense and hold some temporal value. *See supra* Part I.

part that the Firms had not established a “hot news” misappropriation under New York state law and that the Copyright Act preempted the misappropriation claim.⁸⁷

C. THE SECOND CIRCUIT’S RULING

The issue for the Second Circuit was therefore whether the Firms had presented the “extra element” required to survive federal copyright preemption. The Second Circuit in *Barclays II* wrote that although it was bound to follow precedent with regard to the existence of *International News Service*-like claims, the *National Basketball Ass’n* court had actually provided one three-factor test and two five-factor tests to determine what could constitute such a claim⁸⁸ that were not entirely consistent and thus could not have precedential value.⁸⁹

The *Barclays II* court instead focused on the factor that *NBA* had listed as “indispensable” to its ruling: the existence or absence of defendant’s “free-riding” on plaintiff’s efforts.⁹⁰ First, the court determined that the Firms and Fly each sell different products: “[t]he Firms are making the news; Fly, despite the Firms’ understandable desire to protect [the news of their recommendations], is breaking it.”⁹¹ Unlike in *International News Service*, where Defendant appropriated the news gathered by Plaintiff and sold it as if Defendant had collected it, Fly was selling the news that the Firms had made.⁹² Second, the court also noted that the Firms’ “hot news” claim sought to protect recommendations that are created and not acquired, whereas the

87. *Barclays II*, 650 F.3d at 890.

88. *Id.* at 898–902. The court also goes through an extended discussion of what constitutes precedent, but analyzing their reasoning goes beyond the scope of this Note. Before the *Barclays II* court declared that none of the tests in *National Basketball Ass’n* had precedential value, scholars and other commentators had generally concluded that there indeed was one single five-factor test under which to analyze “hot news” claims. See, e.g., Balganes, *supra* note 34, at 423 (listing one of the five-factor sets in *National Basketball Ass’n* as the test to analyze); Amy E. Jensen, Note, *When News Doesn’t Want to Be Free: Rethinking “Hot News” to Help Counter Free Riding on Newspaper Content Online*, 60 EMORY L.J. 537, 562–64 (2010) (also noting only one form of the five-factor test and indicating various courts that had used this form in their misappropriation analyses).

89. *Barclays II*, 650 F.3d at 898–902. The court also mentions how the Firms sought to “use the multiplicity of the factors-lists to their advantage” in their briefs. *Id.* at 900 n.33. “By mixing two different iterations of the factors . . . the Firms thus set forth an easier test for them to meet to avoid preemption than is actually articulated in [*National Basketball Ass’n*].” *Id.* This reasoning perhaps led the court in *Barclays II* to move away from reconciling the different factors from the various tests in *National Basketball Ass’n*.

90. See *id.* at 901–07.

91. *Id.* at 902.

92. See *id.* at 903–04.

original *International News Service* language protects only acquired material.⁹³ Third, nothing in the district court's opinion or the record suggested that a significant portion of the Firms' profits were being diverted to Fly, its subscribers, or anyone else with access to the service.⁹⁴ Finally, based on the difference between the two products, the *Barclays II* court concluded that Fly did not free-ride because it had created its own separate "substantial organized effort" to report financial news—"factual information on Firm Recommendations."⁹⁵ Therefore, because the "free-rider" element was missing, the Firms' "hot news" claim was not exempted from federal preemption.⁹⁶

Although the *Barclays II* court lists several factors related to "free-riding," listed above, that encompass its decision, these all stem from the court's creation of a "make versus break" distinction in the "hot news" environment. The Second Circuit will be less likely to find a "hot news" misappropriation when the two parties at issue are not directly competing.⁹⁷ In the world of the "hot news" tort post-*Barclays II*, the Second Circuit recognizes the existence or absence of a competitive relationship as one of "make versus break."⁹⁸

The *Barclays II* court noted that in the case at hand the Firms only wanted to protect their financial recommendations, "something they *create* using their expertise rather than *acquire* through efforts akin to reporting."⁹⁹ When a company creates valuable information,¹⁰⁰ then it is the business of "making" the news; when a company gathers information akin to news reporting, then it is in the business of breaking the news.¹⁰¹ Because the *Barclays II* court found that the Firms "made" the news and Fly "broke" such news, the rest

93. *Id.* at 903.

94. *See id.* at 904. The *Barclays II* court notes that this is relevant given that *International News Service* described the defendant's tortious behavior as "amounting to an unauthorized interference with the normal operation of complainant's legitimate business *precisely at the point where the profit is to be reaped*, in order to *divert a material portion of the profit* from those who have earned it to those who have not." *Id.* (emphasis added).

95. *Id.* at 905.

96. *Id.* at 905–07.

97. *See id.* at 903–05.

98. *See id.* at 907 (concluding that a Firm's ability to create news does not give it the right to control who breaks the news).

99. *Id.* at 903 (emphasis added).

100. *See id.* at 903–04. The court wrote that created information is valuable when it is "the result of organization and the expenditure of labor, skill, and money, and which is (presumably) salable by a Firm for money." *Id.*

101. *See id.*

of the Second Circuit's "free-riding" analysis was dictated by this newly-created distinction.¹⁰²

In addition to the "make versus break" distinction, the Second Circuit considered, at least in dicta, that its decision could potentially either prevent or allow the despotic monopoly that INS had warned about in the 1918 Supreme Court case *International News Service*. As the Second Circuit noted, there were two interests that could be affected by their decision: (1) an interest in incentivizing the Firms to continue to research and report on enterprises whose securities are publicly traded, and (2) an interest in the right of the public, particularly those who trade in the shares mentioned in the recommendations, to know what the Firms are saying.¹⁰³ If the Second Circuit had granted the Firms relief under a "hot news" claim, then the court would have allowed a court-enforced monopoly of information that favors one group of traders over another to flourish.¹⁰⁴ A decision in favor of the Firms would have made the Firms the prime, if not the only, transmitter of impactful financial news. The Firms would then have the sole ability to both "make" and "break" news of value that could have consequences in the public arena. Although the Second Circuit noted that this did not affect its analysis, in practice the decision favors the interest in sharing and disseminating the information over maintaining an intact incentive for the Firms.¹⁰⁵

A similar line of reasoning can be found in *International News Service*. As Shyamkrishna Balganesh notes, the Supreme Court in that case also tried to balance two contending values, albeit with one key distinction:

The [*International News Service* decision] needed to provide *news collectors* with a sufficient incentive to continue to invest in the process of collecting news and information with promptness. All the same, it needed to recognize and deal with the fact that news was a common pool resource, whose ultimate social value lay in its widest possible dissemination to the public.¹⁰⁶

Whereas both cases acknowledge the need to preserve the dissemination of what is considered news to the public at large, only *International News Service* makes an argument for preserving the incentives for the news industry "collectors" to continue their practices. Since *Barclays II* distinctively refers to the Firms as "news makers" and not "news breakers," they are thus outside

102. *See id.* at 903–05.

103. *Id.* at 896 n.29.

104. *Id.*

105. *See id.*

106. *See* Balganesh, *supra* note 34, at 444.

the scope of news collection and, therefore, also not covered by the protection envisioned under *International News Service*.¹⁰⁷

III. THE CONSEQUENCES FOR “HOT NEWS” MISAPPROPRIATION IN LIGHT OF *BARCLAYS II* IN THE TRADITIONAL NEWS INDUSTRIES AND BEYOND

The Second Circuit’s “make versus break” distinction clarifies that “hot news” misappropriation survives. Indeed, the court provides an instance of when a “hot news” claim is likely to have the extra element required to survive preemption:

107. See *Barclays II*, 650 F.3d at 905 (“[I]n talking about a [hot news] claim . . . we are mindful that the [*International News Service*] court was tightly focused on the practices of the parties to the suit before it: news, data, and the like . . .”). Balganesch provides an overview of the unique problem in the news industry that *International News Service* sought to address in its decision: “While the [hot news] doctrine is directed at deterring free riding, it does so in the context of solving a collective action problem that was and is unique to the newspaper industry, related to the practice of cooperative newsgathering.” Balganesch, *supra* note 34, at 426. Newspapers realized early on that spending time and resources to collect the same news accessible to the public was a needless expenditure. Thus, a practice developed, first informally and later formally, whereby these newspapers would pool their resources into collectives that cooperated with one another and shared information. Free-riding would only be troublesome because it could affect this market cooperation and create a collective action problem, not because it deprived any one source of an intangible it produced—thus explaining why the *International News Service* Court chose to frame its decision in terms of unfair competition and unjust enrichment that offered a gain-based remedy instead of an absolute property right that would have granted a “first-possession-based exclusive entitlement in the news.” See *id.* at 426. But see Epstein, *Protection of “Hot News,” supra* note 48, at 79 (arguing that by the time of *International News Service*, most newspapers had already solved their collective action problems, “such that the ultimate litigation [between AP and INS] operates on the same principles that would govern a dispute between natural persons.”). The Second Circuit’s reasoning and language strengthens Balganesch’s thesis that *International News Service* did not create, and in fact sought to avoid, the creation of a property right in the news. The court writes that applying the “hot news” tort to the Firms’ recommendations would provide protection by making the information available only to the Firms and their licensees (just as an absolute property right would have provided ex ante protection for AP in *International News Service*), but the court uses language rooted in the doctrines of unfair competition and unjust enrichment to describe why this kind of protection should not be granted:

[a decision in favor of the Firms] would ensure that the authorized recipients of the Recommendations would in significant part be profiting because of their knowledge of the fact of a market-moving Recommendation before other traders learn of that fact . . . [these people] would literally be profiting at the expense of persons from whom such knowledge has been withheld who also trade in the shares in question ignorant of the Recommendation.

Barclays II, 650 F.3d at 896 n.29.

If a Firm were to collect and disseminate to some portion of public facts about securities and recommendations in the brokerage industry (including, perhaps, such facts it generated itself—its own Recommendations), and were Fly to copy the facts contained in the Firm’s hypothetical service, it might be liable to the Firm on a ‘hot news’ misappropriation theory.¹⁰⁸

Therefore, a “hot news” claim likely still exists when both industries “break” the news, a situation likely to arise between companies that engage in news-gathering efforts or allege to do so. Furthermore, although one amicus brief asked the *Barclays II* court to repudiate the “hot news” tort altogether,¹⁰⁹ the court decided against it, stating: “[w]ere we to [address the viability of the ‘hot news’ tort *vel non*], though, plainly we would be bound by the conclusion of the previous Second Circuit panel in [*National Basketball Ass’n*] that the tort survives.”¹¹⁰

A. PREVIOUS TRADITIONAL NEWS INDUSTRY CASES ANALYZED UNDER *BARCLAYS II*

Given the court’s clear statement that the tort survives, it is important to consider how it could be applied successfully in modern circumstances. Although the Second Circuit has not heard any recent cases where a “hot news” claim has survived preemption, applying the “make versus break” distinction to cases that have settled suggests that perhaps such a claim survives when more traditional news agencies are the plaintiffs.

Two cases illustrate this point. In *Associated Press v. All Headline News*,¹¹¹ AP sued All Headline News (“AHN”), an online news aggregator¹¹² that had

108. *Barclays II*, 650 F.3d at 905–06.

109. Brief for Google, Inc. and Twitter, Inc. as Amici Curiae Supporting Reversal at 3, *Barclays Capital, Inc. v. Theflyonthewall.com, Inc.*, 650 F.3d 876 (2d Cir. 2011) (No. 10-1372-cv), 2010 WL 2589770.

110. *Barclays II*, 650 F.3d at 890.

111. 608 F. Supp. 2d 454 (S.D.N.Y. 2009). The court refused to dismiss AP’s hot news claim because AHN’s briefing papers had “lumped” it together with AP’s trademark claim, thus failing to properly analyze the boundaries of the tort. *See id.* at 464. The parties, however, eventually settled out of court and the hot news claim was never heard on the merits. *See* Order of Dismissal, No. 1:08-CV-323, ECF. No. 42 (S.D.N.Y. dismissed June 15, 2009).

112. The *Barclays II* court described an aggregator as “a website that collects headlines and snippets of news stories from other websites.” *Barclays II*, 650 F.3d at 883 (citation omitted). As Kimberley Isbell explains, however, there are several kinds of news aggregators that can be categorized based on the sources the aggregators use, the topics on which they focus, the amount of content they take, and what they do with the information (whether they copy and display it verbatim or use it as part of a larger narrative). *See* Isbell, *supra* note 4, at 2–6.

previously been a licensee of AP's wire service for "hot news" misappropriation and other claims.¹¹³ AP alleged that AHN sourced news from AP stories without attribution and rewrote some of AP's stories to place the material on AHN's website.¹¹⁴ Similarly, in *Washington Post v. Total News*,¹¹⁵ the plaintiffs—which included the Washington Post, the Cable News Network, and Reuters—sued Total News ("TN") in part alleging that TN "openly free-rides on plaintiff's efforts by simply lifting plaintiff's content wholesale and selling advertising based on proximity to that content" on TN's website.¹¹⁶

Although *All Headline News* and *Total News* were settled out of court, both involve a "hot news" misappropriation claim. Under a *Barclays II* analysis, a court would likely decide that the AP and Washington Post staffs do not "create" news in the same way that the Firms' staffs in *Barclays II* created their financial reports.¹¹⁷ Rather, the plaintiffs in both cases "acquire" the news through traditional newsgathering efforts, methods that *International News Service*, *Barclays II*, and *National Basketball Ass'n* describe.¹¹⁸ Similarly, based on the description of the online news aggregators at issue,¹¹⁹ both TN and AHN are in the same business of "breaking" the news for an audience,¹²⁰ news that had been gathered but not created (at least in most instances) by the plaintiffs.¹²¹ Therefore, under a *Barclays II* analysis it is likely that today the

113. The other claims included copyright infringement, trademark violation, and breach of contract. *See id.*

114. *See id.* at 7.

115. *The Washington Post Co. v. Total News, Inc.*, No. 1:97-CV-01190 (S.D.N.Y. dismissed June 6, 1997).

116. *See* Complaint at ¶ 39, *The Washington Post Co. v. Total News, Inc.*, No. 1:97-CV-01190 (S.D.N.Y. dismissed June 6, 1997), available at <http://legal.web.aol.com/decisions/dlip/washcomp.html>.

117. *See Barclays II*, 650 F.3d at 903 (noting that the suit at hand focuses on the material the Firms created, not acquired).

118. *See, e.g.*, *Int'l News Serv. v. Associated Press*, 248 U.S. 215, 238–41 (1918); *Barclays II*, 650 F.3d at 903–05; *Nat'l Basketball Ass'n v. Motorola, Inc.*, 105 F.3d 841, 853–54 (2d Cir. 1997).

119. The plaintiffs described TN and AHN as outfits that merely took newspaper articles and rewrote them for the aggregator's website. *See* Isbell, *supra* note 4, at 6–7.

120. "Break" in this sense, however, does not mean that TN and AHN were necessarily the first to post these stories (as had sometimes happened in *International News Service* when INS would publish first on the West Coast the stories it had misappropriated from AP). In this case, TN and AHN reprinted the stories the news companies sought to break themselves to readers.

121. In *All Headline News*, AP described itself as engaging "in effort and great expense to get access to news and to gather, report, package and transmit news stories from every country in the world" while calling AHN an organization that "does not undertake any original reporting" and "hires poorly paid individuals to find news stories on the internet and

plaintiffs would have still had a stronger claim of “hot news” misappropriation claim than the Firms in *Barclays II* did.¹²²

The one notable exception to such a claim would occur when the plaintiff’s reporting of news was in itself news. Under *Barclays II*, this situation would be akin to the Firms’ “creating” the news, and a “hot news” misappropriation claim would not prevail. The Second Circuit gives such an example when it states, for example, that “the fact that the *New York Times* endorses a particular candidate seems to us to be news. When the newspaper publishes its endorsement, that fact is widely reported, without controversy as far as we know, by other news outlets.”¹²³

B. CAN ANY ONLINE NEWS AGGREGATORS EXIST UNDER *BARCLAYS II*?

Even though traditional news agencies are the prime example of a suing party that may be able to bring a successful “hot news” claim, this does not mean that all online aggregators will lose in court. As this Note has explained, a court will first use the “make versus break” distinction to decide whether a competitive relationship exists between the entities at hand, but the analysis does not end there. Although a court using the *Barclays II* analysis will likely almost always decide that both traditional news agencies and online news aggregators are in the “breaking news” business, the court may then engage in a traditional free-riding analysis to decide if an online aggregator’s actions indeed constitute a “hot news” misappropriation.¹²⁴

prepare them for republication under the AHN banner.” *Associated Press v. All Headline News*, 608 F. Supp. 2d 454, 457–58 (S.D.N.Y. 2009) (internal quotation marks omitted). The contrasting description of both parties in *Total News* is similar. *See* Complaint at ¶¶ 7–8, *The Washington Post Co. v. Total News, Inc.*, No. 1:97-CV-01190 (S.D.N.Y. dismissed June 6, 1997), available at <http://legal.web.aol.com/decisions/dlip/washcomp.html>. Because both cases were dismissed before a full trial, a court did not scrutinize the accuracy of these statements. *See, e.g., All Headline News*, 608 F. Supp. 2d at 457 (“For the purposes of the motion [to dismiss AP’s Amended Complaint], the allegations of the Amended Complaint are accepted as true, and all reasonable inferences are drawn in favor of plaintiff Associated Press as the non-movant.”).

122. *See Barclays II*, 650 F.3d at 906 (suggesting that *All Headline News* presents facts closer to a “hot news” claim).

123. *See id.* at 904 n.38.

124. Even though the *Barclays II* majority calls Fly’s news gathering techniques a “substantial organizational effort,” *id.* at 905, the concurrence believes that these efforts were minimal, especially in light of the Firms’s own work in creating the recommendations. *See id.* at 914 (Raggi, J., concurring). Whereas the majority writes that Fly’s employees “are engaged in the financial-industry equivalent of observing and summarizing facts about basketball games and selling those packaged facts to consumers[,]” using this analogy, the Firms are actually the ones making the effort to play the game. *See id.* at 905. Therefore, it appears that the *Barclays II* court did not find free-riding because it was influenced by its determination

The two online aggregators in the litigation described in Section III.A., *supra*, do not represent how all news aggregators work. Kimberley Isbell and the Citizen Media Law Project have placed online news aggregators in four different categories: feed aggregators, specialty aggregators, user-curated aggregators, and blog aggregators.¹²⁵ Each is defined differently, and each provides a different level of content and presentation of the content that go beyond retaking a news item to place one's website. For example, blog aggregators, such as Gawker, often "add additional information or context to a story."¹²⁶ As Isbell suggests, a court is unlikely to find that case involving a blog aggregator like Gawker is entirely similar to a "spam blog or service like All Headline News" appeared to be.¹²⁷

Although the court first uses the "make versus break" distinction to define the existence or absence of a direct competitive relationship, the Second Circuit in *Barclays II* indicates that it also looks at the effort that the party being sued has put into their own enterprise when deciding whether that party has engaged in free-riding.¹²⁸ In *Barclays II*, the bar appears to be relatively low because under "make versus break" the court did not find direct competition and thus free-riding was unlikely.¹²⁹ If the Second Circuit were to find direct competition under the "break versus make" analysis—which it most likely would when deciding cases between traditional news agencies and online news aggregators—the aggregator could perhaps overcome this initial hurdle by proving both that it has an organizational structure akin to Fly and that it provides enough of a different service that prevents it from just being in the exact same "breaking news" business that

that because the Firms and Fly engaged in different business fields altogether, one could not directly free-ride from the other. *See id.* at 904–06. Thus, under the *Barclays II* rationale, even a "breaker's" minimal effort compared to that of a "maker" may prevent the "breaker" from being seen as a free-rider. *See id.* at 905–06. If free-riding can exist at all in a "maker versus breaker" suit, the bar for finding it will therefore likely be higher than a suit between just two "breakers."

125. *See* Isbell, *supra* note 4, at 2–5. Isbell notes that these categories are not universally agreed upon, but that they merely highlight the wide variety of websites that can be considered news aggregators. *Id.*

126. *See id.* at 19.

127. *Id.* Isbell does not explicitly define what a "spam blog" is in her four categories of online news aggregators, but she does offer one characteristic that can be attributed to a spam blog: "merely [rewriting] and [repurposing] the plaintiff's content." *See id.*

128. *See Barclays II*, 650 F.3d at 905–06.

129. *See id.* The Second Circuit quoted the district court in noting that Fly has its "own network and assemble[s] and transmit[s] data [it]sel[f]." *Id.* at 905. After engaging in the "make versus break" distinction, the court did not focus much on the specific content from the Firms that Fly provided other than to say that practically everything qualified as news fit for publication. *See id.* at 902–06.

“spam” aggregators such as *All Headline News* and *Total News* were alleged to be.¹³⁰

C. TWO ISSUES THAT REMAIN UNSETTLED UNDER *BARCLAYS II*: THE CREATION OF “VALUE” AND THE PROBLEM OF THE MAKER-BREAKER.

A peril of the “make versus break” distinction created in *Barclays II* is that a court will be deciding when a company, whether from the financial industry or another business field, creates valuable information that cannot be protected under the current federal intellectual property regime or be kept from the public for a period of time under a “hot news” claim. Under *Barclays II*, this analysis was relatively simple because all the firms in the case were considered market-moving players and thus any action they took was in itself defined as news.¹³¹

This principle, however, might not be as clearly applicable with other plaintiffs. One could imagine, for example, a case in which the plaintiff, against an online news aggregator, is a mid-size firm or an individual analyst with some vague market-moving power. These plaintiffs thus meet the basic definition of “creation” under *Barclays II*: there is an organization of some notoriety that uses its expertise and experience to create, not acquire, information to sell to their clients, and the fact that this product exists has some value that affects that public.¹³² But the Second Circuit left undefined the level at which information becomes sufficiently valuable to justify it as a newsworthy item not protectable under a “hot news” claim.¹³³ If the Second

130. See Isbell, *supra* note 4, at 9–13. This idea is similar to that of the first factor of a traditional fair use analysis under copyright law: the purpose and character of the use. Although Isbell writes about fair use when discussing potential defenses against copyright infringement, a court could adopt a similar analysis to differentiate between online news aggregators—i.e. the more an online aggregator provides new information in addition to the copied facts or the more different the original news information is presented, the more “transformative” the aggregator is compared to a “spam” aggregator that just rehashes the news.

131. See *Barclays II*, 650 F.3d at 907 (“We conclude that in this case, a Firm’s ability to make news—by issuing a Recommendation that is likely to affect the market price of a security—does not give rise to a right for it to control who breaks that news and how.” (emphasis added)).

132. See *id.* at 903–04.

133. *International News Services* identified a value calculation problem analogous to that stems from *Barclays II*. See *Int’l News Serv. v. Associated Press*, 248 U.S. 215, 266 (1918) (Brandeis, J., dissenting) (“Courts are ill-equipped to make investigations which should precede a determination of . . . the circumstances under which news gathered by a private agency should be deemed affected with a public interest.”). Whereas the dissent focused on a court’s inability to properly calculate the value of information that is gathered, the problem for a post-*Barclays II* court will be to calculate value for information that is created.

Circuit, in future cases, adopts an industry-wide rule applicable to any company within an industry,¹³⁴ such a demarcation would have significant consequences for smaller companies that would be adversely affected by the “reporting” actions of online aggregators.¹³⁵ Even a firm-by-firm analysis would be problematic because this would affect firms at the margin of a “creation” analysis; the biggest losers under this formulation of the *Barclays II* scheme would be those entities that are powerful enough to “create” news that cannot be protected under “hot news” but do not have the necessary resources to ward off the effects of dozens if not hundreds of Flies seeking to “break” these news items.

The *Barclays II* decision also does not address the problem of the “maker-breaker.” In her concurrence for the case, Judge Raggi notes that the majority only analyzes situations in which an entity either creates or breaks the news.¹³⁶ Judge Raggi then writes that, unlike the majority, she does not want to “foreclose the possibility of a ‘hot news’ claim by a party who disseminates news it happens to create.”¹³⁷ Although the majority explicitly states that it has no opinion on this point, its earlier suggestion of when a traditional news outlet would not be able to claim “hot news” misappropriation demonstrates that Judge Raggi’s conclusion is correct.¹³⁸ Under the majority’s *New York Times* endorsement example, the famous newspaper “creates” news by virtue of its endorsing a politician and then “breaks” that news by reporting the endorsement first.¹³⁹ Yet, the majority notes that the *New York Times* would likely not prevail if the paper attempted to sue another entity reporting this fact.¹⁴⁰

This “maker-breaker” problem, however, is ultimately related to the value problem because under *Barclays II* value determines whether factual news has

134. Expanding the *Barclays II* rationale, the Second Circuit could consider, for example, that all or most financial firms affect the public in ways that should not be shielded from news “breaking.”

135. As for the Firms in *Barclays II*, the Second Circuit highlighted that it saw nothing to indicate that a “significant portion of the diversion of profits to which the Firms object is lost to brokers in league with Fly or its competitors.” *Id.* at 904. The *Barclays II* court also wrote that “[t]he adoption of new technology that injures or destroys present business models is commonplace. Whether fair or not, that cannot, without more, be prevented by application of the misappropriation tort.” *Id.* at 896. Thus, since the Second Circuit noted that the Firms and Fly did not compete against other, it would be unlikely that even evidence of significant economic harm would have made a difference in favor of the Firms.

136. *See id.* at 913 (Raggi, J., concurring).

137. *See id.*

138. *See id.* at 904 n.38.

139. *See id.*

140. *See id.* at 903–04.

been created. If the Second Circuit plans to continue the “make versus break” analysis it developed in *Barclays II*, then it will have to develop a uniform way to define and calculate what constitutes value sufficient to create a news element that cannot be protected under copyright or “hot news.”

IV. CONCLUSION

Even as commentators propose expanding copyright law to protect the news industry, the “hot news” misappropriation claim in some instances still remains a viable cause of action for news agencies to use against online news aggregators. This Note traced the history of the tort, from its origins in the 1918 *International News Service* decision to its most modern application in the Second Circuit Court of Appeals. Although courts have limited the applicability of the doctrine since the 1976 Copyright Act, the tort remains alive and particularly pertinent as a cause of action for the traditional news industry, the same type of business discussed in the original Supreme Court case. The Second Circuit, however, made significant changes to the “hot news” doctrine in *Barclays II*. The court outright rejected the *National Basketball Ass’n* “tests” as precedent and instead apparently created a new test that emphasizes a “make versus break” distinction.

This Note argued that while the *Barclays II* result potentially prevented the creation of a court-enforced monopoly that benefits those who both make and break the news, the decision left certain issues unanswered. Without indicating a clear way to apply this new test to non-news entities, the Second Circuit will be presented with a “value” calculation problem in future cases. The Second Circuit will also have to contend with the problem of the maker-breaker; in particular, a court will have to decide when (if at all) an organization that makes news but is also in the business of disseminating such news can have “hot news” protection. However, when using the *Barclays II* court’s language and rationale to analyze recent “hot news” cases involving the traditional news industry as plaintiffs, it is likely that even under this new test these kinds of plaintiffs still have a cause of action for misappropriation. Thus, although “hot news” remains alive for the news industry, it has become even more narrow and uncertain for other business fields.

SURVEY OF ADDITIONAL IP DEVELOPMENTS

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I. PATENT DEVELOPMENTS

A. *AUGUST TECHNOLOGY CORP. V. CAMTEK, LTD.*¹

As held by the Supreme Court in *Pfaff v. Wells Electronics, Inc.*, 525 U.S. 55, 67 (1998), the § 102(b) on-sale bar begins when two conditions are met: (1) the product is the subject of a commercial offer for sale and (2) the invention is ready for patenting. However, in *August Technology Corp. v. Camtek, Ltd.*, the Federal Circuit seemingly extended the scope of an “on sale” bar to cover an offer to sell an invention prior to conception. The court held that when an offer to sell is made prior to conception, the § 102(b) on-sale bar date is the same as the date of the subsequent conception.

August Technology Corp. (“August”), the owner of U.S. Patent No. 6,826,298 (“the ’298 patent”), concerning an automated wafer defect inspection system, filed an infringement suit against Camtek, Ltd. (“Camtek”), in the District of Minnesota. Camtek argued that the ’298 patent was obvious under § 103 and asserted an inequitable conduct defense against August for failing to disclose relevant prior art. The salient on-sale bar issue arose when Camtek tried to use August’s NSX-80 wafer inspection machine as undisclosed prior art under § 102(b).

In a special verdict, the jury concluded that the NSX-80 technology was not on sale prior to July 15, 1997, the ’298 patent’s critical date, and thus did not constitute prior art. In making this factual determination, the district court instructed the jury that: “[i]n order to be on ‘sale’ the NSX-80 must also have been ready for patenting at the time the alleged offer for sale is made.” Thus, the court dismissed as moot Camtek’s inequitable conduct charge based on a failure to disclose the NSX-80. Ultimately, the jury found

1. 655 F.3d 1278 (Fed. Cir. 2011).

in favor of August, holding the '298 patent valid and awarding damages of \$6.8 million.

However, on appeal, the Federal Circuit held that the district court erred in its jury instruction because the NSX-80 did not have to be ready for patenting at the time of the offer to qualify as an on-sale bar. Citing their decision in *Robotic Vision Systems v. View Engineering, Inc.*, 249 F.3d 1307 (Fed. Cir. 2001), the court noted that the on-sale bar is “triggered by a prior commercial offer for sale *and* a subsequent enabling disclosure that demonstrated that the invention was ready for patenting prior to the critical date.” The Federal Circuit stated that an invention could not be offered for sale until its conception date. However, the court explained that unretracted offers for sale prior to the date of conception become effective offers for sale of the invention upon the date of conception. Thus, the NSX-80 qualified as prior art. Nonetheless, since the NSX-80 did not render the '298 obvious in view of other cited prior art, the court dismissed Camtek's invalidity and inequitable conduct claims.

The Federal Circuit's ruling in *August* is problematic in light of modifications made to § 102(b) under the Leahy-Smith America Invents Act. Ordinarily, inventors retain a one-year grace period for filing upon initiation of an on-sale bar. However, under a literal reading of § 102(a)–(b) of the new Act, no grace period exists for an “on sale” offer of an invention that has not yet been disclosed since this is not a grace period exempt disclosure. Thus, combined with the *August* case, whenever an inventor offers to sell his invention prior to conception, the inventor must file on the very date of conception or else risk a complete statutory bar to patenting.

The lack of a grace period is particularly acute in this case. When the sale or offer to sell comes after conception, the inventor has a time after conception to file for a patent. However, when an offer to sell comes before conception, the inventor must file on the date of conception, because this is both the first day his invention is eligible to be patented and the last day on which he will not be barred by the offer to sell. Furthermore, while the inventor might be able to file for a patent on the date of conception, often much more research is required to write an enabling specification. In such cases, the inventor would *never* be able to obtain a patent.

B. *GENERAL PROTECHT GROUP, INC. V. LEVITON MANUFACTURING CO.*²

In *General Protecht Group, Inc. v. Leviton Manufacturing Co.*, General Protecht Group (“GPG”) sought a preliminary injunction against Leviton

2. 651 F.3d 1355 (Fed. Cir. 2011).

Manufacturing Co, Inc. (“Leviton”) to enforce a forum selection clause the parties had agreed to in a prior settlement agreement. This prior settlement agreement included a covenant not to sue for infringement of two specific patents and an agreement to prosecute disputes that arose out of the settlement in the U.S. District Court for the District of New Mexico. Leviton later sued GPG for infringement of two continuation patents, related to the specific patents mentioned in the prior settlement agreement, in the Northern District of California and also filed a complaint with the International Trade Commission. Notably, some of the asserted claims of the continuation patents were narrower than the claims of the patents named in the covenant not to sue.

GPG filed for a declaratory judgment in the District of New Mexico, claiming that it had an implied license to use the patents under the settlement agreement, and thus Leviton was required to bring suit within the District of New Mexico pursuant to the terms of their original settlement. The New Mexico district court agreed, holding that Leviton was estopped from asserting the continuation claims because GPG had an implied license. On appeal, the Federal Circuit affirmed, relying on *TransCore v. Electronic Transaction Consultants Corp.*, 563 F.3d 1271 (Fed. Cir. 2009), which found an implied license in continuation patents that had broader claims than the patents that were the subject of a covenant not to sue.

In *TransCore*, the Federal Circuit reasoned that because the licensor had licensed a definable property right for valuable consideration, it could not then derogate or detract from that right by asserting the continuation claims. The court found an implied license despite language in the agreement that the covenant not to sue “shall not apply to any other patents issued as of the effective date of this Agreement or to be issued in the future,” and that “no express or implied license or future release whatsoever is granted.” The court stated that “this language may protect TransCore against broad claims that future patents generally are impliedly licensed, but it does not permit TransCore to derogate from the rights it has expressly granted.” The *General Protecht* court stated that it follows from *TransCore* that

where, as here, continuations issue from parent patents that previously have been licensed as to certain products, it may be presumed that, absent a clear indication of mutual intent to the contrary, those products are impliedly licensed under the continuations as well. If the parties intend otherwise, it is their burden to make such intent clear in the license.

The court did not find a clear indication of mutual intent in the settlement agreement that future litigation could include continuations asserted against the same products. Thus, the Federal Circuit affirmed the district court’s

preliminary injunction based, in part, on the merits of GPG's implied license defense.

C. *CENTOCOR ORTHO BIOTECH, INC. V. ABBOTT LABORATORIES*³

The U.S. Court of Appeals for the Federal Circuit held that the asserted patent for pharmaceutical antibodies used to treat arthritis lacked a written description, thus violating 35 U.S.C. § 112, which requires that a patent application contain “a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same.” The court thus reversed the decision of the U.S. District Court for the Eastern District of Texas, which had affirmed a jury's infringement verdict.

Plaintiffs, Centocor Ortho Biotech, Inc. and New York University (“Centocor”), brought suit against Abbott Laboratories, Abbott Bioresearch Center, Inc., and Abbott Biotechnology Ltd. (“Abbott”), alleging that Abbott's Humira antibody infringed claims in Centocor's patent, U.S. Patent No. 7,070,775. The jury found Abbott liable for willful infringement and awarded Centocor over \$1.67 billion in damages. The district court granted Abbott's motion for judgment as a matter of law (“JMOL”) as to non-willfulness, but denied Abbott's other motions for JMOL. Abbott appealed the district court's denial of its motions as to invalidity, noninfringement, and damages.

The patented technology at issue involves antibodies that neutralize human “tumor necrosis factor α ” (“TNF- α ”), which can help treat various autoimmune conditions, including arthritis. These antibodies have both a variable and constant region. Centocor developed a chimeric antibody that was comprised of a mouse variable region and a human constant region and applied for a patent in 1991. Centocor subsequently filed a series of continuation-in-part (“CIP”) applications in 1994 that added new matter to its claims. Abbott engineered a fully-human antibody and applied for a patent in 1996. In 2002, after the PTO granted Abbott's patent, Centocor filed claims covering fully-human antibodies as part of their application with an effective filing date back in 1994. This application issued into the patent that Centocor asserted in this case.

At issue for the Federal Circuit was whether the corresponding 1994 CIP applications provided an adequate written description under § 112 for the human variable regions claimed in Centocor's patent. The court held that

3. 636 F.3d 1341 (Fed. Cir. 2011).

the written description requirement demanded that, in order to support the claims, the specification needed to provide description of (1) a human constant region, (2) a human variable region, (3) high affinity for human TNF- α , (4) neutralizing activity, and (5) the ability to bind to TNF- α in the same place as the mouse antibody.

The Federal Circuit found that the overwhelming majority of the patent describes only the mouse antibody and the chimeric antibody, with only limited references to a human antibody. The court said that mere *mention* of the human antibodies did not reasonably suggest to one of skill in the art that Centocor was in possession of such antibodies. Centocor claimed that the written description could be found within the claim language itself; however, the court recognized that the claim language that was specific enough to convey that Centocor was in possession of said antibodies was not added until 2002. The court found that Centocor ultimately failed to support its contention that generating fully-human antibodies with the claimed properties would be straightforward for a person of ordinary skill in the art based on the state of human antibody technology in 1994. The court thus reversed the district court and held that the asserted claims of Centocor's patent were invalid for lack of written description.

Petition for rehearing and rehearing en banc were denied.

D. *FINJAN, INC. V. SECURE COMPUTING CORP.*⁴

In *Finjan, Inc. v. Secure Computing Corp.*, the Federal Circuit held that “locked” software could still infringe system and storage medium claims, but could not infringe method claims. The court relied on the idea that “locked” software is already present in the infringing products when those products are sold, and the fact that the locked part must later be unlocked with purchased keys does not make an infringer immune from liability. The court compared the locked part of a software program to “an automobile engine for propulsion, [which] exists in a car even when the car is turned off.”

Finjan, Inc. (“Finjan”), the owner of three U.S. patents relating to proactive scanning software used to detect and neutralize security risks from internet-downloaded materials (e.g. viruses), filed an infringement suit against Secure Computing Corp. (“Secure”), who sold allegedly infringing software, in the District of Delaware. The district court found that Secure willfully infringed all asserted claims, including the method claims, of Finjan's patents. Secure appealed, claiming, in part, that because the allegedly infringing software modules were locked when sold, infringement could only occur

4. 626 F.3d 1197 (Fed. Cir. 2010)

when a customer unlocked the product since “[d]isabled code, by definition, is incapable of being used.” To this extent, Secure’s product could potentially only expose them to indirect or joint infringement, which Finjan failed to allege.

The Federal Circuit disagreed with Secure’s arguments, stating that, unlike method claims, Finjan’s claims directed towards a “system” and “storage medium” do not require the performance of the claim limitations. The mere act of selling the product triggered liability. Moreover, the court rejected Secure’s contention that Finjan’s system claims required software components to have actual operability when sold since Finjan’s claims lacked any language that would require software components to be “active” or “enabled.” Thus, “the fact that users needed to ‘activate the functions programmed’ by purchasing keys [did] not detract from or somehow nullify the existence of the claimed structure in the accused software.”

However, the Federal Circuit did reverse the district court’s finding of infringement for Finjan’s method claims since infringing a method claim requires a person to “have practiced all steps of the claimed method.” Finjan did not allege indirect infringement, and the only evidence of the Secure’s performance of the claimed method pointed to a testing phase carried out in Germany, thus failing the statutory requirement of being performed “within the United States.” Therefore, a lack of evidence that Secure tested or operated any of the accused products in the United States required a finding of non-infringement regarding Finjan’s method claims.

E. *AMERICAN MEDICAL SYSTEMS, INC. V. BIOLITEC, INC.*⁵

The U.S. Court of Appeals for the Federal Circuit held that the preamble language in the asserted claims of American Medical Systems’s patent on methods and devices for vaporizing tissue by using laser radiation did not limit the claims. The court so held because the phrase “photoselective vaporization” did not embody an essential component of the invention but instead was simply a descriptive name for the invention that was fully set forth in the bodies of the claims.

In 2009, American Medical Systems and Laserscope (“AMS”) filed a patent infringement action alleging that Biolitec’s device infringed a number of claims in U.S. Patent No. 6,986,764 (“the ’764 patent”). At trial, AMS argued that the preamble language simply described the invention as a whole and “should not be construed as a limitation of any of the asserted claims.” The U.S. District Court for the District of Massachusetts found that the

5. 618 F.3d 1354 (Fed. Cir. 2010).

repeated use of the phrase “photosensitive vaporization” indicated a “fundamental characteristic” of the invention and was therefore limiting. The district court issued summary judgment of non-infringement for Biolitec because its device operated at a different wavelength and therefore did not satisfy the “photosensitive vaporization” limitation of the ’764 patent.

On appeal, the AMS argued that the term “photosensitive vaporization” in the preamble of each of the asserted claims should not be construed as a claim limitation. The Federal Circuit agreed that the district court erred in holding that “photosensitive vaporization” limited the claims.

The Federal Circuit held that there is no general test to determine whether a preamble term is a claim limitation so cases must be determined based on the unique facts of each individual case in light of the claim as a whole. The preamble may be limiting “if it recites essential structure or steps, or if it is ‘necessary to give life, meaning, and vitality’ to the claim.” It is not limiting if “the claim body describes a structurally complete invention such that deletion of the preamble phrase does not affect the structure or steps of the claimed invention.”

The Federal Circuit held that the term “photosensitive vaporization” and particularly “photosensitive” was not limiting for three main reasons. First, the court said there was no indication in the prosecution history that the inventors added “photosensitive vaporization” to distinguish it from prior art. Second, the preamble does not provide a necessary antecedent basis for the term “the tissue,” nor does it provide any context for understanding the meaning of “the tissue” in the body of each claim. The drafters did not rely on the preamble to define or refine the scope of the asserted claims. Finally, the term “photosensitive” does not embody any essential component of the invention and is only a descriptive name for the invention that is fully explained in the bodies of the claims. Furthermore, the court said that “removal of the duplicative preamble language would neither alter the scope of the claims nor introduce ambiguity as to their coverage.”

Judge Dyk’s dissent suggested instituting a rule recognizing all preambles as limiting because of the lack of clarity and inconsistency in existing law. He argued that a uniform rule would provide a clear definition of the scope of inventions and ensure that “the patentee has the burden of drafting a patent that avoids confusion as to the scope of the claims.” In this case, Judge Dyk argued that “photosensitive vaporization” should limit the claim because, by adding this terminology, the patentee conceded that the term gave “life, meaning, and validity to the claims.”

F. *GENERAL PROTECHT GROUP, INC. V. INTERNATIONAL TRADE COMMISSION*⁶

Three importers of ground fault circuit interrupters (“GFCIs”) appealed a ruling from the U.S. International Trade Commission (“ITC”) that the importation of certain GFCIs violated Section 337 of the Tariff Act of 1930 as amended and codified in 19 U.S.C. § 1337. On appeal, the Federal Circuit reversed as to two of the three patents and remanded the case to the ITC to modify its limited exclusion order. The Federal Circuit majority narrowly interpreted a means-plus-function element in reversing one of the ITC’s infringement findings: the court held that the magnetic means employed by the appellants was not equivalent, within the meaning of 35 U.S.C. § 112 ¶ 6, to the mechanical means disclosed in the asserted patent. Judge Newman, in dissent, contended that mechanical and magnetic means of accomplishing the same function are equivalent and would be considered interchangeable by a person of ordinary skill in the art. Thus, she would have affirmed the ITC’s infringement finding.

GFCIs are used in electrical outlets with “test” and “reset” buttons, often found in bathrooms and kitchens. When the current flowing out from the GFCI does not match the current flowing in, a “ground fault” occurs, and the GFCI cuts off the flow of electricity to prevent the possibility of electrical shock. In September 2007, pursuant to a complaint filed by Pass & Seymour, Inc. (“Pass & Seymour”), the ITC initiated an investigation into the importation and sale of certain allegedly infringing GFCIs. The ITC affirmed an administrative law judge’s finding of infringement against General Protecht Group, Inc. (“GPG”), Wenzhou Trimone Science and Technology Electric Co., Ltd. (“Trimone”), and Shanghai ELE Manufacturing Corp. (“ELE”). The Federal Circuit opinion focused on a limited set of issues regarding two of the three patents-in-suit, U.S. Patent Nos. 7,283,340 (“the ’340 patent”) and 5,594,398 (“the ’398 patent”). The ’398 patent is the patent that had a means-plus-function claim at issue.

The ITC found that GPG’s devices infringe a claim in the ’398 patent that included a “latching means,” which is a means-plus-function element pursuant to 35 U.S.C. § 112 ¶ 6. The Federal Circuit referred to *Kemco Sales, Inc. v. Control Papers Co.*, 208 F.3d 1352, 1364 (Fed. Cir. 2000), in explaining the requirement that the alleged equivalent must “(1) perform the identical function and (2) be otherwise insubstantially different with respect to structure.” Although the majority acknowledged that “magnets were well

6. 619 F.3d 1303 (Fed. Cir. 2010), *reh’g and reh’g en banc denied*, (Fed. Cir. Dec. 14, 2010).

known as latches,” it held that *function*, not interchangeability, was the question. The experts in the case did not testify that the magnets “performed the latching means function in substantially the same way as the mechanical latch,” and the court declined to make that determination itself. Thus, it held that the magnetic means employed by GPG was not equivalent to the mechanical means recited in the ’398 patent and therefore reversed the ITC’s finding of infringement of that patent.

Judge Newman dissented, asserting that the majority disregarded over 200 pages of ITC findings and analysis and instead “[found] its own facts, applie[d] theories that were not raised by any party, use[d] incorrect standards of review, and create[d] its own electrical technology contrary to the uniform and unchallenged expert testimony.” Judge Newman objected to the majority’s conclusion, without discussing evidence, that a magnetic and a mechanical latch can never be equivalent. Instead, Judge Newman emphasized that “[e]quivalence is a question of fact to be determined ‘against the context of the patent, the prior art, and the particular circumstances of the case,’” quoting *Graver Tank & Manufacturing Co. v. Linde Air Prods. Co.*, 339 U.S. 605, 609 (1950). Reasoning that a person of ordinary skill in the art would have considered the two latching means interchangeable, the dissent concluded that the magnetic and mechanical mechanisms were equivalents.

G. *SUN PHARMACEUTICAL INDUSTRIES, LTD. V. ELI LILLY & CO.*⁷

On May 16, 2011, the U.S. Supreme Court denied Eli Lilly’s petition for certiorari after the Federal Circuit panel held Eli Lilly’s anti-cancer method-of-use claims on gemcitabine (the active ingredient in Eli Lilly’s Gemzar chemotherapy drug) invalid because anti-cancer uses of the drug were disclosed in prior issued patent directed at a different use. Eli Lilly’s petition for rehearing and rehearing on banc was also denied. Judge Newman (joined by Chief Judge Rader, and Judges Lourie and Linn) issued a vigorous dissent from the denial of Eli Lilly’s petition for rehearing en banc, in which she indicated that the decision represented a significant departure from prior case law.

The Federal Circuit affirmed the district court judgment that certain asserted use claims of Eli Lilly’s U.S. Patent No. 5,464,826 (“the ’826 patent”) were invalid over another Eli Lilly patent, U.S. Patent No. 4,808,614 (“the ’614 patent”). Both patents resulted from applications filed on December 4, 1984. The ’614 patent was directed at only anti-viral uses, however, it also stated that gemcitabine has “also demonstrated *excellent*

7. 611 F.3d 1381 (Fed. Cir. 2010), *reh’g en banc denied*, 625 F.3d 719 (Fed. Cir. 2010), *cert. denied*, 131 S. Ct. 2445 (2011).

oncolytic activity in standard cancer screens.” The application which resulted in the ’826 patent was directed entirely at anti-cancer uses, and because it was granted later, the ’826 patent was due to expire two-and-a-half years after the expiration of the ’614 patent. Eli Lilly did not file a terminal disclaimer with respect to the ’826 patent.

In 2007, having filed an Abbreviated New Drug Application with the FDA seeking approval to market a generic version of gemcitabine, Sun sought a declaratory judgment that the ’826 patent is invalid and not infringed. In 2009, the district court held that, given the prior disclosure in the ’614 patent, the claims at issue were “not patentably distinct as a matter of law.” The court primarily based its application of the obviousness-type double patenting doctrine on *Geneva Pharmaceuticals, Inc. v. GlaxoSmithKline PLC*, 349 F.3d 1373 (Fed. Cir. 2003) and *Pfizer, Inc. v. Teva Pharmaceuticals USA, Inc.*, 518 F.3d 1353 (Fed. Cir. 2008). The Federal Circuit agreed with the district court that these precedents presented similar factual situations and were controlling in the present case. In both *Geneva* and *Pfizer*, the court construed the differences between an earlier claim, disclosing the utility and specification of a compound, and a later claim, describing a method of use for one of the previously described specifications, not to be patentably distinct.

The Federal Circuit concluded that the decision applied to any and all uses disclosed in prior specifications of an identical compound, regardless of the use to that the earlier patent claimed. Furthermore, the court affirmed the propriety of consulting specifications in conducting obviousness-type double patenting analyses. Although acknowledging that the general rule is to exclude specifications, the court found that specifications may be examined in instances where the disclosures are needed to ascertain the “patentable bounds of the invention.”

Judge Newman’s dissent from the denial of rehearing en banc forcefully disagreed with the panel’s treatment of specifications in double patenting analysis, declaring it a “flawed ruling.” The dissent indicated that the divergent opinions on double patenting deserved an en banc rehearing, particularly in light of a separate district court decision upholding the ’826 patent. *Eli Lilly & Co. v. Sicor Pharms., Inc.*, 705 F. Supp. 2d 971, 1004–10 (S.D. Ind. 2010).

The dissent cited eleven cases from 1964 to 1992 in support of the position that specifications do not fall within the scope of double patenting analysis, charging that “[t]he panel opinion violates a vast body of precedent” in place prior to the *Geneva* and *Pfizer* decisions. At the root of the division in opinion, the dissent identified a statement cited by *Geneva* from *In re Byck*, 48 F.2d 665, 666 (C.C.P.A. 1931), asserting that “it would shock one’s sense of

justice” to allow an inventor with a patent for a composition of matter, having specified its useful purposes, to sell the compound and then prevent the public from using it by securing patents for each use. The dissent observed that this statement was taken out of context; the *Byck* decision also expressly stated that the inventor may disclose a use that, combined with other elements, might constitute a separately patentable invention. The *Pfizer* court cited this out of context interpretation.

The dissent further noted that the policy of limiting obvious-type double patenting was not served in this case because the doctrine’s intent was the prevention of “improper” patent time extension. In this case, however, the anti-cancer use of gemcitabine was a legitimate separate invention. The dissent referred to an amicus curiae brief submitted by the Biotechnology Industry Organization, which declared that continuing research routinely reveals new uses of known compounds that require patent protection. Judge Newman contended that a change in law that may compromise the patentability of later-discovered uses warranted an en banc hearing and letting the present decision stand leaves courts and patent system users without adequate guidance.

H. PILOT PROGRAM IN DISTRICT COURTS TO ENHANCE PATENT EXPERTISE H.R. 628⁸

On January 4, 2011, Congress approved a pilot program in select district courts, which allows judges to take on more or fewer patent cases in order to “encourage enhancement of expertise in patent cases.” First, district judges may request to be designated to hear cases related to patents or plant variety protection. Second, such cases are randomly assigned among all judges. The pilot program allows any non-designated judge who receives a patent case to decline it, at which point the case is randomly reassigned to a designated judge. Though judges retain their power to request the reassignment or transfer of a case pursuant to standard court rules, the program will make it easier for judges to develop expertise in patent and plant variety protection cases.

The program charged the Director of the Administrative Office of the U.S. Courts with choosing at least six district courts, in at least three different judicial circuits, to participate in the program. The Director was permitted to choose from either the fifteen district courts in which patent case filings were most common in the last calendar year or from the district courts that have adopted, or intend to adopt, local rules for patent cases. The Director had to

8. Pub. L. No. 111-349, 124 Stat. 3674 (2011).

select three district courts that each had at least ten district judges authorized for appointment and three district courts that each had fewer than ten district judges authorized for appointment.

To assess the effectiveness of the program, the chief judge of each participating district court shall consult with the Director of the Administrative Office of the U.S. Courts to prepare a report for submission to both the House and Senate Committees on the Judiciary. The reports must analyze five elements:

1. the extent to which the program facilitated the development of patent expertise among district judges in the participating district courts;
2. the extent to which the program improved judicial efficiency by improving expertise;
3. a comparison of the group of judges who requested patent cases and the group who did not, with respect to
 - a. the rate of reversal by the Federal Circuit on the issues of claim construction and substantive patent law and
 - b. the length of time between the filing of a case and the trial start date or summary judgment entry;
4. a discussion of whether litigants chose to file in certain districts because they felt the court would favor them; and
5. whether the pilot program should be expanded to other district courts, or applied universally and permanently to all district courts.

Two of these reports are due during the ten-year period following implementation of the experimental program, after which time the program will end.

II. COPYRIGHT DEVELOPMENTS

A. *COSTCO WHOLESALE CORP. V. OMEGA, S.A.*⁹

In *Costco Wholesale Corp. v. Omega, S.A.*, the Supreme Court upheld the Ninth Circuit's ruling that the first sale doctrine does not apply to imported goods manufactured abroad in its 4–4 split decision. The Ninth Circuit had held that the first sale doctrine, which limits the exclusive rights of a copyright holder, could not provide a defense to copyright infringement for goods manufactured abroad. The Supreme Court's one-line per curiam opinion offered no rationale for its holding.

The first sale doctrine, codified in the Copyright Act, states that the owner of a copy or phonorecord lawfully made under the Act may sell or give away the copy or phonorecord without the permission of the copyright

9. 131 S. Ct. 565 (2010).

owner. The Supreme Court first recognized this principle in *Bobbs-Merrill Co. v. Straus*, where it found that although a copyright owner has the exclusive right to distribute an original work, that right does not permit imposition of price limitations on subsequent sales. After an initial, lawful sale any subsequent owner of the copy may assert the first-sale doctrine as a defense to claims of copyright infringement.

In *Quality King Distributors, Inc. v. L'anza Research International, Inc.*, 523 U.S. 135 (1998), the Supreme Court held that the first sale doctrine applies to “round-trip” goods—those products manufactured in the United States, sold abroad, and then imported back into the U.S. for resale. However, in her concurring opinion, Justice Ginsburg explicitly noted that *Quality King* did not resolve whether or not the first sale doctrine applies to foreign-manufactured goods.

In *Omega*, the Ninth Circuit considered whether the first sale doctrine should apply to the re-sale of goods manufactured abroad. Omega manufactured watches in Switzerland that included a U.S.-copyrighted symbol on the back, and then sold these watches to authorized resellers outside of the United States. Omega did not authorize the importation of the watches into the United States. Costco bought these watches from the gray market. Gray market parallel goods are those “foreign manufactured goods, for which a valid United States trademark has been registered, that are legally purchased abroad and imported into the United States without the consent of the American trademark holder.” Frequently, these overseas goods are sold at a cheaper price than their U.S. equivalents. In *Omega*, a New York company bought the aforementioned watches from unidentified third parties.

Omega challenged the importation and sale, alleging copyright infringement under section 602(a). Section 602(a) provides that unauthorized importation of foreign purchased copies of U.S. copyrighted materials is an infringement of the distribution rights provided by the Copyright Act. Costco argued that following *Quality King*, the first sale doctrine protected its importation of watches. The Ninth Circuit held that the first sale doctrine did not apply to goods manufactured abroad. The court interpreted the phrase “lawfully made under this title” of section 109(a) of the Copyright Act to mean that the doctrine only applied to those goods manufactured in the United States. The Court invoked the presumption against extraterritoriality. The court distinguished between “round-trip goods” first manufactured in the United States, like those in *Quality King*, and the “one-way goods” first manufactured abroad, like the Omega watches.

The Court’s per curiam decision created no federal precedent and leaves sellers and copyright holders in a state of some confusion. It appears that gray market goods constitute copyright infringement and that the first sale

doctrine only applies to copyrighted works manufactured in the United States. This holding suggests that goods manufactured abroad enjoy protections not enjoyed by those manufactured domestically. Critics contend that the holding in *Omega* will induce copyright holders to manufacture abroad.

B. *HARPER V. MAVERICK RECORDING CO.*¹⁰

The Supreme Court declined to review a Fifth Circuit decision that held that an individual's access to the notice of copyright of a phonorecord foreclosed an individual's "innocent infringer" defense pursuant to § 402(d) of the Copyright Act, thereby barring the court's ability to lower the minimum statutory damages from \$750 to \$200 per infringed work.

In 2008, a Texas district court found that 16-year-old Whitney Harper infringed Maverick Recording Company's ("Maverick's") copyrights when she downloaded digital music files via a peer-to-peer file-sharing network and placed them in a "shared folder" from which others could also download the files. Harper asserted the innocent infringer defense, with respect to statutory damages under § 504(c)(2), which gives the district court discretion to reduce the minimum statutory damages from \$750 to \$200 per infringed work if it finds that the infringer was unaware and had no reason to believe that her acts infringed a copyright. Harper's affidavit stated that she did not understand the nature of file-sharing programs and that she thought "listening to music from file-sharing networks was akin to listening to a non-infringing Internet radio station." The district court found there was a genuine issue as to whether Harper was an innocent infringer and denied Maverick's request for the \$750 per infringement minimum.

However, the Fifth Circuit found that § 402(d) foreclosed Harper's innocent infringer defense as a matter of law. Section 402(d) gives "no weight" to the defense if a prescribed notice of copyright appears on *published phonorecords* to which an accused infringer had *access*. "Phonorecords" are defined in the statute as "material objects" in which sounds are fixed and can be perceived. Harper argued that she was too young and naïve to understand that copyrights on published music applied to downloaded music. The court found that the § 402(d) limitation rendered Harper's lack of legal sophistication irrelevant. Harper did not contest that she had "access" to the copyright notice, and therefore the § 402(d) limitation barred her innocent infringer defense.

10. 131 S. Ct. 590 (2010), *denying cert. to* 598 F.3d 193 (5th Cir. 2010).

In his dissent from the Supreme Court's denial of certiorari, Justice Alito emphasized that there is a "strong argument" that the § 402(d) limitation does not apply to cases involving downloaded digital music files. Section 402 was adopted in 1988, long before digital music was available for download on the Internet. Because a person who downloads digital music generally does not see any material object bearing a copyright notice, such as a compact disc containing the songs in question, there is doubt as to whether the infringer has "access" to the notice. If not, the case would simply turn on whether the infringer had a more general "reason to believe" that the downloading was illegal. Alito argued that under the Fifth Circuit's interpretation of § 402(d), the infringer's mere opportunity to learn of the copyright would suffice, presumably through research on the Internet or a visit to a local music store, where the downloader could view a physical item bearing the copyright notice. However, under the alternative interpretation, Harper did not have "access" to the notice and therefore § 402(d) would not exclude an innocent infringer defense. In that case, Harper's youth and legal naïveté could be considered in determining if she had "reason to believe" that her actions were illegal. Though there are no conflicting Circuit decisions to date, Alito suggested that the Fifth Circuit's application of § 402(d) to downloaded digital music files was questionable and therefore warranted the Court's review.

C. *PERFECT 10 INC. V. GOOGLE INC.*¹¹

In the "latest instalment in a legal saga of several years' duration," the Ninth Circuit affirmed the denial of Perfect 10's motion for preliminary injunctive relief against Google. The district court initially denied the injunction, stating that Perfect 10 "had not shown that it was likely to suffer irreparable harm in the absence of such relief" and "failed to satisfy any of the other requirements for a preliminary injunction." On appeal, the Ninth Circuit affirmed, ruling that "a showing of reasonable likelihood of success on merits in a copyright infringement claim did not raise the presumption of irreparable harm" and that the owner's business "did not satisfy the necessary requirement of showing sufficient causal connection between its irreparable harm" and the defendant's operations of its search engine so as to obtain preliminary injunctive relief.

Perfect 10, Inc., a website specializing in the creation and distribution of photographic images of nude models, brought an action against the online services provider and Internet search engine Google Inc. Perfect 10

11. 653 F.3d 976 (9th Cir. 2011).

requested a preliminary injunction against Google for copyright infringement and violation of the rights of publicity assigned to Perfect 10 by some of its models. Perfect 10 appealed the district court's decision denying an injunction, arguing that making a "strong showing of likely success on the merits of its copyright claims" presumes an "irreparable harm" as stated in *Apple Computer, Inc v. Formula International Inc.*, 725 F.2d 521 (9th Cir. 1984). Moreover, it argued that "Google's various services provide free access to Perfect 10's proprietary images, and this access has both destroyed [Perfect 10's] business model and threatened it with financial ruin."

Although it recognized the long-used rule stated in *Apple Computer* for the purposes of a preliminary injunction, the court based its decision on the more recent, controlling decision in *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006). The court emphasized that the Supreme Court has "consistently rejected invitations to replace traditional equitable considerations with a rule that an injunction automatically follows a determination that a copyright has been infringed." The court explained that "the propriety of injunctive relief in cases arising under the Copyright Act must be evaluated on a case-by-case basis in accord with traditional equitable principles and without the aid of presumptions or a 'thumb on the scale' in favor of issuing such relief." Further applying the standard set in *eBay*, the court added that this rule is applicable to the preliminary injunction since "the standard for a preliminary injunction is essentially the same as for a permanent injunction with the exception that the plaintiff must show a likelihood of success on the merits rather than actual success." The court rejected Perfect 10's argument based on the *Apple Computer* rule calling the argument "clearly irreconcilable" with the Supreme Court's decision in *eBay*.

After establishing the case-by-case evaluation rule, the court examined Perfect 10's contention that it is "very close to bankruptcy" due to Google's alleged copyright infringement as a form of irreparable harm. The court held that even if "being forced into bankruptcy qualifies as a form of irreparable harm," Perfect 10 had not shown a sufficient causal connection between irreparable harm to its business and Google's operation of its search engine. The court considered notable the fact that Perfect 10 had failed to show how the injunction would hold it avoid this financial state and "failed to submit a statement from even a single subscriber who ceased paying its service" because of the free availability of its images through Google. The Court therefore denied preliminary injunctive relief to Perfect 10.

D. *WARNER BROS. ENTERTAINMENT, INC. V. X ONE X PRODUCTIONS*¹²

In *Warner Bros. Entertainment, Inc. v. X One X Productions*, the United States Court of Appeals for the Eighth Circuit held that a film's copyright covers all visual depictions of its characters except for aspects that were a part of generally distributed promotional materials, and that public freedom to create new works from public domain materials ends where the derivative work comes into conflict with existing copyright.

Warner Bros. owns registered copyrights to the 1939 Metro Goldwyn Mayer ("MGM") films *The Wizard of Oz* and *Gone with the Wind*. During production for these films, still photographers and artists created promotional materials featuring images of the actors in costume and on set. These materials were distributed to movie theaters and published in newspapers and magazines without complying with the copyright notice requirements of the 1909 Copyright Act, 17 U.S.C. § 1. Warner Bros. is also the owner of registered copyrights to various Tom and Jerry animated short films that debuted between 1940 and 1957. Promotional materials for these films were also created and distributed without the required copyright notice. AVELA obtained restored versions of the promotional materials and extracted images of famous characters from the various films. These extracted images were appropriated for use on items such as T-shirts, lunchboxes, and action figures.

Warner Bros. filed suit against AVELA alleging, inter alia, copyright infringement, trademark infringement and unfair competition. AVELA contended that it was free to use the films' promotional materials because Warner Bros. had placed them in the public domain when it failed to register for copyright protection. Following cross-motions for summary judgment, the district court granted summary judgment to Warner Bros. on its copyright claim and entered a permanent injunction against all use of the materials that were not an exact duplication of individual images. The district court denied summary judgment to both parties regarding the trademark infringement and unfair competition.

The court first examined the distribution of the films' promotional materials and found that their widespread distribution reflected Warner Bros.' intent to abandon their ability to control the reproduction, distribution, and sale of the materials. Next, the court held that AVELA was free to create derivative works from these materials, but that this right ended when it came into conflict with a valid copyright. The court held that Warner Bros.' valid copyrights covered all visual depictions of the films' characters

12. 644 F.3d 584 (8th Cir. 2011).

with the only exception being the precise images in the promotional materials.

The court then examined AVELA's use of the public domain images and held that the works that simply reproduced a single image drawn from the publicity materials did not add an element of expression from the films' characters. However, the court held that AVELA products juxtaposing different images from the publicity materials or with written phrases from the source novel evoked elements of expression derived from the copyrighted films. Lastly, the court examined AVELA products that took the two-dimensional images from the production materials and created three-dimensional products such as action figures and water globe statues and found that because the visual information for creating the characters' third dimension was derived from the feature films, the products infringed Warner Bros.' registered copyrights.

The court concluded that the district court's grant of summary judgment and permanent injunction should be upheld for all AVELA products that manipulated Warner Bros. publicity materials beyond the exact reproduction of the public domain image. The court in turn reversed summary judgment and vacated the permanent injunction to AVELA products that only reproduced the public domain images onto new surfaces.

E. *MURPHY V. MILLENNIUM RADIO GROUP LLC*¹³

In 2006, Peter Murphy photographed the hosts of New Jersey radio station WKXW, Craig Carton and Ray Rossi ("the Station Hosts"), for the magazine *New Jersey Monthly* ("NJM"). NJM used that photo in its "Best of New Jersey" article. Murphy retained the copyright to this photo. A WKXW employee scanned the image from NJM, cut off the original NJM caption, eliminated NJM's gutter credit, and posted the copy to the WKXW website and another website, despite never acquiring Murphy's permission to use the image. After Murphy's attorney asked WKXW to stop this alleged infringement, the Station Hosts stated on their radio show that people should not do business with Murphy "because he would sue his business partners." They also implied that Murphy was a homosexual.

In 2008, Murphy sued the Station Hosts for violation of § 1202 of the Digital Management Copyright Act ("DMCA"), copyright infringement under the Copyright Act, and defamation pursuant to New Jersey state law. In May 2009, after only limited discovery, the Station Hosts filed a motion for summary judgment on all claims. Although Murphy filed a motion

13. 650 F.3d 295 (3d Cir. 2011).

requesting additional discovery before rulings on the summary judgment motions, the district court denied his motion and granted summary judgment on all counts to the Station Hosts. Murphy appealed, and the Court of Appeals for the Third Circuit reversed on all counts.

With regard to the DMCA violation claim, the Third Circuit examined the legislative history, finding that Congress passed the Act in part “to address the perceived need of copyright owners for ‘legal sanctions’ to enforce various technological measures they had adopted to prevent the unauthorized reproduction of their works.” Section 1202 of the DMCA prohibits the intentional removal or alteration of any copyright management information (“CMI”), which includes “[t]he name of, and other identifying information about, the author of a work” Murphy argued that the NJM gutter credit that the Station Hosts removed qualified as CMI and therefore the Station Hosts violated § 1202 when they used the altered image. The Station Hosts countered by arguing that § 1202 must be read in conjunction with § 1201. Section 1201 covers the systems that *protect* copyrighted materials, while § 1202 covers systems that *manage* copyrighted materials. Under this proposed interpretation, “the name of the author of a work is not CMI unless it also functions as part of an ‘automated copyright protection or management system,’” which Murphy’s name in the gutter credit did not. However, the court found that neither the plain language of the statute nor the purpose of the DMCA implied such an interpretation and held that Murphy’s name in the gutter credit was protected under § 1202.

In response to Murphy’s copyright claim, the Station Hosts asserted the affirmative “fair use” defense. While the district court found Station Hosts’ use of the image was protected as “fair use,” the appellate court reversed. The Third Circuit found that the Station Hosts’ use of the image was *not* transformative since it was used for the same purpose as the NJM article—to publicize Carton and Rossi’s award—and that “cognizable market harm to the original [photograph] will occur” when it is duplicated in the manner used by Station Hosts.

Regarding Murphy’s defamation claim, the Third Circuit held that the district court abused its discretion and vacated the summary judgment for the Station Hosts. The Third Circuit then remanded the case to allow “Murphy to conduct adequate discovery” by deposing Carton and Rossi, the alleged defamers.

F. *HO V. TAFLOVE*¹⁴

In an application of the merger doctrine, the Seventh Circuit held that a mathematical model of physical phenomena was an idea and therefore ineligible for copyright protection. Members of a research team, Seng-Tiong Ho and Yingyan Huang, brought this action for copyright infringement, conversion, fraud, and trade secrets misappropriation against Allen Taflove and Shi-Hui Chang, members of another research team at the same university. Plaintiffs' claims rested on the alleged copying of an atomic model, described with equations, figures, and text. The U.S. Court of Appeals for the Seventh Circuit upheld the ruling of the District Court for the Northern District of Illinois, granting a motion for summary judgment in favor of the defendants. Judge Ripple, joined by Judge Hamilton, held that the model was not subject to copyright, that the Copyright Act preempted the fraud and conversion claims, and that the research materials were not protected trade secrets under Illinois law.

During the relevant period, Ho and Taflove were both professors of engineering at Northwestern University. Huang and Chang were graduate students at Northwestern. In 1998, Ho formulated his "4-level 2-electron atomic model with Pauli Exclusion Principle for simulating the dynamics of active media in a photonic device." The model was described in 69 handwritten pages of equations, notes, and mathematical derivations. Chang, then a graduate student in Ho's research group, was tasked with creating a computer program based on the derived equations in the notebooks. Chang did not succeed in producing a computer simulation of the model, and in 2002, left Ho's research group and began working with Taflove. When leaving, Chang failed to return one of the notebooks Ho had issued to him, although he returned several other notebooks. Huang, also a graduate student in Ho's research group, had mentioned the model with permission in a conference paper in 2001 and then published additional research based on the model in her master's thesis in 2002. In 2003 and 2004, Taflove and Chang published two papers on the applications of the model, describing the model and including several figures from Huang's thesis. They did not attribute any of the contents to Ho and Huang. In 2004, Ho submitted his project for publication in another journal and was rejected because of previous publications on the same topic by Taflove and Chang. In 2007, Ho and Huang obtained copyright certificates in the research notebooks, Huang's thesis, and a related visual presentation. They alleged thirty-three

14. 648 F.3d 489 (7th Cir. 2011).

instances of infringement in the two papers published by Taflove and Chang including text, equations, and figures.

The Seventh Circuit affirmed summary judgment for Taflove and Chang, holding that the model was an idea, and that Ho and Huang failed to demonstrate how the model could be expressed through other equations or figures. The court cited prior interpretation of § 102(b) of the Copyright Act as codifying a “fact-expression dichotomy,” which allowed for protection of expressions but not ideas themselves. Under the merger doctrine, when an expression is the only way to express an idea, the expression is not protected because allowing copyright would render the idea itself copyrightable. The fact-expression dichotomy has a long history in copyright jurisprudence, recognized in *Baker v. Selden*, 101 U.S. 99, 103 (1879).

In the present case, Ho and Huang conceded that the model’s value stems from its representation of physical reality. The court found that hypothetical assumptions employed in constructing the model did not render it fictitious, but that it was an embodiment of a scientific principle, and thus a discovered fact. Ho and Huang further claimed a copyright in the substance of the model, not the manner of presentation. Because Ho and Huang failed to demonstrate other ways to express the substance of the model, the court held that the equations and figures are “required by” the model. The court recognized that the text describing the model presents a more difficult question of copyrightability, but declined to overrule the district court on this point because Ho and Huang failed to raise this argument adequately in summary judgment papers. Turning to the state law claims, the court found that the Copyright Act preempted the fraud and conversion claims and that the trade secrets claim failed on the merits because Ho and Huang had published the research in the conference papers and Huang’s master’s thesis. Accordingly, the court affirmed the district court’s grant of summary judgment and denial of motion for reconsideration.

G. *F.B.T. PRODUCTIONS, LLC V. AFTERMATH RECORDS*¹⁵

In 1998, F.B.T. signed an agreement that transferred Eminem’s exclusive recording services to Aftermath. Two provisions governed the amount of royalties to be paid to F.B.T. The “Records Sold” provision of the agreement entitled F.B.T. to receive between 12% and 20% of the adjusted retail price of all “full price records sold in the United States . . . through normal retail channels.” The “Masters Licensed” provision entitled F.B.T. to receive 50% of Aftermath’s net receipts “on masters licensed by us . . . to others for the

15. 621 F.3d 958, 961 (9th Cir. 2010), *cert. denied*, 131 S. Ct. 1677 (2011), *reh’g denied*, 131 S. Ct. 2482 (2011).

manufacture and sale of records for any other uses,” “notwithstanding” the Records Sold provision. F.B.T. and Aftermath formed a new agreement in 2003 that terminated the 1998 agreement but incorporated the language of the “Records Sold” and “Masters Licensed” provisions from the 1998 agreement. In 2006, F.B.T. brought suit after discovering during an audit that Aftermath had been applying the “Records Sold” provision rather than the “Masters Licensed” provision to calculate the royalties due to F.B.T. for sales of Eminem’s recordings in the form of permanent downloads and mastertones.

Before trial, F.B.T. moved for summary judgment, arguing that the “Masters Licensed” provision unambiguously applied to those sales. Aftermath cross-moved for summary judgment. The district court concluded that the language of the agreements was too ambiguous and denied both of these motions. At trial, Aftermath’s motion for judgment as a matter of law was denied. The jury ruled in favor of Aftermath, and awarded it over \$2.4 million in attorneys’ fees. F.B.T. appealed the judgment and the Ninth Circuit Court of Appeals reversed.

The Appeals Court reasoned that the district court erred in determining that the contracts were ambiguous because the agreements provide that “notwithstanding” the “Records Sold” provision, F.B.T. is to receive a 50% royalty on “masters licensed by [Aftermath] . . . to others for their manufacture and sale of records or for any other uses.” The court found that the use of the word “notwithstanding” indicated that F.B.T. was owed 50% royalties on Aftermath’s licenses of Eminem masters to third parties for any use. The court ruled that the broad scope of this provision does not render it ambiguous. Aftermath freely admitted entering into agreements that permitted iTunes, cell phone carriers, and other third parties to use its sound recordings to produce and sell permanent downloads and mastertones, giving out licenses in the ordinary sense of the word. The Ninth Circuit found that the “Masters Licensed” provision therefore applied.

Federal copyright law supports the Ninth Circuit’s interpretation. The Copyright Act differentiates the terms “sale” and “license,” where a sale transfers the title of an individual copy of a work, or sells all exclusive intellectual property rights in a work, and a license “authorizes a third party to exercise public performance rights that otherwise remain the exclusive rights of a copyright holder.” Pursuant to its agreements with Apple and other third parties, Aftermath did not sell anything to the download distributors because Aftermath retained ownership of those files. Case law confirms the Ninth Circuit’s interpretation as well. The Court has held that “where a copyright owner transfers a copy of copyrighted material, retains

title, limits the uses to which the material may be put, and is compensated periodically, the transaction is a license.”

Aftermath admitted that permanent downloads and mastertones are records, and because it permitted third parties to use the Eminem masters to produce and sell records in the form of permanent downloads and mastertones, F.B.T. is entitled to a 50% royalty pursuant to the contract. Therefore, the Ninth Circuit held that the district court erred in denying F.B.T. summary judgment. The court reversed the judgment in favor of Aftermath and vacated the order granting Aftermath its attorneys’ fees.

H. *MARVEL WORLDWIDE, INC. V. KIRBY*¹⁶

The U.S. District Court for the Southern District of New York held, as a matter of law, that artworks depicting iconic characters created by a freelance artist were works for hire within the meaning of the Copyright Act of 1909. Since the comic book publisher was held to be the “author” of the works made for hire, the artist’s heirs did not obtain copyright in the artworks by sending termination notices under 17 U.S.C. § 304(c).

Jack Kirby was a freelance artist who played a key role in the creation of a number of iconic characters, including “The Fantastic Four,” “The Incredible Hulk,” and “The X-Men.” In 1972, Kirby executed an assignment to Marvel Management Company of any and all rights, titles, and interests that Kirby “may have or control” in any works that he created for Marvel (“Kirby Works”). In September 2009, Kirby’s wife and children (“Kirby Heirs”) served Marvel with notice to terminate any and all pre-January 1, 1978 grants of copyrights made by Jack Kirby in the Kirby Works. In January 2010, Marvel Worldwide, Inc., Marvel Characters, Inc., and MVL Rights, LLC (collectively, “Marvel”) sought a declaratory judgment action to nullify the 45 notices purporting to terminate Kirby’s assignment of his copyright in the Kirby Works.

The termination notices relied on 17 U.S.C § 304(c), which gives an author or his heirs a non-waivable right to terminate a prior assignment of copyright at any time during (1) a five-year period that begins on January 1, 1978, or (2) fifty-five years after the date the statutory copyright was originally secured. The Kirby Heirs argued that Marvel acquired the federal copyright in the Kirby Works via Kirby’s 1972 assignment and they were exercising their right to terminate this copyright assignment.

Marvel moved for summary judgment arguing that the undisputed material facts establish that the artworks at issue were works made for hire

16. 777 F. Supp. 2d 720 (S.D.N.Y. 2011).

and therefore statutorily exempt from § 304(c) termination since the “employer” is the statutory “author” of the work. If the Kirby Works were “works made for hire” within the meaning of the Copyright Act of 1909, then Marvel owned the copyright in those works.

In determining whether the challenged artworks were works made for hire, the court applied the “instance and expense” test. First, the court found that Kirby’s artwork was made at Marvel’s “instance” because the undisputed facts showed that that Marvel induced the creation of the work and had the power to control or supervise the work. Kirby did not create the Kirby Works until Stan Lee, Marvel’s art director and editor, assigned him to do so. Furthermore, during the period in which the artwork was published, Lee had “complete editorial and stylistic control” over all published works. Second, the court found that the Kirby Works had been created at Marvel’s expense. Since Kirby did not receive royalties as payment, but only a fixed per-page fee for all of his work at Marvel, he did not bear the risk of profitability. Therefore, the court concluded that Marvel is presumed to be the “author” of the Kirby Works and copyright holder as a matter of law.

The court rejected the Kirby Heirs’ position that the 1972 assignment suggested an understanding that Kirby, not Marvel, originally owned the federal statutory copyright in the work. The court stated that the language assigning all rights, titles, and interests that Kirby “may have” did not acknowledge that Kirby actually retained a copyright in his created works. Instead, the 1972 assignment contained definitive language describing all of Kirby’s works for Marvel as work done by Kirby “as an employee for hire.”

The court concluded that the Kirby Heirs’ termination notices were of no force and effect because Marvel acquired the federal statutory copyright in the Kirby Works by virtue of its status as their “author” under the work-for-hire doctrine.

I. CONSTITUTIONALITY OF LARGE STATUTORY DAMAGES AWARDS IN FILE-SHARING CASES¹⁷

In *Sony BMG Music Entertainment v. Tenenbaum* and *Capitol Records, Inc. v. Thomas-Rasset*—the first two file-sharing cases to go to trial and award damages—district court judges ruled that the excessive damages awarded by the juries violated the Due Process Clause. Judges in both cases reduced the awards to \$2,250 per infringed sound recording, which is three times the statutory minimum.

17. *Capitol Records, Inc. v. Thomas-Rasset*, No. 06 1497 (MJD/LIB), 2011 WL 3211362 (D. Minn. July 22, 2011); *Sony BMG Music Entm’t v. Tenenbaum*, 721 F. Supp. 2d 85, 116 (D. Mass. 2010).

In a copyright infringement action, parties may elect statutory damages under the Copyright Act over actual damages. In the statutory damage scheme, evidence of the monetary value of the actual harm suffered is not required and damage amounts range from \$750 to \$150,000 per work infringed, depending in part on the willfulness of the infringement. Statutory damages may encompass both compensatory and punitive awards.

In July 2010, Judge Gertner of the District of Massachusetts issued a memorandum holding that an award of \$675,000 in statutory damages for a music downloader's infringement of thirty copyrighted works was grossly excessive in violation of the Due Process Clause. In *Sony*, five recording companies brought a copyright infringement action against the defendant, who was an undergraduate in college when his file sharing was detected. The plaintiffs established defendant's liability for copyright infringement and sought statutory damages. A jury awarded damages of \$22,500 per song, for a total award of \$675,000, which is well within the statutory range.

The court subsequently addressed the defendant's constitutional challenge to the jury's damages award. The court looked to the three guideposts articulated in *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996), to assess the constitutionality of the jury's damage award. The court noted that while the *BMW* guideposts are helpful aids, the ultimate question is whether the jury's award is "grossly excessive" in relation to the interests of compensation and deterrence. The court addressed each of the *BMW* factors: (1) the degree of reprehensibility of the defendant's misconduct, (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award, and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases. The court concluded that the jury's highly punitive \$675,000 award violated the Due Process Clause because the award bore no rational relationship to the government's interests in compensating copyright owners and deterring infringement. The court reduced the award to \$2,250 per song, three times the statutory minimum, as the outer limit of what a jury could reasonably and constitutionally impose in this case.

On September 16, 2011, the First Circuit affirmed in part, vacated in part, and reversed in part the decision of the district court. Notably, it reversed the reduction of damages and vacated the district court's holdings on due process. The court found that the trial court erred in failing to consider the defendant's request for a remittitur before jumping to the constitutional questions. As a decision on the constitutionality of the award was neither necessary nor inevitable, the trial court failed to follow the doctrine of constitutional avoidance. The First Circuit therefore reinstated

the original award (\$675,000), vacated the due process holdings, and remanded for consideration of the remittitur.

In *Capital Records*, recording company plaintiffs brought a copyright infringement action against the defendant, alleging illegal downloading and distribution of sound recordings via an online peer-to-peer file sharing application. A jury found willful infringement of 24 sound recordings and awarded statutory damages of \$9,250 per sound recording, for a total of \$222,000. The court granted the defendant's motion for a new trial, where the jury again found willful infringement of 24 sound recordings but this time awarded statutory damages of \$1.92 million—\$80,000 per song. The court found this award “shocking and unjust” and remitted the damages award to \$2,250 per song. The plaintiffs rejected remittitur and requested a new jury trial on damages. In this third trial, the jury entered a verdict for statutory damages of \$1.5 million, \$62,500 per song. The defendant filed a motion for judgment as a matter of law requesting that the court reduce the award of statutory damages as unconstitutional.

The court looked to the standard in *St. Louis, I.M. & S Ry. Co. v. Williams*, 251 U.S. 63 (1919) to evaluate whether the damages award violated the Due Process Clause. The *Williams* standard states that an award of statutory damages satisfies due process so long as it is not so severe and oppressive as to be wholly disproportioned to the offense or obviously unreasonable. The *Williams* Court articulated three factors in analyzing whether a statutory damage award complies with due process: (1) the interests of the public, (2) the numberless opportunities for committing the offense, and (3) the need for securing uniform adherence to established passenger rates. Evaluating these factors, the court concluded that a substantial award was warranted. However, because the defendant was not a business acting for profit nor did the harm to the plaintiff bear any relation to the amount rewarded, the court deemed the jury's award severe, oppressive, and disproportionate to the offense. The court reduced the damage award to \$2,250 per song, for a total award of \$54,000, three times the statutory minimum and the maximum award consistent with due process.

J. COPYRIGHT CLEANUP, CLARIFICATION, AND CORRECTIONS ACT
OF 2010¹⁸

In December 2010, the President signed into law the Copyright Cleanup, Clarification, and Corrections Act of 2010. Then purpose of the Act was to increase Copyright Office efficiency by shifting toward electronic

18. Pub. L. No. 111-295, 124 Stat. 3180 (2010).

communication and clarifying ambiguities. The Senate passed the Act by unanimous consent in August and the House passed it in November after deleting language that expressly permitted the owner of any exclusive rights comprising a copyright to transfer or license the exclusive right to another person in the absence of a written agreement to the contrary. The final version ultimately made modest changes to Title 17 of the United States Code by modifying Copyright Office procedure, clarifying sections on ownership, and correcting technical errors.

First, the Act eliminates the requirement that the Register of Copyrights maintain a directory of agents available to the public in both electronic and hard copy formats, requiring only that the directory be available through the Internet. The Act also streamlines the copyright registry process by authorizing the electronic submission of sworn or official certifications to the Copyright Office.

The Act repealed § 601, deleting “Manufacturing Requirements” from the title of Chapter 6, which is now “Importation and Exportation.” Section 601 prohibited the importation and public distribution into the United States of copies of a protected, preponderantly non-dramatic literary work written in English unless it was manufactured in the United States or Canada. Before 1986, this Section burdened foreign manufacturers, forcing them to print these works domestically.

The Act also clarifies Congress’s 1997 amendment to § 303(b) by expanding the phonograph publication exemption to include dramatic and literary works. The exemption provides that copyright owners do not lose their copyright by distributing phonographs without copyright notice before 1978.

Finally, the Act subjects regulations issued by the Copyright Royalty Judges to judicial review, where before these decisions were only subject to approval by the Librarian of Congress.

III. TRADEMARK DEVELOPMENTS

A. *VOICE OF THE ARAB WORLD, INC. v. MDTV MEDICAL NEWS NOW, INC.*¹⁹

In *Voice of the Arab World, Inc. v. MDTV Medical News Now, Inc.*, the First Circuit held that an appellee’s excessive delay in filing for a preliminary injunction made it unnecessary to decide whether the Supreme Court’s decision in *eBay v. MercExchange, LLC*, 547 U.S. 388 (2006), required a

19. 654 F.3d 26 (1st Cir. 2011).

departure from the presumption of irreparable harm in cases where a trademark holder has demonstrated a likelihood of success on the merits.

In November 2009, MDTV Medical News Now, Inc. (“MNN”) moved to preliminarily enjoin Voice of the Arab World, Inc. (“VOAW”) from using its MDTV mark as part of its counterclaim for trademark infringement, unfair competition and cybersquatting. MNN applied to register the MDTV mark in 1998 and first sent VOAW a cease-and desist letter threatening trademark infringement action in January 2000. In September 2000, VOAW applied to register the MDTV mark in connection with providing medical information to the Arab world. Further, it had owned the “mdtv” Internet domain names since 2008. The USPTO issued MNN’s trademark in 2002, and after initially rejecting VOAW’s application due to MNN’s prior registration, approved VOAW’s application in 2008.

Unsuccessful negotiations between MNN and VOAW over use of the MDTV mark culminated in MNN’s petition to the USPTO to cancel VOAW’s MDTV trademark. In August 2009, VOAW made a number of changes to its website including declaring a wider scope of services, providing links to other medical entities, and removing limiting references to the Muslim and Arab World. MNN then sent a letter threatening action for trademark infringement in 2009, VOAW’s suit for declaratory judgment and MNN’s counterclaim and move for preliminary injunction followed. The district court approved the injunction, finding that MNN had demonstrated a likelihood of success on the merits of its trademark claim, and was thus entitled to an injunction based on the presumption of irreparable harm.

On appeal, VOAW argued (1) that the presumption of irreparable harm in trademark infringement cases is inconsistent with the Supreme Court’s *eBay* decision, and (2) that MNN’s excessive delay in filing for injunctive relief should defeat any such presumption in its case even if irreparable harm may be presumed in certain trademark infringement cases.

The court agreed that the validity of the First Circuit’s prior held standard that “a trademark plaintiff who demonstrates a likelihood of success on the merits creates a presumption of irreparable harm” might be “called into question” by the Supreme Court’s holding in *eBay*. In that case, the Supreme Court held that a court’s discretion over granting permanent injunctions in patent cases must be exercised “consistent with traditional principles of equity,” thus rejecting the general rule applied to patent disputes that a “permanent injunction will issue once infringement and validity have been adjudged” except in special cases. The First Circuit noted that the Supreme Court supported its opinion with a broad swath of non-patent cases, including those that had considered preliminary injunctions. It found, therefore (1) that the same “traditional four-factor permanent injunction

standard” should be applied to trademark cases as well as patent cases, and (2) that those principles were equally applicable to preliminary injunctions.

Still, the court declined to address whether the “presumption of irreparable harm” where a “trademark plaintiff has demonstrated a likelihood of success on the merits” is consistent with the traditional equitable principles required by *eBay*. The parties’ briefs, the court explained, did not adequately address the validity of a presumption of harm in light of the *eBay* principles.

Instead, the court found that it could decide the case without considering the validity of the presumption rule because MNN had, as a matter of law, excessively delayed filing for injunction. The court found that under the existing trademark rule, a presumption of irreparable harm arising from a likelihood of success on the merits is inoperative if the plaintiff delays in filing suit or moving for injunctive relief. The court rejected the lower court’s finding that VOAW’s amendments to its website in August 2009 could revive MNN’s ability to seek injunctive relief, because the changes did not create a “qualitatively new harm,” as such a revival would require.

The court concluded that MNN’s excessive delay rendered a “presumption of irreparable harm upon a finding of likelihood of success on the merits” inoperative, even if a court were still entitled to such presumptions in trademark cases. The court thus vacated the lower court’s preliminary injunction, and remanded the case for “proper consideration of the preliminary injunction standard” in trademarks.

B. *MASTERS V. UHS OF DELAWARE, INC.*²⁰

In *Masters v. UHS of Delaware, Inc.*, the Eighth Circuit affirmed the district court’s decision and held that proof of actual confusion is not necessary for a plaintiff to be awarded monetary damages under the federal Lanham Act. The court’s decision brought the Eighth Circuit in line with the Sixth and Ninth Circuits on the issue.

Virginia Masters and her late husband, William Masters, gained acclaim as pioneers of human sexuality and sexual dysfunction. In 1995, the Masters licensed their unregistered MASTERS AND JOHNSON service mark to Universal Health Services, Inc. (“UHS”), allowing UHS to use the mark “in treatment of sexual dysfunction and sexual trauma in accordance with the established methodology of” Masters and Johnson. In 2006, Masters sued UHS in federal court for, among other things, infringing upon her service mark under section 1125(a) of the Lanham Act based on the defendant’s use of the service mark in materials promoting treatment programs unrelated to

20. 631 F.3d 464 (8th Cir. 2011).

sexual dysfunction and trauma (such as eating disorders and chemical dependency) and treatment methods unrelated to the methodology associated with the mark (such as yoga and t'ai chi). The jury found that UHS had willfully infringed on the mark and breached the licensing agreement. The jury awarded Masters \$2.4 million in disgorged profits from UHS, and the trial court affirmed the award.

On appeal, the Eighth Circuit rejected all of UHS's arguments, including assertions that their equitable defenses should have been decided as a matter of law; that their use of the service mark was not "use in commerce"; that the verdict was improper and internally inconsistent; and that the damages were improper because injunction is the exclusive remedy for Masters under the Lanham Act, because there was insufficient evidence supporting the finding that UHS willfully infringed, and because Masters failed to prove that actual confusion resulted from UHS's infringement of the mark. The court also rejected Masters' appeal regarding the district court's denial of her motion for an award of prejudgment interest. Of particular significance in this case is the court's discussion and decision regarding the necessity of actual confusion for monetary damages.

The court rejected the existence of a precedential bright-line rule requiring actual confusion as a prerequisite for monetary damages under the Lanham Act, referenced in a footnote of *Woodsmith Publ'g Co. v. Meredith Corp.*, 904 F.2d 1244 (8th Cir. 1990). First, the court explained, the Lanham Act itself does not explicitly require actual confusion. Second, all of the cases upon which the supposed rule is based—*Woodsmith; Co Rect Prods., Inc. v. Marvy! Adver. Photography, Inc.*, 780 F.2d 1324 (8th Cir. 1985); *Minnesota Pet Breeders, Inc. v. Schell & Kampeter, Inc.*, 41 F.3d 1242 (8th Cir. 1994)—were decided for reasons unrelated to actual cause, and are dicta.

In addition, the court explained that an actual confusion requirement could undermine the "equitable nature of the Lanham Act's remedial scheme," as it did in the present case. First, although proof of actual confusion is useful in traditional trademark cases concerning comparisons of similar marks, similarity is not a relevant criterion in the current case. The relevant test is whether UHS's use of the MASTERS AND JOHNSON mark differed from the contractual limits, and it is unclear how proof of actual confusion could contribute to such analysis. Second, section 1117(a) of the Lanham Act subjects awards of an infringing party's profits only to the principles of equity, which can be satisfied without proof of actual confusion where the jury finds willful infringement that was likely to cause confusion. Two of the purposes of disgorgement of profits in equity are to deter prospective infringers and to limit unjust enrichment, both of which are achieved in this case. Additionally, the court noted that the decision against

an actual confusion requirement is supported by similar decisions in the Sixth and Ninth Circuits.

The court concluded that when a party's actions are prohibited under the Lanham Act in such a way that they are likely to cause confusion, to cause a mistake, or to deceive others, the owner of the mark infringed upon is entitled to disgorged profits, subject to the principles of equity, effectively abolishing the actual confusion requirement in the Eighth Circuit.

C. *FEDERAL TREASURY ENTERPRISE SOJUZPLODOIMPORT V. SPIRITS INTERNATIONAL N.V.*²¹

The U.S. Court of Appeals for the Second Circuit recently held in *Federal Treasury Enterprise Sojuzplodoimport v. Spirits International N.V.* that a recorded assignment of a mark, despite attaining "incontestable status," may be challenged if registration was allegedly procured through fraud.

Various entities in Russia have been engaged in a battle for ownership of the STOLICHNAYA trademark. Federal Treasury Enterprise ("FTE"), an entity created and granted rights by the Russian government to manage trademarks, sued the defendant Spirits International N.V. ("SPI") over ownership of the STOLICHNAYA trademark, alleging improper assignment to the Dutch company Allied Domecq.

The history of the trademark itself is mired in a complicated web of transfers and assignments. After the dissolution of the Soviet Union in 1991, the director of the state-owned company VVO-SPI allegedly crafted a scheme to seize assets of the company by transferring assets to a privately registered Russian company called VAO-SPI. VAO-SPI then sold reversionary rights to the STOLICHNAYA mark from a previous contract with PepsiCo to a new Russian company, ZAO-SPI, which then in turn sold its rights to defendant SPI, a Swiss company. However, since both ZAO-SPI and SPI allegedly have common ownership, the transfer of rights effectively allowed defendants to move these assets outside of Russia. Subsequently, SPI agreed to assign its marks to Allied Domecq, who then began selling the popular vodka in the United States in 2001. However, in 2002, FTE recovered rights to the STOLICHNAYA trademarks in Russia in a ruling from a division of Russia's highest commercial court that nullified the original fraudulent transfer of rights from VVO-SPI to VAO-SPI. They next sought to reclaim their rights abroad, filing suit in the US against SPI entities and Allied Domecq in the District Court for the Southern District of New York in 2005.

21. 623 F.3d 61 (2d Cir. 2010).

In a motion to dismiss, SPI argued that FTE could not challenge its or Allied Domecq's ownership of the registration because the registration was attained incontestability in the US in 1974. Specifically, a US federal trademark registration for which a Section 15 affidavit has been accepted after five years of continuous use is said to be "incontestable." When the incontestable mark's registration was assigned to SPI and Allied Domecq, they could step into the shoes of the original registrant and thus the recorded assignment could not be contested. The district court agreed.

The Second Circuit reversed, holding that the assignee only steps into the shoes of the incontestable registrant if the assignment was proper. For this reason, a court must evaluate whether the assignment was proper before awarding the "assignee" the cloak of incontestability. Thus, FTE could challenge the ownership rights since "only after a *valid* assignment of trademarks does the assignee succeed to the rights of the assignor" and "[o]bviously, an assignment attained by fraud would not be valid." The court argued that holding otherwise would lead to "perverse result[s]" in some cases where "the disputed assignment comes from a series of transactions" many years after the designation of incontestability.

D. *GEORGIA PACIFIC CONSUMER PRODUCTS V. MEYERS SUPPLY, INC.*²²

In *Georgia Pacific Consumer Products v. Meyers Supply, Inc.*, the United States Court of Appeals for the Eighth Circuit held, after a bench trial, that industry acceptance of a practice can be determinative in finding that the practice creates no actual trademark confusion amongst the general public. The ruling rejected a nearly identical Fourth Circuit case, *Georgia Pacific Consumer Products v. Von Dreble Corp.*, which held that consumer surveys suggesting sufficient actual confusion were enough to defeat summary judgment despite industry acceptance.

In *Meyers*, Georgia-Pacific ("G-P") brought action against Myers Supply, Inc. ("Myers") alleging that Myers engaged in contributory trademark infringement that violated provisions of the Lanham Act. G-P manufactures and leases hands-free enMotion paper towel dispensers containing a visible G-P trademark. Every lease stipulates that lessees and sublessees are required to use only G-P towels in the enMotions. G-P also sells marked universal towel dispensers, which are often filled with another brand's towels. Myers sells paper towels that are cheaper than those of G-P, which fit into enMotion dispensers. Myers knew that its customers were using Myers towels in the enMotion dispensers, but continued distribution to those

22. 621 F.3d 771 (8th Cir. 2010).

customers anyway. With varying results, both parties conducted surveys to determine whether bathroom users associate the trademark on the dispenser with the towels that were dispensed.

G-P argued that Myers committed contributory trademark infringement by continuing to sell their towels to customers who they knew used the towels in enMotion dispensers despite knowing of G-P's lease agreements with its customers. A party commits contributory trademark infringement if it intentionally induces a merchant to "pass off" the party's product as that of the trademark owners or if the party continues to supply its product to merchants after it knew infringement was taking place. A merchant infringes on a trademark under the Lanham Act if it uses another's mark "in connection with a product in a manner that is likely to cause confusion as to the source of the product." The Eighth Circuit applied a six-factor test to determine likelihood of confusion: strength of the plaintiff's mark, similarity between the marks at issue, competition between the plaintiff and the infringing product, alleged infringer's intent to confuse the public, the degree of care reasonably expected of potential customers, and evidence of actual confusion.

In *Von Drehle Corp.*, an earlier Fourth Circuit case cited by G-P, G-P brought a nearly identical contributory trademark infringement action against Von Drehle ("VD"), the manufacturer of the towels sold by Myers. The trial court entered summary judgment in favor of VD on all G-P claims, finding no evidence of confusion. The Fourth Circuit overturned the summary judgment decision, holding that the trial court improperly limited the "likelihood of confusion" inquiry by failing to include the general public. The court held that the consumer surveys were sufficient evidence for a jury to find a likelihood of confusion. Furthermore, the court distinguished the accepted industry practice relied upon in the Eighth Circuit, noting that G-P intended to create a branded experience with the enMotion different from that of universal dispensers. G-P bolstered this intent by requiring enMotion lessees to use only G-P towels. The court vacated the decision and remanded the case, holding that G-P's bathroom user surveys were sufficient evidence for a jury to find actual confusion.

In contrast, in the the district court of the Eight Circuit, the judge entered summary judgment in favor of Myers, relying on evidence of an accepted industry practice of using one brand's towels in the dispensers of another and thus finding no confusion by bathroom users. G-P appealed, citing the Fourth Circuit's decision.

The Eighth Circuit affirmed the judgment entered by the district court, finding that the district court had properly held that the G-P's surveys—the same as those relied upon by the Fourth Circuit to reverse summary

judgment—were fatally flawed in that they presupposed that G-P’s mark was source-identifying. The Eight Circuit found that the court properly relied upon evidence establishing a widespread industry practice to disprove actual confusion.

IV. TRADE SECRET DEVELOPMENTS

A. *TEWARI DE-OX SYSTEMS, INC. V. MOUNTAIN STATES/ROSEN, L.L.C.*²³

The United States Court of Appeals for the Fifth Circuit held that although information disclosed in a published patent application was no longer a trade secret, a unique combination of elements previously disclosed by the owner could nonetheless constitute a trade secret.

Tewari De-Ox Systems, Inc. (“Tewari”) filed an action against Mountain States/Rosen L.L.C. (“MTSR”) alleging misappropriation of a trade secret that combined a unique combination of disclosed elements and the implementation process. In 2005, at MTSR’s request, Tewari shared with MTSR its zero parts-per-million meatpacking method. After Tewari and MTSR signed a nondisclosure agreement, Tewari’s President and CEO, Dr. Tewari, demonstrated his meatpacking method, allegedly revealing trade secrets. Tewari sued, stating that MTSR subsequently misappropriated those trade secrets, but MTSR moved for summary judgment on all of Tewari’s claims, alleging that Tewari did not have any trade secrets because the process was disclosed in a 2004 patent application. The district court denied summary judgment on MTSR’s argument that Tewari had no trade secrets, holding that “a patent application does not disclose a trade secret.”

MTSR then moved for reconsideration, arguing that disclosure in a patent application alone does in fact destroy a trade secret’s secrecy, and that the district court erred in finding otherwise. Upon reconsideration, the district court found that Tewari had disclosed its trade secret in its 2004 patent application, or that the alleged trade secret was already known in the industry. The court then held that Tewari had not raised an issue of fact as to the existence and use of a trade secret, since the primary difference between the 2004 patent application and the 2005 process disclosed to MTSR was “the 2005 process was merely a customization based on MTSR’s needs using MTSR’s equipment.” Accordingly, the district court then granted MTSR’s motion for summary judgment on all claims Tewari asserted against it.

23. 637 F.3d 604 (5th Cir. 2011).

The Court of Appeals held that the district court “incorrectly ruled that Tewari’s unique combinations of previously disclosed elements could not constitute trade secrets.” Under Texas law, which governs this case, “Trade secret misappropriation . . . is established by showing: (a) a trade secret existed; (b) the trade secret was acquired through a breach of a confidential relationship or discovered by improper means; and (c) use of the trade secret without authorization from the plaintiff.” The court looked to the Restatement of Torts to determine whether a trade secret exists, enumerating six factors: (1) the extent to which the information is known outside of the business; (2) the extent to which it is known by employees and others involved in the business; (3) the extent of measures taken to guard the secrecy of the information; (4) the value of the information to the business and to its competitors; (5) the amount of effort or money expended in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others. To assess the second and third elements of whether the trade secret was acquired by improper means, the appeals court stated that “[i]f what Tewari disclosed to MTSR was in fact a trade secret, it was disclosed in confidence pursuant to the NDA and MTSR’s later use, if any, constitutes a breach of that confidence.”

The Intellectual Property and Communications Omnibus Reform Act of 1999 allows publication after eighteen months of a patent application submitted after November 29, 2000. The appeals court noted that while no post-2000 Texas case addresses whether publication of a patent application eliminates the secrecy of its contents, “the weight of authority from other jurisdictions holds that it does.”

However, the appeals court held that the Fifth Circuit has “specifically rejected the contention that a combination of disclosed technologies cannot itself constitute a trade secret.” Since Tewari argued that its trade secrets were unique combinations of disclosed technologies or processes, the court held that the specific details such as the amount of chemicals used and the times and temperatures for cleaning the fasteners were protectable, even if the general process is public knowledge. Consequently, the Fifth Circuit held that a genuine dispute of material fact existed as to the existence of Tewari’s trade secrets and whether MTSR used those alleged trade secrets, and reversed the district court’s grant of summary judgment.

V. RIGHT OF PUBLICITY DEVELOPMENTS

A. *HABUSH V. CANNON*²⁴

A Wisconsin circuit court in Milwaukee County held that a law firm's use of two competing trial attorneys' names as keywords for the purpose of targeting advertisements in Google, Yahoo, and Bing search engines was an invasion of privacy, but that plaintiffs were not entitled to relief under Wisconsin Statute § 995.50 because the invasion was not unreasonable.

Plaintiffs Robert Habush and Daniel Rottier are personal injury lawyers and shareholders of the law firm Habush Habush & Rottier, S.C. Defendants William Cannon and Patrick Dunphy are also personal injury lawyers and shareholders of the competing law firm of Cannon & Dunphy, S.C. In 2009, Cannon & Dunphy, S.C. contracted with Google, Yahoo!, and Bing to be the first paid search result above the list of organic search results whenever a user queried for either "Habush," or "Rottier."

Plaintiffs argued that Cannon & Dunphy S.C. had invaded their privacy in violation of § 995.50, which prohibited "the use, for advertising purposes, or for purposes of trade, of the name . . . of any living person, without having first obtained written consent of the person." Plaintiffs sought to prevent defendants' continued use of "Habush" and "Rottier" as keyword terms for Internet searches. Defendants responded that the free speech provisions of the United States Constitution protected their conduct and that plaintiffs should be barred from seeking injunctive relief because the plaintiffs had engaged in similar conduct on other search engines such as YellowPages.com.

The court rejected defendants' First Amendment defense and held that using a computerized system to order search results was "not speech, commercial or otherwise." The court also rejected the "unclean hands" defense, distinguishing the advertisements for plaintiff's law firm as a subject-based rather than name-based free "throw-in" from the publisher for purchasing full-page ad on the back cover of the printed copy of the Yellow Pages.

The court then separated § 995.50 into four elements and held that defendants had satisfied each. First, the court found defendants "used" plaintiffs' names by running advertisements on queries for the names. Second, the court held that defendants purchase of ads on any query for plaintiffs' names amounted to use "for advertising purposes or for purposes

24. Case No. 09-CV-18149, 2011 WL 2477236 (Wis. Cir. Ct. June 8, 2011), *cert. granted*, 2012 WL 2345137 (Wis. Ct. App. June 21, 2012).

of trade.” Third, the court pointed to the undisputed fact that the keywords purchased by defendants were for the names of “living people.” Fourth, the court held that “clear consent” must be obtained “for the use sought by another,” and that plaintiffs had not consented to defendants’ use of their name.

Although the court held that defendants invaded plaintiffs’ privacy, the court found that the invasion was not unreasonable. First, the court found that while each plaintiff had an individual reputation, their names had gathered a dual meaning with the firm in which they were both shareholders, and the court held that defendants’ unreasonableness in using those names was diminished by the dual meaning. Second, the court held that potential customers were unlikely to be confused by the sponsored link purchased by defendants because web users have learned to be skeptical of web pages, and given the lack of plaintiffs’ names in the link text of defendants’ ad, users were unlikely to be confused and could easily return to the list of web results in the event of a brief confusion. Third, the court held that the frequent developments in Internet advertising were such that an injunction against purchasing sponsored links might prove unreasonable in the face of “the moving-target nature of the competitive landscape.” Lastly, the court rejected plaintiffs’ claim that defendants’ conduct was unethical, finding no support for this contention in any regulatory or judicial statement. Balancing its considerations, the court found that the defendants’ actions were not “irrational, lacking a rational basis, not guided by reason, or capricious,” and therefore could not be seen as unreasonable.

B. *JULES JORDAN VIDEO, INC. V. 144942 CANADA, INC.*²⁵

In *Jules Jordan Video, Inc. v. 144942 Canada, Inc.*, the Ninth Circuit held that an adult film star’s right of publicity claim under California law was preempted by the Copyright Act because the essence of the claim was that a distributor reproduced and distributed copyrighted DVD films without authorization.

Ashley Gasper, the plaintiff in the case, is an adult film actor who performs under the stage name Jules Jordan, and is the president and sole shareholder of Jules Jordan Video (“JJV”). Gasper brought suit in the U.S. District Court for the Central District of California, against 144942 Canada, Inc. d/b/a Kaytel Video Distribution, Leisure Time Video Canada, Inc., Alain Elmaleh, the principal shareholder of each of the corporate defendants, (collectively the “Kaytel defendants”), Jacky’s One Stop and other

25. 617 F.3d 1146 (9th Cir. 2010).

defendants. He alleged that defendants had copied and sold thirteen copyrighted adult DVDs, for which either JJV or Gasper owned the copyright or which featured Gasper's performances. The complaint alleged numerous violations but only the claims for copyright infringement for the replication and distribution of the said DVDs and violation of Gasper's right of publicity under California law were tried. At trial, Gasper argued that the Kaytel defendants misappropriated his name, persona and "dramatic persona" by copying and distributing his videos. The jury found that the defendants had violated Gasper's right of publicity and awarded damages for lost profits and punitive damages totaling approximately \$2.85 million dollars.

On appeal, the defendants argued that Gasper's right of publicity claim was preempted by the Copyright Act. The court used the two-part test laid out in *Laws v. Sony Music Entertainment, Inc.*, 448 F.3d 1134 (9th Cir. 2006) and found that the Copyright Act in fact preempted Gasper's claim. Under the first prong, the court held that because the rights are works of authorship fixed in a tangible medium of expression, Gasper's right of publicity claim does fall within the subject matter of copyright. Under the second prong, the court found that the rights Gasper asserted under California Civil Code § 3344 (the right of publicity claim) are equivalent to the rights within the scope of § 106 of the Copyright Act. For these reasons, the court held that his claims arise under the Copyright Act, reversed the district court's decision on the right of publicity claim and vacated the judgment against defendants.

At trial, the jury also found for Gasper/JJV on the copyright claims and awarded statutory damages, but the court granted defendants' motion for judgment as a matter of law. The court held that since Gasper was employed by JJV, JJV was the author of the motion pictures as works for hire under 17 U.S.C. § 101 and, therefore, Gasper did not have standing to try the claim. On appeal, the court held that the district court erred in holding that the motion pictures were works for hire, and reversed the court's grant of judgment as a matter of law. The court found that there was no dispute over ownership of the copyright because JJV was Gasper and JJV intended what Gasper intended and Gasper intended to keep his own "creative works" separate from his work for JJV and that he alone would have ownership over the copyright. The court said it would be "unusual and unwarranted" to allow a third party to invoke § 101 in order to avoid suit for copyright infringement where there was no dispute between the two potential owners.

Having concluded that the trial court erred in granting judgment as a matter of law, the appellate court reinstated the jury's verdict in favor of Gasper for copyright infringement. Although the trial court erred in allowing the plaintiff to read a number of requests for admission, it was still more

probable than not that the jury would have reached the same verdict even without that evidence because plaintiffs read ninety-nine equally damaging admissions that defendants did not and could not challenge on appeal.

VI. PRIVACY DEVELOPMENTS

A. FEDERAL TRADE COMMISSION CONSUMER PRIVACY REPORT²⁶

In December 2010, the Federal Trade Commission (“FTC”) issued a consumer privacy report (“report”), concluding that businesses’ attempts at self-regulation have been inadequate. The report proposed a framework of privacy guided by design, simplified choice, and greater transparency as the best way to protect consumers’ privacy. Aimed at guiding both policymakers and businesses, the framework is meant to inform the creation of new privacy laws and policies as well as the development of more effective company practice and self-regulation. Among its potential remedies, the FTC report proposed the implementation of a “Do Not Track” system, allowing users to permanently opt-out of being tracked or receiving targeted advertisements.

Online tracking of browsing habits and consumer behavior is currently collected, analyzed, and shared in ways that are not always transparent. Consumer data has become the currency of the digital marketplace and the FTC report found that while companies often use this information to create new and efficient products, they sometimes use the data invisibly and irresponsibly. Differences in consumer understanding, attitude, and behavior regarding the use of data present unique challenges in the regulation of online consumer privacy and existing regulations have struggled to keep up with the frequent iterations of technology used to collect and utilize consumer data. In response, the FTC’s investigation and resulting report produces a framework intended to apply broadly to all entities engaged in the collection and use of consumer data.

First, the report suggests that companies should incorporate privacy protections into their business practices. In response to unreasonable uses, the FTC suggests that companies collect only what is necessary, provide security for the data, and retain it only for the time required to achieve a business purpose—safely disposing of the data no longer in use. Furthermore, the report recommends that companies increase self-regulation

26. FED. TRADE COMM’N, PROTECTING CONSUMER PRIVACY IN AN ERA OF RAPID CHANGE: A PROPOSED FRAMEWORK FOR BUSINESSES AND POLICYMAKERS (Dec. 2010), *available at* www.ftc.gov/os/2010/12/101201privacyreport.pdf.

through training and employing personnel to internally oversee privacy issues and ensure new products and services receive a thorough privacy review.

Second, the report calls for simplified choice, proposing that businesses inform users when they enter situations that require them to make decisions regarding the tracking or use of their data. The report argues that this will be most effective if companies remove notices for commonly accepted practices such as fraud prevention and first-party marketing are removed, leaving only the situations that require informed and meaningful choices.

Chief among its remedies, the FTC supports the implementation of a “Do Not Track” system by which users could change a setting on their internet browser that would function as a permanent cookie or HTTP header. This would allow the browser to communicate the user’s choice not to be tracked or receive targeted ads to websites. The feature is already available as an extension for the Mozilla Firefox and Google Chrome browsers, but the FTC proposal would make it more readily understandable and accessible. The report cautions lawmakers that the system’s implementation must neither undermine the funds it provides to online content providers nor prohibit personalized advertisements many consumers find useful. A possible solution may be to allow users to affirmatively choose the types of advertisements they wish to receive.

Lastly, the report calls for increased transparency of company data practices. The report proposes a standardized system of reporting that is both clearer and shorter than the current system. Such a system would also require companies to provide reasonable access to the data they maintain and inform users when their data is used in a manner inconsistent with what was presented when originally collected. Furthermore, the FTC believes that stakeholders should embark on a broad campaign to educate the public about company data practices and the options available to consumers.

