

Bright Ideas



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- Long-Arm Jurisdiction in Online Infringement Cases
- The Presumption of Validity For Substitute Claims After PTAB Proceedings
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When Can a Trademark Settlement Be Unlawful Collusion? A Discussion of the FTC's Case Against 1-800-Contacts

*Presented by the Antitrust Section and Intellectual Property Section
of the New York State Bar Association*

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1.5 MCLE credits | 6:00 – 7:30 pm

Complimentary program

If a trademark owner secures a commitment from a competitor not to purchase advertisements on online search engines that target consumers searching for the owner's trademarks, can that violate the antitrust laws? Late last year, an FTC Administrative Law Judge held that a series of agreements between 1-800-Contacts and rival online contact lens sellers that restricted the competitors from purchasing advertising on search engine results pages for trademarks owned by 1-800-Contacts violated the antitrust laws. The decision is now on appeal. This panel will explore the legal, economic, and policy implications raised by the FTC's case, and how it could affect the enforcement of trademarks in the online marketplace.

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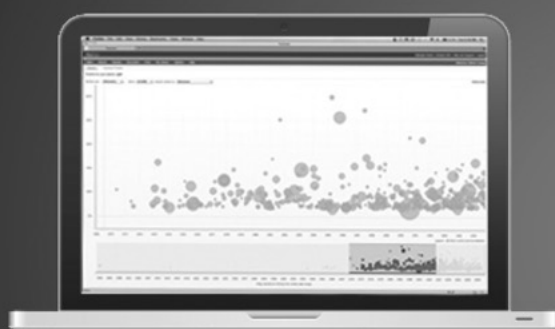
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Turn the page on write-downs and write-offs

One State Is Not Like the Others: New York Rejects Avoided Development Costs as a Measure of Trade Secrets Damages

By Victoria A. Cundiff

I. Introduction

Calculating damages for trade secret misappropriation can be challenging. Misappropriation is often detected before either the trade secret owner or the misappropriator has been able to establish a market—and profits—for products made through use of the trade secrets, making both side's internal projections more aspirational than concrete. The misappropriation may effectively halt the trade secret owner in its tracks, leaving it unable to attract future business, or document lost profits, at all. Since, by definition, information that qualifies as a trade secret is not generally known to the relevant public, coming up with a market value for a secret product or process can quickly become an exercise in speculation. Many trade secrets are not licensed voluntarily, and licensing practices of competitors are frequently kept under wraps, making it difficult to turn to “comparable” licenses in developing reasonable royalty calculations. Much of the case law regarding damages for misappropriation therefore emphasizes that trade secrets cases require a “flexible and imaginative approach to the problem of damages.”¹

Both the Defend Trade Secrets Act (DTSA) and the Uniform Trade Secrets Act (UTSA), which has been adopted in some form by every state except New York,² help provide such flexibility by permitting victims of misappropriation to seek three types of damages: actual loss caused by misappropriation, unjust enrichment caused by the misappropriation not taken into account in computing actual loss, or, in lieu of damages measured by any other method, a reasonable royalty for unauthorized use or disclosure.³ States operating under the UTSA and common law as well as recent decisions under the DTSA have construed “unjust enrichment” to include both profits on sales the defendant made using trade secrets, including sales the plaintiff would not have been able to make, and the defendant's savings through avoiding development costs by misappropriating the trade secret owner's developments without paying for them.⁴ This latter approach, accepted by the *Restatement (Third) of Unfair Competition* (1995), has been particularly useful to trade secret owners as a means of at least partially quantifying recovery where neither the trade secret owner nor the alleged misappropriator has yet had material success in exploiting the trade secret, and a reasonable royalty calculation for an untested product or process is difficult to construct.⁵

New York, however, has not adopted a version of the UTSA. Instead, its trade secrets jurisprudence is largely grounded in the *Restatement (First) of Torts*, section 757 *et*

seq., and a deep body of case law, much of which is consistent with the UTSA.

This year's 4-3 decision by the New York Court of Appeals in *E.J. Brooks Co. v. Cambridge Security Seals*⁶ creates a new and significant difference between New York common law and the DTSA and the UTSA.⁷ Responding to a question certified to it by the Second Circuit, the New York Court of Appeals held that under New York common law, a trade secret owner *may not recover the development costs the defendant avoided due to its unlawful activity* under theories of trade secret theft, unfair competition, or unjust enrichment.⁸

II. The Facts of *E.J. Brooks*

E.J. Brooks is in the business of designing, manufacturing, and selling plastic security seals used to indicate whether goods transported in air and over-the-road cargoes have been tampered with in transit. Starting in the late 1990s, E.J. Brooks and its predecessor organization invested substantial time and money to purchase and develop a proprietary fully automated manufacturing processes to manufacture these indicative security seals at a lower cost than its competitors. E.J. Brooks protected and maintained these innovations as its trade secrets.

In a scenario familiar to many organizations, beginning in 2009, a number of E.J. Brooks' long-term employees resigned to develop and run their own indicative security seals business as a new product line for an existing business, Cambridge, which previously had been a customer of E.J. Brooks. Shortly thereafter, Cambridge formed Cambridge Security Seals (CSS) and began advertising its indicative security seals for sale on its website as well as directly to some of E.J. Brooks' customers.

E.J. Brooks, complaining that the employees and their new company had used its trade secret processes to manufacture these seals, sued CSS and the former employees in the Southern District of New York, claiming, among other things, that the defendants had misappropriated its trade secrets, engaged in unfair competition, and unjustly enriched themselves through their use and disclosure of the plaintiff's confidential, proprietary, and trade secret information. The case went to trial before a jury.⁹

The jury found the defendants liable under all three theories for misappropriating three trade secrets to design

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and operate a secret process for manufacturing indicative security seals.

At trial, E.J. Brooks could not quantify with reasonable precision sales it had lost to CSS. Further, the plaintiff's damages expert concluded that "profit information from [CSS] was not sufficient" to permit the plaintiff's expert to calculate profits the defendant had made relating to the misappropriation.¹⁰ Accordingly, the plaintiff expressly disclaimed damages from the loss of customers. The plaintiff's damages expert testified that an appropriate measure of damages in the case would be "based on the idea that, by stealing [E.J. Brooks'] trade secrets, [CSS] was able to avoid development costs...."¹¹ The court instructed the jury that if it found misappropriation, it should compare the actual costs CSS had incurred in developing its manufacturing process incorporating the trade secrets to the development costs incurred by E.J. Brooks. The court instructed that the difference is "defendant's avoided development costs," which may be awarded as unjust enrichment damages. Based on these instructions, the jury awarded damages of \$3.9 million. It did not award punitive damages.¹²

In deciding post-trial motions, the court found that the plaintiff had "offered evidence that the Defendants stole [E.J. Brooks'] trade secrets to set up nearly-identical manufacturing processes and, as a result, [CSS] was able to avoid costs that it would have otherwise incurred to develop such processes."¹³ The district court held that this amount could properly be awarded and that it could be "just as aptly categorized as [E.J. Brooks'] 'losses' or CSS's 'gains.'"¹⁴

In reaching this conclusion, the trial court relied on earlier New York damages cases, cases from out of state, and the approach suggested in the *Restatement (Third) of Unfair Competition*.¹⁵

If the benefit derived by the defendant consists primarily of cost savings, such as when the trade secret is a more efficient method of production, the "standard of comparison" measure that determines relief based on the savings achieved through the use of the trade secret may be the most appropriate measure of relief.¹⁶

CSS appealed.

III. The Second Circuit's Certified Question

In reviewing the appeal, the Second Circuit recognized that the "avoided costs" measure of damages finds some support in New York law under a contract theory and under Second Circuit precedent in the context of a specific promise to pay the equivalent of accrued savings, as well as more explicitly in the *Restatement (Third) of Unfair Competition*. It concluded, however, that it could not

"say with certainty that those provisions of the Restatement accurately describe New York law with respect to calculating damages in trade secret and unfair competition cases." The New York Court of Appeals had never cited that section of the *Restatement*.

To the contrary, the Second Circuit found:

New York courts have suggested that the measure of damages in trade secret cases, even when measured by reference to a defendant's profits, should correspond to a plaintiff's losses as a means of compensation. . . . Assuming New York requires that the trade secret damages bear some connection to the plaintiff's losses, it is not apparent to us that assessing damages based on the defendant's avoided costs satisfies the requirement.¹⁷

Accordingly, the Second Circuit found, the issue was an unresolved policy decision that the New York Court of Appeals was better situated to make, and it requested that court to decide "[w]hether under New York law, a plaintiff asserting claims of misappropriation of a trade secret, unfair competition, and unjust enrichment can recover damages that are measured by the costs the defendant avoided due to its unlawful activity."¹⁸

IV. The Court of Appeals Majority: Defendant's Avoided Development Costs Are Not Recoverable Under Any Legal Theory

In a 4-3 decision, written by Judge Paul D. Feinman over a vigorous dissent by Judge Rowan D. Wilson, sought to clarify the law. Taking as its starting point the principle that "[u]nder our common law, compensatory damages must return the plaintiff, as nearly as possible, to the position it would have been in had the wrongdoing not occurred—but do no more,"¹⁹ the Court concluded that "damages in trade secret actions must be measured by the losses incurred by the plaintiff, and . . . damages may not be based on the infringer's avoided development costs."²⁰

Unlike the trial court, which had viewed avoided development costs as being capable of being characterized as either the trade secret owner's "losses" or the misappropriator's gains, the Court of Appeals majority observed that other states awarding avoided development costs as a measure of damages almost universally consider these avoided costs as a measure of the defendant's unjust gains.²¹ Relying on New York cases holding that in a trade secrets case the plaintiff was entitled to recover as damages the amount of loss it had sustained, including opportunities for profit on accounts diverted from it through the defendants' conduct,²² the Court held that the focus in awarding damages in trade secrets cases must be on the effect of the misappropriation on the plaintiff. The Court opined that an award of the defendant's

avoided development costs is not necessarily tied to the plaintiff's loss and therefore is "not a permissible measure of damages."²³

Recognizing that in trade secrets cases "loss" is broadly defined, the Court did conclude that in the case where the disclosure of a trade secret has destroyed the plaintiff's competitive edge, "the *plaintiff's* costs of developing the product may be the best evidence of the (now-depleted) value that the plaintiff placed on the secret,"²⁴ but that "it is neither automatically nor presumptively the case that the costs avoided by the *defendant* will be an adequate approximation of the *plaintiff's* investment losses, any more than it can be presumed that the *defendant's* sales would approximate those of the plaintiff."²⁵

The Court further concluded that avoided development costs are not recoverable under an unfair competition theory. The essence of unfair competition through misappropriation is not simply that the defendant has "reap[ed] where it has not sown" but that it has done so in an unethical way and "thereby unfairly neutralized a commercial advantage that the plaintiff achieved through honest labor." Damages, therefore, must be measured by the loss of the *plaintiff's* commercial advantage, which may not correspond to what the defendant has wrongfully gained.²⁶ Once again, the majority found, "the principle that a plaintiff's losses may be measured practically and flexibly does not remove the requirement that damages be measured by the plaintiff's actual losses."²⁷ The Court found that the defendant's profits in such cases are relevant only insofar as they are a reasonable proxy for the plaintiff's loss.²⁸

Finally, the Court held, avoided costs could not be awarded as compensatory damages in an unjust enrichment action, since the amounts the defendant saves through its unlawful activities that otherwise would have been payable to *third parties* do not constitute funds held by the defendant "at the expense of" the plaintiff.²⁹

V. The Dissent: Avoided Development Costs Are Available as an Equitable Remedy

The dissent did not conceal its disdain for the majority's approach:

The majority answers the questions through a misguided bottoms-up attempt to decide this plaintiff's case rather than a top-down approach announcing the principles of law. Not only does that approach produce an incorrect answer here, but it also forsakes New York's historic role at the vanguard. Where we should lead, we now refuse even to follow.³⁰

In resolving the certified questions, the dissent took as its guiding framework the principles that:

- "there is no wrong without a remedy";
- New York case law expressly allows "flexible recovery in equity";
- the fact that damages cannot be measured with absolute mathematical certainty does not bar substantial recovery if they may be "approximately fixed"; and
- protectible intellectual property in whatever form "has a value greater than merely its development cost and innovation depends on the ability of inventors to protect that property from theft."³¹

The dissent observed that avoided costs are widely recognized as an available measure of damages in trade secrets cases nationally and comport with each of these guiding principles.

As a policy matter, the dissent urged, damages in trade secrets cases "are not, unlike in other commercial tort cases, confined to a single incident of loss of use and depreciation."³² Rather, the injury to the plaintiff encompasses many things, including the lost profits the plaintiff might have made, the loss in potential exclusive licensing opportunities, the loss in the value of the trade secret once it is exposed to others, and, most importantly, the lost incentive for others to expend their time and efforts on innovation.³³ The dissent urged that the majority had ignored crucial precedent: "[U]nder New York law, a defendant's ill-gotten gains are available as an *equitable* remedy, particularly in trade secret and unfair competition cases."³⁴ In short, the dissent urged, the majority had provided only "a half-answer to the Second Circuit, 'avoided-cost damages have not been historically recoverable at law,' instead of a full answer: equity allows flexibility in damage awards, unrestricted to the plaintiff's lost profits."³⁵ Even if avoided development costs were not a remedy at law, the dissent urged, "the Second Circuit did not ask us whether avoided costs may be an appropriate measure at law but not in equity."³⁶ Avoided development costs are available as an equitable remedy, the dissent contended, to ensure that every wrong has a remedy.

The dissent criticized the majority's "narrow" interpretation of damages that failed to "engage meaningfully with the unique nature of trade secrets, as well as the differences between profits and development costs."³⁷ Far from awarding successful trade secret plaintiffs too much, the dissent found, awarding the plaintiff only the defendant's avoided development costs would most likely undercompensate the plaintiff because "no rational economic actor would spend \$X to recover profits of merely \$X."³⁸ Nor would an award solely of the plaintiff's lost profits make the trade secret plaintiff whole:

[I]f the defendant could have independently developed the trade secrets at a cost of \$X in a period of Y years, and the plaintiff recovers \$X plus the profits lost

during the Y years due to defendant's early entry made possible by the theft, the plaintiff will be put exactly into the position it would have been in had the defendant not stolen the secrets—which satisfies the majority's 'fundamental purpose' to 'make the victim whole' (citations omitted). The majority restricts plaintiffs to profits lost during Y years, which plainly does not restore the plaintiff to the position it would have been in had the theft not occurred, because the defendant spends nothing to obtain use of the secrets. The majority's rule fails to adhere to the proposition it touts, that damages 'must be measured by the loss of the *plaintiff's* commercial advantage'³⁹

Avoided development costs are "reasonably related" to the value of a trade secret,⁴⁰ the dissent concluded, since no one would pay more for a trade secret than what it would cost to develop it, or a good substitute for it.⁴¹ Even though an award of avoided development costs would not, except in the rare case where the plaintiff's lost profits were exactly \$0, fully compensate the trade secret plaintiff, the dissent recognized, calculation of avoided-costs damages may be easier and less subject to challenge than lost-profits damages. This fact could make avoided development costs an attractive, albeit incomplete, alternative for plaintiffs "who are willing to forgo a potentially larger recovery in favor of a smaller, more certain one."⁴²

It is of no moment that they may not be the same dollar number as a lost-profits analysis might show: as anyone who has ever retained an expert to determine lost profits knows, no two experts are likely to arrive at the same figure. Again, the law does not require such exactitude in recompensing a wrong.⁴³

The dissent recognized that there might be situations in which avoided development costs would not be an appropriate measure of damages and offered a detailed guide for how avoided cost calculations might be challenged in particular cases.⁴⁴ The defendant might have been able to develop the information more cheaply than the trade secret owner, for example, because of greater efficiency,⁴⁵ technology advances, or the availability of licenses from third parties.⁴⁶ The dissent took pains to reflect that avoided development costs are not always the best measure of damages. "Rather, it is one of several measures of damages, subject to election by the plaintiff, challenge by the defendant, and acceptance by the trier of fact."⁴⁷ The majority's error, the dissent urged, was to conclude that the plaintiff's loss must be measured *exclusively* by plaintiff's lost profits, something the cases on which the majority relied do not hold.⁴⁸

Avoided development costs are also available for unfair competition under principles of equity, the dissent urged, because avoided costs can be a reasonable approximation of the injury to the plaintiff, effectively allocating some portion of the defendant's profits to the contribution of the secrets the defendant misappropriated from the plaintiff.⁴⁹

As to the availability of avoided development costs under an unjust enrichment theory, the dissent argued that while an element of the claim of unjust enrichment is that the defendant must have been enriched at the plaintiff's expense, "it can hardly be said that pilfered commercially valuable trade secrets are not stolen 'at the plaintiff's expense.'"⁵⁰ Finding that "[CSS] was unjustly enriched by stealing to avoid development costs, which injured [E.J. Brooks],...[i]t would be against equity to allow the defendant to retain the value it received."⁵¹

The dissent concluded with a sober assessment of the implications of the Court's decision:

Under the majority's rule, I am encouraged to steal your trade secrets. If I can make better use of them than you, because I am a better salesperson, better funded or a cheaper purchaser of inputs, even if I lose when you sue me, I can make a net profit, repaying you only what you can prove you lost in sales. If I am not better suited to exploit your trade secrets, I may nevertheless profit if you are unable to prove your lost sales, which, because of the messiness of the real world, is often difficult or impossible to do. At worst, I may be subjected to an injunction, but at that point, the secret has begun to leak out, and you will be hard-pressed to prove that some third, fourth or fifth party derived its identical process from your secret. *The incentive for others to innovate will be replaced by the incentive to steal.*⁵²

VI. What Does *E.J. Brooks* Mean for Trade Secret Owners?

The Second Circuit vacated the original award and remanded the case to the district court for further proceedings, and the case then settled.⁵³ But other potential litigants bringing claims for misappropriation of trade secrets under New York law must continue to grapple with the decision. How can they plan ahead to increase the chances of recovering at least their investment in the event of misappropriation?

A. Potential Approaches to Seeking Damages in Ongoing Litigation Under New York Law

For trade secret owners that are already in litigation under New York law, *E.J. Brooks* suggests a number of practical pointers and potential damages theories to explore.

1. Trade secret owners should build their damages claims under New York law around theories they can tie squarely to the plaintiff's loss. The trade secret owner is entitled to recover its lost profits on the defendant's sales to the plaintiff's customers made by reason of the misappropriation.⁵⁴ It should work to develop evidence to establish that it lost sales, actual or reasonably projected,⁵⁵ to the party accused of misappropriation.
2. Under case law applying New York law prior to the *E.J. Brooks* decision, the trade secret owner was also entitled to recover profits the defendant made through use of the misappropriated trade secret.⁵⁶ *E.J. Brooks* itself holds that the trade secret owner may be allowed to attempt to recover the defendant's profits as a proxy for compensatory damages in an unfair competition case but that it must show a "causal relation not wholly unsubstantial and imaginary, between the gains of the aggressor and those diverted from his [or her] victim."⁵⁷ The plaintiff should conduct discovery to establish this nexus. Where the trade secret owner and the defendant are shown to be the only companies capable of producing the products at issue, and the defendant's ability to produce the products is tied to its use of the trade secrets, the trade secret owner may be able to show that the defendant's sales "[o]bviously came at the expense of the [plaintiff]."⁵⁸ In a multi-competitor market, in seeking any portion of the defendant's profits as a proxy for its own lost profits, the trade secret owner should consider whether it can develop evidence that it would have been able (or was working) to make sales that the defendant made or, more broadly, to establish that the driver of demand for the defendant's products was in fact the plaintiff's trade secrets. The plaintiff then will argue that the defendant's misappropriation diverted the trade secret owner's ability to make those sales that were tied to its own trade secrets, satisfying the test laid out in *E.J. Brooks* for recovering profits from the defendant.⁵⁹
3. In some cases, the trade secret owner may be able to develop a damages model based on pre-misappropriation evidence showing what a prospective investor was actually prepared to pay to own or acquire an interest in the trade secrets at issue. Evidence concerning of any pre-misappropriation overtures or negotiations to purchase either the trade secret or the business and the reasons for the prospective investor's interest that are tied to the trade secrets, such as evidence of any efficiencies the trade secrets helped the trade secret owner to enjoy over competitors, will help the trade secret owner to advance this argument. The trade secret owner may be able to establish that the defendant's acts destroyed or eroded its reasonable expectancies for further investment⁶⁰—but not if its "expectancies" were sheer speculative hopes or were principally tied to factors other than trade secrets.
4. Where the plaintiff contends that the misappropriation has effectively destroyed the value of its trade secret, it may be able to recover *its own* investment in the trade secret as part of its damages. The majority in *E.J. Brooks* observed that in such a case "the plaintiff's costs of developing the product may be the best evidence of the (now-depleted) value that the plaintiff placed on the secret."⁶¹ If contemporaneous development cost records are not available for use in establishing this loss, as may be true in other cases like *E.J. Brooks* itself, for example, where part of the technology at issue was purchased long ago from third parties, working closely either with the actual developers of the trade secrets or with industry experts who can help estimate the trade secret owner's likely development costs by reference to business and industry practice can help establish the plaintiff's development costs.⁶² Discovery may also be able to show what the defendant itself had estimated as the cost of development prior to the misappropriation. Such calculations may help buttress the plaintiff's estimates of its own lost development costs.
5. The trade secret plaintiff should consider whether a reasonable royalty calculation can be developed that will properly compensate the trade secret owner for its loss.⁶³ A reasonable royalty in trade secrets cases, as in patent cases, is based on a hypothetical negotiation prior to the misappropriation in which it is assumed that the plaintiff would have been willing to license the trade secret and that the accused party would have been willing to pay to do so. The costs the *plaintiff* incurred to develop the trade secret together with its reasonably projected profits and sales from using the trade secret (along with projected profits and sales of associated products) will help establish a floor on what the plaintiff would have accepted as a reasonable royalty in the hypothetical negotiation; the development costs the *defendant* was able to avoid through misappropriation and the alternative cost of any substitutes, along with the defendant's estimates of its likely profits through use of the trade secret, will be factors that can help suggest what the defendant would have been willing to pay for a license. The earlier the misappropriation occurs

in the lifecycle of the trade secret, however, the more difficulty the claimant will face in developing a royalty model that is found to be more than speculative.⁶⁴

6. The plaintiff should consider whether it can prevent future damages by pursuing injunctive relief. While an injunction will not recover the plaintiff's lost investment or make it whole, it will prevent further use of the trade secrets to the plaintiff's detriment.

B. In New Cases, Consider Suing under the DTSA and Asserting an Unfair Competition Cause of Action

For parties considering bringing a trade secrets claim (or parties in existing suits who are able to amend their claims), the trade secret owner should consider whether a DTSA claim, which is not subject to the holding in *E.J. Brooks*, is appropriate. In such a proceeding, the trade secret owner may be able to pursue its own lost profits; the defendant's non-duplicative profits gained through use of the trade secrets, whether as a proxy for the trade secret owner's own lost profits or as a separate form of unjust enrichment;⁶⁵ the defendants' avoided development costs; and, in lieu of these measures, reasonable royalty damages. Further, while many cases brought under the DTSA nationally to date have been coupled with a state-law trade secret misappropriation claim, a party whose dispute will be governed by New York law who wants to avoid the reach of *E.J. Brooks* should consider asserting a trade secrets claim *only* under the DTSA and not under New York common law, being mindful, of course, of limitations the DTSA imposes on certain types of injunctive relief.⁶⁶

In light of the Court of Appeals' recognition that the defendant's profits can be awarded as damages under an unfair competition theory if they are sufficiently linked to the use of the plaintiff's trade secrets, trade secret owners suing under New York law should explore asserting a claim for unfair competition if the alleged misappropriator is a competitor.

C. Address *E.J. Brooks* in Contracts to Share Trade Secrets Under New York Law

Parties who are developing contracts that will be governed by New York law (either expressly or by default, given the locus of the business arrangement and the parties) under which they plan to share trade secrets should consider negotiating provisions to address *E.J. Brooks* directly, including, where not contrary to the party's other objectives, an express contractual provision that any trade secret disputes relating to information shared under the contract shall be brought under the DTSA and a provision specifying that the development costs a party that misappropriates the trade secrets that have been shared is able to avoid and the profits it makes through the unauthorized use of the trade secrets are recoverable

damages for breach of the non-disclosure contracts or for misappropriation of trade secrets disclosed thereunder.

VII. What Does *E.J. Brooks* Mean for New York?

E.J. Brooks squarely holds that under New York common law the defendant's avoided development costs are not directly recoverable as damages for trade secrets misappropriation except where they can be shown to be a reasonable proxy for the trade secret owner's loss. This holding puts New York out of step with statutes and much decisional law throughout the rest of the country.

The DTSA and the UTSA provide expressly for recovery of the unjust enrichment caused by the misappropriation as a measure of damages. New York is now the only state that arguably has not adopted a version of the UTSA. Two draft proposals to enact a variation of the UTSA currently are pending in New York.⁶⁷ The *E.J. Brooks* decision, and its dissent, may provide legislators with a new reason to act.

Endnotes

1. *University Computing Co. v. Lykes-Youngstown Corp.*, 504 F.2d 518, 538, *reh'g denied*, 505 F.2d 1304 (5th Cir. 1974), cited in, for example, in *Linkco, Inc. v. Fujitsu Ltd.*, 232 F. Supp. 2d 182 (S.D.N.Y. 2002) (affirming award of royalty damages where neither party had established profit); *Lightlab Imaging, Inc. v. Axsun Technologies*, 13 N.E. 3d 604, 614 (2014) (rejecting proffered lost profit damages calculation as speculative where neither side had marketed products but recognizing that "other theories of damages may lend themselves to misappropriation of trade secrets cases and that such theories may be ripe for testing in our courts.").
2. The Massachusetts legislature became the latest state to adopt a variation of the Uniform Trade Secrets Act on August 10, 2018, Mass. Gen. Laws ch. 149, § 21 (1918). While there is some disagreement among experts as to whether Alabama and North Carolina have enacted a version of the UTSA, the wording of the two states' enacted statutes reflect substantial conceptual similarities along with some differences, not relevant here, from the UTSA.
3. 18 U.S.C. § 1836(b)(3)(B)(i)-(ii); UTSA § 3(a). There is variation in the wording of the Uniform Trade Secrets Act as adopted by the various states, although not with respect to permitting recovery of the defendant's unjust enrichment (which may include avoided development costs) as a measure of damages, the subject of this article. Enacted versions of the UTSA and related practice differ, for example, with respect to who determines an award of reasonable royalty damages, with California holding that this is an issue to be decided by the court, *see, e.g., Ajaxo, Inc. v. E*Trade Financial Corp.*, 187 Cal. App. 4th 1295, 1308 (2010), *on remand*, 2015 Cal. Super. LEXIS 190 (Sept. 16, 2015), while other states hold that this is an issue to be decided by the jury. *See, e.g., Storagecraft Tech. Corp. v. Kirby*, No. 2:08-CV-921 DN, 2012 WL 6029128, at *2 (D. Utah Dec. 4, 2012), *aff'd*, 744 F.3d 1183 (10th Cir. 2014). State law also differs as to whether reasonable royalty damages are available if either of the two other measures can be calculated. California, for example, requires a showing that the other two measures are not provable, before a reasonable royalty measure of damages is available. *See, e.g., Cal. Civ. Code* § 3426.3(b) (1984); *Ajaxo, supra* (rejecting reasonable royalty calculations and exercising discretion not to award reasonable royalty). Georgia and Illinois permit recovery of royalty damages if the trade secret claimant proves neither damages nor unjust enrichment by a preponderance of the evidence. *Ga. Code Ann.* §10-1-763(a) (2009); 765 Ill. Comp. Stat. Ann. §1065/4 (a) (2010). For a comparison of the wording of

- state trade secrets statutes as enacted, *see* the comparison chart posted at <https://www.faircompetitionlaw.com/wp-content/uploads/2018/08/Trade-Secret-50-State-Chart-20180808-UTSA-Comparison-Beck-Reed-Riden-2016-2018.pdf>.
4. Dobbs, REMEDIES §10.5; *Steves and Sons Inc. v. Jeld-Wen Inc.*, No. 3:16-CV-00545-REP, 2018 WL 2172502, *6 (E.D. Va. May 10, 2018) (holding that avoided cost calculations were “appropriately considered as part of unjust enrichment damages” under the DTSA); *Via Technologies v. ASUS Computer Int’l*, No. 5:14-cv-03586, 2017 WL 3051048, *4 (N.D. Cal. July 7, 2017) (holding in a case brought under the DTSA and California’s version of the UTSA that “Where the plaintiff’s loss does not correlate directly with the misappropriator’s benefit...defendant’s unjust enrichment might be calculated based upon cost savings or increased productivity resulting from use of the secret”; *Southwestern Energy Prod. Co. v. Berry-Helfand*, 491 S.W. 3d 699 (Tex. Sup. Ct. 2016) (Texas common law, holding that damages for the value of a trade secret can be measured by defendant’s saved development costs and remanding for further proceedings); *Bourns, Inc. v. Raychem Corp.*, 331 F. 3d 704, 709-10 (9th Cir. 2003) (affirming award of damages under California’s UTSA based on defendant’s avoided development costs); *Sunoco Products v. Johnson*, 23 P. 3d 1287 (Colo. Ct. App. 2001) (affirming award of avoided development costs where defendant had not used trade secrets; applying Colorado UTSA).
 5. *See, e.g., GlobeRanger Corp. v. Software AG US*, 836 F. 3d 477, 499 (5th Cir. 2016) (affirming award of \$19.7 million under common law for avoided development costs); *Hallmark Cards, Inc. v. Monitor Clipper Partners, LLC*, No. 0:13-cv-01993, 2014 WL 3409953 (8th Cir. July 15, 2014) (8th Cir. 2014) (affirming award of \$21.3 million under Missouri Uniform Trade Secrets Act for avoided development costs or reasonable royalty) (both theories presented and affirmed); *Bourns, Inc. v. Raychem Corp.*, 331 F. 3d 704 (9th Cir. 2003) (affirming award of damages under California Uniform Trade Secrets Act of \$9 million defendant had saved through avoided development costs because of the misappropriation); *Avery Dennison Corp. v. Four Pillars Enter.*, 45 F. App’x 479 (6th Cir. 2002) (affirming award of \$81 million damages, which included amount for avoided development costs); *Epic Sys. Corp. v. Tata Consultancy Servs. Ltd.*, 2017 WL 4357993 (W.D. Wis. 2017) (on jmol, awarding \$140 million as defendant’s avoided development costs under Ohio Uniform Trade Secrets Act, which reflected a reduction from plaintiff’s development costs of \$200 million due to defendant’s lower cost of labor); *Lumileds LLC v. Elec-Tech Int’l Co. Ltd.*, No. 2015-1-cv-278566 (Cal. Super. Ct. Santa Clara Cty. Aug. 10, 2018) (verdict of \$66 million under California Uniform Trade Secrets Act for defendant’s avoided research and development costs).
 6. *E.J. Brooks Co. v. Cambridge Sec. Seals*, 31 N.Y.3d 441 (N.Y.), *remanded*, 729 F. App’x 115 (2d Cir. 2018).
 7. Another difference in remedies between New York common law and the UTSA and DTSA is that New York law does not provide for an award of attorney’s fees in trade secrets cases absent an independent basis for an award of fees. The UTSA and the DTSA give courts discretion to award attorney fees where claims of misappropriation are made in bad faith, a motion to terminate an injunction is made or resisted in bad faith, and in cases of willful or malicious misappropriation.
 8. 31 N.Y. at 444, 448-58.
 9. These facts are taken from the Amended Verified Complaint for Injunctive and Monetary Relief, Case No. 7:12-cv-02937-KMK-PED, Dkt. 104 (S.D.N.Y. Oct. 23, 2013) and the district court’s decision on jmol, *E.J. Brooks Co. v. Cambridge Security Seals*, No. 12-CV-2937 (LAP), 2015 WL 9704079 (S.D.N.Y. Dec. 23, 2015).
 10. *E.J. Brooks Co. v. Cambridge Sec. Seals*, 858 F.3d 744, 747 (2d Cir. 2017).
 11. *E.J. Brooks*, 31 N.Y. 3d at 445.
 12. This was substantially less than the \$6–12 million in avoided costs plaintiff’s damages expert had calculated. 31 N.Y.3d at 445.
 13. *E.J. Brooks*, 2015 WL 9704069, at *7.
 14. *Id.* at *4.
 15. RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 45 cmt. f & Reporters’ Note to cmt. f (1995).
 16. *E.J. Brooks*, 2015 WL 9704069, at *4.
 17. *Id.* (citations omitted).
 18. *Id.* at 752.
 19. 31 N.Y.3d at 444.
 20. *Id.* at 454 (emphasis added).
 21. *Id.* (emphasis added).
 22. *Id.* at 453.
 23. *Id.*
 24. *Id.* (emphasis added).
 25. *Id.* (emphasis added).
 26. *Id.* at 449-450.
 27. *Id.* at 450.
 28. *Id.*
 29. *Id.* at 456-57.
 30. *Id.* at 457.
 31. *Id.* at 458-59.
 32. *Id.* at 461 (citations omitted).
 33. *Id.* at 461.
 34. *Id.* at 460 (emphasis added).
 35. *Id.*
 36. *Id.* at 474.
 37. *Id.* at 461.
 38. *Id.* at 464, citing *LinkCo Inc. v. Fujitsu, Ltd.*, 232 F. Supp. 2d 182, 186 (S.D.N.Y. 2002) for the proposition that “losses measured solely by [plaintiff’s] development costs would not adequately compensate the company for its loss of the potentiality valuable trade secret.”
 39. *E.J. Brooks*, 31 N.Y. 3d at 464.
 40. *Id.* at 462.
 41. *Id.* at 463.
 42. *Id.* at 459.
 43. *Id.*
 44. *Id.* at 463-64.
 45. For example, in *Epic Sys. Corp. v. Tata Consultancy Svc. Ltd.*, 2017 WL 4357993, at *4 (W.D. Wis. Sept. 29, 2017), the jury awarded avoided development costs based on the defendant’s lower overhead for labor than the costs the plaintiff had incurred.
 46. 31 N.Y.3d at 462.
 47. *Id.* at 459.
 48. *Id.* at 464.
 49. *See discussion id.* at 468-69.
 50. *Id.* at 470.
 51. *Id.* at 472.
 52. *Id.* at 476-77 (emphasis added).
 53. *E.J. Brooks Co. v. Cambridge Sec. Seals*, No. 1:12-cv-02937-LAP, Dkt. 379 (S.D.N.Y. Aug. 20, 2018).
 54. *Shamrock Technologies, Inc. v. Medical Sterilization, Inc.*, 808 F. Supp. 932 (E.D. N.Y. 1992), *aff’d*, 6 F. 3d 788 (Fed. Cir. 1993).
 55. *Cf. Scentsational Technologies, Inc. v. Pepsi, Inc.*, No. 13-cv-8645, *Slip Op.* at 41-42 (KBF) (S.D.N.Y. Feb. 14, 2018) (excluding damages expert’s report offering lost profits analysis where models of profits projections were based on trade secret owner’s projections).

of revenues it “hoped” to make and assumption that successful commercialization of the technologies at issue worldwide was 100 percent likely but-for the alleged misappropriation; projections did not take into account plaintiff’s business, past performance, or the market as a whole. “Simply put, his data points are untested; analysis of lost profits must rely on more than conversations with a plaintiff’s executive and internal emails regarding the hoped-for revenues”).

56. See, e.g., *A.F.A. Tours, Inc. v. Whitchurch*, 937 F.2d 82, 87 (2d Cir. 1991) (“The amount of damages recoverable in an action for misappropriation of trade secrets may be measured either by the plaintiff’s losses or by the profits unjustly received by the defendant” (citations omitted)); *ScentSational Technologies LLC v. PepsiCo, Inc.*, No. 13-CV-8645, 2017 WL 4403308 (S.D.N.Y. Oct. 2, 2017); *Stanacard, LLC v. Rubard LLC*, No. 12 Civ. 5176 (CM), 2016 WL 6820741 (S.D.N.Y. Nov. 10, 2016).
57. *E.J. Brooks*, 31 N.Y. 3d at 450 (citations omitted).
58. *Electro-Minatures Corp. v. Wendon Co.*, 771 F.2d 23, 27 (2d Cir. 1985).
59. *E.J. Brooks*, 31 N.Y. 3d at 452.
60. See, e.g., *Cardiovention, Inc. v. Medtronic, Inc.*, 483 F. Supp. 2d 830, 845-46 (D. Minn. 2007) (permitting expert to calculate trade secret owner’s damages to include loss of further investments because of misappropriation).
61. *Id.* at 454 (citations omitted). Examples of pre-*E.J. Brooks* decisions cited by the trial court in *E.J. Brooks* permitting recovery of the plaintiff’s development costs include *In re Cross Media Mktg. Corp.*, No. 06 Civ. 4228 (MBM), 2006 WL 2337177 (S.D.N.Y. Aug. 11, 2006) (affirming award entered by bankruptcy court finding defendant accused of misappropriation liable for plaintiff’s cost to develop customer names multiplied by the number of customers at issue), and *Linkco, Inc. v. Fujitsu Ltd.*, 232 F. Supp. 2d 182, 185 (S.D.N.Y. 2002).
62. To fill out gaps and as a cross-check, the plaintiff should consider conducting discovery into the defendant’s development costs and explore whether they can be argued, in the specific case, to be a reasonable proxy for the plaintiff’s own development costs. While the majority in *E.J. Brooks* found no general presumption that the costs would be related, the plaintiff may be able to develop such evidence in a particular case.
63. A reasonable royalty calculation is “a common form of award in both trade secret and patent cases,” *Vermont Microsystems, Inc. v. Autodesk, Inc.*, 138 F.3d 449, 450 (2d Cir. 1998) (applying California law); *LinkCo.*, 232 F. Supp. 2d at 186, and has been found to be “ideal” when the commercial context in which the misappropriation occurred requires consideration of multiple factors in order to compensate the plaintiff adequately. *University Computing Co. v. Lykes-Youngstown Corp.*, 504 F.2d 518, 535-37 (5th Cir. 1974) (cited by *Vermont Microsystems*); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 45 cmt. g (1995). A reasonable royalty can be an appropriate remedy even if the trade secret owner retains use of the trade secret, *LinkCo.*, 232 F. Supp. 2d 182, 188 S.D.N.Y. 2002). Cf. *Softel, Inc. v. Dragon Med. and Scientific Communs., Inc.*, 118 F.3d 955, 969 (2d Cir. 1997) (finding that the total value of the secret could not be awarded to the plaintiff under the specific facts presented because the secret had not been destroyed and the plaintiff retained use of the secret).
64. See, e.g., *Tesla Wall Systems, Inc. v. Budd*, No. 14-Civ. 8564 (LLS), 2017 WL 1498052, *1 (S.D.N.Y. April 26, 2017) (reversing a \$14.5 million jury verdict and remanding for a new trial on damages for breach of contract, breach of fiduciary duty, violation of the Delaware Trade Secrets Act and related claims, finding that “[t]he calculation tendered by plaintiff’s expert, . . . while theoretically coherent, was so detached from and dismissive of the facts in the case that it is unacceptable.” Among other things, even though plaintiff had lost money every year for the short period it existed and lost money on every project, the damages model assumed that but-for the acts complained of plaintiff would over the next two years become four to five times more profitable than the industry leader and that it would earn annual revenues of \$175 million per year into perpetuity under contracts with as yet unknown customers); *Affiliat PLC v. Architelos, Inc.*, No. 1:15-cv-14 (LMG/JFA), 2016 WL 1245006 (E.D. Va. March 23, 2016) (granting a remittitur of a jury award for misappropriation to \$2 million from the verdict of \$5 million because plaintiff’s damages expert’s “reasonable royalty” calculation was “excessive” when compared to a newly established plaintiff’s actual research and development costs and defendant’s actual profits).
65. To the extent that the defendant’s profits gained through misappropriation are pursued under the DTSA not as a proxy measure of the plaintiff’s loss (which would be determined by the jury) but as an independent substitute for or an addition to lost profits, the trade secret owner will want to consider the potential import of the Federal Circuit’s determination in *Texas Advanced Optoelectronic Solutions, Inc. v. Renesas Electronics America, Inc.*, No. 2016-2121, 2016-2208, 2016-2235, 2018 WL 3358927, *10-16 (Fed. Cir. July 9, 2018) (concluding that such a restitutionary award is an equitable remedy, not a legal remedy, which must be determined by the court, not by the jury).
66. The DTSA imposes limitations on certain forms of injunctive relief with employees. See 18 U.S.C. § 1836(b)(3)(A)(i)(I) and (II).
67. SB S4688, introduced Feb. 24, 2017, in committee; A06419, introduced to the New York State Assembly Mar. 7, 2017 (same text as SB 24688).

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Is the Presumption of Validity Dead for Substitute Claims Issued as a Result of Motions to Amend After PTAB Proceedings?¹

By Charles R. Macedo, Christopher Lisiewski, and Sean Reilly

I. Introduction

Under section 282 of the Patent Act of 1952, a patent “shall be presumed valid,” and “[t]he burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting such invalidity.”² As Judge Rich, one of the authors of the 1952 Patent Act, explained, the rationale for this presumption is based on “the basic proposition that a government agency such as the [PTO] was presumed to do its job.”³ This presumption makes sense in the context of the statutory scheme of the 1952 Act, which first codified this presumption, where a patent application follows an “inquisitorial process between patent owner and examiner.”⁴ Thus, the examiner, acting on behalf of the government, can be presumed to have performed his or her job if and when patent claims issue.

However, in 2011, under the Leahy-Smith American Invents Act (AIA), unlike the original prosecution, or even traditional *ex parte* reexamination, “the petitioner is master of its complaint and normally entitled to judgment on all of the claims it raises, not just those the decisionmaker might wish to address.”⁵ To the extent all the PTAB is performing is “a second look at an earlier administrative grant of a patent,”⁶ continuing to apply this presumption to claims that survive a PTAB proceeding (like an *inter partes* review) continues to make sense. After all, the government did its job in the first instance in the original inquisitorial examination, and a third-party challenger was unable to demonstrate error.

However, since the Federal Circuit’s decision in *Aqua Products, Inc. v. Matal*⁷ confirmed that the burden of persuasion on the patentability of amended claims in a motion to amend in an *inter partes* review proceeding (and presumably other post issuance PTAB proceedings) is placed on the petitioner, the theoretical rationale for section 282(a)’s presumption of validity is no longer present for such amended claims. In particular, there is no government agency that is tasked with performing the inquisitorial examination that gave rise to the original presumption. How can there be a presumption that the government agent charged with examining the patent claims did his or her job, when there is no such person assigned to perform that job?

II. Historical Rationale for the Presumption of Validity Through 1952

As early as 1874, the U.S. Supreme Court laid out the common law roots of the presumption of validity, holding that prior art “must be shown by the defendant.”⁸

“The burden of proof rests upon him, and every reasonable doubt should be resolved against him.”⁹ Not long thereafter, the Court explained that “[t]he patent itself is *prima facie* evidence that the patentee was the first inventor, at least it casts upon him who denies it the burden of sustaining his denial by proof.”¹⁰

By the 1930s, these principles had become firmly incorporated into the common law. For example, in *Radio Corp. of America v. Radio Engineering Laboratories*, Justice Cardozo explained:

A patent regularly issued, and even more obviously a patent issued after a hearing of all the rival claimants, is presumed to be valid until the presumption has been overcome by convincing evidence of error.¹¹

The 1952 Act, which first codified the statutory law on the presumption of validity, provided that a patent “shall be presumed valid” and that the burden of establishing invalidity “shall rest on the party asserting it.”¹² The reviser’s note to that section stated simply: “The first paragraph declares the existing presumption of validity of patents.”¹³

III. Federal Circuit Jurisprudence on the Presumption of Validity

In *American Hoist*, Judge Rich, an author of the 1952 Act and a distinguished patent jurist, wrote an early Federal Circuit decision addressing confusion regarding how the presumption of validity applied with respect to evidence considered and evidence not considered previously by the Patent Office in the original examination of an issued patent claim. Significantly, as Judge Rich explained, “Behind it all . . . was the basic proposition that a government agency such as the then Patent Office was presumed to do its job.”¹⁴ Thus, the presumption should arise, in theory, only when the job is actually performed or expected to be performed.

In *Microsoft Corp. v. i4i Ltd. Partnership*,¹⁵ the Supreme Court clearly recognized the applicability of section 282:

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[T]he first paragraph of § 282 provides that “[a] patent shall be presumed valid” and “[t]he burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting such invalidity.” Thus, by its express terms, § 282 establishes a presumption of patent validity, and it provides that a challenger must overcome that presumption to prevail on an invalidity defense.¹⁶

In doing so, Justice Sotomayor, writing for the Court, relied upon the inquisitorial nature of the patent examination process as part of the rationale justifying such a presumption. The Court noted that when Congress adopted the common law term “presumed valid” in section 282, it intended to adopt the meaning already attached to this term, since the “presumption of patent validity had long been a fixture of common law.”¹⁷ She saw “[n]othing in [section] 282’s text suggest[ing] that Congress meant to depart from that understanding to enact a standard of proof that would rise and fall with the facts of each case.”¹⁸

IV. The America Invents Act and the Changed Paradigm from Inquisitorial to Adversarial Proceedings

The AIA became effective on September 16, 2011, just a few months after the Supreme Court’s ruling in *Microsoft*.¹⁹ Under the AIA, any person other than the patent owner can file a petition for *inter partes* review.²⁰ After the institution of an *inter partes* review, the matter proceeds before the PTO “with many of the usual trappings of litigation.”²¹ As Justice Gorsuch explained in *SAS*, this new, adversarial approach clearly deviated from the inquisitorial approach used in the PTO in the past in both original prosecution and in the prior *ex parte* reexaminations and *inter parte* reexaminations. “[R]ather than create (another) agency-led, inquisitorial process for reconsidering patents, Congress opted for a party-directed, adversarial process.”²² Under the new *inter partes* review regime, the petitioner defines challenges for the PTO to decide.²³ The new structure also includes the right for a patent owner to amend the patent or to cancel one or more of its claims.²⁴

The patent owner can file a motion to amend by “propos[ing] a reasonable number of substitute claims.”²⁵ However, unlike district court litigation, in which the presumption of validity applies, the new proceedings instead utilize a preponderance of the evidence standard.²⁶

V. Motions to Amend Under *Aqua Products*

In 2017, the full Federal Circuit found fault with the PTO’s prior practice and held in *Aqua Products v. Matal* that, at least under the current PTO regulations, “The only legal conclusions that support and define the judg-

ment of the court are: (1) the PTO has not adopted a rule placing the burden of persuasion with respect to the patentability of amended claims on the patent owner that is entitled to [*Chevron*] deference; and (2) in the absence of anything that might be entitled deference, the PTO may not place that burden on the patentee.”²⁷ Significantly, the question of whether the PTAB may raise patentability challenges to amended claims *sua sponte* was “reserved for another day.”²⁸

Faced with this radical departure from its prior practice, the PTAB quickly responded with new guidance on the decision (“Guidance”).²⁹ The PTAB confirmed that the burden of persuasion will no longer be placed on a patent owner with respect to the patentability of substitute claims presented in a motion to amend.³⁰ Further, in reviewing a patent owner’s motion to amend, as long as the motion satisfies the statutory requirements under 35 U.S.C. § 316(d), the PTAB will “determine whether the substitute claims are unpatentable by a preponderance of the evidence based on the entirety of the record, including any opposition made by the petitioner.”³¹

Substitute claims that issue as a result of motions to amend during post-issuance proceedings do not undergo an initial prosecution process in which the PTO engages in fact-finding and refers to that fact-finding in making patentability determinations.³² Without the initial inquisitorial fact-finding process, a patent examiner has not, *inter alia*:

- (1) searched prior art to ensure that an invention is new and unique;
- (2) reviewed patent applications to ensure conformity to formal requirements; or
- (3) issued office actions communicating the examiner’s findings on patentability to inventors and patent practitioners.

Therefore, the theoretical rationale underlying the presumption of validity—that the PTO “in its expertise, has approved the claim”³³—no longer applies to substitute claims, as there is no government agency tasked with performing the inquisitorial examination that gave rise to the original presumption.

Without a full inquisitorial approach, claims amended in an *inter partes* review proceeding or other post-issuance challenge are likely to be subject to a greater scope of challenges, since the foundation for the presumption of validity that otherwise exists is no longer present. Thus, as Justice Sotomayor explained, challenges on grants not already raised “may be easier to sustain.”³⁴

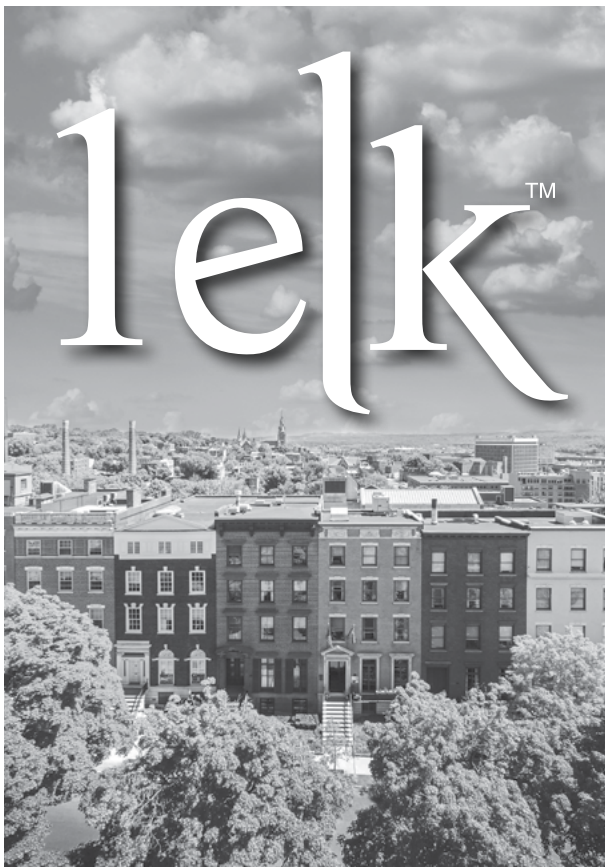
VI. Conclusion

A presumption of validity that is based on the assumption that government officials are presumed to have done their job is reasonable when a government office

has been so tasked. However, in the context of amended claims coming out of an *inter partes* review, the rationale falls apart. No presumption should remain for such claims, at least as long as the burden in an *inter partes* review rests solely upon a petitioner with respect to substitute claims offered by amendment.

Endnotes

1. This article is adapted from a White Paper published by Askeladden L.L.C.'s Patent Quality Initiative. A full copy of the paper is available at <http://www.patentqualityinitiative.com/-/media/pqi/files/articles/pqi---presumption-of-validity-article.pdf>.
2. 35 U.S.C. § 282 (2018).
3. *American Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1359 (Fed. Cir. 1984).
4. *See SAS Institute, Inc. v. Iancu*, 138 S. Ct. 1348, 1353 (2018).
5. *Id.* at 1355; *see id.* at 1356 ("[T]he petitioner's petition, not the Director's discretion, is supposed to guide the life of the [*inter partes* review] litigation.").
6. *Oil States Energy Servs., LLC v. Greene's Energy Grp.*, 138 S. Ct. 1365, 1374 (2018) (quoting *Cuozzo Speed Techn. LLC v. Lee*, 136 S. Ct. 2131, 2144 (2016)).
7. 872 F.3d 1290 (Fed. Cir. 2017) (*en banc*).
8. *Coffin v. Ogden*, 85 U.S. 120, 124 (1874) (Strong, J.).
9. *Id.*
10. *Smith v. Goodyear Dental Vulcanite Co.*, 93 U.S. 486, 498 (1877) (Strong, J.); *see also Lehnbeuter v. Holthaus*, 105 U.S. 94, 96 (1882) (Woods, J.) ("The patent is *prima facie* evidence of both novelty and utility, and neither of these presumptions has been rebutted by the evidence.").
11. 293 U.S. 1, 7-8 (1934) (emphasis added) (internal quotations and citations omitted).
12. 35 U.S.C. § 282 (1952 ed.).
13. 35 U.S.C. § 282 note (1952 ed.) (Historical and Revision Notes).
14. *Am. Hoist*, 725 F.2d at 1359 (citing *Morgan v. Daniels*, 153 U.S. 120, 125 (1894)).
15. 131 S. Ct. 2238 (2011).
16. *Id.* at 2245 (quoting 35 U.S.C. § 282 (2002 ed.)).
17. *Id.* at 2246.
18. *Id.* at 2250.
19. Leahy-Smith America Invents Act, Pub. L. No. 112-29 (2011).
20. 35 U.S.C. § 311(a) (2012 ed.).
21. *SAS*, 138 S. Ct. at 1353-54.
22. *Id.* at 1355 (citation omitted).
23. *Oil States Energy Servs.*, 138 S. Ct. at 1371.
24. *SAS*, 138 S. Ct. at 1354 (citing 35 U.S.C. § 316(d)).
25. *Oil States*, 138 S. Ct. at 1371 (citing 35 U.S.C. § 316(d)(1)(B)).
26. *See* 35 U.S.C. § 316(e) (2018).
27. 872 F.3d 1290, 1327 (2017) (*en banc*).
28. *Id.* at 1325.
29. Memorandum from David P. Ruschke, Chief Admin. Patent Judge, U.S. Patent and Trademark Office on Guidance on Motions to Amend in view of *Aqua Products* to Patent Trial and Appeal Board (Nov. 21, 2017), https://www.uspto.gov/sites/default/files/documents/guidance_on_motions_to_amend_11_2017.pdf.
30. *Id.*
31. *Id.*
32. *Microsoft*, 131 S. Ct. at 2242.
33. *KSR Int'l Co. v. Teleflex Inc.*, 550 U.S. 398, 426 (2007).
34. *Microsoft*, 131 S. Ct. at 2251.



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Second Circuit Clarifies Significance of Trade Channels in Trademark Infringement Litigation

By Jessica Vosgerchian

I. Introduction

In *Excelled Sheepskin & Leather Coat Corp. v. Oregon Brewing Co.*¹ the Second Circuit reversed district court decisions that had granted summary judgment for the plaintiff Excelled Sheepskin & Leather Coat Corp. (“Excelled”) and entered a permanent injunction against the defendant Oregon Brewing Co. (OBC) in a dispute over the use of the mark ROGUE on certain clothing.² The Second Circuit was correct to do so, both as a matter of law and as a matter of policy. The lower court misinterpreted established principles relating to the significance of different trade channels in trademark law. Moreover, the shifting nature of retail marketing practices cautions against delineating trademark rights first and foremost on distinctions between the types of stores selling the goods at issue, as the district court in the case did.

II. Background

Excelled involves a trademark dispute over use of the mark ROGUE on T-shirts, sweatshirts, hats, and similar apparel between Excelled, an apparel company, and OBC, a commercial brewery that primarily uses the ROGUE mark as a brand name for beer. In 1989, OBC began selling casual clothing, such as t-shirts, sweatshirts, hats, and aprons, bearing the ROGUE mark in its own places of business in Oregon, as well as across the country at beer festivals and through mail orders. In 1995, OBC began distributing its ROGUE apparel through two third-party retailers, and in 2004 expanded into other retail stores and online retail websites, including Beer Clothing Co., Crazy Shirts, Portland State University’s bookstore, Whole Foods, and sharpedgebeer.com. In 2011, OBC began selling its ROGUE clothing through department and clothing stores, including Urban Outfitters, Nordstrom, and Sears.

Excelled began using the brand name ROGUE in 2000 on leather coats and jackets sold by third-party retailers, primarily department stores and clothing-only stores. It expanded its ROGUE product line in 2009 to include the same categories of apparel on which OBC uses the mark ROGUE. Excelled sued OBC in the Southern District of New York in 2012 alleging trademark infringement and related claims based on OBC’s sale of ROGUE-branded apparel in department and clothing-only stores beginning in 2011. OBC counterclaimed, alleging trademark infringement by Excelled based on Excelled’s sales of ROGUE-branded t-shirts, sweatshirts, and hats beginning in 2009. OBC also sought cancellation of four of Excelled’s federal trademark registrations on the theory of fraud on the trademark office.

The district court entered summary judgment for Excelled on its trademark infringement, counterfeiting, false designation of origin, and unfair competition claims. In a later decision, the court awarded damages and attorneys’ fees to Excelled and entered a permanent injunction barring OBC from using ROGUE “in the advertising or sale of any clothing in Department and Clothing Stores; or in any trade channels other than where OBC’s ROGUE branded beer is sold as complements to and in promotion of Defendant’s own brewing and beverage business.”³ The court found that Excelled had prior rights in ROGUE for branded clothing sold in department stores and clothing-only stores despite OBC’s prior use of the mark on the types of apparel at issue that it sold in other retail outlets. The court also concluded that Excelled’s prior registration of its ROGUE mark established its priority notwithstanding OBC’s prior use and that OBC’s delay in suing Excelled gave rise to forfeiture of its claims based on laches. The parties cross-moved for summary judgment; Excelled moving in favor of its claims and for dismissal of OBC’s counterclaims and OBC seeking dismissal of Excelled’s claims. The court ruled in favor of Excelled, granting summary judgment on its trademark infringement claims and dismissing all of OBC’s counterclaims. OBC appealed.

The Second Circuit reversed, holding that OBC had priority over Excelled in the use of ROGUE on certain clothing items throughout the United States; laches did not bar OBC’s claims; and a genuine issue of material fact barred dismissal of OBC’s cancellation claim. The court ordered the district court to enter summary judgment in favor of OBC on its infringement claims, reversed the award of an injunction, damages, and fees to Excelled, and vacated and remanded for trial OBC’s cancellation counterclaim.

Although the Second Circuit disagreed with the district court in a number of respects—including as to its application of the laches doctrine and on the significance of OBC’s intent in selling ROGUE-branded apparel⁴—this article focuses on the district court’s emphasis on distinctions between retail outlets in deciding trademark priority.

III. Priority Is (and Should Be) Based on a User’s Offerings, Not on Its Trade Channels

The district court found that OBC’s prior use of ROGUE did not give it priority for use of the mark on clothing sold in department stores and clothing-only

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stores on the ground that Excelled “was the first to use and the first to register its Rogue marks for use throughout the United States in the *department and clothing store* markets.”⁵ This priority determination also arose from the fact that OBC did not show “that prior to 2000, the date of Excelled’s first Rogue federal registration for clothing, OBC had conducted any sales that were not in connection with or in promotion of its beer business.”⁶ The Second Circuit reversed, finding that OBC had prior rights to use of ROGUE on t-shirts, sweatshirts, and hats regardless of the type of retail outlet offering them or OBC’s intent in selling branded apparel.⁷

The Second Circuit, in a decision by Judge Pierre N. Leval, explained that by delineating prior rights by first use in particular types of stores, the district court had misinterpreted the proposition that first use of a mark does not give a trademark owner exclusive rights “as to all goods or services and across all markets.”⁸ As the court of appeals reasoned (correctly), “expanding into new product lines in which someone else has priority is different from beginning to sell the goods on which one has nationwide priority in a new category of stores (where a junior user is making infringing sales under the senior user’s mark).”⁹ Under established law, prior rights are limited to a trademark owner’s current offerings and related goods and services that are within the scope of “natural expansion.”¹⁰ If an unregistered mark is not used nationwide, its owner’s common law rights will be limited to the geographic scope of the use. But prior rights are not limited to the trade channels in which the senior user’s offerings travel. Rather, in a trademark infringement action, relatedness of the parties’ trade channels (and likelihood that the senior user will bridge the gap) is merely one of several *Polaroid* factors in the analysis of whether the defendant’s use creates a likelihood of consumer confusion.¹¹ If the trade channels are sufficiently different, this factor weighs against confusion. It is important to note, however, that trade channel distinction is not among the most important *Polaroid* factors, and for good reason.

In determining priority based on trade channels, the district court followed a long tradition of trademark cases emphasizing trade channel distinctions and, in particular, recognizing “department stores” as a distinct and exceptional market. *Sara Lee Corp. v. Kayser-Roth Corp.*¹² exemplifies this impulse. In that case, laches did not bar the plaintiff’s claim against a competing hosiery manufacturer that only recently expanded its product line from upscale department stores to the “food, drug, and mass merchandise market” in which the plaintiff sold its own hosiery. In the court’s view, the defendant’s use of a similar mark on the same goods did not trigger the plaintiff’s duty to sue until the defendant expanded beyond the rarefied realm of department stores.

Focusing on store type—perhaps over the relatedness of the goods—makes some intuitive sense. Many

people would likely agree that a Bloomingdale’s department store seems more distinct from a Walgreens pharmacy than, say, a jacket seems different from a t-shirt. However, the frequently shifting nature of marketing practices makes trade channel distinction too slippery a concept on which to predicate trademark rights. Consider the 1987 decision *Elizabeth Taylor Cosmetics Co. v. Annick Goutal, S.A.R.L.* (“*Goutal*”),¹³ which enjoined the infringer from selling its competing perfume in the senior user’s primary market: “‘first-tier’ stores, for example, Bergdorf–Goodman, Nieman–Marcus [sic], I. Magnum [sic], Henri Bendel, and stores of comparable quality.” In so doing, the court issued a permanent prohibition based on the nebulous notion of the “quality” of a collection of stores as they were in 1987, as if that quality were not subject to change, and limited the plaintiff’s trademark rights to its marketing practices up to that point. This approach is divorced from the commercial reality that the marketing strategies of trademark owners and retailers alike are prone to change. Indeed, since that decision, the retailer I. Magnin folded,¹⁴ and the owner of the Henri Bendel brand announced it would soon close all stores.¹⁵ Meanwhile, Neiman-Marcus has for decades pursued a more middle-market strategy in response to financial struggles.¹⁶

Goutal irrationally assumed that consumers would not suffer confusion if they encountered the infringing product in an outlet other than (in the court’s view) the obviously distinct realm of “first-tier stores.” Several later cases have taken a more realistic view of how consumers experience upscale department stores and “mass market” retailers. As one court put it, “[A]ffluent people shop at Sears and less affluent people shop at Macy’s. Hence there would seem to be overlap in customer base even though the retail outlets where the parties’ products are sold are not exactly the same.”¹⁷ This approach wisely recognizes that trade channels are not all that distinct if the same shoppers patronize them in similar ways.

Like *Goutal*, the injunction in *Excelled* also set prohibitions based on store types that in reality are vague and unstable. Specifically, the court enjoined OBC from selling its ROGUE apparel in “Department and Clothing Stores; or in any trade channels other than where OBC’s ROGUE branded beer is sold as complements to and in promotion of Defendant’s own brewing and beverage business.”¹⁸ What the court must have imagined was a clear delineation of types of stores is actually quite uncertain in practice. Is the nationwide retailer Target a department store or a clothing store covered by this injunction? Does the fact that Target began offering a wide variety of groceries in 2010 change its status?¹⁹ Or consider the archetypal department store Neiman Marcus, which operates restaurants in dozens of its stores.²⁰ If Neiman Marcus begins serving OBC’s ROGUE beer in its restaurants, can OBC sell its ROGUE apparel in Neiman Marcus department stores? If Whole Foods ceases to sell ROGUE beer, must

OBC pull its ROGUE apparel from Whole Foods stores even though it first sold apparel there in 2004?

Such questions justify basing the scope of a senior user's trademark rights on the nature of the trademark owner's offerings rather than on classification of its retail outlets. Undoubtedly, apparel companies commonly offer both the types of clothing offered by OBC under ROGUE (e.g., T-shirts) and the types of items Excelled is still allowed to sell under the mark (e.g., jackets), so the Second Circuit's preference for dividing rights by clothing type does not necessarily protect against consumer confusion. Still, the fact is that apparel categories are far more static than retail outlet categories. Target can begin competing directly with Whole Foods, but a jacket cannot realistically substitute for pants. Thus, categories of goods and services make for more stable fault lines for defining rights than ever-changing trade channels.

Endnotes

1. *Excelled Sheepskin & Leather Coat Corp. v. Oregon Brewing Co.*, 897 F.3d 413 (2d Cir. 2018) ("Excelled II").
2. *Excelled Sheepskin & Leather Coat Corp. v. Oregon Brewing Co.*, No. 12 CIV. 01416 GBD, 2014 WL 3874193, at *1 (S.D.N.Y. Aug. 5, 2014) (granting summary judgment for Excelled and against OBC); *Excelled Sheepskin & Leather Coat Corp. v. Oregon Brewing Co.*, No. 12CIV1416GBDRLE, 2016 WL 5409482, at *1 (S.D.N.Y. Sept. 28, 2016) (awarding damages, attorney's fees and an injunction against OBC).
3. *Excelled*, 2016 WL 5409482, at *4.
4. *Excelled II*, 897 F.3d at 418-20 (original emphasis).
5. *Excelled*, 2014 WL 3874193, at *6.
6. *Id.*
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8. *Id.* at 417-18.
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REQUEST FOR ARTICLES



Under New York's Long-Arm Statute, When Is Infringement "Within the State"?

By Jeffrey M. Koegel

I. Introduction

You represent creative people, and you may occasionally be called on to help them enforce their intellectual property rights. Unfortunately, advances in technology and global interconnectedness have made it more challenging to protect creative works against unauthorized copying and reproduction. To add insult to injury, the internet has even made it difficult to determine where injury arising from such infringement has occurred. The limitless extent of unauthorized copying and transmission of copyrighted works to anyone, anywhere, at any time can be maddening to copyright owners. Although there are remedies against such infringement, it is not always clear where the infringer can be sued. If someone sitting in Texas copies an image from a website owned by an artist in New York, is the artist injured in New York? Will she or he be able to hale the infringer into court in New York?

As you might imagine, the answer depends on whether the injury occurred "within the state," so that the infringer can be subject to personal jurisdiction under New York's long-arm statute. But where the injury occurs is not always clear. To explore this issue, this article focuses on, and discusses the impact of, two cases in which the Second Circuit addressed personal jurisdiction over non-New York defendants in copyright infringement actions.

II. *Penguin Group*: The Internet, Digital Piracy, and Non-Traditional Infringement

In *Penguin Group (USA) Inc. v. American Buddha*,¹ a New York publishing company brought a copyright infringement action in the Southern District of New York against an Oregon not-for-profit organization based in Arizona. The plaintiff alleged that the defendant had uploaded digital copies of four books, in their entirety, to its websites, and then made those copies freely available for downloading to its 50,000 users throughout the country.

The district court dismissed the complaint for lack of personal jurisdiction, finding that the alleged injury (the copying and uploading of the plaintiff's works) took place in either Oregon or Arizona, not New York. The plaintiff appealed to the Second Circuit, which certified to the New York Court of Appeals the question of how to apply New York's long-arm statute, CPLR § 302, to copyright infringement claims against out-of-state defendants. Specifically, the Second Circuit wanted to know whether the alleged infringement met the statute's requirement that the tortious act "caused an injury to a person or property in New York."² Specifically, the certified question was:

In copyright infringement cases, is the situs of injury for purposes of determining long-arm jurisdiction under N.Y. C.P.L.R. § 302(a)(3)(ii) the location of the infringing action or the residence or location of the principal place of business of the copyright holder?³

The Court of Appeals, for its part, narrowed the question presented based on "the Internet play[ing] a significant role in this case."⁴ The reformulated question (with emphasis added) was:

In copyright infringement cases *involving the uploading of a copyrighted printed literary work onto the Internet*, is the situs of injury for purposes of determining long-arm jurisdiction under N.Y. C.P.L.R. § 302(a)(3)(ii) the location of the infringing action or the residence or location of the principal place of business of the copyright holder?⁵

In answering this question, the Court of Appeals found that the situs of the injury "under the circumstances of th[e] case" was the "location of the copyright holder."⁶ Based on this answer, the Second Circuit reversed the district court and held that New York did, in fact, have jurisdiction over the non-resident defendant.

In narrowing the issue certified question, the Court of Appeals sought to avoid a "Pandora's box" that might result in "any nondomiciliary accused of digital copyright infringement [being] haled into a New York court" by a New York plaintiff.⁷ Likewise, it acknowledged that the internet's role in the uploading of copyrighted books made the case distinguishable from "traditional commercial tort cases" in which jurisdiction is properly exercised where sales or customers are lost.⁸ To guide its analysis, the Court identified two factors relevant to whether an injury was incurred in New York for purposes of section 302(a)(3)(ii): (1) the nature of the infringement and whether the injury could be associated with a particular geographic area and (2) the unique bundle of copyright rights implicated by the alleged tortious act.

As to the first factor, the Court noted that the "intended consequence[]" of the defendant's digital privacy was "the instantaneous availability of those copyrighted works . . . for anyone, in New York or elsewhere, with an

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Internet connection to read and download the books free of charge.”⁹ As to the second factor, the Court explained that the defendant’s piracy—by making copyrighted materials free—threatened to “diminish[] the incentive to publish or write.”¹⁰ In balancing these factors, the Court held that the defendant could be subject to jurisdiction in New York, since the plaintiff’s lost sales were “difficult, if not impossible” to correlate to any particular geographic area, and the infringement of the plaintiff’s copyright rights resulted in the plaintiff “suffer[ing] something more than indirect financial loss.”¹¹

Although New York plaintiffs point to *Penguin* as authority for extending New York’s long-arm jurisdiction over non-resident defendants in copyright infringement cases, defendants insist that the Court went out of its way to narrow its holding to cases involving digital piracy and “the uploading of a copyrighted printed literary work onto the Internet.”¹² Ultimately, facts that implicate some use of the internet in connection with infringe-

tor—the nature of the infringement—the court found that there was nothing about the case that prevented the injury from being circumscribed to a particular locality, namely California or Germany. The court distinguished *Penguin* on the ground that unlike that case, the facts in *Troma* did not involve injury that was “virtually impossible to localize” (i.e., widespread digital copying and distribution of literary works over the internet).¹⁵ The court found instead that the case at hand was more of a “traditional commercial tort case[],” where the injury could be circumscribed to a particularly locality (California and/or Germany).¹⁶ The court determined that this factor weighed heavily in favor of finding that jurisdiction did not lie in New York.

With respect to the second factor—the unique bundle of copyright rights at issue—the court found that plaintiff had not pled anything more than “simple economic losses.”¹⁷ The court stated that *Penguin* did not “relieve[] intellectual property owners of the obligation, in each case, to allege facts demonstrating a non-speculative and

“In Penguin, the Court of Appeals found that the copying and reproduction of the entirety of copyrighted works endangered the central purpose of copyright protection, namely, incentivizing the creation of creative works.”

ment are not by themselves determinative of whether a non-resident defendant can be haled into court in New York. The question of whether personal jurisdiction applies requires a more thorough examination of whether the plaintiff’s injury can be ascribed to New York or anywhere else the copyright owner might obtain relief.

III. *Troma*: Traditional Commercial Torts and “Simple” Economic Injury

In *Troma Entm’t Inc. v. Centennial Pictures Inc.*¹³ the Second Circuit took the opportunity to clarify the long-arm test in a “traditional” (non-internet) infringement case, where personal jurisdiction would not extend over a non-resident defendant. In *Troma* a motion picture producer and distributor based in New York brought a copyright infringement action in New York against defendants who met in California to arrange for the unauthorized distribution of the plaintiff’s work in Germany.

The district court dismissed the case based on the plaintiff’s failure to allege that the defendants caused the plaintiff’s injury within New York, as section 302(a) (3) requires. The plaintiff appealed to the Second Circuit, where it complained of the “generalized harm” it experienced due to the alleged infringement.¹⁴ The Second Circuit affirmed. The court balanced the *Penguin Group* factors and found that the plaintiff had not established a basis for long-arm jurisdiction. Regarding the first fac-

direct New York-based injury to its intellectual property rights.”¹⁸ Moreover, the court found that the plaintiff had failed to articulate a unique intellectual property right that would distinguish the case from a traditional commercial tort case. In *Penguin*, for instance, the Court of Appeals found that the copying and reproduction of the entirety of copyrighted works endangered the central purpose of copyright protection, namely, incentivizing the creation of creative works. In *Troma*, by contrast, the court found the loss of a distribution deal to be more akin to a generalized economic harm that did not satisfy the requirements of a harm “within New York” under section 302. In the absence of factual allegations demonstrating an injury suffered in New York, the Second Circuit affirmed the dismissal of the complaint for lack of personal jurisdiction.

IV. *Adwar*: The Internet Is Not Enough

In *Adwar Casting Co. v. Star Gems, Inc.*¹⁹ the plaintiff was a New York corporation that manufactured, distributed, marketed, and sold original jewelry products throughout the United States. The defendant was a Georgia-based corporation that was a wholesale manufacturer of jewelry products. The plaintiff alleged that the defendant manufactured and sold knock-offs of the plaintiff’s copyright-registered jewelry products. The complaint alleged (and the plaintiff argued) that the de-

defendant's infringing activities included the use of the internet to access the plaintiff's website and download images of the plaintiff's copyrighted designs, which the defendant then posted on its Facebook page with links to sales of its knock-offs. The plaintiff sued for infringement in the Eastern District of New York, where it was located, and the defendant moved to dismiss for lack of personal jurisdiction. The district court (Hon. Denis R. Hurley) granted the motion on the ground that the plaintiff had not sufficiently alleged that the claimed infringement had caused injury within New York.

In reaching this conclusion, the court applied the analysis set forth by the Second Circuit in *Penguin* and held that, notwithstanding the allegations of the internet-based copying of the plaintiff's works, by failing to allege any acts specifically tying the "knock-offs" to New York (e.g., that they were sold or advertised in New York), the plaintiff had failed to establish personal jurisdiction. The court concluded that the case was more akin to a traditional commercial tort case in the vein of *Troma* than to a digital piracy case like *Penguin*.

Although the defendant's use of the internet was a feature of the alleged infringement, the internet did not prevent the injury from being circumscribed to any particular location. Instead, the injury—the manufacture and sale of copyright-protected jewelry products—was one that could be remedied in an infringement action in Georgia. Moreover, the court found that the plaintiff's alleged generalized loss did not amount to anything more than a simple economic loss, which weighed against a finding of long-arm jurisdiction.

Although the plaintiff could have brought the suit in Georgia, where the defendant resides, it can be forgiven for suing in New York in reliance on *Penguin*. However, merely alleging that the internet played some role in infringement is not enough for New York to extend its jurisdictional reach beyond its borders.

The plaintiff also was unable to establish jurisdiction over out-of-state defendants in two separate cases brought by Freeplay Music in the Southern District of New York. In *Freeplay Music, LLC v. Dave Arbogast Buick-GMC, Inc.*²⁰ the plaintiff brought a copyright infringement case against an Ohio car dealership for uploading videos to the internet containing the plaintiff's copyrighted music. Although this case involved copyright infringement aided by the internet, the plaintiff did not allege "the type of 'digital piracy' at issue" in *Penguin*.²¹ Instead, the court characterized the plaintiff's injury as the deprivation of licensing revenue that would have otherwise been paid by the Ohio defendant. Moreover, the court noted that the plaintiff did not allege that it was injured when the infringing videos were viewed by third parties over the internet in, say, New York. Since the plaintiff only suffered simple economic harm based on infringing activities in Ohio and did not otherwise suffer injury to the "unique bundle of rights" provided under

copyright law, the court found no personal jurisdiction in New York.²²

The same court found that personal jurisdiction over the defendant was lacking where the New York copyright owner (Freeplay Music) sued an Indian defendant for uploading videos containing its copyrighted musical works.²³ The court distinguished the case from *Penguin* on the ground that the plaintiff did not allege that its musical works were copied or uploaded in order to be freely accessible for viewing and downloading by anyone with an internet connection. Rather, the alleged harm, the loss of licensing fees, was purely economic. Since the case involved a narrowly circumscribed economic injury, the court concluded that it amounted to a traditional tort case under *Troma* and did not warrant the exercise of long-arm jurisdiction.

V. The Aftermath of *Troma*

The progeny of *Troma* illustrates the limitation of *Penguin* to a narrow set of circumstances. It is not enough for an owner of intellectual property residing in New York to allege infringement against an out-of-state defendant; New York courts require the plaintiff to plead non-speculative and direct injury to its intellectual property rights within the state of New York before long-arm jurisdiction will be extended.

For example, in *Verragio, Ltd. v. Malakan Diamond Co.*²⁴ the court found no personal jurisdiction over a California defendant where the New York plaintiff alleged that the defendant manufactured certain infringing jewelry in California that was sold in Wisconsin, Ohio, and Idaho. The court held that these allegations reflected a traditional commercial tort claim and that the plaintiff had not articulated a non-speculative injury in New York.

New York courts apply a similar pleading standard in patent infringement cases. In *Rates Tech., Inc. v. Cequel Communs., LLC*,²⁵ for example, the alleged infringement involved the plaintiff's patented technology claiming methods of routing telephone calls, which used telecommunications infrastructure passing through New York. While the defendant's alleged infringing services involved the transmission of data through New York, the defendant did not possess or own any equipment in New York but instead routed its data through networks and fiber owned by third parties. The court held that jurisdiction lay where infringing sales were made, and because the plaintiff did not allege that the defendant solicited New Yorkers to buy its infringing services, the long-arm statute did not confer jurisdiction.

In certain trademark cases, meanwhile, plaintiffs have had some success in pleading "something more" than the economic injury baked into typical copyright infringement claims. In *Lewis v. Madej*, following the out-of-state defendant's fraudulent trademark application attempting to usurp the New York plaintiff's brand, the plaintiff

successfully pled personal jurisdiction based on the defendant's "intentional and fraudulent trademark infringement specifically directed at the plaintiffs who reside in New York."²⁶ Likewise, in *International Diamond Imps., Inc., v. Med Art, Inc.*²⁷ a New York-based jewelry designer brought copyright and trademark infringement allegations against a Turkish defendant, and personal jurisdiction was found based on the claimed reputational harm and lost business suffered by the plaintiff.

However, in other cases, where the parties involved are exclusively foreign entities, New York jurisdiction is not certain even where the *Penguin* factors are satisfied. In *Alibaba Group Holding Limited v. Alibabacoin Foundation*,²⁸ for instance, the Chinese e-commerce giant Alibaba sued a group of companies based in Dubai and Belarus for trademark infringement. Applying *Penguin*, the district court found that (1) the injury—the loss of business, reputation, and goodwill due to "online infringement"—could be easily circumscribed to a specific location, and (2) the trademark infringement resulted in "something more" than indirect financial loss.²⁹ Nevertheless, after applying the *Penguin* test, the court found that the plaintiff did not establish the requisite New York-based injury due to a lack of "allegations of specific, non-speculative harm in the form of actual or potential injury in a New York market for its services."³⁰ Subsequently, however, the court did find jurisdiction, not under the *Penguin* test but based on amended allegations that the defendant "transacted business in New York," which satisfied another section of New York's long-arm statute, CPLR § 302(a)(1).³¹

In *Pablo Star Ltd. v. Welsh Gov't*³² a copyright owner in the United Kingdom sued the government of Wales for the use of two of the plaintiff's photographs on a government tourism website. Although the court agreed that the infringement over the internet was difficult, if not impossible, to localize, the plaintiff was not relieved of its obligation to allege facts demonstrating non-speculative and direct New York-based injury to its rights. Moreover, although New Yorkers could access infringing content on a Welsh website over the internet, the requirements for establishing personal jurisdiction over the defendant were not met where the "most concrete" injury to the plaintiff was lost license fees.³³

VI. Conclusion

To help determine what types of infringing defendants fall within the scope of New York's long-arm statute, the Court of Appeals in *Penguin* set forth a two-factor balancing test to help locate the situs of the injury so as to resolve questions of long-arm jurisdiction in copyright infringement cases. The test considers (1) the nature of the alleged infringement and (2) the nature of the rights at issue. Although the Court crafted its test in relation to particular facts involving digital piracy of printed literary

works on the internet, courts have continued to apply the *Penguin* test to balance the rights of the parties in other online infringement cases.

A takeaway from the cases discussed above is that in order to avoid being vulnerable to dismissal for lack of personal jurisdiction in a case involving online infringement, plaintiffs should plead a violation of their intellectual property rights that is not clearly rooted in any particular location, and they should allege that the infringement is uniquely injurious to the plaintiff's rights, implicating more than mere financial loss. Moreover, in accordance with *Troma*, plaintiffs should plead facts demonstrating a non-speculative and direct New York-based injury to their intellectual property rights.

Endnotes

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5. *Id.* at 301-02.
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7. *Id.* at 307.
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9. *Id.* at 304-05.
10. *Id.* at 305.
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13. 729 F.3d 215 (2d Cir. 2013).
14. *Id.* at 220 (quoting Appellant's Br. at 13).
15. *Id.* at 220.
16. *Id.* at 220 (quoting 16 N.Y.3d at 306).
17. *Id.* at 220.
18. *Id.*
19. 2018 U.S. Dist. LEXIS 179389 (E.D.N.Y. Oct. 18, 2018).
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23. *See Freeplay Music, LLC v. Nian Infosolutions Private Ltd.*, 2018 U.S. Dist. LEXIS 115659 (S.D.N.Y. July 10, 2018).
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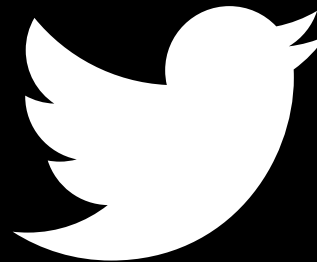
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