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Best Practices for Defending Against Patent Trolls

Today's companies face a business reality rarely encountered by their predecessors: "patent trolls." There is much debate over what constitutes a patent troll, but by most definitions, patent trolls are patent owners that do not make or sell patented inventions, and instead enforce their patents through infringement lawsuits to generate revenue in the form of license fees gained through settlements or jury awards. These companies, also sometimes less pejoratively referred to as "patent-holding companies" or "non-practicing entities" (NPEs), with business models centered on litigation rather than competition, are unsavory to many. But some "trolls" were once operating companies in their markets, and now seek to monetize their intellectual assets. Under any name, patent trolls have become a prominent fixture on today's intellectual property landscape. While every case is unique, Quinn Emanuel's extensive experience litigating against patent trolls has revealed effective defense strategies.

Proactively Responding to a Troll's Initial Demand

Patent trolls often fire the first shot with a letter "inviting" a potentially infringing company to consider paying for a license. The opening salvo in any form should be taken seriously and responded to thoughtfully. Ignoring the letter is ill-advised, as a judge or jury will likely hear how the defendant was put on notice of its infringement, but couldn't be bothered to respond. A better practice is to respond directly, affirming one's respect for intellectual property rights and commitment to innovation, and requesting more information. Asking a troll to identify infringing products, to explain element-by-element why it believes there is an infringement, and to provide prior licenses to its patents will aid a defendant's analysis and may provide some free discovery not otherwise available until litigation ensues. It may also buy some time to begin preparing one's case. If the troll refuses to respond, this could give rise to an estoppel defense. In our experience, trolls who are not fully invested

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The Lawyer Names Quinn Emanuel 2011 "International Law Firm of the Year"

THE LAWYER AWARDS 2011 WINNER In association with TRAVELERS International Law Firm of the Year

The Lawyer Magazine, the London legal news magazine, recognized Quinn Emanuel Urquhart & Sullivan, LLP as the "International Law Firm of the Year" at *The Lawyer* awards banquet in London on June 21, 2011. Quinn Emanuel's London office launched only three years ago, making this recognition particularly remarkable. *The Lawyer* accepted nominations from in-house counsel and submissions from international firms of any jurisdiction. The judging panel consisted of current in-house general counsel, former law firm managing partners and Queen's Counsel. The selection criteria were strategic vision tailored to an international client base, consistent delivery of outstanding client services, significant case wins and strong international management. Quinn Emanuel was recognized for successfully implementing the firm's business litigation only strategy internationally. Q

Quinn Emanuel Named to "Appellate Hot List" by *National Law Journal*

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Quinn Emanuel Bankruptcy Partner Benjamin Finestone Named Outstanding Young Restructuring Lawyer

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in their causes will simply go away when faced with a response that shows commitment to defending the case.

When a troll persists, companies accused of infringement should insist on entering a non-disclosure agreement to facilitate communication. Recent cases have suggested that, without extra protections, negotiations over settlement agreements may be discoverable in litigation, as evidence of a reasonable royalty. *See ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 871-72 (Fed. Cir. 2010); *Tyco Healthcare Group LP, et al. v. E-Z-EM, Inc., et al.*, Case No. 2:07-CV-262 (TJW) (E.D. Tex. March 2, 2010) (ordering discovery of settlement negotiations and holding that based on *ResQNet*, a privilege no longer protects settlement negotiations from discovery).

Making an early judgment call about whether the troll's demands have merit and assessing the risk of litigation is crucial. At least three decision-makers, one who knows the technology, one who knows the sales and marketing of the accused products, and a lawyer, should review the demand letter and assess the strength of the accusations and their impact on the business if proven in court. A company's lawyers should implement a "document hold" to preserve potential evidence and avoid the risk of sanctions for not doing so. Quickly preparing for litigation often helps facilitate an early and favorable resolution.

Knowing Your Enemy

Not all NPEs are created equal. Knowing your adversary, and its lawyers, is essential. Researching who the company is, how many patents they own and have licensed, whether they have any other assets or operations that may be vulnerable to counterclaims, how often they have taken their claims to trial, and what type of settlements they have worked out in the past all provides insight into resolving a case. A start-up NPE with only a few patents may be less willing to risk its limited resources in litigation. An experienced NPE with a large portfolio may be more willing to tolerate a measure of risk with the hope of obtaining a large award. Developing an effective strategy also depends on understanding an NPE's business model. NPEs may target many defendants to accumulate many small license fees, seek larger fees from a smaller number of defendants, or look for a homerun by targeting just a handful of companies for multi-million dollar settlements or damages awards. The quality and track record of the NPE's selected counsel, and whether they typically charge hourly or on contingency, may also reflect the investment the NPE is prepared to put into its case. Using discovery, once it begins, to uncover a troll's prior licenses and settlements permits the prepared defendant to bargain for a better deal, or at least an equally favorable deal, compared to others. Knowing which routes an NPE usually follows is a useful guide in developing an opposition strategy.

Knowing Your Enemy's Weapons

NPEs assert patents of varying strengths. Candidly reviewing each asserted patent and its applicability to a product or method accused of infringing obviously informs litigation strategy. Whether the patent at issue already has been tested – in litigation or other legal proceedings, like reexaminations before the Patent Office – may be an indicator of the strength of the case. If the NPE is asserting a patent for the first time, it may be willing to offer a better licensing deal to early licensees. And if the patent has not yet been tested in litigation and has not yet survived challenges to its validity, a vigorous attack on the patent itself in view of the prior art may expose new vulnerabilities.

Fighting on Your Own Turf (or at Least the Most Favorable Turf)

One of the most important influences on outcome is venue. Although plaintiffs generally select their preferred courts in which to file suit, companies accused of infringement usually have options to secure a more favorable forum. If an NPE has been threatening litigation but has not yet filed suit, an accused infringer may start the litigation and pick the battlefield by seeking a declaratory judgment (of non-infringement or invalidity) in a court of its choice, such as its home state or a locale where it enjoys name recognition and a positive reputation. NPEs often prefer forums with historically short times to trial, such as the Eastern District of Texas and the Eastern District of Virginia, although recent increases in time to trial in Texas may be changing the calculation. *See* PriceWaterhouseCoopers, A Closer Look: Patent Litigation Trends and the Increasing Impact of Nonpracticing Entities, 17 (2009). Speed is valuable to NPEs, and especially to counsel representing them on contingency, because it lessens legal fees and shortens the time to secure a settlement or verdict. The Eastern District of Texas is a popular venue choice for NPEs because of a perception that it is both friendly to plaintiffs and moves cases to trial quickly.

Even when an NPE has already filed suit in a preferred forum, the battle for venue is by no means over. A growing body of case law has made clear that if a defendant does not have significant ties to the venue, and another court is clearly better situated to try the case, transferring venue may be in order. Recent decisions from the Federal Circuit have eased the requirements for venue transfer and given defendants new ammunition when attempting their cases to more appropriate venues. The shift began with *In re TS Tech USA Corp.*, 551 F.3d 1315 (Fed. Cir. 2008), in which the Federal Circuit reversed the denial of a transfer motion by a trial judge in the Eastern District of Texas. The Federal Circuit held that the trial court had erred in its weighing of the factors for and against transfer. *Id.* at 1320-21. The district court gave too much deference to the plaintiff's choice of venue by treating it as a separate factor weighing against transfer and gave insufficient weight to the inconvenience to witnesses, ease of access to evidence, and the localized interests of the transferee venue. *Id.* The deference some trial courts had given plaintiffs' choice of venue was further eroded the following year by *In re Genentech, Inc.*, 566 F.3d 1338 (Fed. Cir. 2009), in which the Federal Circuit ordered transfer to the Northern District of California because many of the witnesses and much of the physical evidence was in California and none was in the Eastern District of Texas. *Id.* at 1344-46. These decisions have made it easier for some defendants to transfer cases out of the Eastern District of Texas – particularly where the evidence and witnesses are located elsewhere. *See, e.g.*, *In re Microsoft Corp.*, 630 F.3d 1361 (Fed. Cir. 2011) (granting transfer when Plaintiff's presence in Texas was established solely for litigation).

Fighting with the Right Platoon

NPEs often name as many defendants in a case as possible to try and defeat potential venue transfer motions (by naming defendants located throughout the country and some in Texas) and to exploit potential conflicts in claim construction, non-infringement, discovery and other strategic issues. However, defendants can take advantage of being sued together in a number of ways. Most familiar, defendants can pool resources in a joint defense group and share fees and costs associated with common work, such as claim construction, invalidity, and discovery of the NPE. Defendants may also be able to achieve more favorable settlements as members of a group than they would otherwise obtain on their own.

It does not always make sense for defendants to stay together in a group, however. Another important strategic move can be to move to sever one's case from other defendants who are uncooperative or have different interests, often in connection with a motion to transfer, or a motion to sever under Federal Rule of Civil Procedure 21. There is a current strand of thought in the Federal Circuit and elsewhere that multi-defendant patent cases are actually a violation of Federal Rule of Civil Procedure 20, which outlines what parties may be joined as defendants in a single action, and many companies view misjoinder motions as a way of gaining some control over large multi-defendant patent suits. Severing a case may also give an individual defendant greater control of strategy, can avoid conflicts, and may result in another defendant's case being resolved first, providing a preview of litigation developments.

Counterattacks

It is a common misconception that typical trolls have no exposure to liability in the patent lawsuits they file. But patent litigation provides defendants with an opportunity to target an NPE's most valuable assets, often only assets, its patents, by proving their invalidity or unenforceability. Focusing on ownership and assignment has also been an effective strategy for many defendants involved in litigation with patent trolls. Proving improper assignment through different entities, co-ownership of patents through divorce proceedings, or improperly identified inventors are some ways that defendants have turned the tables on patent trolls. Defendants also should pursue all available discovery that could uncover invalidating prior art or activity. Not just deposing the inventors, but also seeking evidence from them, their current or former employers, co-workers, and consultants, to name a few, may reveal helpful prior art or evidence of invalidating public disclosure or early sale of the patented inventions. Aggressive and creative discovery by the defense often exposes invalidity issues that trolls failed to anticipate before filing suit.

Defendants also should seize every opportunity to exploit behavior by an NPE that could subject it to counterclaims. For example, abusing the patent system or engaging in monopolistic practices may subject NPEs, even those that do not compete in the marketplace, to serious counterclaims. *See, e.g., Senza-Gel Corp. v. Seiffhart*, 803 F.2d 661, 667-68 (Fed. Cir. 1986) (finding patent misuse). And NPEs who are overly aggressive in their pre-litigation tactics and communications with potential infringers and their customers may find themselves subject to claims for wrongly interfering with business relationships. *See, e.g., Enzo Life Sciences, Inc. v. Digene Corp.*, 295 F. Supp. 2d 424, 429-30 (D. Del. 2003). Thinking creatively, and outside the context of traditional patent defenses, can help the thoughtful defendant apply unexpected litigation pressures. Few NPEs are

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prepared to have their role as plaintiff reversed and take on the burden and expense of defending against counterclaims, which may provide valuable leverage.

Proceedings in the Patent Office

Initiating proceedings before the Patent Office to reexamine the validity of a plaintiff's issued patent can be a valuable tool that impacts litigation. For example, some – but far from all – courts may be persuaded to stay their proceedings pending the outcome of a reexamination, providing a respite from the expense of litigation. The extra burden and risk to a plaintiff whose patent is being reexamined for validity may factor into a potential settlement. But reexaminations carry potential risks and should be used very carefully. If the Patent Office confirms in reexamination that the patent is valid, and the patent emerges from the proceedings unscathed, the NPE may well be in a stronger position than before the reexamination, its patent now battle-tested. With an *ex parte* reexamination, where a third party (often the defendant in litigation) initiates but does not participate in the reexamination, if the Patent Office does not narrow or invalidate the claims, the patent may appear more legitimate in litigation, especially since the NPE will most certainly have provided the Patent Office all of the prior art produced by the defendants in the lawsuit, "washing" that art in the eyes of the judge and jury. With an *inter partes* reexamination, where a third party initiates and also participates in the reexamination, the risks are even greater. Although the initiating party is allowed to participate in the *inter partes* proceeding, the cost for that participation is that the initiating party may be estopped in litigation from challenging patent claims on invalidity grounds that were or *could have been raised* in the course of an *inter partes* reexamination. In the end, a successful reexamination that invalidates or narrows a patent's claims can be an effective way to weaken the position of an NPE, but the decision to file for reexamination depends on a careful consideration of the specific facts and circumstances surrounding the case, including whether a particular judge is likely to stay proceedings pending the reexamination.

Major Patent Case Milestones

Another important strategic decision involves when to request a claim construction hearing. An early interpretation of the patent's claims is often advantageous to defendants because a positive defense construction (for example, a narrow construction that avoids infringement or a broad construction that supports an invalidity argument) may undercut an NPE's theory of the case. At a minimum, the parties have more clarity as to the direction of the case once the meaning of disputed patent claim terms is resolved. Because the discovery burdens typically weigh far more heavily on defendants than plaintiffs in patent cases, having claim construction issues resolved early and before much discovery takes place can effect significant savings in costs and legal fees. Some courts, recognizing that claim construction can be case dispositive, may also stay fact discovery until claim construction is resolved.

Early summary judgment on non-infringement or invalidity can also save defense costs by bringing about a swifter resolution. Summary judgment also keeps the cases out of the hands of juries, where NPEs tend to have far higher success rates than they do at the summary judgment stage. *See* PriceWaterhouseCoopers, at 12.

Trial Themes

A clear and compelling trial theme is as important to winning a case against an NPE as any other. The contrast between NPEs who simply collect patents without contributing valuable products or technology to the marketplace, on one hand, and companies that through innovation and entrepreneurialism bring new products to market, on the other, often resonates with juries. On the other hand, NPEs often attempt to present themselves as the everyman "David" against "Goliath" corporations, and defendants in such cases are well served by personalizing their case with human interest stories about the individuals who independently created new technology now accused of infringement. Arriving at universal trial themes early in a case helps separate the important from the irrelevant throughout the litigation, and humanizes the story before a judge and jury, setting the framework for a winning defense.

Conclusion

Developing an effective defense against a troll requires understanding the themes common to NPE cases and tailoring the strategies to the specific characteristics of a particular adversary. Patent trolls or NPEs, a reality of today's business climate, must be taken seriously and an informed and comprehensive litigation strategy can maximize the opportunity for a successful resolution. Q

London Litigation Update

***CDO Misselling*:** In *Cassa di Risparmio della Repubblicca di San Marino SpA* ("CRSM") *v. Barclays Bank Ltd* ("Barclays"), Case No: 08-757, High Court of Justice, Queen's Bench Division, the court provided a clear summary of the legal principles that apply in CDO misselling claims, particularly if contractual disclaimer is at issue. Barclays sold CRSM four sets of AAA-rated, credit-linked notes (the "Notes") in 2004/early 2005 having a total face value of €406 million. The Notes matured in 5 to 7 ½ years. In exchange for the principal value of the Notes, CRSM received a coupon for approximately Euribor + 0.95 %. CRSM's central claim was that although Barclays had sold it the Notes on the basis of an AAA-rating that Barclays intended it to rely upon, and upon which it did rely, Barclays knew through internal modeling that the Notes had a probability of default equivalent to B-rated instruments. CRSM further alleged that Barclays deliberately structured the Notes to maximize its own profits.

Barclays's expert witness testified that this practice – known as "credit ratings arbitrage" – was widespread in the structured finance sector during the boom. In many U.S. courts, the claimants have argued successfully that banks engaging in such practices acted fraudulently.

Nonetheless, the court agreed with Barclays that, on the facts, this aspect of CRSM's claim "compared the incomparable." Unlike the Notes' credit rating, the court found that Barclays's internal projection of the risks associated with the Notes was not concerned with default risk. Instead, its purpose was to derive a market price for the Notes to mark its books to market, hedge against the risks associated with the Notes, and calculate notional profits.

Barclays also argued that CRSM's claims were defeated by the terms and conditions of the Notes and disclaimers in the deal documentation. However, the court made it clear that although contracting parties may agree that one party has not made any pre-contractual representations, or that any such representations will not be relied upon, very clear language will be necessary if a term is to be construed as having that effect.

The decision will be welcomed by banks as yet another case in which investors' claims concerning complex financial products have been dismissed. That said, claimants will draw comfort from the court's clarification that misrepresentation claims are contractually excluded only if the banks' disclaimers are sufficiently precise. The key implication is that the stronger the evidence, the more difficult it will be for banks to rely on standard, widely worded disclaimers.

Commercial Contracts: Although disagreements concerning the meaning of contract documents are not new, they are becoming more common in complex debt restructuring cases. Under the "modern approach," contractual interpretation requires a court to decide how a "reasonable person," having all the background knowledge available to the parties, would have understood the words when the contract was made. According to Lord Neuberger, contractual interpretation is now an "iterative process" that requires "checking each of the rival meanings against other provisions of the document and investigating [their] commercial consequences." So long as an argument for a particular interpretation can be made in good faith based on background material and commercial purpose, a party is legitimately entitled to raise that argument. The court will then be required to decide between the alternatives, even if the literal meaning of the contract is clear and unambiguous on its face.

Quinn Emanuel was recently involved in a case (*European Directories* (2010)) which shows how this approach is applied to distressed investments. In *European Directories*, the European Directories group borrowed money under a €1.5 billion senior facilities agreement in exchange for guarantees and security from various group companies. A restructuring was proposed pursuant to which the group's holding company, DH7, would be placed into administration and DH7's shares in its subsidiaries would be sold to a new company. To complete the restructuring, the administrators needed to transfer the subsidiaries' liabilities. They also needed to release the guarantees and security granted by DH7 and its subsidiaries pursuant to using a "release on disposals" clause. Under a narrow construction, that clause permitted the administrators to release only DH7's liabilities, not those of the subsidiaries. According to the High Court, the clause extended only to DH7; its purpose had to be determined from its wording, and its scope "should not be enlarged beyond the ambit of the clause itself" so as to apply to the subsidiaries by reference to a priori notions of commerciality. However, the Court of Appeal disagreed, holding that the clause had to be construed broadly and that the administrators' powers extended to the subsidiaries as well. The Court of Appeals reasoned that because the commercial purpose of the clause was to maximize the value of the disposal, in circumstances where a clause was capable of two meanings and neither flouted

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business common sense, courts should adopt the more commercial construction.

Bankruptcy Litigation Update

Supreme Court Limits Bankruptcy Court Authority to Render Final Orders on State Law Counterclaims: The Supreme Court recently issued a decision resolving "two issues: (1) whether the Bankruptcy Court had the statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on [a debtor's counterclaim against a creditor]; and (2) if so, whether conferring such authority on the Bankruptcy Court is constitutional." *Stern v. Marshall*, 131 S.C. 2594, 2600. *Stern* involves a dispute between Vickie Marshall (professionally known as Anna Nicole Smith) and Pierce Marshall regarding the disposition of the assets of J. Howard Marshall, Vickie's husband and Pierce's father.

During the pendency of this dispute, Vickie filed for chapter 11 bankruptcy protection. Pierce filed a proof of claim in Vickie's chapter 11 case in respect of a pending litigation over defamation of character. Vickie responded by asserting a counterclaim for tortious interference with a gift she expected from J. Marshall. The Bankruptcy Court for the Central District of California subsequently entered judgment in Vickie's favor. The District Court held that the Bankruptcy Court lacked authority to enter a final order, but ultimately affirmed the Bankruptcy Court's holding. However, by the time the California District Court entered its order on appeal, a jury paneled in Texas State Court found for Pierce on his defamation claim. The Ninth Circuit ultimately held that because the Bankruptcy Court lacked authority to enter a final order, the Texas State Court judgment, as the first final judgment entered by a court of competent jurisdiction, controlled.

In discussing the Bankruptcy Court's authority to enter a final order on the state law counterclaim, the Supreme Court first construed the scope of 28 U.S.C. § 157(b)(2)(c). The Supreme Court held that Congress had clearly provided that counterclaims against the debtor were "core" matters under section 157(b)(2)(c) and that such section evidenced Congress's clear intent to provide the bankruptcy courts with authority to hear and enter final orders on such counterclaims. However, the Supreme Court held that while section 157(b)(2)(c) provided bankruptcy courts with statutory authority to enter final orders on such counterclaims, such authority violated Article III of the Constitution which vests the "judicial power of the United States" solely in judges with life tenure and salary protection.

The Supreme Court held that Article III of the Constitution limited the Article I bankruptcy courts' authority to enter final judgments to those situations where: "the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process." *Id.* at 2618 Ultimately, the Supreme Court held that the state common law tortious interference claim did not stem from the bankruptcy, as it was a claim arising under state common law, and was not integral to determining the allowance or disallowance of Pierce's claims against Vickie's estate. As such, the Court held that Article III of the Constitution prevented the bankruptcy court from entering a final order on the state law counterclaims.

Stern has sparked significant debate among litigants over its scope or whether it should be limited to its facts. The extent to which courts and litigants will use this opinion as a means to move adjudication of bankruptcy matters to final judgment from the United States Bankruptcy Courts to United States District Courts also remains to be seen.

Bankruptcy Court Holds That Transaction Regarding Closely Held Corporation Is Subject to Challenge as a Constructive Fraudulent Transfer Notwithstanding Safe Harbor Provisions: On April 21, 2011, the United States Bankruptcy Court for the Southern District of New York held that section 546(e) of the Bankruptcy Code, which protects certain transfers (in particular margin and settlement payments and transfers made under a securities contract between the debtor and a qualifying financial participant) from avoidance absent actual fraud, did not apply to transfers connected with a transaction regarding a closely-owned corporation.

In *MacNenamin's Grill*, the debtor was a closely-held corporation owned by three equal shareholders. In 2007, the debtor entered into a stock purchase agreement with the shareholders to repurchase all outstanding stock. The stock sale was financed by a bank loan secured by the debtor's assets. The debtor was unable to service the acquisition loan and filed for chapter 11 protection. The chapter 11 trustee subsequently commenced an action to avoid both the cash transfers to the shareholders and the bank loan and security interest as constructive fraudulent transfers. The shareholders and lender each argued that the transaction was protected by the section 546(e) safe harbors.

The Bankruptcy Court held that section 546(e) was inapplicable cash transfers to shareholders involving a small, private transaction, notwithstanding that they were settlement payments were made through a financial intermediary (*i.e.*, a bank). The court noted that the policies underlying the statutory safe harbor provisions (*i.e.*, the reduction of systemic risk and preservation of the financial markets) were not served by protecting the sale of three shareholders' interests in a small business when the funds simply passed through a financial institution. The court adopted a five-part test to determine whether a transaction qualified for protection under the Bankruptcy Code safe harbor provisions:

(1) whether the transactions were long settled through actual transfers of consideration, so that a subsequent reversal of the trade could disrupt the securities industry, potentially creating a chain reaction that could cause the affected market to collapse;
(2) whether consideration was paid for the securities or property interest as part of the settlement of the transaction;
(3) whether the transfer of cash or securities effected contemplated the consummation of a securities transaction;
(4) whether the transfers were made to financial intermediaries involved in the national clearance and settlement system; and
(5) whether the transaction affected participants in the system of intermediaries and guaranties involved in the clearing and settlement process of public markets, thus creating the potential for adverse impact on the securities market if any of the guaranties were invoked.

The Bankruptcy Court found that the shareholders did not provide "any evidence that the avoidance of the transaction at issue involved any entity in its capacity as a participant in any securities market, or that the avoidance of the transactions at issue poses any danger to the functioning of the securities market." As such, the court found that the section 546(e) safe harbor provisions did not apply.

The court further held that the Section 546(e) protections did not apply to the trustee's action to avoid the underlying loan obligations. It noted that the reasons for holding the safe harbors inapplicable applied equally to the shareholders and lenders. It further held that Section 546(e) applies only to actions to avoid a "transfer of property of the debtor" and not to actions to avoid incurring an obligation of the debtor. Because the loan agreement constituted the incurrence of an obligation by the debtor, it was not protected by the statutory safe harbor. The case is *Geltzer v. Mooney (In re MacNenamin's Grill LTD)*, 09-8266 (Bankr. S.D.N.Y. April 21, 2011).

Second Circuit Rules that Chapter 11 "Gifting" Plan Violates Absolute Priority Rule: The Second Circuit recently held that a chapter 11 plan allowing a secured creditor to "gift" property to a junior class of stake holders, notwithstanding that a more senior class of unsecured creditors had not been paid in full, violated the Absolute Priority Rule of Bankruptcy Code section 1129. *In re DBSD North America, Inc.*, 634 F.3d 79, 100 (2d Cir. 2011). In *DBSD*, the debtor sought confirmation of a chapter 11 plan to refinance the first lien debt, equitize the second lien debt (at less than par recovery), distribute new equity to holders of unsecured claims (providing a recovery estimated at less than 50%), and distribute new shares and warrants to the existing equity holder. Sprint Nextel objected that the plan violated the Absolute Priority Rule, which provides that absent the agreement of all senior classes, junior creditors classes and interest holders may not receive distributions under a reorganization plan unless all senior classes are paid in full.

The Second Circuit reversed the bankruptcy court, holding that the distribution to existing equity holders, though labeled a "gift," was nonetheless a distribution that failed to comply with Bankruptcy Code section 1129(b)(2)(B). In doing so, the Court distinguished the leading gifting case, *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993), on the basis that *SPM* involved a chapter 7 case in which a secured creditor had already obtained relief from the automatic stay. It was therefore free to dispose of its recouped collateral as it saw fit because distribution was not made pursuant to a chapter 11 plan.

DBSD might make it more difficult to achieve consensus in complex chapter 11 cases by creating obstacles to allocating value to junior stakeholders. *DBSD* is also noteworthy in that it upheld a bankruptcy court ruling designating (i.e. disregarding) DISH Network's vote on the basis that DISH voted against the plan not as a creditor seeking to maximize its return but as a competitor seeking to gain control of the debtor. Prior rulings had established that Bankruptcy Code section 1126(e) (authorizing the designation of votes) should be invoked sparingly, but the facts supported the designation of DISH's vote.

Trademark and Copyright Litigation Update

Logos, Emblems, and Characters Find Trademark Protection Tenuous in Wake of Ninth Circuit Decision: On February 23, 2011, the Ninth Circuit affirmed the grant of summary judgment against Fleischer Studios, which claimed ownership and

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infringement of the Betty Boop character under both copyright and trademark theories. *Fleischer Studios v. A.V.E.L.A., Inc.*, 636 F.3d 1115 (9th Cir. 2011). While the copyright ruling is unlikely to have a broad impact beyond this case, the trademark ruling substantially restricts the scope of trademark protection, especially as to copyrightable works of authorship.

Max Fleischer first developed the Betty Boop cartoon character in 1930. The plaintiff, Fleischer Studios, claimed ownership of the copyright to the Betty Boop character through a chain of assignments. The district court found that a break in the chain of title meant that Fleischer Studios did not own the character and had no standing to sue for infringement of it. The Ninth Circuit affirmed, disposing of Fleischer's copyright infringement claim.

It is for the trademark infringement analysis, however, that *Fleischer* is most significant. There the court looked to two cases, neither cited by the parties, to conclude that "functional aesthetic" works, like the Betty Boop character, receive no trademark protection and that copyrightable works, like the character, likewise cannot receive trademark protection where the copyright is in the public domain. 636 F.3d at 1124-25 (citing *Int'l Order of Job's Daughters v. Lindeburg & Co.*, 633 F.2d 912 (9th Cir. 1980) and *Dastar Corp. v. Twentieth Century Fox Film Corp.*, 539 U.S. 23 (2003)).

The "functional aesthetic" doctrine revived by the court distinguishes between the use of a plaintiff's mark in a manner that causes consumer confusion as to "the maker, sponsor, or endorser of the product" and the use of a mark by its wearer to "publicly express her allegiance to [an] organization." 636 F.3d at 1123. Only the former is actionable; the latter is permitted. As the *Fleischer Studios* court explained, *Job's Daughters* held that where the defendant's use of the plaintiff's emblem (on jewelry) was a "prominent feature of each item so as to be visible to others when worn," "never designated the merchandise as 'official' merchandise or otherwise affirmatively indicated sponsorship," and "did not show a single instance in which a customer was misled about the origin, sponsorship, or endorsement [ ] nor that it received any complaints about [the challenged products]. there was no infringement." 636 F.3d at 1124. The emblem was "functional[ly] aesthetic," and unprotected from such alleged infringement. *Job's Daughters*, 633 F.3d at 920. Applying the same analysis led the *Fleischer Studios* court to the same result: the images of Betty Boop, as used in the defendant's dolls, t-shirts and handbags, were functionally aesthetic – the character was "a prominent feature of each item so as to be visible to others when worn," and it was not used to indicate Fleischer's sponsorship; it was "functional and aesthetic." 636 F.3d at 1124-25.

The panel also applied the Supreme Court's 2003 decision in *Dastar*. In that case, the Supreme Court held that where a copyright is in the public domain, a party may not assert a trademark infringement action against an alleged infringer if that action is essentially a substitute for a copyright infringement action. The *Fleischer Studios* court ruled, *sua sponte,* that this precluded a finding of trademark protection for Betty Boop since the plaintiff's claim for copyright protection failed. To hold otherwise, the court reasoned, would allow trademark holders perpetual rights to exploit their creative works, which conflicts with the principles of copyright.

Ninth Circuit Limits Scope of Copyright Preemption: In our July 2010 Newsletter, we noted a significant new Ninth Circuit decision, *Montz v. Pilgrim Films & Television, Inc., et al.*, 2010 WL 2197421 (9th Cir. June 3, 2010), which appeared to substantially enhance the force and effect of copyright preemption in the implied-in-fact contract context. In *Montz*, the plaintiffs sued a studio and others, claiming they had conceived and pitched the idea for a reality television series investigating paranormal activity with the assistance of high-tech equipment. The studio later aired a show, "Ghost Hunters," allegedly based on plaintiffs' pitch but without credit or compensation, leading to claims for copyright infringement, breach of implied-in-fact contract, and breach of confidence. The Ninth Circuit at first affirmed dismissal of the non-copyright causes of action, holding they were preempted by the Copyright Act, 17 U.S.C. § 301(a), *et seq.*, because there was no "extra element" to distinguish those claims from the copyright infringement claim. As we reported last year, that was a significant addition to Ninth Circuit jurisprudence on copyright preemption, and limited the court's prior decision in *Grosso v. Miramax Film Corp.*, 383 F.3d 965 (9th Cir. 2004).

The Ninth Circuit then decided to rehear the matter *en banc*, and in May it reversed course, holding in a 7-4 decision that neither the breach of implied contract nor the breach of confidence claim was preempted. *Montz v. Pilgrim Films & Television, Inc.*, 2011 WL 1663119 (9th Cir. May 4, 2011). The court reaffirmed, as it had ruled in *Grosso,* that a bilateral expectation of payment, at least in the context of an idea pitch, is an "extra element" that "transforms a claim from one asserting a right exclusively protected by federal copyright law, to a contractual claim that is not preempted by copyright law." 2011 WL 1663,119 at *1. An implied agreement to "pay for use of the disclosed ideas" is, unlike the "monopoly protection of copyright law," a "personal" relationship between the parties which yields the required extra element to avoid preemption. *Id.* at *4-5. Like "[c]ontract claims generally," which survive preemption because they require proof of such an extra element, a claim for breach of an "implied agreement of payment for use of a concept" is not preempted. *Id.* at *4. Moreover, the breach of confidence claim "protects the duty of trust or confidential relationship between the parties, an extra element that makes it qualitatively different from a copyright claim." *Id.* at *6.

The *en banc Montz* decision, which is of clear benefit to plaintiffs, imposes important limits on copyright preemption in the Ninth Circuit. The *en banc* court not only vacated the prior panel's opinion, but, notably, also cited a longstanding Ninth Circuit precedent relied on by defendants urging preemption – *Del Madera Props. v. Rhodes & Gardner, Inc.*, 820 F.2d 973 (9th Cir. 1986). *Del Madera*, discussed at length by the dissent in *Montz*, held a claim for unjust enrichment based on an implied promise to be preempted by copyright. *Del Madera Properties v. Rhodes and Gardner, Inc.*, 820 F.2d 973, 977 (9th Cir. 1987) ("The foundation of Del Madera's unjust enrichment claim is its contention that the defendants violated an implied promise, based on the parties' relationship, not to use the Tentative Map and supporting documents. But an implied promise not to use or copy materials within the subject matter of copyright is equivalent to the protection provided by section 106 of the Copyright Act. Therefore, this portion of Del Madera's unjust enrichment claim is also preempted."). *See Montz*, 2011 WL 1663119 at *10 (dissent) ("a breach of a relationship of trust does not, by itself, transform the nature of an action") (citing *Del Madera*). While it does not do so expressly, the majority's opinion, which cites but does not follow this precedent, arguably overrules it.

State law causes of action for idea theft, which hearken back at least to *Desny v. Wilder*, 299 P.2d 257 (Cal. 1956), are alive and well in the Ninth Circuit following *Montz*. "Since an idea cannot be copyrighted, a concept for a film or television show cannot be protected by a copyright. 17 U.S.C. § 102. But the concept can still be stolen if the studio violates an implied contract to pay the writer for using it." *Montz*, 2011 WL 1663119 at *3. Q

Quinn Emanuel Named to "Appellate Hot List" by *National Law Journal*

Quinn Emanuel has been named to the 2011 "Appellate Hot List" by the *National Law Journal*, one of only 17 firms to earn this recognition. The Appellate Hot List recognizes firms that have made exemplary contributions to appellate practice during the preceding year. The list is based on reader nominations and the magazine's research. The *National Law Journal* praised Quinn Emanuel's recent victories before the United States Supreme Court in *Kawasaki Kisen Kaisha Ltd. v. Regal-Beloit Corp.* and *Bruesewitz v. Wyeth, LLC*, as well as the firm's Second Circuit victory in *Federal Treasury Enterprise Sojuzplodoimport v. Spirits International N.V.* Quinn Emanuel's appellate group is headed by partner Kathleen M. Sullivan, formerly the Dean of the Stanford Law School. Q

Quinn Emanuel Bankruptcy Partner Benjamin Finestone Named Outstanding Young Restructuring Lawyer

Benjamin Finestone, a partner in the firm's New York office, has been selected by *Turnarounds & Workouts* as one of the nation's 12 "outstanding young restructuring lawyers" for 2011. *Turnarounds & Workouts* praised Finestone for his involvement in Quinn Emanuel's representation of the official creditors' committees in the chapter 11 cases of SemGroup and Sentinel Management Group, and the firm's representation of debtors in possession, such as Washington Mutual, Solutia, and FairPoint Communications. Finestone's bankruptcy practice includes debtor-side and creditor-side engagements (representing official as well as ad hoc committees and individual bondholders), and the representation of clients in all aspects of chapter 11 cases, including DIP and exit financing, contested plan confirmation, adversary proceedings, and appeals from bankruptcy court decisions. Q

Trial Victory for Major Brazilian Company

The firm recently won a complete victory for its client, Companhia Siderurgica Nacional ("CSN"), following a jury trial in the United States District Court for the Southern District of New York. CSN, a large Brazilian steel company, sued its former Chief Financial Officer, Lauro Rezende for converting (1) the shares of a bearer-share company called International Investment Fund ("IIF") that held assets valued at approximately $500 million dollars; (2) approximately $14.2 million in dividends paid on stock owned by IIF; and (3) $2.2 million dollars from IIF's bank account in 2001. CSN also sought a declaration that it is the owner of IIF.

IIF was formed by CSN in 1999 to purchase stock in a Brazilian railroad company. When the railroad stock was first purchased by CSN in 1999, its financial value was quite low. Over the years, the value of its stock increased dramatically and the railroad began to pay millions in dividends to shareholders. Mr. Rezende was one of CSN's most senior executives at the time. Seizing upon what he no doubt believed to be a golden opportunity, Mr. Rezende attempted to convert IIF from CSN by removing the original bearer share certificates that represented IIF's capital stock from CSN's vault. Upon discovering the theft, CSN immediately filed suit, and a subsequent internal investigation revealed that Mr. Rezende had also embezzled $2.2 million dollars from CSN in 2001.

Prior to trial, the firm moved for sanctions against Mr. Rezende for perpetrating an elaborate fraud on the Court in connection with a discovery-related matter. After extensive briefing and a two-day evidentiary hearing on CSN's motion for sanctions, the Court found that Mr. Rezende had not only repeatedly perjured himself but also had fabricated and falsified numerous documents that he submitted to the Court as evidence. As a sanction, the Court ordered Rezende to pay more than $600,000 in attorneys' fees to CSN and instructed the jury at trial that Rezende had previously been found to have lied under oath and fabricated documents in connection with this proceeding.

Quinn Emanuel's trial strategy was two-fold: First, to meticulously present the mountain of evidence in CSN's favor by putting on ten fact witnesses, many of whom were former CSN employees with no interest in the outcome of the litigation. Second, to destroy the credibility of Mr. Rezende. During a two-day cross examination, Quinn Emanuel did just that and impeached Mr. Rezende literally dozens of times until his credibility was in tatters. After deliberating for just three hours, the jury gave CSN a complete victory. The jury declared that CSN is the owner of IIF and all of its assets, and it found that Mr. Rezende had embezzled $2.2 million from IIF. The verdict brings CSN's three-year dispute with Mr. Rezende to a conclusion and affirms that the approximately $500 million of assets at the center of the dispute belong to CSN. Following the verdict, the Court referred Mr. Rezende to the United States Attorney's Office for the Southern District of New York for criminal prosecution.

Appellate Patent Victory for Yahoo!

The firm recently secured a complete reversal of a patent infringement judgment on behalf of Yahoo!. The case was tried to a jury in the Eastern District of Texas by another firm, resulting in an award of $12 million and an ongoing royalty of 23% on Yahoo!'s profitable IMVironments product.

The plaintiff had alleged infringement of a patent concerning the display of advertising in the background to electronic messages. After the jury found willful infringement, Yahoo! redesigned IMVironments attempting to avoid a prospective remedy. The district court nevertheless denied Yahoo!'s post-trial motions, enhanced the damages, held that the redesigned IMVironments willfully infringed, and awarded a 23% ongoing royalty. Yahoo! then turned to Quinn Emanuel.

On appeal, it persuaded the Federal Circuit that the district court had failed to resolve a fundamental claim construction dispute – whether each recited "logic" in the asserted claim had to be configured to operate on the same electronic message. Quinn Emanuel then persuaded the Federal Circuit that IMVironments did not infringe as a matter of law under the appropriate claim construction. The reversal secured Yahoo!'s ultimate victory in the company's first patent infringement case litigated through trial in the Eastern District of Texas. Yahoo! may now continue to use its profitable IMVironments program free from any royalty. The complete judgment of non-infringement also allows Yahoo! the option to restore its pre-verdict design or continue using the post-verdict redesign.

Appellate Patent Victory for Pharmaceutical Companies

The firm recently won an affirmance from the Federal Circuit of a judgment as a matter of law in favor of the firm's clients, Lundbeck, Inc. and Forest

Laboratories, Inc. The plaintiff had brought claims seeking damages and ongoing royalties with respect to the antidepressant drugs CELEXA® and LEXAPRO®, which have over $2 billion in annual U.S. sales. After the Southern District of New York ruled that no reasonable jury could fail to find the asserted patent claim invalid due to obviousness, the Federal Circuit agreed decisively. It issued a Rule 36 affirmance three days after the appellate oral argument by Quinn Emanuel. The plaintiff's damages and royalty claims were not only defeated but the possibility that an injunction might issue affecting CELEXA® or LEXAPRO® was eliminated.

Chapter 11 Plan Confirmation Victory

The firm recently obtained an order from the District Court for the Southern District of New York affirming FairPoint Communications chapter 11 plan. A federal bankruptcy court had earlier approved the plan, which included a critical third-party injunction, over the objection of Verizon Communications.

FairPoint was spun off from Verizon in a 2008 transaction that saddled FairPoint with an unserviceable debt load in excess of $2.5 billion. FairPoint filed for bankruptcy in late 2009. To reach a consensual plan of reorganization, FairPoint agreed to assign claims against Verizon arising out of the spin-off transaction to a litigation trust, but the assignment left FairPoint vulnerable to indemnification "claims over." For that reason, FairPoint's plan included a third-party injunction that precluded Verizon from asserting contribution or indemnification claims arising out of the assertion of the litigation trust claims against it.

Verizon objected to confirmation of the reorganization plan, arguing that the third-party injunction was not justified by "truly unusual circumstances," as required under Second Circuit case law, and that the bankruptcy court lacked jurisdiction to enjoin the non-debtor claims. As FairPoint's conflicts counsel, Quinn Emanuel convinced the court that the protection provided by the third-party injunction was essential to the debtor's reorganization and in the best interest of the estate, and that the court had jurisdiction to authorize the injunction. The bankruptcy court then approved the injunction and confirmed FairPoint's plan.

Verizon appealed the confirmation order, again challenging the bankruptcy court's jurisdiction to authorize the injunction. The district court agreed with Quinn Emanuel that the Second Circuit would uphold the bankruptcy court's jurisdiction. The court also agreed that the remainder of Verizon's appeal was equitably moot due to the myriad transactions FairPoint and its creditors had already entered into in reliance on the confirmed plan.

Appellate Genetic Testing Patent Victory

The firm recently obtained a precedential opinion from a unanimous Federal Circuit panel affirming a judgment in favor of Associated Regional University Pathologists ("ARUP," a reference laboratory at the University of Utah) and Bio-Rad Laboratories. The plaintiff had alleged infringement of two patents related to genetic testing for hemochromatosis, an iron disorder. The firm won a defense judgment in the district court that all asserted claims were invalid. Following oral argument, the Federal Circuit affirmed in all respects.

It adopted Quinn Emanuel's argument that the first of plaintiff's patents was invalid under the written description requirement of 35 USC § 112 because the inventor filed for a patent on a DNA mutation without knowing the actual DNA sequences. In essence, the inventor filed too early – more work needed to be done before the claimed invention was complete. The Court underscored that simply knowing roughly where a DNA mutation would be found in the genome is insufficient to claim a patentable invention.

The court also held that the second patent was also invalid because it was filed too late and was anticipated by prior art. Between the filing dates of the plaintiff's two patents, another group of scientists had isolated the relevant gene and mutations and proposed genetic testing for hemochromatosis. The court found that their discovery anticipated the claims of second patent, not withstanding that they did not fully recognize the utility of the DNA mutations at the time. Q

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business litigation report

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- We are a business litigation firm of more than 450 lawyers — the largest in the world devoted solely to business litigation.
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