Intellectual Property

2008 SUMMER BULLETIN

In This Bulletin

FENWICK & WEST LLP

District Court Holds Software Transfer Not a License, Okays Downstream eBay Auction Under First Sale Doctrine

BY MITCHELL ZIMMERMAN

Rejecting the authority of a trio of more recent Ninth Circuit cases on the ground that their holdings could not be reconciled with an earlier Ninth Circuit decision, a Washington District Court has held a transfer of computer software to represent a sale, not a license. *Vernor v. Autodesk*, 2008 WL 2199682 (W.D. Wash. May 20, 2008). Although an agreement with an earlier purchaser barred resale, and contract remedies would be available against that party, the agreement's "ban on transferring the software is of no consequence under the Copyright Act," ruled the Court, and the first sale doctrine allows a subsequent purchaser to auction the software on eBay.

Vernor sells goods on eBay. When he offered lawfully-made packages of Autodesk's AutoCAD software for sale, Autodesk sent eBay a DMCA take-down notice, claiming Vernor's sale would infringe its copyright, and eBay ended the auction. Vernor lodged a counter-notice, to which Autodesk did not respond. eBay reinstated the auction, and Vernor sold the Autodesk software. After this happened four more times in 2007, eBay suspended Vernor's eBay account for repeat infringement, and Autodesk threatened to "take further action" should Vernor attempt to continue to sell copies of AutoCAD.

Vernor possesses two further copies of AutoCAD which he wishes to sell. He sued for declaratory relief of non-infringement and for unfair competition.

Factual Background

The copies at issue were originally produced by Autodesk and transferred to an architectural firm, Cardwell/Thomas Associates ("CTA"), as part of the settlement of an unrelated dispute. The Settlement Agreement provided that CTA would adhere to an Autodesk Software License Agreement, which in turn granted only a "Non-transferable License to Use" the program, and expressly barred "transfer [of] all or part of the Software."

Since the copies at issue were lawfully made, if CTA (then Vernor) were deemed to be the "owners" of the copies, they would plainly be allowed — pursuant to the first sale doctrine — to sell their copies to others without thereby violating the copyright holder's distribution right. 17 U.S.C. § 109(a).

First Sale or License?

Autodesk's motion turned on its assertion that, because of the License, the transfer of AutoCAD packages to CTA was not a sale. Without a sale, there can be no "first sale." Or, phrased in the language of § 109(a), without a sale, CTA was not an "owner of a . . . copy" of Autodesk software. If CTA was not an owner within the meaning of the statute, Mr. Vernor was also not an owner within the meaning of § 109(a).

The court noted that "mere possession of a copyrighted copy pursuant to a license is not a sale, and thus not a basis to invoke the first sale doctrine."

The issue before the court, then, was whether a contract styled as the "Autodesk Software License Agreement" was a license or a first sale to CTA. Bright line rules do not distinguish mere licenses from sales, the court observed, nor is the title or label on the agreement determinative. Instead, the District Court was guided by a 30-year-old precedent, *United States v. Wise,* 550 F.2d 1180 (9th Cir. 1977).

Wise involved prints of motion picture films, not computer software, and that court considered a range of agreements, finding most of the movie prints agreements to be licenses but some sales. The *Vernor* court concluded:

> In comparing the transactions found to be sales in *Wise* with those that were not, the critical factor is whether the transferee kept the copy acquired from the copyright holder. When the film studios required that prints be returned, the court found no sale. When the studios did not require the transferee to return the prints, the court found a sale.

Based on this principle, and consistent with the specific details of the instances in which *Wise* found sales, *Vernor* held that *Wise* mandated the conclusion that the AutoCAD transfer to CTA was a sale.

So far, the district court's analysis appears to have been straightforward. The difficulty is this: *Wise* was the Ninth Circuit's last and only word on what constitutes a "sale" for purposes of the first sale doctrine. But it was not the Ninth Circuit's last or only word on what is a sale or license in other contexts, particularly involving computer software transfers. Three other, more recent cases considered the sales versus license issue in the context of § 117 of the Copyright Act, and concluded that contract terms comparable to those in *Wise* represented licenses and not sales: *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511 (9th Cir. 1993); *Triad Sys. Corp. v. Se. Express Co.,* 64 F.3d 1330 (9th Cir. 1995); *Wall Data Inc. v. Los Angeles County Sheriff's Dep't.*, 447 F.3d 769 (9th Cir. 2006).

Section 117(a) allows owners of computer software to make or authorize the making of a copy insofar as necessary for the use of the program in a machine—a recognition, basically, that one cannot use a purchased program without making at least one copy in a computer's random access memory. The well-known *MAI* decision held that the possessor of a program did *not* have the right to authorize an independent service organization to boot up a computer containing the program. *MAI* reasoned that this caused a copy to be made, and that the purchaser could not authorize the creation of that copy since the purchaser was a licensee, not an owner of the copy. Similarly, the courts in *Triad Systems* and *Wall Data* held software agreements styled as licenses not to be sales.

The *Vernor* District Court observed that none of the decisions cited *Wise,* and that—except to some extent in the case of *Wall Data*—the decisions embodied no analysis of the agreements at issue. Rather, they largely assumed the agreements at issue were licenses, not sales.

Finding no basis for distinguishing the *MAI* trio from *Wise*, the district court concluded they were in direct conflict, and considered itself bound to follow *Wise*. "Where opinions of three-judge Ninth Circuit panels conflict," the court noted, "the court must rely on the earliest opinion."

Importantly, the court did not consider the fact that there had been a "tsunami of technological change between the decisions in *Wise* and the *MAI* trio" to provide any basis to avoid the conflict between the decisions. First, public policy considerations should play no role, the court believed, in allowing a district court to decide which of conflicting circuit court decisions to follow. Second, those changes had no bearing (in the court's view) on the non-technological matter at issue: *Vernor's* right to sell a package of physical objects containing copies of copyrighted material.

Considering itself bound by *Wise* and only *Wise*, the court denied Autodesk's motion for summary judgment.

Lessons of *Vernor*

Three points are worthy of further consideration.

First, under *Vernor* and *Wise*, the distinction between a license and sale seemingly turns entirely on whether the transferee can keep or must return the copy. Various fairly onerous restrictions on use do not appear to make any difference, provided the transferee need not return the copy.

Second, let us consider what software vendors are to do if they conclude that they are in, or may face litigation in, a jurisdiction that chooses to follow *Vernor.* One possible fix might be a contractual requirement that the purchaser return the copy after, say, ten years, with perhaps an option to renew for another additional ten year term for one dollar. Since the "limited term" of lawful possession would generally exceed the useful life of nearly all programs, it is difficult to say whether a *Vernor-Wise* following court would regard the requirement as a subterfuge or as illusory. Nor is it clear whether terms like this are commercially feasible. (Incidentally, we note that an agreement to destroy the transferred copy at a certain time was held insufficient to make the transaction a sale, under *Wise,* so return does appear to be what is required.)

Finally, we should be clear on what *Vernor* did not decide. *Vernor* did not hold the "license" terms and limitations to be invalid or unenforceable as against a contracting party. Software end users who are deemed owners, rather than mere licensees, under *Vernor* still may be contractually constrained by the terms of their "sale" arrangements not to reverse engineer, to limit the number of users, or even not to transfer their copies — though they will apparently not have a copyright remedy if this last provision is breached. (Perhaps in some circumstances, then, this might be a reason to provide for liquidated damages regarding such breaches.) Of course, this may be of limited comfort to vendors, since a buyer who obtains a copy of a program from a seller who breaches such terms simply will not be bound by the license restrictions.

What of EULAs authorizing transfer of the entire program, providing no copies are made and (purportedly) "subject to" the original terms and conditions? Although the answer is far from clear, in light of *Vernor* it would appear dubious whether mere acceptance of a transfer constitutes a manifestation of assent to the original license, even if the new acquiree has actual knowledge of those terms.

It seems obvious that the Ninth Circuit should address the division within its own ranks over the license-sale issue, but it is not evident that this will happen any time soon. *Vernor* itself is now proceeding toward trial, and we do not know if it will ever get there, nor whether there will be an appeal, nor how a new panel of the Ninth Circuit would see the tension between *Wise* and the *MAI* trio, nor whether *en banc* review would ever be granted. Meanwhile, software companies and their high-tech lawyers will continue to do what we always have done: adjust again to shift in a climate still characterized by rapid change and high legal uncertainty.

Postscript: *UMG Recordings v. Augusto*. On June 10th, a district court in the Central District of California ruled on a similar license-first sale issue. UMG distributed CDs to music industry insiders for promotional purposes. The Promo CDs bore a purported license that barred resale or transfer of possession. Augusto came into possession of same Promo CDs and tried to sell them on eBay, occasioning a lawsuit similar to *Vernor*. Relying on *Krause v. Titleserv*, Inc., 402 F.3d 119 (2d Cir. 2005), as well as *Wise*, the district court held the transfer to be a gift or sale, not a license, on the primary ground that recipients had the right to possess the CDs in perpetuity. The court also held the transfer to be a gift under 39 U.S.C. § 3009, a section of the Postal Reorganization Act governing unordered merchandise sent through the mail. *UMG Recordings, Inc. v. Augusto*, 2008 WL 2390037 (C.D. Cal. June 10, 2008).

Effect of *KSR* on Obviousness Analysis of Chemical Compounds

BY PAULINE FARMER-KOPPENOL, M.S.

Since *KSR International Co. v. Teleflex Inc.*, 127 S. Ct. 1727 (2007), the Court of Appeals for the Federal Circuit has rendered several decisions in which the obviousness of a chemical compound was at issue. Patents for chemical compounds are at the core of patent protection for small-molecule drugs and therefore the impact of *KSR* on obviousness is important to the pharmaceutical industry at all levels — from start-ups to "big pharma." Prior to *KSR*, there was established case law addressing several obviousness scenarios unique to chemical practice. The Federal Circuit does not see the *KSR* decision as upending the established case law at issue in these particular disputes.

In *Takeda Chemical Industries, Ltd. v. Alphapharm Pty., Ltd.*, 492 F.3d 1350 (Fed. Cir. 2007), Alphapharm, a generic drug manufacturer, had filed an Abbreviated New Drug Application to make a generic version of one of Takeda's compounds, pioglitazone. As part of its defense against Takeda's infringement claims, Alphapharm argued that Takeda's patent on pioglitazone was invalid because a prior art compound, which differed only slightly from pioglitazone (identified as "compound b"), rendered pioglitazone obvious. Both compounds include a ring of five carbons and one nitrogen, a pyridyl ring. Compound b has a methyl group (a group containing only one carbon) at position 6 on the pyridyl ring. Pioglitazone has an ethyl group (containing two carbons) at position 5 on its pyridyl ring (one carbon over from position 6). Alphapharm contended that these changes were structurally obvious because they were examples of two practices common in the pharmaceutical industry: replacing one group with a similar group (methyl to ethyl) or homologization, and "ring-walking" the substituent group from position 6 to position 5 on the pyridyl ring. The district court, ruling before *KSR*, found that compound b was not an obvious choice to modify to make an antidiabetic because one of its side effects is weight gain. Weight gain, while generally undesirable, is even less so in diabetic patients. Additionally, compound b is toxic and therefore less suitable for treatment of chronic diseases, like diabetes. On appeal to the Federal Circuit, Alphapharm argued that the changes to get from compound b to pioglitazone were "obvious to try," citing the intervening *KSR* opinion. The appellate court, however, affirmed the lower court and upheld the validity of the Takeda patent. As part of its decision, the court pointed to the unexpected properties of pioglitazone. The toxicity and other side effects of compound b, the closest prior art, taught away from the claimed invention and so the prior art did not suggest modifying compound b either by homologization or ring-walking. Additionally, the possible alternatives to the original methyl in the 6 position were enormous. The court stated that therefore this was not the "obvious to try" situation contemplated by the Supreme Court in *KSR* because compound b's negative properties and the numerous substitutions from which to choose when replacing the original methyl group in the 6 position.

In *In re Sullivan*, 498 F.3d 1345 (Fed. Cir. 2007), the applicants for a patent claimed invention of a compound using portions of an antibody called "Fab fragments" to neutralize snake venom. During prosecution, the examiner had rejected the claims as obvious over references to using the entire antibody to neutralize snake venom and a reference that discloses a method of making the Fab fragments, using the Fab fragments to detect snake venom. Additionally disclosed in a prior art reference was that for the purpose of detecting snake venom, Fab fragments had similar results to whole antibodies. Additionally, the U.S. Patent and Trademark Office argued that this application was merely a new use for a known composition. The applicants had submitted declarations showing that there was evidence to suggest that Fab fragments would not work as well as whole antibodies for neutralizing snake venom and therefore, the fact that Fab fragments do indeed work to neutralize snake venom was an unexpected result. The Federal Circuit sided with the applicants, citing back to *In re Papesch*, 315 F.2d 381 (CCPA 1963) for the proposition that a compound and all of its properties are inseparable and so the unexpected property of the Fab fragments led to a use that was not just new but also unexpected.

In *Aventis Pharma Deutschland GmbH v. Lupin, Ltd.*, 499 F.3d 1293 (Fed. Cir. 2007), the compound in question was the drug ramipril, which has several different isomers. Isomers are compounds that share the same chemical formula but have different structure and potentially dramatically different properties. The isomers of ramipril are stereoisomers, which means that their structures differ in the configuration in space of the atoms attached to a central atom. Stereoisomers are distinguished by using R and S designations for each point, or stereocenter, in the molecule that leads to a stereoisomer. Ramipril has five such stereocenters.

Aventis had a patent on the form of ramipril where each stereocenter had the S conformation, known as 5S ramipril. Additionally, the claim included the limitation that it was substantially free of other isomers of ramipril. Ramipril generally is in the prior art. Therefore, the novelty of the Aventis claim was in 5S ramipril substantially free of the other isomers.

Aventis sued Lupin for patent infringement after Lupin, a generic manufacturer, filed an Abbreviated New Drug Application for a generic version of ramipril. Seeking to invalidate the Aventis patent, Lupin argued that it was obvious to separate a mixture of ramipril isomers to get purified 5S ramipril. The district court, ruling prior to the *KSR* decision, decided in favor of Aventis, finding that there was no teaching, suggestion or motivation to separate the isomers in a mixture to produce pure 5S ramipril. The Federal Circuit, ruling after *KSR*, found that the district court had applied the teaching, suggestion or motivation doctrine too rigidly, as *KSR* warned against doing. Citing *KSR,* the Federal Circuit explained that it was only necessary to show "some articulated reasoning with some rational underpinning to support the legal conclusion of obviousness." The court then cited a 1978 U.S. Court of Customs and Patent Appeals (CCPA) ruling for the proposition that if it is known that a desirable property of a mixture is due to one of the components of that mixture, then purifying that one component is obvious even if there is no explicit teaching to separate the mixture and purify that one component. The court also cited to CCPA decisions from 1960 and 1938 in which purified components from known mixtures were held to be obvious. While the Federal Circuit found that the district court had erred in its application of the teaching, suggestion or motivation doctrine, the court additionally cited to pre-*KSR* decisions in support of its reversal of the district court.

More recently, in *Ortho-McNeil Pharmaceutical, Inc. v. Mylan Laboratories, Inc.* 520 F.3d 1358 (Fed. Cir. 2008), the Federal Circuit affirmed the validity of Ortho McNeil's patent on the epilepsy drug, topiramate. Mylan Laboratories had filed an Abbreviated New Drug Application to market a generic version of topiramate and Ortho McNeil sued for patent infringement in response. As part of its defense, Mylan argued that the Ortho patent was invalid due to obviousness. Topiramate was invented as part of a research program to develop drugs that are FBPase inhibitors for treatment of diabetes. Topiramate was an intermediate compound made in the synthesis of an FBPase inhibitor. Mylan, relying on *KSR,* argued that it was obvious to try to build drugs that are FBPase inhibitors for the treatment of diabetes. The court however found that Mylan's expert was viewing the research pathway with hindsight and that it would not have been obvious at the time of the invention because there were so many different possible starting compounds and different pathways to produce the desired compound. While the court acknowledged *KSR*'s warning against rigid application of the teaching, suggestion or motivation doctrine, the court pointed to its own post-*KSR* decision stating that a TSM test, flexibly applied, is necessary to avoid hindsight analysis. *In re Translogic Tech., Inc.* 504 F.3d 1249 (Fed. Cir. 2007). The court also noted that in order for topiramate to be obvious, it would have had to have been obvious to stop at this intermediate compound in the synthesis and test it for anti-convulsive properties.

While *KSR* is casting a new hue on obviousness analysis also for chemical compounds, these early cases seem to indicate that pre-*KSR* caselaw continues to be relevant and applied by the Federal Circuit. Patent practitioners are likely to find that while new compounds claims are more likely to withstand obviousness challenge, optimization claims to different salt forms, excipients, dosages, and the like are likely to be rejected or invalidated for obviousness. However, the effect of *KSR* and subsequent Federal Circuit cases to claims to new administration forms or new combinations is harder to predict, and their validity is likely to depend on showing unexpected results, such as synergy or superior therapeutic efficacy.

Quick Updates

Trademarks in Meta-tags: Heard, But Not Seen

The Eleventh Circuit recently decided that use of a competitor's trademark in meta-tags is use in commerce for purposes of trademark infringement. *North American Med. Corp. v. Axiom Worldwide, Inc.*, 522 F. 3d 1211 (11th Cir., 2008). The court found it was a use in commerce because, although the trademarks were not viewable by website visitors, they still influenced search engine listings.

Meta-tags are words and phrases embedded within a webpage's computer code that provide information about the webpage, such as who created the webpage, when it was updated, and which keywords best describe page content. A typical website visitor does not see the meta-tag data, but the information is used by some search engines to find, describe, or sort relevant websites. It is common for companies to list competitor names or products in their meta-tags in order to influence search hits for their website.

Axiom Worldwide (Axiom) did just that, inserting two of North American Medical's (NAM) trademarks, ACCU-SPINA and IDD THERAPY, in its webpage meta-tags. A Google search using either of NAM's trademarks listed NAM as the most relevant website, but also listed Axiom as the second most relevant website. Google's search results also displayed a short description of Axiom's website pulled from the meta-tags, which included NAM's trademarks. NAM sued Axiom for trademark infringement and other related claims. The District Court for the Northern District of Georgia enjoined Axiom from various behaviors, including use of NAM's trademarks in meta-tags, and Axiom appealed.

Axiom, analogizing this case to the *1-800 Contacts* case, argued that use of a competitor's trademarks in meta-tags is not use in commerce because a consumer never sees the marks. *1-800 Contacts, Inc. v. WhenU.com, Inc.*, 414 F.3d 400 (2d Cir. 2005). In *1-800 Contacts*, the defendant reproduced the plaintiff's website address, which was similar but not identical to the plaintiff's trademarks, in a place inaccessible to consumers. The defendant did not reproduce or display plaintiff's actual trademarks at all, nor did it cause the trademarks to be displayed to consumers. Accordingly, the Second Circuit decided that defendant's "invisible" use of the plaintiff's website address was not "use" in commerce of a trademark for purposes of trademark infringement. The Second Circuit reasoned that internal utilization of another's trademark in a way that does not communicate it to the public does not violate trademark law, because trademark law is intended to prevent consumer confusion; if a consumer does not see the use of the mark, the consumer cannot be confused.

In *Axiom*, the Eleventh Circuit, critical of the reasoning in *1-800 Contacts,* noted that, unlike in *1-800 Contacts*, Axiom actually used NAM's trademarks and caused them to be seen by consumers in the search result description of Axiom's website. The court found that Axiom was listed second in search results for NAM's trademarks because those trademarks were listed in meta-tags and therefore had a causal relationship with search results. This use of NAM's trademarks by Axiom was part of an effort to promote and advertise its own competing products on the Internet, and therefore it constituted "use" in commerce for the purpose of trademark infringement.

Importantly, the court explained that the fact Axiom did not visibly display NAM's trademarks on the webpages was not relevant in deciding whether there was use of the trademarks in commerce, although that fact would be relevant for other elements of trademark infringement, such as likelihood of confusion. The court expressly noted that its holding was narrow and specific to the facts in this case and conceded that a defendant may have a legitimate reason to use another's trademarks in meta-tags, such as explicit comparative advertising.

Ultimately, the Eleventh Circuit reversed the preliminary injunction granted by the district court and remanded for a review of whether NAM would suffer irreparable harm without the removal of the meta-tags. It is unclear whether other courts will follow the Eleventh Circuit's ruling, but until then, website owners might want to check for and reconsider the use of trademarks owned by others in meta-tags.

Neville v. Chudacoff's Guidance on Notifying Customers That Someone Has Stolen Your Secrets

California employers face tricky rules regarding their pre-litigation ability to notify customers of a departed employee's bad acts. Employers wish to avoid sparking counterclaims for defamation or interference with the employee's new business prospects. While such counterclaims are often struck down under California's Anti-SLAPP law—which allows defendants to dismiss claims seeking to chill the exercise of constitutional free speech rights, including writings in connection with a civil litigation—there has been no magic line demarcating which pre-litigation customer communications are "safe" from counter-suit. However, a recent California Court of Appeal decision has provided some guidance on where such a line should be drawn.

In *Neville v. Chudacoff*, 160 Cal. App. 4th 1255 (2008), a California employer terminated an employee in December of 2004 for allegedly misappropriating customer lists and soliciting customers to start a competing enterprise. Several months later, in May of 2005, the employer's in-house counsel sent a letter to its customers notifying them of these accusations. The letter further expressly indicated that the employer intended to commence litigation against the former employee and suggested that customers should refrain from doing business with the former employee to avoid potential involvement in the ensuing litigation. When the employer then filed its suit in September 2005, the employee filed a cross-complaint for defamation.

The Court of Appeal held that, even though litigation had not yet commenced at the time the letter was sent and, in fact, was not filed until four months after that letter, the letter constituted a communication "in connection with an issue under consideration or review by a judicial body," within the meaning of California's Anti-SLAPP statute. The letter fell within the statute because (1) it directly related to the employer's claims against the employee, and (2) the employer was "seriously and in good faith contemplating litigation" against the employee. Because the former employee failed to show a likelihood of success on the merits the court granted the employer's motion to strike the defamation claim.

California district courts have already followed *Neville*, including most recently in *American National Red Cross v. United Way California Capitol Region*, No. Civ. S-07-1236, 2008 U.S. Dist. LEXIS 43055 (E.D. Cal. May 30, 2008). There, the parties were in ongoing negotiations regarding lease disputes, and the Red Cross filed suit in June of 2007. The United Way counterclaimed for tortious interference based on statements that the Red Cross had made several months earlier regarding the validity of United Way's property ownership options. The district court determined that the Red Cross's statements since February of 2007 were "in connection with an issue under consideration or review by a judicial body" for a suit later filed in June of 2007. The limited factual record before the Court in making this determination is interesting: the Red Cross had submitted a declaration regarding the starting period of its good faith contemplation of litigation and, with little else apparently on the record, the Court found there was no reason to doubt such anticipation. As in *Neville,* because the counterclaimant in turn could not show that they would have succeeded on the claim, it was properly stricken.

While the safe zone of pre-litigation customer contact will never be certain, *Neville* has set forth important guidelines for when such communications might be permitted and what they should convey, which should always be subject to counsel's advice.

Congress Mulls New Copyright Provision

On June 11, 2008, the House Subcommittee on Courts, the Internet and Intellectual Property held hearings on proposed legislation that would extend the copyright law's performance right to radio broadcasts of sound recordings. Witnesses representing musicians testified that such a new right was needed to close a "loophole" under which radio stations did not have to pay their "fair share" to copyright holders. A 1995 amendment to the Copyright Act made digital radio transmissions subject to the performance right. However, several attempts to extend the right to traditional analog radio have failed. Now, bills are pending in both the House (H.R. 4789) and the Senate (S. 2500) to make all audio transmissions of sound recordings subject to a performance right.

When introducing the legislation late last year, Representative Howard Berman of California explained that songwriters and music publishers "rightly do get paid when their song is played on the radio, but the artist whose voice or musical talent brings in the ad revenue for the station never receives a penny from the station." Representative Berman explained that broadcasters in almost all other countries in the world pay such a performance right, "except for China, Iran, North Korea, and Rwanda." He also explained that cable, satellite and Internet radio services already pay a fee determined by the Copyright Royalty Board for a statutory license to broadcast music, and the proposed legislation would simply extend that to terrestrial broadcasters such as AM and FM radio stations.

In the June 11 hearings, Nancy Sinatra testified on behalf of recording artists by asking the rhetorical question, "Why is the broadcasting exemption allowed to rob us of our hard-earned income?" Thomas Lee, president of the American Federation of Musicians and speaking on behalf of a number of other musicians' groups, said, "Radio is not the only industry that uses recorded music to make money. But it is the only one with a free pass to pay performers nothing. That's unfair any way you cut it."

Understandably, the broadcast industry witnesses weighed in with a very different point of view. They asserted that the performance right revenue would, under typical recording contracts, go not to the artists themselves but to record companies. In their view, the proposed legislation is little more than the recording industry's search for "new revenue streams to make up for" the losses it has suffered with the emergence of digital technologies. Broadcaster Charles Warfield testified that, "Prior to 1995, U.S. copyright law did not recognize any right of public performance in sound recordings," and explained that the advent of digital broadcasting brought about "very specific concerns about copying and piracy issues." Warfield bluntly characterized the issue as follows: "The simple reality is that broadcasters are not responsible for the financial woes of the recording industry."

Indeed, it will be telling if Congress passes in 2008 legislation extending performance rights to technologies that have been around for nearly a century—almost from the birth of audio transmission via radio waves. Commentators suggest that such a move would not fix a longstanding inequity, but would instead signal a continuing expansion of copyright law. As reported in the Winter 2008 edition of this publication, Canada is also currently struggling with the decision of whether to expand its copyright protection in what some have been calling the "U.S. style," or to resist the trend and maintain its current balance between the rights of copyright holders and those of users.

Lost Profits May Not Be Available to Parent Corporations Who License Patents to a Subsidiary

The Federal Circuit recently held that a parent company could not recover its lost profits for infringement of a patent when the patent was licensed by a wholly owned subsidiary. *Mars, Inc. v. Coin Acceptors, Inc.*, No. 2007-1409, -1436, 2008 WL 2229783, 2008 U.S. App. LEXIS 11707 (Fed. Cir., June 2, 2008). Plaintiff candy manufacturer, Mars, Inc., held a patent that covered technology to allow vending machine coin changers to recognize and authenticate different denominations of coins electronically. Mars did not manufacture the vending machine coin changers, but licensed the patent to its wholly owned subsidiary, Mars Electronics International, Inc. (MEI). The parent maintained consolidated financial statements that reflected the profits, losses, assets, and liabilities of all of its subsidiaries, including MEI. The licensing agreement entitled Mars to a certain percentage of the MEI's gross sales, regardless of whether the MEI made a profit.

Mars sued Coin Acceptors, one of the subsidiary's competitors, alleging that Coin Acceptors infringed its patent. During the lawsuit, Mars sought to recover profits it had lost as a result of Coin Acceptors' alleged infringement. The district court did not allow Mars to seek its lost profits and the parent appealed that decision to the Federal Circuit.

In general, a patent holder is allowed to recover the lost profits of another entity when those profits would have flowed inexorably to the patent holder. Mars argued that the financial statements consolidating Mars with all of its wholly owned subsidiaries, including MEI, showed that Mars would have ultimately received any of MEI's profits. Any profits of its subsidiaries would be reported as profits of the parent, under Mars' reasoning.

The Federal Circuit rejected this reasoning. The court looked instead to the licensing agreement between Mars and MEI. The court reasoned that, since Mars received only a royalty payment based on gross sales of MEI, Mars was never entitled to MEI's profits. Therefore, it could not have lost any profits by the defendant's infringement. Accordingly, the court denied that Mars was entitled to lost profits and, instead, limited Mars to a reasonable royalty based on Coin Acceptors' infringement.

The court's decision is not surprising given the general requirement to prove "but for" causation to establish lost profits. However, it is a warning to companies that split manufacturing and patent ownership between multiple corporate entities to carefully consider their internal licensing arrangements. Companies cannot rely on the mere fact that their profits and financials for related entities are consolidated. In order to establish lost profit damages, the patent-owning entity has to show that it was entitled to receive the profits from the manufacturing entity. Since the court's decision in this case turned on the specific terms in the licensing agreement between a parent and subsidiary, the decision may prompt companies that split manufacturing and patent ownership between multiple corporate entities to reexamine their agreements.

Fenwick
FENWICK & WEST LLP

Intellectual Property Bulletin Editorial Staff

Staff Editor	Stuart P. Meyer
Assistant Editors	Jennifer R. Bush
	Christopher D. Joslyn
Article Contributors	Pauline Farmer-Koppenol, David M. Lacy Kusters, Candace J. Morey, Rachael G. Samberg, Karen A. Webb, Mitchell Zimmerman

Fenwick & West LLP Practice Groups

Intellectual Property

David L. Hayes	*Chair*
Sally M. Abel	*Chair, Trademark Group*
Ralph M. Pais	*Chair, Technology Transactions Group*
Mark Ostrau	*Co-Chair, Antitrust Group*
John T. McNelis	*Chair, Patent Group*
Mitchell Zimmerman	*Chair, Copyright Group*
Roger R. Cole	*Chair, Trade Secret Group*

Litigation

Darryl M. Woo	*Chair*
Tyler A. Baker	*Co-Chair, Antitrust Group*
Patrick E. Premo	*Chair, IP & Technology Litigation Group*
Laurence F. Pulgram	*Chair, Copyright Litigation Group*
Charlene M. Morrow	*Chair, Patent Litigation Group*
Jedediah Wakefield	*Chair, Trademark Litigation Group*
Roger R. Cole	*Chair, Trade Secret Litigation Group*
Vic Schachter	*Chair, Employment Practices Group*

Corporate

Daniel J. Winnike	*Chair*
Douglas N. Cogen	*Co-Chair, Mergers & Acquisitions Group and Private Equity Group*
David W. Healy	*Co-Chair, Mergers & Acquisitions Group*
Horace L. Nash	*Chair, Securities Group*
Scott P. Spector	*Chair, Executive Compensation & Employee Benefits Group*
Mark C. Stevens	*Co-Chair, Private Equity Group*
Richard L. Dickson	*Chair, Start-Ups and Venture Capital Group*

Tax

David L. Forst	*Chair*
Kenneth B. Clark	*Chair, Tax Litigation Group*

Fenwick & West's Intellectual Property Group offers comprehensive, integrated advice regarding all aspects of the protection and exploitation of intellectual property. From providing legal defense in precedent-setting user interface copyright lawsuits to prosecuting software patents and from crafting user distribution arrangements on behalf of high-technology companies to implementing penetrating intellectual property audits, our attorneys' technical skills enable the Firm to render sophisticated legal advice.

Offices

801 California Street
Mountain View, CA 94041
Tel: 650.988.8500

555 California Street, 12th floor
San Francisco, CA 94104
Tel: 415.875.2300

1191 Second Avenue, Suite 1610
Seattle, WA 98101
Tel: 206.389.4510

950 Bannock Street, Suite 850
Boise, ID 83702
Tel: 208.331.0700

www.fenwick.com

We appreciate your feedback!
If you have questions, comments, or suggestions for the editors of the IPB, you can e-mail them to IPB@fenwick.com.

For subscription requests and address changes, please e-mail IPB@fenwick.com.