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PATENT PROTECTION OF COMPUTER HARDWARE
AND SOFTWARE

Brian J. McNamara†

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ABSTRACT

The explosion of consumer and industrial devices incorporating software controlled processors and the recent spectacular growth of both wired and wireless networked systems have combined to make patenting computer hardware and software an essential element of many competitive strategies. Since the invention of the telegraph, however, courts have struggled to define patent eligible subject

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matter, while patentees have sought to protect more and more abstract inventions. Until recently, the Supreme Court had not spoken directly on the issue in almost thirty years. During that hiatus, the Court of Appeals for the Federal Circuit articulated a number of tests and guidelines with varying levels of success. This article traces the evolution of the analysis of patent eligible subject matter from the Supreme Court’s guidance in the 1970s and 1980s, through the Federal Circuit’s cases, to the most recent Supreme Court cases rejecting the Federal Circuit’s approach in Bilski and Mayo v. Prometheus. Although it is too soon to see how lower courts will apply the Supreme Court’s guidance in Mayo v. Prometheus, the article also reviews how courts have applied the Supreme Court’s instructions concerning the level of abstraction in claimed subject matter following Bilski. The article also provides practical information concerning the approach taken by the U.S. Patent and Trademark Office post-Bilski.

This article also explores issues arising out of the distributed nature of networked systems. Traditionally, a single actor must perform all the steps of a process to be an infringer. As systems become more networked and more participants carry out different steps of a patented process, questions arise concerning whether different participants are acting under the control of a single entity in a manner that rises to the level of infringement. The article explores this issue, which is now under consideration by the Federal Circuit en banc. This article also explores the approaches courts have taken concerning the effect that geographic distribution of system resources outside the United States has on patent infringement.

I. INTRODUCTION

Modern computer systems are complex assemblies of systems and subsystems operating under software control. The trend toward integrating hardware and software functions presents special challenges to those protecting the intellectual property in such systems. Creative applications of computer technology to networks in which different computers or actors perform separate portions of a task, and produce numeric results or implement methods of doing business, further complicate the intellectual property practitioner’s task.

Intellectual property protection of computer hardware and software

generally takes two forms—patents and copyrights. The scope of the protection offered by each form has evolved along with technology. Neither patents nor copyrights protect abstract ideas. Indeed, a recent patent case decided by the Supreme Court, *Bilski v. Kappos*, suggests that courts will now focus on whether the patent claims defining the metes and bounds of an invention are so abstract as to be unpatentable as a matter of law. Courts have wrestled for years with the concept of what is “abstract,” and there is no clear test or definition. This article explores some of the major issues facing those drafting and enforcing patent claims drawn to various aspects of computer hardware and software. It addresses patent eligible subject matter, “joint” or “divided” infringement, claims to networked systems, and obviousness as applied to such systems since the Supreme Court’s *KSR* decision.

II. PATENTING COMPUTER HARDWARE AND SOFTWARE

Whether a claim recites patent eligible subject matter under 35 U.S.C. § 101 is only a threshold test—a claimed invention must also be novel (§ 102), non-obvious (§ 103) and fully and particularly described (§ 112). Computer system patent claims typically include apparatus claims drawn to computer hardware and method claims drawn to processes controlled by software. Although there is nothing that categorically precludes a business method claim from being treated as a process under 35 U.S.C. § 101, business method claims raise special problems in terms of vagueness and suspect validity. Claims that attempt to patent abstract ideas are not patentable processes under 35 U.S.C. § 101.

Patent claims drawn to computer networks may include claims drawn to the structure of a network itself and the methods that the network uses to complete various tasks at various levels of functionality. However, as networks facilitate performing tasks across different jurisdictions with multiple actors, another challenge facing American patent practitioners is drafting claims that are infringed by a

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4 130 S. Ct. 3218 (2010).
5 *Id.* at 3229-30.
7 *Id.* at 3225.
9 *Id.* at 3229-30.
single actor in the United States. Recently, the U.S. Court of Appeals for the Federal Circuit announced that it will address en banc the following issue: “If separate entities each perform separate steps of a method claim, under what circumstances would that claim be directly infringed and to what extent would each of the parties be liable?”

A. Statutory Subject Matter—Supreme Court Cases

Generally, “anything under the sun that is made by man” is patentable. This broad statement by the Supreme Court in 1980 also recognizes that subject matter not made by man is not patentable. The Supreme Court has articulated only three exceptions to the Patent Act’s broad patent-eligibility principles: laws of nature, physical phenomena, and abstract ideas. Until 2010, the Supreme Court had not spoken on 35 U.S.C. § 101 statutory subject matter issues concerning patents on automated systems in nearly thirty years, leaving the lower courts to rely on a trilogy of cases decided in the decade between 1972 and 1981.

In 1972, in *Gottschalk v. Benson*, the Court ruled that an algorithm (in this case an algorithm to convert binary coded decimal numerals into pure binary code) by itself is not patentable as a process, because it is merely an abstract idea.

In 1978, in *Parker v. Flook*, the Court conceded that a process is not unpatentable simply because it contains a law of nature or a mathematical algorithm, but held the claimed subject matter not statutory, because it applied a newly discovered mathematical relationship (which is not statutory subject matter) to a well-known process. Even though the patent claims in *Flook* did not preempt the

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10 Akamai Techs., Inc. v. Limelight Networks, Inc., 419 F. App’x 989 (Fed. Cir. 2011).
12 Id.
14 Gottschalk v. Benson, 409 U.S. 63, 67-68 (1972); see id. at 71-72 (holding claims to a method of converting binary coded decimals into pure decimal numbers with a general purpose computer ineligible for patent protection, notwithstanding claims with digital electronic structure limitations (signals and re-entrant shift register), because the practical effect would be to preempt the formula and impermissibly award a patent for a discovery in mathematics that had no application except in connection with a digital computer).
15 Parker v. Flook, 437 U.S. 584, 590, 591 (1978); see id. at 594 (holding claims drawn to method of updating numerical alarm limits found ineligible for patent protection, notwithstanding post-solution activity and the fact that the claims did not wholly preempt the mathematical function involved, because the invention merely claimed a newly discovered mathematical formula coupled to a computer applied to a well-known process of updating alarm limits in a chemical application).
use of the formula outside the petrochemical and oil refining industries, the Court rejected the “notion that post-solution activity, no matter how conventional or obvious in itself, can transform an unpatentable principle into a patentable process.”

In 1981, in *Diamond v. Diehr*, the Court again noted that laws of nature, natural phenomena and abstract ideas are not patentable, and explained that its ruling in *Flook* meant that the prohibition against patenting abstract ideas “cannot be circumvented by attempting to limit the use of the formula to a particular technological environment” or adding “insignificant post-solution activity.” However, the Court distinguished between a law of nature and its application stating “an application of a law of nature or a mathematical formula to a known structure or process may well be deserving of patent protection.” Considering the invention as a whole, instead of dissecting the claims into old and new elements, the *Diehr* Court held that claims drawn to a previously unknown industrial process for molding rubber products could constitute patentable subject matter under 35 U.S.C. § 101, adding that “a claim drawn to subject matter that is statutory does not become non-statutory simply because it uses a mathematical formula, computer program or digital computer.” “When a process for curing rubber is devised which incorporates in it a more efficient solution of the equation, that process is at the very least not barred at the threshold by § 101.”

In distinguishing *Flook*, the Court noted:

[I]n *Flook* that the patent application did not purport to explain how the variables used in the formula were to be selected, nor did the application contain any disclosure relating to chemical processes at work or the means of setting off an alarm or adjusting the alarm unit . . . . All the application provided was a formula for computing an updated alarm limit.

Over the next thirty years, lower courts wrestled with rules, tests and formulations to facilitate the analysis of emerging technologies in a manner consistent with the Supreme Court’s guidance in this trilogy

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16 *Id.* at 590.
17 *Diamond v. Diehr*, 450 U.S. 175, 191 (1981); *see id.* at 185 (holding claimed process for operating rubber molding press, which included mathematical formula, eligible for patent protection because claim drawn to entire rubber curing process).
18 *Diamond*, 450 U.S. at 187.
19 *Id.*
20 *Id.* at 188.
21 *Id.* at 192 n.14.
of cases. In 2010, the Supreme Court returned to the issue of patentable subject matter in *Bilski v. Kappos.* The Court reminded practitioners of its fundamental approach in this long-standing trilogy. The Court ruled that the Federal Circuit’s “machine-or-transformation” test, while useful in some circumstances, is not the sole criteria for determining the existence of patentable subject matter. Indeed, the Court went even further, stating, “nothing in today’s opinion should be read as endorsing interpretations of § 101 that the Court of Appeals for the Federal Circuit has used in the past.” Nevertheless, the Court went on to hold that in “disapproving an exclusive machine-or-transformation test, we by no means foreclose the Federal Circuit’s development of other limiting criteria that further the purposes of the Patent Act purposes and are not inconsistent with its text.” For this reason, the approaches taken by the Federal Circuit over the years remain important to patent practitioners. The material that follows outlines the evolution of judicial reasoning until the *Bilski* decision and some of the approaches implemented since the Supreme Court decided *Bilski.*

B. Evolution in the Federal Circuit

Application of the above principles in 35 U.S.C. § 101 has spawned extensive patent litigation. This litigation has resulted in the substantial evolution of U.S. patent law since the late 1980s. A few of the relevant cases are discussed below.


In this 1992 case, the Federal Circuit found that the claimed transformation of electrocardiograph signals from a patient’s heartbeat by a machine through a series of mathematical calculations was patentable subject matter, because it constituted a practical application of an abstract idea (mathematical formula) and produced a useful, concrete, or tangible thing—an indication of the condition of the patient’s heart.

2. *In re Alappat.*

This case concerned an anti-aliasing technique to display smooth
waveforms on a digital oscilloscope. Alappat’s technique modulated the intensity of pixels illuminated along vectors connecting successive pairs of points in a bit map representing a sampled waveform. 29 Alappat used a mathematical expression to calculate the intensity of the modulation for each pixel as a function of the pixel’s distance from the trajectory of each vector. 30 By more brightly illuminating those pixels whose center point lay directly on the vector trajectory and decreasing pixel illumination as the pixel’s distance from the vector trajectory increased, the oscilloscope displayed a smooth waveform. 31 Alappat claimed a rasterizer for converting vector list data representing sample magnitudes of an input waveform into anti-aliased pixel illumination intensity data. 32 Alappat claimed the invention in “means plus function” language reciting: (a) means for determining vertical distance between the endpoints of each of the vectors in the data list, (b) means for determining the elevation of a row of pixels spanned by the vector, (c) means for normalizing the vertical distance and elevation, and (d) means for outputting illumination intensity data as a predetermined function of the normalized vertical distance and elevation. 33 The court reversed the conclusion of the U.S. Patent and Trademark Office (USPTO) that Alappat’s claim was essentially a series of steps, which combined to form a mathematical algorithm for computing pixel information. 34 Citing In re Donaldson, the Federal Circuit ruled that the “means” in Alappat’s claims could not be interpreted to read on each and every means for performing the recited functions and that the Examiner erred by treating these limitations as equivalent to process steps. 35 The court also concluded that Alappat claimed a machine, which is one of the four statutory categories of patentable subject matter. 36 The court further rejected the USPTO’s position that Alappat’s claim was unpatentable under a “mathematical algorithm” exception. 37 Finding Alappat’s claim statutory, the court

29 Id. at 1537.
30 Id.
31 Id.
32 Id.
33 Id. at 1538-39.
34 Id. at 1544.
35 Id. at 1540 (citing In re Donaldson, 16 F.3d 1189, 1193 (Fed. Cir. 1994) (holding that that U.S. Patent and Trademark Office must interpret “means plus function” or “step plus function” claims to cover the corresponding structure, material or acts described in the specification or equivalents thereof)).
36 Id. at 1541-42. “Whoever invents or discovers any new and useful process, machine, manufacture or composition of matter, or any new and useful improvement thereof, may obtain a patent therefore, subject to the conditions and requirements of this title.” 35 U.S.C. § 101 (2006).
37 33 F.3d at 1542.
stated that it is not necessary to determine whether the claim contains mathematical subject matter, which standing alone would not be patentable, since it directs its inquiry to whether the claim as a whole is statutory subject matter.\textsuperscript{38} In a footnote, the court mentioned that dissecting a claim to identify whether part of the claim recites mathematical subject matter, such as performed under the now outdated Freeman-Walter-Abele test, is not necessarily an improper analysis.\textsuperscript{39}

3. \textit{In re Schrader.}\textsuperscript{40}

Schrader claimed a method of bidding on a plurality of items in which received bids are entered into a record and a combination of winning bids is determined by assembling a “completion” from all the entered bids.\textsuperscript{41} A “completion” is the particular combination of bids, which would complete a sale of all of the items being offered at the highest offered total price.\textsuperscript{42} The items are then sold in accordance with the “completion.”\textsuperscript{43} On the basis that “assembling a completion” was a process for solving a given type of mathematical problem, the court determined that the claims recited an algorithm, notwithstanding the absence of a mathematical equation in the claim.\textsuperscript{44} The court rejected Schrader’s argument that even if a mathematical algorithm were present, there was a physical transformation of data, which rendered the claims statutory. According to the court, there was nothing physical about the bids \textit{per se} and the grouping or regrouping of bids cannot constitute a physical change, effect, or result.\textsuperscript{45} The court also noted that the terms “bid data,” “completion data,” or “display data” were not mentioned in the claim.\textsuperscript{46} The court pointed out that the only physical effect or result required by the claims is the entering of bids in a “record,” a step that can be accomplished simply by writing the bids on a piece of paper or a chalkboard.\textsuperscript{47} Citing \textit{In re
Grams, the court noted that for purposes of 35 U.S.C. § 101, such activity is indistinguishable from data gathering steps, which are insufficient to impart patentability to a claim involving the solution of a mathematical algorithm.

4. In re Lowry.

Lowry disclosed an “Attribute data model” that represents data in terms of attributes and relationships between attributes. Lowry’s claims recited a memory for storing data for access by an application program comprising various attribute data objects. An attribute data object is a sequence of bits containing information used by the application program and information regarding the attribute data object’s relationship to other attribute data objects. The Board of Patent Appeals and Interferences (BPAI) had reversed the Examiner’s § 101 rejection finding instead that claims directed to a memory were directed to an article of manufacture. However, the BPAI gave no patentable weight to the claimed data structure, analogizing it to unpatentable printed matter.

On appeal, the court noted that Lowry did not attempt to claim information content or the attributive data model in the abstract, but rather specific structural elements, which impart a physical organization on the information stored in the memory. The court found that Lowry’s data structures were physical entities that provide increased efficiency in computer operation and were not analogous to printed matter. The following year, the USPTO dropped its opposition to another applicant’s appeal concerning claims drawn to certain computer programs embodied in a tangible medium, such as a floppy disk. As a result, claims drawn to “stored indicia” on a computer readable medium became known as “Beauregard claims.” The reference to § 101 in the USPTO’s withdrawal and the fact that

48 In re Grams, 888 F.2d 835, 840-41 (Fed. Cir. 1989) (holding clinical testing steps are not eligible subject matter).
49 In re Schrader, 22 F.3d 290, 294.
50 32 F.3d 1579 (Fed. Cir. 1994).
51 Id. at 1580.
52 Id. at 1581.
53 Id. at 1580-81.
54 Id. at 1583.
55 Id. at 1584.
56 In re Beauregard, 53 F.3d 1583, 1584 (Fed. Cir. 1995) (“The Commissioner states that computer programs embodied in a tangible medium, such as floppy diskettes, are patentable subject matter under 35 U.S.C. § 101 and must be examined under 35 U.S.C. §§ 102 and 103 . . . and agrees with Beauregard that the printed matter exception is not applicable.”).
the *Beauregard* case was not adjudicated by the courts may have led to a misperception that one could avoid ineligible subject matter issues by claiming a program recorded on computer readable media because that would be a patentable eligible “manufacture” under § 101.\(^{57}\)

5. *In re Warmerdam*.\(^{58}\)

Warmerdam refined collision avoidance systems using a hierarchy of successively more refined bursting bubbles placed along the medial axis of objects to determine a collision avoidance path.\(^{59}\) The court found method claims drawn to the steps of locating the medial axis and creating the bubble hierarchy not patentable subject matter.\(^{60}\) The court reasoned that Warmerdam claimed nothing more than the manipulation of basic mathematical constructs, notwithstanding any implications in the claim of measuring the contour of an object. However, the court found claim 5, addressing a machine having a memory which contains data representing a bubble hierarchy as generated by the method of any of claims 1 through, to be statutory subject matter and definite.\(^{61}\) The court reasoned that the claim recites a machine and there was no showing that one skilled in the art would have any difficulty in determining whether a machine having a memory storing a bubble hierarchy is within the scope of the claim.\(^{62}\)

6. *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*\(^{64}\)

In 1998, the Federal Circuit’s *State Street Bank* decision ushered in a new era of patent practice under 35 U.S.C. § 101. The court ruled that a data processing system for managing a financial services configuration of a portfolio claimed in “means plus function language” and producing a numerical result was statutory subject matter.\(^{65}\) The court held that “the transformation of data representing discrete dollar amounts by a machine through a series of mathematical calculations into a final share price, constitutes a practical application of a mathematical algorithm, formula, or calculation” because the “final share price momentarily fixed for recording and reporting purposes”

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\(^{57}\) See cases cited and discussion *infra* Parts II.D.4, II.D.6.

\(^{58}\) 33 F.3d 1354 (Fed. Cir. 1994).

\(^{59}\) *Id.* at 1356-57.

\(^{60}\) *Id.* at 1360.

\(^{61}\) *Id.*

\(^{62}\) *Id.* at 1361.

\(^{63}\) *Id.*

\(^{64}\) 149 F.3d 1368 (Fed. Cir. 1998).

\(^{65}\) *Id.* at 1372.
was a “useful, concrete and tangible result.” Noting that the Freeman-Walter-Abele test from the Court of Customs and Patent Appeals (CCPA) was of little value after the Supreme Court’s decisions in *Diehr* and *Chakrabarty*, the Federal Circuit focused its inquiry not on which of the four categories of subject matter the claim recites, “but rather on the essential characteristics of the subject matter, in particular, its usefulness.” The fact that the claim was directed to a machine that produces a useful, concrete and tangible result renders the claim statutory, even if that result is expressed in numbers, such as price, profit, percentage, cost or loss. The court took the opportunity to dispel the notion that business methods are inherently unpatentable. Stating “we take this opportunity to lay this ill conceived exception to rest,” the court noted that “business methods have been, and should have been, subject to the same legal requirements for patentability as applied to any other process or method.

7. *AT&T Corp. v. Excel Communications, Inc.*

In this case, the court found patentable subject matter in a claimed method of indicating a call recipient’s primary interexchange carrier (long distance telephone carrier) as a data field in a message. The claim recited generating a message and including in the message an indicator, whose value is a function of whether the interchange carrier of the terminating subscriber is a subscriber of a predetermined interexchange carrier. The court noted that the judicial proscription against patenting a mathematical algorithm is narrowly limited to algorithms in the abstract. The claimed process was statutory because its use of Boolean algebra produced a useful result without preempting others from using the mathematical principle. Noting that the court’s analysis in *Schrader* and *Grams* were unhelpful because they did not examine the usefulness of the result, the court explained that patent claims need not involve a physical

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66 *Id.* at 1373.
67 *Id.* at 1374.
68 *Id.* at 1375.
69 *Id.*
70 *Id.*
71 172 F.3d 1352 (Fed. Cir. 1999).
72 *Id.* at 1361.
73 *Id.* at 1354.
74 *Id.* at 1356.
75 *Id.* at 1356.
76 *Id.* at 1360.
transformation or conversion of the subject matter to be statutory.\textsuperscript{77} The court further noted that no inquiry into structure is necessary in the case of process claims.\textsuperscript{78}

8. \textit{In re Nuijten}.\textsuperscript{79}

On September 20, 2007, the Court of Appeals for the Federal Circuit issued two panel decisions significant to the issue of statutory subject matter under 35 U.S.C. § 101.\textsuperscript{80} One of the court’s decisions, \textit{In re Nuijten}, addressed “physical but transitory forms of signal transmission such as radio broadcasts, electrical signals through a wire, and light pulses through a fiber-optic cable, so long as those transmissions convey information encoded in the manner disclosed and claimed by Nuijten.”\textsuperscript{81} The majority stated “[w]e hold that such transitory embodiments are not directed to statutory subject matter.”\textsuperscript{82}

When content publishers “watermark” a signal, such as an audio file, to prevent or control copying, the watermarking process introduces distortion.\textsuperscript{83} Nuijten’s improved watermarking method modified the watermarked signal with additional data to compensate for such distortion.\textsuperscript{84} The USPTO allowed claims drawn to recite “[a] method of embedding supplemental data into a signal,” “[a]n arrangement for embedding supplemental data in a signal” including various structural elements, and “[a] storage medium having stored thereon a signal with embedded supplemental data.”\textsuperscript{85} Thus, the court noted, “Nuijten has been allowed claims to the process he invented, a device that performs that process, and a storage medium holding the resulting signals.”\textsuperscript{86}

The issue before the Federal Circuit panel was whether Nuijten’s claim 14, drawn to the signals themselves, constituted statutory subject matter.\textsuperscript{87} Claim 14 read as follows:

\begin{quote}
A signal with embedded supplemental data, the signal being encoded in accordance with a given encoding process and selected samples of the signal representing supplemental data, and at least one of the samples
\end{quote}

\begin{footnotes}
\item[77] \textit{Id.} at 1358-59.
\item[78] \textit{Id.} at 1359.
\item[79] 500 F.3d 1346 (Fed. Cir. 2007).
\item[80] See \textit{id.}; \textit{In re Comiskey}, 499 F.3d 1365 (Fed. Cir. 2007).
\item[81] 500 F.3d. at 1353.
\item[82] \textit{Id.}
\item[83] \textit{Id.}
\item[84] \textit{Id.}
\item[85] \textit{Id.} at 1351.
\item[86] \textit{Id.}
\item[87] \textit{Id.}
\end{footnotes}
preceding the selected samples is different from the sample corresponding to the given encoding process.\textsuperscript{88}

The USPTO contended that claim 14 could include mere data without any physical embodiment, while Nuijten contended that the term “signal” must have sufficient physical substance to be discerned and recognized by a recipient.\textsuperscript{89} Although the court agreed with Nuijten that the claims were limited to require some physical carrier of information, it did not specify what carrier is to be used or specify any physical medium.\textsuperscript{90} Therefore, the court concluded that the “[t]he only limitations in claim 14 address the signal’s informational content.”\textsuperscript{91}

The Federal Circuit reviews claim validity under 35 U.S.C. § 101 as a question of law de novo.\textsuperscript{92} The court found that the claims on appeal cover transitory electrical and electromagnetic signals propagating through some medium, such as wires, air or a vacuum, and are not encompassed by any of the four statutory categories enumerated in the patent statute; process, machine, manufacture or composition of matter.\textsuperscript{93} Noting that the Supreme Court has consistently required the term “process” to require action, the court rejected Nuijten’s argument that his claims to a signal, even if they recite acts, are patentable. “The presence of acts recited in the claim does not transform a claim covering a thing—the signal itself—into one covering the process by which that thing was made.”\textsuperscript{94} Turning to a “machine” under the patent statute, the court noted that the Supreme Court’s definition of a machine was “a concrete thing, consisting of parts, or of certain devices and combination of devices.”\textsuperscript{95} The court then concluded that while a transitory signal made of electrical or electromagnetic variances is physical and real, it is not a “machine” as that term is used in 35 U.S.C. § 101 because it is not made of parts or devices in any mechanical sense.\textsuperscript{96}

Acknowledging the fact that the claimed signals are “man-made, in the sense of having been encoded, generated and transmitted by artificial means,” the panel’s majority nevertheless found that the claimed signals did not qualify for patent protection under the statute

\textsuperscript{88} Id.
\textsuperscript{89} Id.
\textsuperscript{90} Id.
\textsuperscript{91} Id. at 1353.
\textsuperscript{92} Id. at 1352 (citing AT&T Corp. v. Excel Commc’ns, Inc., 172 F.3d at 1352, 1355 (Fed. Cir. 1999).
\textsuperscript{93} Id.
\textsuperscript{94} Id. at 1355.
\textsuperscript{95} Id. (citing Burr v. Duryee, 68 U.S. 531, 570 (1863)).
\textsuperscript{96} Id. at 1355-56.
as “manufactures.”97 Reviewing Supreme Court cases addressing articles of manufacture, the Federal Circuit panel majority concluded that a transient electric or electromagnetic transmission does not fit within the Supreme Court’s definition, which focuses on tangible articles or commodities.98 Finally, the court concluded that a signal comprising a fluctuation in electric potential or electromagnetic fields is not a chemical union, nor a gas, fluid, powder or solid and is therefore not a composition of matter.99

Judge Linn, in a dissenting opinion, agreed that Nuijten’s signals were not “machine,” “process,” or “composition of matter” under the statute, but parted ways with the majority opinion as to “manufacture.”100 In his dissent, Judge Linn noted that the definition of “manufacture” is not limited to tangible or non-transitory inventions and questioned the accuracy of the majority’s characterization of Nuijten’s signal as “fleeting.”101 Judge Linn found support for a broad definition of “manufacture” in the Supreme Court’s Chakrabarty decision, which extended patent protection to “anything under the sun that is made by man.”102 In his dissent, Judge Linn concluded that the claimed signal is an application of technology to provide some useful transformation in the real world and is not directed to an abstract mathematical or scientific principle that fails to qualify as new.103

Judge Linn reasoned that the invention is useful—the information it conveys is wholly distinct from the invention itself—the signal is an information carrier, not an attempt to claim the information itself.104 Finally, Judge Linn noted the Supreme Court’s allowance of a claim to Samuel Morse’s use of telegraphy to convey Morse code, “the system of signs, consisting of dots and spaces,” allowed a claim directed to a signal—a particular way of encoding information so that it can be conveyed.105 Judge Linn would have found Nuijten’s signal claims patentable as conveying two streams of data.106

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97 Id. at 1356.
98 Id.
99 Id. at 1357.
100 Id. at 1359 (Linn, J., concurring in part and dissenting in part).
101 Id. at 1359-60.
102 Id. at 1362 (quoting Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980) (internal citations omitted)).
103 Id. at 1367-68.
104 Id. at 1368.
105 Id. at 1368-69 (citing O’Reilly v. Morse, 56 U.S. 62, 86 (1853). Allowed claims drawn to a recording or printing telegraph and claims drawn to a system of signs consisting of dots, spaces and horizontal lines, but found invalid a claim drawn to the use of the motive power of electric or galvanic current, however developed, for making or printing intelligible characters at a distance).
106 Id. at 1369.
9. *In re Comiskey.*\(^{107}\)

Also on September 20, 2007, a different panel of Federal Circuit judges addressed business method claims in *In re Comiskey.*\(^{108}\) The panel held that claims drawn to a “method for mandatory arbitration resolution” which do not require the use of a machine “do not describe a process of manufacture or a process for the alteration of a composition of matter.”\(^{109}\) Stating that such claims “seek to patent the use of human intelligence in and of itself,”\(^{110}\) the court found them unpatentable.

In independent claims 1 and 32, Comiskey claimed a business method for mandatory arbitration resolution.\(^{111}\) The claimed steps included enrolling a document and its author in the system, incorporating arbitration language into the enrolled document requiring that a contested issue be presented for binding arbitration, requiring a complainant to submit a request for arbitration, conducting arbitration resolution, providing support to the arbitration and determining an award.\(^{112}\) It was undisputed that the steps of these claims could be performed without any mechanical device, such as a computer.\(^{113}\) Recalling its decision in *State Street Bank*, which rejected the proposition that a method of doing business is not subject to patent protection, the court noted that such claims should not be categorized as methods of doing business, but should be treated like any other process claims.\(^{114}\) Citing the Supreme Court’s decision in *Parker v. Flook*, the court emphasized that not every process is patentable because abstract ideas are not patentable.\(^{115}\)

The court explained:

1. An abstract concept without a claimed practical application is not patentable.\(^{116}\)

2. Claims reciting abstract ideas or algorithms with practical application are patentable only in a process which is “either . . . tied to a particular apparatus or . . . operated to change materials to a ‘different state or

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\(^{107}\) 499 F. 3d 1365 (Fed. Cir. 2007).

\(^{108}\) Id.

\(^{109}\) Id. at 1379.

\(^{110}\) Id.

\(^{111}\) Id. at 1368-69.

\(^{112}\) Id.

\(^{113}\) Id. at 1369.

\(^{114}\) Id. at 1374.

\(^{115}\) Id. at 1375-76 (citing Parker v. Flook, 437 U.S. 584, 589 (1978)).

\(^{116}\) Id. at 1376.
thing.”\textsuperscript{117}

3. “[M]ental processes—or processes of human thinking—standing alone are not patentable even if they have practical application.”\textsuperscript{118}

In this case, the mere recitation of a practical application as a form of post solution activity does not render an abstract idea patentable.\textsuperscript{119} “[T]his court and our predecessor court have refused to find processes patentable when they merely claimed a mental process standing alone and untied to another category of statutory subject matter even when a practical application was claimed.”\textsuperscript{120}

Recognizing that Comiskey’s claims 1 and 32 “claim the mental process of resolving a legal dispute between two parties by the decision of a human arbitrator,”\textsuperscript{121} the court concluded that the claims were non-statutory subject matter directed to mental processes for resolving a dispute.\textsuperscript{122} Claims drawn to the use of human intelligence in and of itself are not patentable.\textsuperscript{123} The court noted that claims 17 and 46, which recite the use of “modules” and other “means,” do recite statutory subject matter.\textsuperscript{124} The court explained that “[w]hen an unpatentable mental process is combined with a machine, the combination may produce patentable subject matter, as the Supreme Court decision in \textit{Diehr} and our own decisions in \textit{State Street Bank} and \textit{AT&T} have confirmed.”\textsuperscript{125} The court went on to distinguish non-patentable data collection and post solution activity, stating “[w]hile the mere use of that machine to collect data necessary for application of the mental process may not make the claim patentable subject matter, these claims in combining the use of machines with a mental process, claim patentable subject matter.”\textsuperscript{126}

C. The \textit{Bilski} Cases

\textit{1. In re Bilski}.\textsuperscript{127}

On October 30, 2008, the Court of Appeals for the Federal Circuit

\textsuperscript{117} \textit{Id.} at 1376 (citation omitted).
\textsuperscript{118} \textit{Id.} at 1377.
\textsuperscript{119} \textit{Id.} at 1378-79 (citing \textit{Flook}, 437 U.S. at 590).
\textsuperscript{120} \textit{Id.} at 1378 (citing \textit{In re Schrader} 22 F. 3d 290, 293-94 (Fed. Cir. 1994).
\textsuperscript{121} \textit{Id.} at 1379.
\textsuperscript{122} \textit{Id.}
\textsuperscript{123} \textit{Id.}
\textsuperscript{124} \textit{Id.}
\textsuperscript{125} \textit{Id.}
\textsuperscript{126} \textit{Id.} at 1380 (citation omitted).
\textsuperscript{127} 545 F. 3d 943 (Fed. Cir. 2008).
issued an important and controversial decision affirming the rejection of claims drawn to a method of hedging risk in commodities trading. In that decision, the Federal Circuit, echoing its ruling in *Comisky*, announced a “machine or transformation” test for determining the presence of patentable subject matter under 35 U.S.C. § 101. On June 28, 2010, the Supreme Court overruled the Federal Circuit’s test as the sole test for patentable subject matter. An understanding of the *Bilski* case is important because the Supreme Court noted that its “precedents establish that the machine or transformation test is a useful and important clue, an investigative tool, for determining whether some claimed inventions are processes under § 101,” and because the Federal Circuit and lower courts continue to cite the “machine or transformation” test as part of the statutory subject matter analysis.

In *Bilski*, claim 1 broadly recited the steps of (i) initiating a series of transactions between commodity consumers and providers at a fixed rate based on historical averages, (ii) identifying market participants having a counter-risk position to the consumers and (iii) initiating a series of transactions between the commodity provider and the market participants at a second fixed rate that balances the risk positions of the series of consumer transactions. Using this method, an intermediary “provider” sells a commodity, such as coal, to a consumer at a first fixed price, thereby isolating the consumer from sudden demand driven price increases. The provider also purchases the same commodity from the market participant at a second fixed price, thus isolating the market participant from sudden price drops. The provider hedges its risk because in cases where demand skyrockets and prices rise, the provider’s disadvantage resulting from the lower than market fixed price it receives from the consumer of the commodity is offset by the fact that provider bought the same commodity at a lower than market fixed price from the market participant (or vice versa if demand crashes). The Examiner rejected the claims, which are not restricted to operation on a computer, as not limited to a specific apparatus, not directed to the technological arts, and as merely manipulating an abstract idea.

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128 *Id.*
130 *Id.*
132 *In re Bilski*, 545 F.3d at 949.
133 *Id.* at 949-50.
134 *Id.* at 950.
135 *Id.*
(solving a mathematical problem). The Board of Patent Appeals and Interferences overruled the Examiner, stating that the law does not support a “technological arts” test or a “specific apparatus” test. Rejecting the Examiner’s specific apparatus test, the Board noted that mixing two chemicals is a statutory transformation, even in the absence of a claimed apparatus. However, the Board rejected the claims on the basis that the financial, non-physical transformation claimed was not patentable subject matter, the claims preempted performing the steps either by a human or a machine, and the claims did not produce a useful, concrete, tangible result.

On appeal, the Federal Circuit articulated the question at issue as “whether Applicants’ claim recites a fundamental principle and, if so, whether it would preempt substantially all uses of that fundamental principle.” Recognizing that process claims of the 21st century are seldom limited to the highly specific, plainly corporeal industrial manufacturing processes of Diehr or the pure abstractions of Benson, the court reconciled the Supreme Court cases into a “definitive test” for a process claim. The court held, “A claimed process is surely patent eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing.” The court noted that under this “machine or transformation” test, the use of a specific machine or the transformation of an article must impose meaningful limits on the claim’s scope and that the involvement of the machine or transformation in the claimed process must not be merely insignificant extra-solution activity.

Because the claims at issue in Bilski did not limit the process to any specific machine or apparatus, the Federal Circuit left the contours of this aspect of the test to future cases. Turning to the transformation prong of the test, the Federal Circuit opinion stated that the transformation must be central to the purpose of the claimed process and emphasized that patentability turns on whether a process transforms an article into a different state or thing. Recognizing the nature of electronic signals, electronically manipulated data and even

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136 Id. at 950.
137 Id.
138 Id.
139 Id.
140 Id. at 954.
141 Id.
142 Id.
143 Id. at 961-962.
144 Id. at 962.
145 Id. at 962.
more abstract relationships associated with business methods, the court discussed processes that qualify as a patent eligible transformation.146 For example, the electronic transformation of data into a visual depiction of the structure of human organs, without any transformation of the underlying physical objects, was sufficient for patentability of the process.147 There is no danger of preemption as long as the claimed process is limited to a practical application of a fundamental principle to transform specific data, and the claim is limited to a visual depiction that represents specific physical objects or substances.148 Purported transformations or manipulations simply of public or private legal obligations or relationships, business risks, or other such abstractions cannot meet the test. This is because they are not physical objects or substances; therefore, they are not representative of physical objects or substances.149 Hence, the Federal Circuit found Bilski’s claims to be unpatentable.150

The Federal Circuit declined to adopt the “technological arts” test151 and took the opportunity to clarify some of its earlier cases, as well. The court noted that the analysis under State Street Bank for a “useful, concrete and tangible result” might indicate whether a claim is drawn to a fundamental principle or a practical application of such a principle, but is not sufficient to determine patent eligibility.152 The Federal Circuit also confirmed that there is no “business method exception” to patentable subject matter and business methods are patentable under the same criteria applicable to any other process or method.153 The court specifically declined to adopt a broad exclusion of software or any other category of subject matter from patentability.154 The Federal Circuit also noted that its decision in Comiskey should not be read to bar any claim reciting a mental process that lacks significant physical steps.155 A claim that purportedly lacks any “physical steps,” but is still tied to a machine or achieves an

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146 Id. at 958-59.
147 See id. at 959 (citing In re Abele, but rejecting as under-inclusive of patentable subject matter (per In re Grams), the Freeman-Walter-Abele two step test of (1) determining whether the claim recites an algorithm, and then (2) determining whether the algorithm is applied in any manner to physical elements or process steps).
148 Id. at 963.
149 Id.
150 Id. at 966.
151 Id. at 963.
152 Id.
153 Id.
154 Id. at 961 n.24.
155 Id. at 960.
eligible transformation, passes muster under §101. However, a claim that recites physical steps but neither recites a particular machine or apparatus, nor transforms any article into a different state or thing is not drawn to eligible subject matter. Finally, under the Federal Circuit’s test, a claimed process wherein all of the process steps may be performed in the human mind is obviously not tied to any machine and does not transform any article into a different state or thing and would not be patentable under §101.


The Supreme Court ruled on the *Bilski* case on June 28, 2010. The Court found that that Bilski’s method claims recited an unpatentable abstract idea, but rejected the Federal Circuit’s “machine or transformation” test as the sole basis for determining the patent eligibility of a process. Much of the Court’s decision turned on its approach to the term “process” in the Patent Act. The Court stated that courts should not read into the patent laws limitations and conditions that the legislature has not expressed. Instead, the Court noted that the Patent Act excepts from patentable subject matter only laws of nature, physical phenomena and abstract ideas, adding that its prior attempts to explain these exceptions does not give courts carte blanche to impose other limitations inconsistent with the statute’s purpose and design. The Court then concluded that adopting the Federal Circuit’s “machine or transformation” test, as the sole test for what constitutes a “process” under the Patent Act (as opposed to just a useful and important clue), would violate statutory interpretation principles. The Court indicated that it was unaware of any ordinary contemporary, common meaning of “process, art or method” that would require these terms to be tied to a machine or transform an article; concluding that, while the “machine or transformation” test may well provide a sufficient basis for evaluating processes similar to those in the Industrial Age, there are reasons to doubt whether the test should be the sole criterion for determining the patentability of inventions in the Information Age. Referencing amici briefs and Judge Rader’s dissent in the Federal Circuit, the Supreme Court noted

156 *Id.*
157 *Id.* at 961.
158 *Id.* at 961 n.26.
159 130 S. Ct. 3218 (2010).
160 *Id.* at 3226-27.
161 *Id.* at 3226.
162 *Id.*
163 *Id.* at 3226-27.
that confining courts to the questions posed by the “machine or transformation” test would create uncertainty as to the patentability of software, advanced diagnostic medical techniques and inventions based on linear programming, data compression and the manipulation of digital signals.  

Relying on similar statutory interpretation principles, the Court specifically affirmed the patent eligibility of claims to business methods in the United States. Referring to defenses to patent infringement based on earlier invention in 35 U.S.C. § 273, which define “method” as “a method of doing or conducting business” in 35 U.S.C. § 273(a)(3), the Court specifically determined that “a business method is simply one kind of ‘method’ that is, at least in some circumstances, eligible for patenting under § 101.”

Applying these principles to the claims at issue in Bilski, the Court noted that hedging is a fundamental and prevalent economic practice. The Court concluded that the concept of hedging recited in claim 1 and reduced to a mathematical formula in claim 4 is an unpatentable abstract idea, like the algorithms at issue in Benson and Flook. Allowing such claims would preempt use of this approach and effectively grant a monopoly over an abstract idea. Stating that the remaining claims recited broad examples of how hedging could be used in commodities and energy markets, the Court concluded that they were unpatentable under Flook, which held that limiting an abstract idea to one field or adding token postsolution components does not make the concept patentable.

The Supreme Court’s focus on the language of the statute and reliance on its thirty-year-old decisions in Benson, Flook and Diehr suggest a back-to-basics approach, which eschews complex tests in favor of fundamental statutory interpretation. The practical realities of such an approach in the Information Age remain to be seen. Several cases have recently been decided in the wake of the Court’s Bilski decision.

164 Id. at 3227-28.
165 Id. at 3227-29.
166 Id. at 3228.
167 Id. at 3231.
168 Id.
169 Id.
D. Decisions After Bilski v. Kappos

1. Ultramercial, LLC v. Hulu, LLC.\textsuperscript{170}

On August 13, 2010, the District Court for the Central District of California wrestled with the patent eligibility of claims drawn to a method of allowing users to view Internet material free of charge in exchange for viewing advertisements.\textsuperscript{171} Recognizing the “machine or transformation” test was merely a guideline and no longer a litmus test of patent eligibility, the district court determined that the claims were drawn neither to a machine nor a transformation, but instead to the abstract idea that one can use advertisement as an exchange for money.\textsuperscript{172} In finding that the claims lacked patentable subject matter, the district court cited \textit{Cybersource Corp. v. Retail Designs, Inc.} from the Northern District of California to find that the Internet is an abstraction, not a machine.\textsuperscript{173} In addition, the court cited \textit{Benson} for the proposition that one cannot circumvent the patentability test by limiting the claim to a computer.\textsuperscript{174} Although the district court’s decision was later reversed,\textsuperscript{175} the district court’s analysis nevertheless demonstrates how courts are struggling to determine patent-eligibility in the wake of \textit{Bilski} without a clearly articulated test.

On September 15, 2011, the Federal Circuit reversed.\textsuperscript{176} The court noted that the claimed method was a “process” under the statute and focused its inquiry on the abstractness of the claimed subject matter.\textsuperscript{177} Although the Federal Circuit agreed that the idea of using advertising as a form of currency is abstract, it concluded that the claimed multistep process was drawn to a particular revenue collection and media distribution method requiring a controlled interaction with a consumer via an Internet website, rather than a mathematical algorithm, purely mental steps or any similarly abstract concept.\textsuperscript{178}

The court noted that the subject matter of the invention as a whole involved an extensive computer interface and that certain steps (e.g., providing media products for sale on the Internet and restricting general public access to those media products) required specific

\textsuperscript{171} \textit{Id.} at *1.
\textsuperscript{172} \textit{Id.} at *3, *6.
\textsuperscript{173} \textit{Id.} at *4 (citing Cybersource Corp. v. Retail Decisions, Inc., 620 F. Supp. 2d 1068 (N.D. Cal. 2009)).
\textsuperscript{174} \textit{Id.} at *4 (citing Gottschalk v. Benson, 409 U.S. 63, 64 (1972)).
\textsuperscript{175} Ultramercial, LLC v. Hulu, LLC, 657 F.3d 1323 (Fed. Cir. 2011).
\textsuperscript{176} \textit{Id.}
\textsuperscript{177} \textit{Id.} at 1328.
\textsuperscript{178} \textit{Id.} at 1329-30.
application to the Internet and a cyber-market environment and involved complex software programming. Without defining the level of programming complexity required for patent eligibility, or holding that using an Internet website is necessary or sufficient to satisfy § 101, the court found the claims to be patent eligible, in part because of these factors. The court cited In re Alappat for the proposition that a general purpose computer becomes a special purpose machine once it is programmed to perform particular functions. In addition, the court found that such a “new machine” could be claimed in terms of the programming that facilitates a unique function without being abstract.

Through this approach, the court appeared to consider these particular claims as reciting an improvement in digital computer technology. Concluding that the failure of the claimed method to specify a particular media delivery mechanism did not render the claim impermissibly abstract, the court noted that the disclosure need not detail the particular instrumentalities for each step, assuming that the patent disclosure satisfies the written description and enablement conditions of § 112.

2. Chamberlain Group, Inc. v. Lear Corp.

In a claim construction (Markman ruling on November 24, 2010, the district court found patent eligible subject matter in claims drawn to a particular form of transmitter, which included a microcontroller used for generating and sending a secure signal for the purpose of opening and closing a door. The district court did not end its inquiry with its determination that the claims were drawn to a machine, instead commenting that it considered the scope of § 101 to be the same whether the claims were drawn to a process or a machine. The district court declined to apply the “machine or

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179 Id. at 1328.
180 Id. at 1328-29 (citing In re Alappat, 33 F.3d 1526, 1583 (Fed. Cir. 1994) (J. Rader, concurring) (noting, “In this field, a software process is often interchangeable with a hardware circuit.”)).
181 Id.
182 Id. at 1329.
183 756 F.Supp.2d 938 (N.D. Ill. 2010).
184 A Markman hearing is a preliminary hearing at which the court receives evidence and argument concerning the construction to be given to terms in a patent claim at issue. BLACK’S LAW DICTIONARY (9th ed. 2009), available at Westlaw BLACKS.
185 Chamberlain, 756 F.Supp.2d at 967.
186 Id. at 966 (citing AT&T Corp. v. Excel Commc’ns, Inc. 172 F.3d 1352, 1357-58 (Fed. Cir. 1999)).
transformation” test in view of the Supreme Court’s comment that the “machine or transformation” test was useful, but not the sole test, for determining the eligibility of claims drawn to a process—although the claims under consideration were instead drawn to a machine. 187 The district court concluded that the claims recited patent eligible subject matter because the mathematical algorithms underlying the asserted claims were directed at a physical product to be used for a specific purpose, 188 and preemption of the formula was not an issue in this case. 189

3. Research Corporation Technologies v. Microsoft Corp. 190

On December 10, 2010, the Federal Circuit reversed the district court’s decision in Research Corporation Technologies, finding patent eligible subject matter in claims drawn to (i) a method of half-toning grey scale and color images utilizing a pixel-by-pixel comparison of the image to a blue noise mask; 191 (ii) similar apparatus claims; 192 (iii) a machine comprising a computer readable storage device which stores a dither matrix for use in half-toning image information and a comparator responsive to the storage device in which dot profiles produced by thresholding have a spectrum substantially characteristic of a blue noise power spectrum; 193 and (iv) a computer readable memory device comprising a threshold half-toning mask designed to produce all substantially pleasing dot profiles when thresholded at a number of levels. 194 Following the Supreme Court’s Bilski guidance, the court focused on only three exceptions to patentable subject matter and recognized that laws of nature and physical phenomena were not an issue in the case. Instead, the court focused on “abstractness” of the subject claims. 195 Noting the comments in Justice Stevens’s Bilski concurrence, stating that the Supreme Court has never provided a satisfying account of what constitutes an unpatentable abstract idea, the Federal Circuit chose not to define “abstract” beyond recognizing that this disqualifying characteristic should exhibit itself so manifestly as to override the broad statutory categories of eligible subject matter. 196 The Federal Circuit further noted, “[I]nventions with

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187 Id. at 967.
188 Id. at 969-70.
189 Id.
190 627 F. 3d 859 (Fed. Cir. 2010).
191 Id.
192 Id. at 872-73.
193 Id. at 866.
194 Id.
195 Id. at 868.
196 Id.
specific application or improvements to technologies in the marketplace are not likely to be so abstract that they override the statutory language and framework of the Patent Act.”

Although the patentees sought protection for a process of half-toning in computer applications, which incorporated algorithms and formulas that control half-toning, the Federal Circuit concluded that the claims were not even close to the level of abstraction that would override statutory categories.

The Federal Circuit also noted that a claim that is not so manifestly abstract as to override § 101 may nevertheless be unpatentable under § 112 if the patent lacks sufficient concrete disclosure to warrant a patent. This is the case if the written description is so conceptual that a person of ordinary skill could not replicate the invention or if the written description does not provide enough particularity and clarity to inform skilled artisans of the bounds of the claims.


On February 14, 2011, the District Court in the Eastern District of Missouri granted Sun Life’s motion for summary judgment, finding that claims drawn to a method of managing a life insurance policy and a life insurance policy management system did not recite patent eligible subject matter. The court treated system claims, which recited a “policy generator for generating a life insurance policy,” “a fee calculator for generating fees,” and similar terms, as process claims. Applying the “machine or transformation” test the court found that the specified machines were no more than objects on which the method operates and that, although a computer readable medium can be considered a manufacture or machine under § 101, merely reciting data or instructions on a stored machine readable medium does not make a claim statutory under § 101. The district court also found that fetching and processing data are not patentable processes and that the claims failed to recite transforming raw data into anything other than more data and do not recite a transformation into a representation of any physical objects as in In re Abele. Addressing

197 Id. at 869.
198 Id.
199 Id.
201 Id. at 1067.
202 Id. at 1057.
203 Id. at 1064.
204 Id. at 1065.
205 Id. at 1066.
Bancorp’s arguments that the Federal Circuit’s opinion in Research Corp. stands for the proposition that inclusion of hardware elements renders a claim patentable, the district court noted that in Research Corp. the process involved improving a visual display in hardware that is integral to the patent. In contrast, the hardware Bancorp relied upon falls within the category of insignificant post-solution activity. Rather than improve the function of the computer, Bancorp’s claims use computers to improve administration of separate life insurance policies. Even if they address a need, Bancorp’s claims are unpatentable under Bilski, Benson, and Flook.

5. CLS Bank International v. Alice Corp. Pty. Ltd.

On March 9, 2011, the District of Columbia District Court ruled that claims directed to a method for exchanging obligations between parties through an intermediary to reduce counter-party risk, as well as claims drawn to the system and a computer program product, failed to recite patent eligible subject matter under § 101. Applying the “machine or transformation” test to the method claims, the district court noted that the single fact that the claims were implemented on a computer does not mean the methods are tied to a particular machine—even though a general purpose computer that has been specifically programmed to perform the steps of a method may no longer be considered a general purpose computer, but instead, a particular machine. Exploring the question of what constitutes a particular machine, the district court looked to whether the machine or apparatus imposes meaningful limits on the process itself. Citing the Federal Circuit’s pre-Bilski decision in SiRF Technology, Inc. v. International Trade Commission, the district court stated “a machine meaningfully limits the method when the machine is essential to the operation of the claimed methods.” Unlike SiRF where the methods to improve a GPS receiver’s calculation of position could not be

206 Id. at 1067.
207 Id.
208 Id.
209 Id.
211 Id.
212 Id. at 237.
213 Id. at 238.
214 See SiRF Tech., Inc. v. Int’l. Trade Comm’n., 601 F. 3d 1319, 1333 (Fed. Cir. 2010) (holding that claimed methods for teaching a GPS receiver an improved method to calculate its position were tied to a particular machine, because the methods could not be performed without the machine itself).
215 CLS Bank Int’l, 768 F. Supp. 2d at 239.
performed without the machine itself, the claims asserted by Alice gave no indication that the computers or other devices required to implement the methods are specifically programmed, or that the claims required computers at all. For this reason, the method claims were not patent eligible subject matter under the “machine or transformation” test. The district court went on to conclude that the claimed methods were directed to the abstract idea of employing an intermediary to facilitate simultaneous exchange of obligations in order to minimize risk. This abstract idea, if patented, would preempt the use of an electronic intermediary to guarantee exchanges across an incredible swath of the economic sector. The district court concluded that such claims were not patent eligible subject matter under the Supreme Court’s Bilski decision. "Turning to the computer system and product claims, the district court concluded that these claims, while drawn to a machine, merely represent an incarnation of the abstract idea on a computer without any further meaningful limitation, and also failed to recite patent eligible subject matter.

6. Cybersource Corp. v. Retail Decisions, Inc.

On August 16, 2011, the Federal Circuit affirmed a district court’s finding that claims drawn to a method of verifying the validity of a credit card transaction, as well as “Beauregard” apparatus claims that detect fraudulent transactions by causing one or more processors to carry out similar steps, were not eligible subject matter. Method claim 3 reads, “(i) obtaining information about other transactions that have utilized an Internet address that is identified with the credit card transaction; (ii) constructing a map of credit card numbers based upon the other transactions and; (iii) utilizing the map of credit card numbers to determine if the credit card transaction is valid.” Applying the “machine or transformation” test, the Federal Circuit

216 Id.
217 Id. at 242.
218 Id. at 243-44.
219 Id. at 246 (noting that the dependent claims, rather than limiting the invention, illustrated how broadly the invention might sweep its monopoly across commerce).
220 Id. at 255.
221 Id. at 252.
222 654 F.3d 1366 (Fed. Cir. 2011).
223 “A Beauregard claim — named after In re Beauregard — is a claim to a computer readable medium (e.g., a disk, hard drive, or other data storage device) containing program instructions for a computer to perform a particular process.” Id. at 1373 (citation omitted).
224 Id. at 1367 (objection of US Patent and Trademark office withdrawn).
225 Id. at 1370.
noted that the collection and organization of credit card data was insufficient to meet the transformation prong and the plain language of claim 3 did not require a machine. The court also concluded that the claimed process recited “an unpatentable mental process—a subcategory of unpatentable abstract ideas.” The court’s analysis noted that claim 3 was not limited in scope to any particular algorithm and would extend to any method of detecting credit fraud based on relating past transactions to an Internet address, including methods performed entirely by the human mind.

Turning to the plaintiff’s argument that the computer readable medium claim was eligible subject matter because it was drawn to a “manufacture,” the court looked “to the underlying invention for patent-eligibility” and concluded that Cybersource had not met its burden to demonstrate that the claim is truly drawn to a specific computer readable medium, rather than to the underlying method of credit card detection. Noting that the incidental use of a computer readable medium did not impose a meaningful limit on the claim’s scope or perform a significant part in permitting the claimed method to be performed, the court concluded that the basic character of a process claim is not changed by claiming only its performance on a computer or by claiming the process embodied in program instructions on a computer readable medium. The court distinguished Cybersource’s claims from those found to meet the eligibility standard in other cases. Specifically, the court cited to *SiRF Technology, Inc. v. International Trade Commission*, which found that the methods at issue for calculating the position of a GPS receiver could not be performed without the use of a GPS receiver, and *Research Corp. Technologies v. Microsoft Corp.*, which found that the claimed methods for rendering a halftone image by manipulating pixels and a two dimensional mask array and outputting a computer data structure could not be performed entirely in a human’s mind and were eligible subject matter.

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226 *Id.*
227 *Id.* at 1371.
228 *Id.* at 1372.
229 *Id.* at 1374-75.
230 *Id.* at 1375.
231 *SiRF Tech., Inc. v. Int’l Trade Comm’n.*, 601 F.3d 1319, 1332 (Fed. Cir. 2010).

Dealertrack sought to expedite car loan applications by eliminating the need for a dealer to fill out multiple bank specific car loan applications for a customer, fax them to different banks, and wait for the bank personnel to enter the faxed data before responding with a loan decision. Dealertrack’s automated system allowed a car dealer to fill out a single loan application for a customer and control the order and timing in which the application was sent to the selected banks. The method claims of one of the Dealertrack’s patents (the ’427 patent) recited a computer aided method of managing a credit application whose steps included (A) receiving application data from a remote application and display device, (B) selectively forwarding the application to a remote funding source terminal device, and (C) forwarding funding decision data from the remote funding terminal devices to the remote application and display devices. The claims also recited alternative steps for selectively forwarding the application simultaneously or sequentially until a positive decision is reached or all funding sources are exhausted.

Applying the machine prong of the “machine or transformation” test, the district court found the claims were not patent eligible under § 101, because the implicated computer was nothing more than a general purpose computer programmed in some unspecified manner—therefore, not a “particular machine” (Dealertrack did not contend the claims effected a transformation). On appeal after the Supreme Court’s *Bilski* decision, the Federal Circuit reviewed the question of patent eligible subject matter de novo as a question of law. Recognizing that Dealertrack’s claimed method recited processing information through a clearinghouse in much the same way as that claimed in *Bilski*, the Federal Circuit concluded that the steps did not “impose meaningful limits on the claim’s scope.” The “computer aided” language in the preamble, even if read as a substantive limitation, does not render the claim patent eligible because the claim is silent as to how the computer has any significance to performing the method.

233 Dealertrack, Inc. v. Huber, --F. 3d --, 2012 WL 164439 (C.A. Fed (Cal.)).
234 Id. at 1.
235 Id.
236 Id. at 14.
237 Id. at 14-15.
238 Id. at 15.
239 Id. at 16 (citing SiRF Tech., Inc. v. Int’l. Trade Comm., 601 F.3d 1319, 1331 (Fed. Cir. 2010)).
240 Id. (quoting *In re Bilski*, 545 F.3d 943, 961-62 (Fed. Cir. 2008)).
Thus, the court noted, “the computer does not play a significant part in permitting the claimed method to be performed,” and the “undefined phrase ‘computer aided’ is no less abstract than the idea of a clearinghouse itself.”\(^{241}\) The court found Dealertrack’s “computer aided” claim, omitting any level of involvement or detail, to be distinguished from the claims in Ultramercial, which recite a practical application with concrete steps requiring an extensive computer interface.\(^{242}\) The court gave no weight to algorithms disclosed in the specification but not recited in the claims, noting that Dealertrack had not appealed the district court’s claim construction, which did not limit the claims to any particular algorithm.\(^{243}\) Finally, the court rejected Dealertrack’s arguments that the claims were limited to the car loan application process as precisely the type of field of use limitation held to be insufficient by the Supreme Court in Bilski.\(^{244}\)

8. *Fort Properties, Inc. v. American Master Lease LLC.*\(^{245}\)

Seeking to exploit a provision in the tax code that allow an owner of property to exchange one property for another of like kind without incurring tax liability under certain conditions,\(^{246}\) American Master Lease (AML) developed an investment tool in which real estate is aggregated into a portfolio and divided into interests called deedshares for sale to investors, in a manner similar to the sale of stocks.\(^{247}\) The deedshares could be reaggregated after a predetermined time interval.\(^{248}\) A district court invalidated AML’s claimed method of creating such a real estate investment instrument, which did not require the use of a computer.\(^{249}\) The Federal Circuit affirmed,

\(^{241}\) *Id.* at 17 (quoting *Cybersource*, 654 F.3d at 1357).
\(^{242}\) *Id.* at 15-17.
\(^{243}\) *Id.* at 17. On a claim construction matter concerning another patent in the same case (the ‘841 patent), the court found that to avoid indefiniteness resulting from pure functional claiming, the structure associated with a “processing means . . . for executing a computer program which implements and controls credit application processing and routing” must include the algorithms disclosed in the specification which are necessary to performance of the recited functions. *Id.* at 13. The court also found that, in determining infringement of a means plus function claim where the specification discloses more than one algorithm, an equivalent structure for performing the function must be found in the accused device for at least one, but not necessarily all, of the algorithms disclosed. *Id.*
\(^{244}\) *Id.* at 17-18.
\(^{245}\) *Fort Props., Inc. v. American Master Lease LLC*, --F. 3d--, 2012 WL 603969 (C.A. Fed. (Cal.)).
\(^{247}\) *Fort Props., Inc.*, --F. 3d--, 2012 WL 603969 at 1.
\(^{248}\) *Id.*
\(^{249}\) *Id.* at 2.
rejecting AML’s argument that the process was patentable and not an abstract idea because the series of steps occurs in the real world and involves real property and physical deeds signifying real property ownership. Instead, the Federal Circuit found that the patent disclosed an abstract concept, i.e., an investment tool to enable the tax-free exchange of property.

Sustaining the district court’s finding of invalidity concerning other claims that did include a computer to generate the plurality of deedshares, the Federal Circuit cited CyberSource for the proposition that “the basic character of a process claim drawn to an abstract idea is not changed by claiming only its performance on computers, or by claiming the process embodied on instructions on a computer readable medium.” The court distinguished the recitation of a computer in the claims in Ultramercial as being drawn to an invention which itself involved advances in computer technology, rather than mere post-solution activity.


On March 20, 2012, the Supreme Court again addressed the patentability of process claims under 35 U.S.C. § 101, reversing two Federal Circuit decisions and finding that the claims did not recite patent eligible subject matter. Prometheus does not involve computer technology. However, the Court’s opinion offers guidance about how the steps of a process claim affect patentability when the claim involves a law of nature, natural phenomena or abstract idea, which itself is unpatentable even if newly discovered. Prometheus was the exclusive licensee of patents that claimed a method of

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250 Id. at 5.
251 Id.
252 Id. at 6 (quoting CyberSource, 654 F.3d at 1375).
253 Id. (citing Ultramercial, LLC v. Hulu, LLC, 675 F. 3d at 1328).
255 Id. Prior to the Supreme Court’s decision in Bilski v. Kappos, the Federal Circuit, applying the “machine or transformation” test, found that the claims involved the transformation of the human body or blood taken from the body and reversed the district court’s determination that the claims were not patentable subject matter because they effectively claimed a natural law. See Prometheus Laboratories, Inc. v. Mayo Collaborative Serv., 581 F.3d 1336, 1345-47 (Fed. Cir. 2009). The Supreme Court granted cert., but after ruling in Bilski v. Kappos that the machine or transformation test was not determinative, the Court remanded the case to the Federal Circuit, which reaffirmed its earlier conclusion that the body is transformed by administering the drug, and the blood is transformed by analyzing it to determine metabolite levels. See 628 F.3d 1347, 1355-57 (Fed. Cir. 2010).
optimizing therapeutic efficacy for treatment of an immune-mediated gastrointestinal disorder. The method in an exemplary claim included the steps of “administering” a drug providing a metabolite to a subject having the disorder and “determining” the level of the metabolite in the subject having the disorder, wherein a level of metabolite below a certain level indicates the need to increase the amount of the drug subsequently administered to the subject, and a level of metabolite above a certain level indicates a need to decrease the amount of the drug subsequently administered to the subject. As an initial matter, the Court found the relationship itself to be a law of nature, thus not patentable subject matter.

The Court then directed its inquiry to whether the “claims add enough to their statements of the correlations to allow the processes they describe to qualify as patent-eligible processes that apply natural laws,” noting that a process involving a law of nature is not patentable unless the process has additional features that provide practical assurance that the process is more than a drafting effort designed to monopolize a law of nature itself. According to the Court, one must do more than simply instruct a user to use the principle; one must explain how the principle can be implemented in an inventive way. This led the Court to consider whether the steps involve more than a conventional application of the principle.

In ruling against patentability based on the “administering” and “determining” steps, the Court cited precedent all the way back to its decision in the Morse telegraph case, which invalidated a claim drawn to the use of motive power of electric or galvanic current for making or printing intelligible characters, to “further support the view that simply appending conventional steps, specified at a high level of generality, to laws of nature, natural phenomena, and abstract ideas cannot make those laws, phenomena, and ideas patentable.” However, the Court specifically stated that it was not deciding whether

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257 Id.
258 Id. at 1296-97.
259 Id. at 1297.
260 Id.
261 Id. at 1300 (citing the English case Neilson v. Harford, Webster’s Patent Cases 295, 371 (1841), in which the patentee, recognizing the natural principle that introducing hot air into a furnace promotes ignition better than introducing cold air, included in his claim the unconventional step of interposing an externally heated receptacle between the blower and the furnace).
claims with less conventional steps would be invalid.\textsuperscript{264} Recognizing that the § 101 patent eligibility and § 102 novelty inquiries might at times overlap, the Court declined to shift the inquiry entirely to novelty as too uncertain, as that would require treating the newly discovered principle as if it were prior art, something not provided for in the current statute, and could render all inventions unpatentable, since underlying principles, once known, make their implementation obvious.\textsuperscript{265} Reversing the Federal Circuit’s application of the “machine or transformation” test, the Court noted that the test does not trump the law of nature exclusion for patent eligible subject matter.\textsuperscript{266}

In addition, the “administering” step is irrelevant to transforming the human body because it simply helps to pick out the group of individuals likely interested in applying the law of nature (treating physicians); the “determining” step could be satisfied without transforming the blood should science develop a different system for determining metabolite levels without such a transformation.\textsuperscript{267}

E. Current USPTO Practice

1. Statutory Subject Matter Examination Guidelines


\textsuperscript{264} \textit{Id.} at 1302.
\textsuperscript{265} \textit{Id.} at 1304.
\textsuperscript{266} \textit{Id.} at 1303.
\textsuperscript{267} \textit{Id.}
\textsuperscript{269} See Memorandum from Andrew H. Hirshfeld, Acting Deputy Comm’r for Patent Examination Policy to TC Dirs., \textit{Interim Examination Instructions for continued} . . .
and that the August 2009 *Interim Instructions* are to be consulted for determining patent eligibility under 35 U.S.C. § 101 of machine, composition and manufacture claims. It is important to note that the August 2009 *Interim Instructions* “supersede previous guidance on subject matter eligibility that conflicts with the Instructions, including MPEP 2106(IV), 2106.01 and 2106.02.”

Thus, while these MPEP sections are still operative, the extent to which they actually apply is modified by the August 2009 *Interim Instructions*. The USPTO now addresses method claims in accordance with the July 2010 *Interim Bilski Guidance*. As expected, there is considerable overlap in the approaches taken in each of these sources.

**a. The July 2010 Interim Bilski Guidance**

The July 2010 *Interim Bilski Guidance* identifies a non-exhaustive list of factors Examiners are to consider in determining whether a method claim is directed to an abstract idea and therefore is not eligible for patenting. The factors are considered when analyzing the claim as a whole. Although the analysis need not be taken further than necessary to conclude that a claim contains patent eligible subject matter, where patent eligibility is not easily determined, Examiners are directed to consider every relevant factor. No one factor alone is conclusive, the weight each factor receives varies based on the facts of the application and other factors may be more pertinent depending upon the technology of the claim. Generally, factors favoring patent eligibility satisfy the criteria of the Federal Circuit’s “machine or transformation” test or provide evidence that an abstract idea is being practically applied. Factors that weigh against patent eligibility neither satisfy the “machine or transformation” test nor provide evidence that an abstract idea has been practically applied. Recognizing that abstract ideas were not patentable even before the *Bilski* decision, the focus of the July 2010 *Interim Bilski Guidance* is to assist Examiners in determining whether a claimed method that fails the “machine or transformation” test is still patent eligible (i.e., is not an abstract idea) or whether a claimed method which does pass the “machine or transformation” test is patent ineligible (i.e., it is an

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270 *Id.*

271 July 2010 Interim Bilski Guidance, at 43,923.

272 *Id.* at 43,927.

273 *Id.*

274 *Id.*

275 *Id.*
abstract idea).\(^{276}\)

The July 2010 *Interim Bilski Guidance* announces four factors an Examiner should consider in determining patent eligibility.\(^{277}\)

(1). The first factor is whether the method involves or is executed by a particular machine or apparatus.\(^{278}\) If so, the claims are less likely to be drawn to an abstract idea. Where a machine or apparatus is recited, the July 2010 *Interim Bilski Guidance* further directs the Examiner to consider the particularity or generality of the machine or apparatus, since the incorporation of a particular machine, as opposed to a machine in general, weighs toward patentability.\(^{279}\) The July 2010 *Interim Bilski Guidance* also directs the Examiner to consider whether the machine or apparatus implements the steps of the method, because the integral use of the machine to perform the method weighs toward patentability, whereas patent eligibility is not indicated when the machine is merely an object on which the method operates.\(^{280}\) Another consideration applicable to the first factor concerns the machine’s involvement in extra-solution activity or the field of use, since use of a machine that contributes only nominally or insignificantly to the execution of the claimed method (e.g., a data gathering step or a field of use limitation) weighs against patent eligibility.\(^{281}\) Thus, in analyzing whether the method involves or is executed by a machine, under the July 2010 *Interim Bilski Guidance* the Examiner should consider the extent to which (or how) the machine limits execution of the claimed method steps.

(2). The second factor identified in the July 2010 *Interim Bilski Guidance* is whether performance of the method results in or otherwise involves a transformation of a particular article.\(^{282}\) Where such a transformation exists, the claims are more likely to recite patent eligible subject matter. In applying this factor, the July 2010 *Interim Bilski Guidance* notes that a more particular transformation weighs toward patent eligible subject matter.\(^{283}\) Similarly, the degree to which a transformation applies to a particular article is to be considered, because a transformation applied to a generically recited article weighs against patent eligibility.\(^{284}\) The July 2010 *Interim Bilski Guidance* also directs the Examiner to consider the nature of the transformation,

\(^{276}\) *Id.* at 43,925.

\(^{277}\) *Id.* at 43,925-26.

\(^{278}\) *Id.* at 43,925.

\(^{279}\) *Id.*

\(^{280}\) *Id.*

\(^{281}\) *Id.*

\(^{282}\) *Id.*

\(^{283}\) *Id.*

\(^{284}\) *Id.*
since the more extensive the transformation (such as a change in the use or function of the article), the more likely the claim is to recite patent eligible subject matter. Another aspect of the analysis of this factor is the nature of the article transformed. For example, transformation of an object weighs toward patent eligibility, while transformation of a concept or contractual obligation weighs against patent eligibility. The July 2010 Interim Bilski Guidance also directs the Examiner to consider the extent to which the transformation imposes meaningful limits on the execution of the claimed method steps. A transformation that only contributes nominally or insignificantly to the execution of the method weighs against patent eligible subject matter.

(3). The third factor of the July 2010 Interim Bilski Guidance directs the Examiner to consider whether the performance of the method involves an application of a law of nature, even in the absence of a particular machine, apparatus, or transformation, since the claims are less likely to be drawn to an abstract idea where such an application exists. This factor weighs against an application that applies across many fields of endeavor, such as where a claim recites an effect of a law of nature or claims every mode of accomplishing that effect. This factor also weighs against a claimed method solely involving subjective determinations, such as a way of thinking about or reacting to a law of nature. Finally, as with the other factors, this factor weighs against a claim where the law of nature applies only nominally or insignificantly to the execution of the claimed method and fails to meaningfully limit execution of the claimed method.

(4). The July 2010 Interim Bilski Guidance also directs the Examiner to consider whether a general concept, such as a principle, theory, plan or scheme, is involved in executing the steps of the method, since the presence of such a concept in a claim suggests that the claim could be drawn to an abstract idea. Among the considerations weighing against patent eligibility in analyzing this factor are (i) whether the claim would effectively grant a monopoly on the concept, (ii) whether the claim is so abstract it would cover both known and unknown uses of the concept and be performed through any existing or future devised machinery, or even without any apparatus, and (iii) the extent to which the claim would cover all possible solutions to any particular problem, such that it describes the

285 Id.
286 Id.
287 Id.
288 Id.
289 Id.
problem rather than offers a particular solution. Another factor in
the analysis is the extent to which the concept is disembodied or
instantiated in some tangible way. Instantiation weighs in favor of
eligibility, although limiting a claim to a field of use or adding token
post-solution components does not contribute to patent eligibility.
In addition, steps that are observable and verifiable rather than
subjective or imperceptible are more likely to include patent eligible
subject matter. The July 2010 Interim Bilski Guidance identifies
some general concepts which are not likely to involve patent eligible
subject matter such as: basic economic practices (hedging, marketing,
financial transactions), basic legal theories (contracts, dispute
resolution, fields of law), mathematical concepts (algorithms, spatial
relationships geometry), mental activity (forming a judgment,
observation, evaluation), interpersonal relationships (conversing,
dating), teaching concepts (memorization, repetition), human behavior
(exercising, wearing clothing, following rules or instructions), and
instructing how business should be conducted.

In addition to the formal notice in the Federal Register, the USPTO
also issued a “Quick Reference Sheet” to the Examiners.

b. The August 2009 Interim Examination Instructions

The July 2010 Interim Bilski Guidance also directs Examiners to
apply the USPTO’s August 2009 Interim Examination Instructions For
2009 Interim Instructions) in non-method claims. These guidelines
first instruct the Examiners to apply the “utility” guidelines in MPEP §
2107 to evaluate whether the claims and supporting disclosure have an
asserted and well established utility that is specific, substantial and
credible, commensurate with the broadest interpretation of the claimed
invention in light of the specification as interpreted by an ordinarily
skilled artisan.

Turning to subject matter eligibility, the August 2009 Interim
Instructions now applicable to non-method claims, instruct Examiners
to conduct a two-step analysis:

Step 1: Is the claimed invention directed to one of the four

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290 Id. at 43,925-26.
291 Id. at 43,926.
292 Id.
293 Id.
294 Id.
295 Memorandum from Andrew H. Hirshfeld, supra note 269.
296 Id. at 1.
statutory categories\(^{297}\), i.e.

(i) process—an act or series of steps tied to a particular machine or to transform a particular article – process or method claims are now analyzed under the July 2010 \textit{Interim Bilski Guidance},

(ii) machine—a concrete thing consisting of parts, devices or a combination of devices,

(iii) manufacture—an article produced from raw material or prepared materials by giving to these materials new forms, qualities, properties of combinations,

(iv) composition of matter—all compositions of two or more substances and all composite articles; and

\textit{Step 2:} Is the claim wholly directed to subject matter encompassing a judicially recognized exception such as abstract ideas, mental process, laws of nature and natural phenomena, or other judicially recognized non-statutory categories such as physical phenomena, scientific principles, systems that depend on human intelligence alone, disembodied concepts, and disembodied mathematical algorithms and formulas?\(^{298}\) Or is the claim directed to a particular application of a judicial exception, which may be statutory? Some examples of claims that are not directed to statutory categories include:

(i) transitory forms of signal transmission,

(ii) naturally occurring phenomena,

(iii) a human per se,

(iv) a legal contractual agreement between two parties,

(v) a game defined by a set of rules,

(vi) a computer program per se, and

(vii) a company.\(^{299}\)

The August 2009 \textit{Interim Instructions} note that a claim drawn to both statutory and non-statutory subject matter, under the broadest reasonable interpretation of the claim in view of the specification, includes non-statutory subject matter and therefore should be rejected as non-statutory under 35 U.S.C. § 101.\(^{300}\) However, if a judicial exception is recited in a claim, it must be determined if the judicially excepted subject matter has been practically applied in a product.

Eligible machines, manufactures, and compositions of matter are non-naturally occurring products typically formed of practical elements or parts that embody a particular or specific tangible practical

\(^{297}\) \textit{Id.} at 1-2.

\(^{298}\) \textit{Id.} at 2.

\(^{299}\) \textit{Id.}

\(^{300}\) \textit{Id.}
An idea that is applied to a structure is no longer abstract and a law of nature or natural phenomena that is practically applied to a structure is limited to that particular application of the concept. Once a practical application has been established, preemption must be evaluated to determine whether the claim impermissibly covers substantially all practical applications of the judicially excepted subject matter. If so, the claim is not patent eligible. If the claim covers only the practical application of the judicially excepted subject matter, it is patent eligible. Descriptive material should be evaluated to determine if the material has a functional relationship to the underlying structure in order to determine whether it creates a patentable distinction over the prior art or is merely non-functional descriptive material that creates no patentable distinction. As an example, the August 2009 Interim Instructions describes printed matter on an object or mere data, such as music, stored in a memory as not patentable subject matter. On the other hand, a printed circuit board or computer programmed with executable instructions as a base structure combined with functional material that could create a patentable distinction over the prior art may be eligible subject matter.

The August 2009 Interim Instructions further instruct Examiners to: (1) determine the meaning of the claim as a whole using the “broadest reasonable interpretation” standard, (2) determine if the claim falls in one of the statutory categories of invention, and (3) “determine if the claim as a whole is directed to a particular practical application of a judicial exception . . . or a judicial exception in its entirety.”

When no judicially excepted subject matter is present in a claim, and the claim is within one of the statutory categories, it is patent eligible. If a judicially recognized exception is present, the Examiner must “determine if the claim recites structural limitations to qualify as a practical application of the judicial exception.” If the claim fails to recite a tangible embodiment, it is not patent eligible. If the claim does recite a tangible embodiment, the Examiner then considers whether the claim covers “substantially all practical uses of the judicial exception” (preemption). If the claim is limited to a

301 Id. at 3.
302 Id. at 4.
303 Id.
304 Id. at 6-7.
305 Id. at 7.
306 Id.
307 Id.
308 Id.
particular practical application, it is directed to statutory subject matter and is eligible.\textsuperscript{309} If substantially all uses of the judicial exception are covered, the claim is directed to non-statutory subject matter and the Examiner is expected to reject it.\textsuperscript{310}


An understanding of the MPEP in view of the July 2010 Interim Bilski Guidance and the August 2009 Interim Instructions gives practitioners insight into how Examiners will evaluate claims. Practitioners should note, however, that the guidelines and the MPEP are just that—guidelines. Neither the July 2010 Interim Bilski Guidelines, nor the August 2009 Interim Instructions, nor the MPEP, has the force of law and, where appropriate, practitioners should consider creative approaches to drafting claims outside these guidelines in order to obtain appropriate patent protection consistent with current jurisprudence.

As the MPEP indicates, the first step an Examiner takes is determining what the applicant has invented.\textsuperscript{311} According to the MPEP, the Examiner seeks to exclude from patent protection, claims that are drawn from ideas, laws of nature, and natural phenomena, or claims that preempt such categories.\textsuperscript{312} The MPEP instructs the Examiner to first determine whether the claims fall within one of the statutory categories in 35 U.S.C. § 101, i.e., process, machine, manufacture, or composition of matter.\textsuperscript{313} Where an invention is a combination of devices that appear to be directed to a machine and one or more steps performed by the machine, the claim is considered an apparatus claim including functional limitations.\textsuperscript{314} Because the burden is on the USPTO to set forth a prima facie case of unpatentability,\textsuperscript{315} the Examiner must provide an explanation as to why he or she considers it more likely than not that the claim falls outside the statutory categories in order to shift the burden of asserting patentability to the applicant.\textsuperscript{316}

Assuming there is adequate written description in the specification, the claims can be amended to recite subject matter within one of the

\textsuperscript{309} Id.
\textsuperscript{310} Id.
\textsuperscript{312} Id. at § 2106(IV)(A).
\textsuperscript{313} Id. at § 2106(IV)(B).
\textsuperscript{314} Id.
\textsuperscript{315} Id.
\textsuperscript{316} Id.
statutory categories.

Where the claim falls within one of the statutory categories enumerated in 35 U.S.C. § 101, the MPEP directs the Examiner to determine if the claim falls within one of the judicial exceptions to patentability—laws of nature, natural phenomena, and abstract ideas.\textsuperscript{317} The MPEP recognizes that while claims drawn solely to such features are unpatentable, practical applications of such features, e.g., methods and products employing abstract ideas, natural phenomena, and laws of nature, may well be patentable.\textsuperscript{318}

The MPEP analysis of such practical applications proceeds along two paths. First, if the claimed invention transforms an article or physical object to a different state or thing, the claim is statutory under 35 U.S.C. § 101 and the Examiner moves on to other inquiries concerning patentability, such as inquiries concerning the adequacy of the description under 35 U.S.C. § 112 and/or prior art inquiries under 35 U.S.C. §§ 102, 103.\textsuperscript{319} Note, however, that a transformation is no longer sufficient to conclude that the claim recites patent eligible subject matter.\textsuperscript{320}

Utility is also required. “The USPTO’s official interpretation of the utility requirement provides that the utility of an invention has to be (i) specific, (ii) substantial and (iii) credible.”\textsuperscript{321} Because the focus is on the claim, “statements in the specification describing a practical application may not be sufficient to satisfy the requirements” under 35 U.S.C. § 101.\textsuperscript{322} In addition, under the guidelines, “a claim that can be read so broadly as to include statutory and nonstatutory subject matter must be amended to limit the claim to a practical application.”\textsuperscript{323}

Consistent with the July 2010 \textit{Interim Bilski Guidance} and the August 2009 \textit{Interim Instructions}, the MPEP next instructs the Examiner to evaluate whether the claim preempts a judicial exception under 35 U.S.C. § 101.\textsuperscript{324} Recall that the Examiner first determines if the claim covers a judicial exception or practical application of a judicial exception, and then evaluates whether the claimed invention is a practical application of a judicial exception. Here, the Examiner considers a somewhat different issue, i.e. preemption. Citing the Supreme Court, the MPEP notes, “[o]ne may not patent a process that

\textsuperscript{317} Id. at § 2106(IV)(C).
\textsuperscript{318} Id. at § 2106(IV)(C)(1).
\textsuperscript{319} Id. at § 2106(IV)(C)(2)(1), (V)(B), (VI), (VII).
\textsuperscript{320} Id. at § 2106(IV)(C)(2)(1), (2).
\textsuperscript{321} Id. at § 2106(IV)(C)(2)(2)(a).
\textsuperscript{322} Id.
\textsuperscript{323} Id.
\textsuperscript{324} Id. at § 2106(IV)(C)(3).
comprises every ‘substantial practical application’ of an abstract idea, because such a patent ‘in practical effect would be a patent on the [abstract idea] itself.’” 325 Should the Examiner conclude that the claim preempts a 35 U.S.C. § 101 exception, the Examiner must “identify the abstraction, law of nature, or natural phenomenon and explain why the claim covers every substantial application thereof.” 326

2. Computer Programs and Data Structures

MPEP § 2106.01 distinguishes “functional descriptive material,” such as “data structures and computer programs which impart functionality when employed as a computer component,” from “non-functional descriptive material,” such as music, literary works, or other arrangements of data. 327 Computer program listings per se and data structures not claimed as embodied in computer readable media are not statutory under 35 U.S.C. § 101 because they are not physical things and are not capable of being executed to cause functional change in a computer. 328 However, a computer readable medium encoded with a data structure can define structural and functional interrelationships between the data structure and the computer hardware and software components, which permit realization of the data structure’s functionality. 329 A computer readable medium encoded with a computer program can achieve a similar result. Thus, both functionally descriptive material encoded as data structures on computer readable media and computer programs encoded on computer readable media may be statutory subject matter. 330 When a computer program is recited in conjunction with a physical structure, such as a memory, the Examiner treats that claim as a product claim. 331

Descriptive material such as music and photographs, which have no functional interrelationship with a computer, is not a process, machine, manufacture, or composition of matter and, by itself, is non-statutory. 332 Such non-functional descriptive material may be combined with functional descriptive material on a computer readable medium to provide the necessary functional and structural interrelationship to satisfy the requirements of 35 USC § 101. 333

325 Id. (referencing Gottschalk v. Benson, 409 U.S. 63, 71-72 (1972)).
326 Id. at § 2106(IV)(C)(3).
327 Id. at § 2106.01.
328 Id. at § 2106.01.
329 Id. at § 2106.01(I).
330 Id. at § 2106.01(II).
331 Id. at § 2106.01(II).
This portion of the MPEP should be read in context with July 2010 Interim Bilski Guidance and the August 2009 Interim Instructions which emphasize structural limitations such that an idea tangibly applied to a structure is no longer abstract. As the August 2009 Interim Instructions notes, “a claim to a non-transitory, tangible computer readable storage medium per se that possesses structural limitations under the broadest reasonable interpretation standard . . . would be patent eligible subject matter.”

Having evaluated whether the claim recites statutory subject matter under 35 USC §101, the Examiner evaluates the patentability of the claim under the remaining principles of the patent statute, such as compliance with the description requirements of 35 USC §112 and recitation of subject matter that is patentable over the prior art under 35 USC §§ 102 and 103.

F. The Supreme Court’s KSR Decision and Obviousness

On April 30, 2007 the United States Supreme Court handed down an important decision on the scope of obviousness under 35 U.S.C. § 103. Although the case concerned the placement of an electronic control, (i.e., a throttle control) on a vehicle control pedal, language in the decision could have an affect on the scope afforded claims drawn to computer implemented inventions, such as automated systems and business method patents.

1. KSR’s Implications for Computer Hardware and Software Claims

Applying a “teaching, suggestion, motivation test” (TSM test) the Federal Circuit had reversed a district court’s finding that a claimed vehicle control pedal was obvious. The Supreme Court, citing Federal Circuit case law characterized the TSM test as one “under which a patent claim is only proved obvious if . . . the prior art . . . the nature of the problem, or the knowledge of a person having ordinary skill in the art” reveals some motivation or suggestion to combine the prior art teachings. Acknowledging that the idea underlying the TSM test is not necessarily inconsistent with the expansive and flexible functional approach the Supreme Court has taken toward

334 Memorandum from Andrew H. Hirshfeld, supra note 269.
336 Id. at 406.
337 Id. at 413.
338 Al-Site Corp. v. VSI Int’l., Inc., 174 F.3d 1308, 1323-24 (Fed. Cir. 1999).
obviousness, the Court found the Federal Circuit’s application of the TSM test as a rigid rule that limits the obviousness inquiry to be incompatible with its precedents.

The Supreme Court agreed that a patent composed of several elements is not proved obvious merely by demonstrating that each of its elements was, independently, known in the prior art. However, the Court also stated that its precedents make clear that the analysis need not seek out precise teachings directed to the specific subject matter of the challenged claim, because a court can take account of the inferences and creative steps a person of ordinary skill in the art would employ. Often it will be necessary to look to interrelated teachings of multiple patents, the effects of demands known to the design community or known in the marketplace and the background knowledge possessed by a person having ordinary skill in the art to determine whether there was an apparent reason to combine the known elements in the fashion of the patent claims.

Claims drawn to computer implementations of business practices are likely to receive scrutiny, given the Court’s statement that the “combination of familiar elements according to known methods is likely to be obvious when it does no more than yield predictable results.” Another reason to expect scrutiny of claims drawn to computer implemented inventions, such as Internet implementations of business practices, is the Court’s comment that “[w]hen a work is available in one field of endeavor, design incentives and other market forces can prompt variations of it, either in the same field or a different one. If a person of ordinary skill can implement a predictable variation, § 103 likely bars its patentability.” Noting that in many fields there is little discussion of obvious techniques or combinations, and that market demand, rather than scientific literature may drive design trends, the Court commented that granting patent protection to advances that would occur in the ordinary course without real innovation retards progress. Expanding the obviousness inquiry from scientific literature to market forces seems likely to affect the analysis of whether claims drawn to business methods and Internet implementations are merely advances in the ordinary course.

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340 Id. at 419.
341 Id.
342 Id. at 418.
343 Id.
344 Id.
345 Id. at 416.
346 Id. at 417.
347 Id. at 419.
The Court also noted that in some cases a patent claim may be proved obvious by showing the combination of elements was obvious to try.\textsuperscript{348} The Court noted that a “person of ordinary skill is also a person of ordinary creativity.”\textsuperscript{349} Where a design need or market pressure to solve a problem exists and there are a finite number of identified, predictable solutions, an ordinarily skilled person has good reason to pursue the known options within his grasp.\textsuperscript{350} Because achieving the anticipated success is not the result of innovation, but of ordinary skill and common sense, the fact that the combination was obvious to try might show it was obvious under § 103.\textsuperscript{351}

In view of the Court’s comments, the patentability of computer-implemented inventions may depend upon demonstrating innovation beyond merely migrating well-known techniques to an automated system or business practices to the Internet. Computer implemented inventions are likely to face scrutiny as to whether they constitute real innovation producing unexpected results or, instead, are mere advances in the ordinary course.

2. Obviousness After KSR


On May 9, 2007, in its first obviousness ruling after KSR, the Federal Circuit sustained a district court’s finding that a claim drawn to an interactive learning device with a processor, a memory and a reader, was obvious over the combination of a prior art electro-mechanical learning device and another device using a processor and a memory.\textsuperscript{352} Neither prior art device contained the claimed reader, which identified the book inserted into the claimed device.\textsuperscript{353} In its decision, the court noted that accommodating a prior art mechanical device to modern electronics would have been reasonably obvious to one of ordinary skill in designing children’s learning devices and that applying modern techniques to older mechanical devices has been commonplace for years.\textsuperscript{354}

The prior art electro-mechanical device (Bevan) used a phonograph record and an electric motor actuated by depressing uniquely shaped puzzle pieces to cause a phonograph needle to move

\textsuperscript{348}Id. at 421.
\textsuperscript{349}Id.
\textsuperscript{350}Id.
\textsuperscript{351}Id.
\textsuperscript{352}Leapfrog Enter., Inc. v. Fisher-Price, Inc., 485 F. 3d 1157 (Fed. Cir. 2007).
\textsuperscript{353}Id. at 1162.
\textsuperscript{354}Id. at 1161.
to a specific place on the record to play a sound corresponding to a letter. The court found that Bevan’s electromechanical device taught an apparatus that achieves the goals of the claimed invention, i.e., associating letters with their sounds and encouraging children to sound our words phonetically.

The second piece of prior art (“SSR”) was a learning toy, which produced the sound of a word’s first letter and the remaining portion of the word, instead of each individual letter. The SSR device had a speaker, a memory and a processor, which determined the identity of the book and the page from the locations of triangles and stars on the book’s pages when depressed by the user. The court concluded that SSR provided a road map to one of ordinary skill desiring to produce an electronic based phonics learning tool for children. Thus, the court reasoned that the district court’s conclusion that the one of ordinary skill could have utilized the electronics of SSR with the operational method taught by Bevan to allow a child to press each letter of a word to hear the corresponding sound was not clear error.

Turning to the reader, the court determined that there was ample evidence in the record that readers were known in the art at the time of the invention and, citing KSR, noted that Leapfrog failed to present any evidence that including a reader in this type of device was uniquely challenging or difficult for one of ordinary skill.

The court also found that notwithstanding the evidence of commercial success, praise and long-felt need, the strength of the prima facie obviousness showing was such that these secondary considerations could not overcome the district court’s finding of obviousness.

b. Muniauction, Inc. v. Thomson Corp.

Muniauction, Inc. v. Thomson Corp. concerned a patent directed to electronic methods for conducting original issuer auctions of financial instruments. The Federal Circuit concluded that certain claims differed from the prior art only in their use of a prior art web browser. Applying the reasoning in KSR, the court focused on

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355 Id.
356 Id.
357 Id.
358 Id.
359 Id. at 1162.
360 Id.
361 Id.
362 Id.
364 Id. at 1325-28.
whether the improvement is more than the predictable use of prior art elements according to their established functions and concluded that the claims were not valid. Citing its reasoning in *Leapfrog*, the court concluded that the record in *Muniauction* demonstrated that adapting existing electronic processes to incorporate modern internet and web browser technology was commonplace at the time the patent application was filed.

**c. Asyst Technologies v. Emtrak, Inc.**

*Asyst Technologies v. Emtrak, Inc.* concerned a system for tracking articles passing through processing stations. The patented invention’s use of a multiplexer to communicate among the article processing stations was the primary distinction over the prior art systems, which used a bus to communicate among article processing stations. The court cited *KSR* for the proposition that replacing the prior art bus with a multiplexer is little more than “the simple substitution of one known element for another” because the evidence showed that the choice between the two devices was a familiar one based on well-known considerations.

**d. Perfect Web Technologies, Inc. v. Infousa, Inc.**

*Perfect Web Technologies, Inc. v. Infousa, Inc.* concerned a system that compared successfully delivered e-mail messages against a predetermined desired quantity and repeated the steps of selecting and e-mailing customers until the desired number of successful deliveries had been achieved. Since the other steps were found in the prior art, at issue was whether the repetition step was obvious to an e-mail marketer of ordinary skill. In this case, the court delved into what constitutes “common sense” under *KSR*. The Federal Circuit noted that, although the obviousness analysis under *KSR* should “take account of the inferences and creative steps that a person of ordinary skill in the art would employ,” the Supreme Court did not relax the requirement that “to facilitate review, this analysis should be made

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365 Id.
366 Id. at 1326-27.
368 Id. at 1312.
369 Id. at 1314.
370 Id. at 1315.
371 Perfect Web Techs., Inc. v. Infousa, Inc., 587 F.3d 1324 (Fed. Cir. 2009).
372 Id. at 1326.
373 Id. at 1328-31.
The Federal Circuit concluded that the district court properly based its “common sense” reasoning concerning repetition of the steps on record evidence. The Federal Circuit noted the district court’s conclusion that until success in delivering the requisite number of e-mails is achieved there is little else the marketer could do but try again, as well as testimony that if initial delivery fell short of the desired number, the only options are to stop or to find more e-mail addresses. The court also noted that simple logic suggests that sending messages to new addresses is more likely to produce successful deliveries than sending messages to addresses that have already failed and that there was no evidence of any unexpected results and that the predictable result of repetition is that more e-mail messages reach more recipients. Citing KSR, the court noted that where trying a limited number of solutions leads to anticipated success, it is likely the product not of innovation, but of ordinary skill and common sense.

G. Product and Method of Use Claims

A single invention may support both product and process claims. Apparatus claims recite the structure of the computer invention. In contrast, method claims recite a series of steps for carrying out a process. For example, a claim could recite a method of transmitting data comprising a programmed series of steps. Method claims can also recite a process for using an invention. Such a claim could recite a method of applying a signal to an external device comprising a series of steps. A computer invention can also claim a processor comprising stored indicia encoded to perform a series of steps. In this context, the claim is drawn to a computer product having functionally descriptive material stored thereon. As discussed above, such a claim can be statutory under 35 U.S.C. § 101. Such claims are also definite under 35 U.S.C. § 112 because they provide the public adequate notice of the scope of the claim.

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374 Id. at 1330 (citing KSR Int’l Co. v. Teleflex, Inc., 550 U.S. 398, 418 (2007)).
375 Id.
376 Id. at 1330-31.
377 Id. at 1331.
378 Id. at 1331 (citing KSR Int’l Co. v. Teleflex, Inc., 550 U.S. 398, 421 (2007)).
In contrast, a claim drawn to structure and a method of using that structure is invalid under 35 U.S.C. §112 as indefinite. In *IPXL Holdings LLC v. Amazon.com, Inc.*, the Federal Circuit found invalid a dependent claim, which recited both a structure having an input means and a user using the input means to input certain data. The court based its finding on the principle of inadequate notice, reasoning that one could not determine if infringement occurs when one makes the product or when one uses the product.

**H. “Joint Infringement”—Multiple Actors Required**

Adequate patent protection requires the practitioner draft claims that are subject to infringement. Business method patents and networked implementations of automated systems present special claim drafting challenges. Under the “all elements rule” patent infringement does not occur unless all the elements of the claim are found in the infringing product or method, whether or not the infringing device or method includes additional subject matter. Application of the “all elements rule” virtually requires that a single actor perform all the steps of a claimed method in order for infringement to exist. Although the Federal Circuit has suggested that joint infringement is possible, joint infringement would appear to apply only to actors performing steps of the claim in concert with each other. A patent claim that requires multiple, independent actions not under the control of a single party would be not be infringed by any of the parties, because no one party satisfies the “all elements” rule. For example, a business method claim that requires a user to input information, a financial institution to process the information input by the user and a third party to receive the processed information and transfer funds would not be infringed by any of the parities because no one party carries out all the steps of the method. In the absence of direct infringement, there can be no contributory infringement, leaving the patentee with no means to enforce any patent rights.

1. **BMC Resources Inc. v. Paymentech, L.P.**

In *BMC*, the Federal Circuit brought to rest any confusion it may have caused by its earlier decision in *On Demand Machinery*. In *BMC*
the court addressed the issue of infringement where the actions of multiple parties are required to infringe a single claim. Stating that “liability for infringement requires a party to make, use, sell or offer to sell the patented invention, meaning the entire patented invention,” the court confirmed the applicability of the “all elements rule.” Applying principles of vicarious liability, the court noted that the law imposes liability for the acts of another in circumstances showing that the liable party controlled the conduct of the acting party, adding that in the context of patent infringement a defendant cannot avoid liability for direct infringement by having someone else carry out one or more of the claimed steps on its behalf. Courts faced with a divided infringement theory have generally refused to find liability where one party did not control or direct each step of the patented process.

Although BMC established the viability of the “all elements rule” and the principle that one cannot avoid liability by contracting out steps of a patented process, BMC did not establish the level of control generally required to establish liability. The Federal Circuit addressed the level of control necessary to establish liability for joint infringement in Muniauction.


In Muniauction, the court determined that the actions of a bidder and an auctioneer in an automated bidding system could not be combined to find direct infringement by the auctioneer. It was undisputed that no single party performed every step of the method recited in certain claims that survived a validity challenge. For example, the claims recited the bidder inputting information into the bidder’s computer system, while most of the remaining steps were performed by the auctioneer’s system. Citing BMC, the court noted that “where the actions of multiple parties combine to perform every step of a claimed method, the claim is directly infringed only if one party exercises ‘control or direction’ over the entire process such that every step is attributable to the controlling party, i.e. the ‘mastermind’” and that “‘arms-length cooperation’ will not give rise to direct infringement by any party.” The court agreed with the BMC

387 Id. at 1380.
388 Id. at 1381.
389 Id. at 1379.
390 Id. at 1380.
392 Id.
393 Id. at 1328.
394 Id. at 1329.
court’s position that the “control or direction” standard is satisfied in situations where the law would traditionally hold the accused direct infringer vicariously liable for the acts committed by another party required to complete performance of a claimed method.\textsuperscript{395} In the absence of evidence or a legal theory that the defendant, Thomson, was in any way vicariously liable for the acts of the bidders, the court found no infringement.\textsuperscript{396} Thomson’s controlling access to its system and instructing bidders on the system’s use was not sufficient to incur liability for direct infringement.\textsuperscript{397} Applying the vicarious liability standard, in \textit{Emtel, Inc. v. Lipid Labs, Inc.},\textsuperscript{398} the court noted that a contracting party is not vicariously liable for the actions of an independent contractor unless that party controls the details of the independent contractor’s work to such an extent that the contractor cannot perform the work as he chooses.\textsuperscript{399} Applying this analysis, the court concluded that for liability to attach the mastermind must so control the third party that in its performance of the infringing steps the third party does so as the defendant’s agent.\textsuperscript{400} Making information available to the third party, prompting the third party, instructing the third party, or facilitating or arranging for the third party’s involvement in the alleged infringement is not sufficient.\textsuperscript{401}

3. \textit{Keithley v. The Home Store.com, Inc.}\textsuperscript{402}

In \textit{Keithley}, a district court explored the “control or directs” issues of \textit{Muniauction} in more detail. Referring to the briefs filed in \textit{Muniauction}, the court noted that, even when combined, the following actions did not rise to the level of infringement where the bidders, rather than the defendant carry out the step of inputting the bids to their own computers: (1) requiring bidders to install and configure certain software and to use pre-assigned passwords, (2) connecting bidders to the a server maintained by the defendant, as well as allowing bidders to use the server to calculate and prepare bids for submission and allowing issuers and financial advisers to review the results of the bidding process; (3) providing detailed screen shots and written instructions to bidders about what to do throughout the auction process; and (4) exercising contractual control over the bidders by

\textsuperscript{395} \textit{Id.} at 1330.

\textsuperscript{396} \textit{Id.}

\textsuperscript{397} \textit{Id.}

\textsuperscript{398} \textit{Emtel, Inc. v. Lipid Labs, Inc.}, 583 F. Supp. 2d 811 (S.D. Tex. 2008).

\textsuperscript{399} \textit{Id.} at 837.

\textsuperscript{400} \textit{Id.} at 839.

\textsuperscript{401} \textit{Id.}

licensing the software, requiring that all bids be irrevocable and reserving the right to terminate or change the system at any time.\textsuperscript{403}

4. \textit{Akamai Technologies, Inc. v. Limelight Networks, Inc.}\textsuperscript{404}

In Akamai, decided in December 2010, the Federal Circuit again addressed infringement when multiple parties perform different steps of a claimed method. Akamai disclosed a content delivery method, which improved upon prior art “mirroring” of entire websites on geographically dispersed computers.\textsuperscript{405} Akamai disclosed a method in which a base document of a web site is delivered from a content provider’s computer.\textsuperscript{406} However, individual embedded objects, which are links in the form of URLs (uniform resource locators) pointing to the location of actual objects to be used in the website, are stored on an object-by-object basis on a Content Delivery Network (“CDN”) of computers strategically placed at various geographic locations to maximize efficient delivery of information over the Internet.\textsuperscript{407} Akamai’s claimed method included the step of “tagging” embedded objects so that the requests for the objects resolve to a domain other than the content provider’s domain.\textsuperscript{408} Limelight’s contract with its content providers made each content provider responsible for identifying, via Limelight’s then current process, URLs for the customer’s content to be delivered by Limelight’s CDN.\textsuperscript{409} Under that process, Limelight’s customers accomplished this “tagging” by changing the name of one or more page objects in the initial web page to point to Limelight’s servers or by changing the alias information in the customer’s DNS server so that the hostname addresses of the page objects resolve to Limelight’s servers. In either case, the customer and not Limelight performs the “tagging” step of Akamai’s claimed method, requiring Akamai to present a joint liability theory at trial.\textsuperscript{410} Although the jury returned a verdict of infringement, the district court, relying upon the Federal Circuit’s \textit{Muniauction} decision, granted the defendant’s JMOL motion of non-infringement and the Federal Circuit affirmed.\textsuperscript{411}

In finding non-infringement, the Federal Circuit held that “as a
mater of Federal Circuit law, there can only be joint infringement when there is an agency relationship between the parties who perform the method steps or when one party is contractually obligated to the other to perform the steps. The court noted that:

what is essential is not merely the exercise of control or the providing of instructions, but whether the relationship between the parties is such that the acts of one are attributable to the other . . . for an agency relationship to exist, and thus for infringement to be found, both parties must consent that the agent is acting on the principal’s behalf and subject to the principal’s control.

The court recognized that an agency relationship need not be a purely fiduciary relationship, but further focused on the right to control the agent’s actions as an essential element of agency and explained, “there is no indication that an agency relationship arises when one party simply provides direction, no matter how explicit, to another party.” Although Limelight’s contract required its customers to perform certain claim steps if they use Limelight’s service, the court noted that Limelight’s contract did not obligate customers to perform any of the method steps, since the customers choose what, if any, content they deliver through Limelight’s CDN. The court found no infringement because Limelight did not perform the “tagging” step and its agreement merely provided its customers with the tools to allow them to exercise independent discretion and control over how and in what respect to implement the system. The court noted that claims in two other patents sharing the same specification did not implicate the joint infringement issue because of the way the asserted claims were drafted.


On January 20, 2011, in Centillion, the Federal Circuit addressed the question of what constitutes use of a system that includes elements in the possession of more than one actor. The court held that “to

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412 Id. at 1320.
413 Id. at 1319.
414 Id. at 1320-21.
415 Id. at 1321.
416 Id. at 1321-1322.
‘use’ a system for purposes of infringement, a party must put the invention into service, i.e., control the system as a whole and obtain direct benefit from it.” ⁴¹８ The court agreed that direct infringement by “use” of a system claim requires a party to use each and every element of a claimed system, but, citing NTP, Inc. v. Research In Motion, Ltd., ⁴¹⁹ the court noted that physical control of the elements by the user does not matter, as long as the user makes the elements work for the patented purpose. ⁴²⁰ Applying these principles, the court found that both a user’s on-demand query and a user’s subscription to receive monthly reports constitute “use” of the system as a matter of law. ⁴²¹ In each case, either on demand or at periodic intervals, the user requires the system to perform back-end processing, which would not otherwise be put into service. The user controls the system by causing it to perform certain processing and obtaining the benefit of the result. ⁴²² Because Qwest’s customers “use” the system, even though they do not physically possess the system elements, the court remanded to the district court to determine whether Qwest could be inducing its customers to infringe. ⁴²³ The court further determined that Qwest itself did not “use” the system as a matter of law because Qwest never puts into service the users’ personal computer data processing means. ⁴²⁴ Qwest was also not vicariously liable for the actions of its customers because Qwest does not direct its customers to perform nor do Qwest’s customers act as Qwest’s agents. ⁴²⁵ Qwest provides software and technical assistance, but it is entirely the customer’s decision whether to install and operate the software in its personal computer. ⁴²⁶ Qwest also did not “make” the patented invention because it does not combine all of the claim elements, because Qwest does not provide the personal computer data processing means recited in the claims. ⁴²⁷

On April 12, 2011, in *McKesson*, the Federal Circuit again turned to the issue of method claims where the steps of the method are carried out by multiple parties. Epic licensed its MyChart software package to healthcare providers, who decided whether to offer MyChart to their patients.429 If a patient uses MyChart, that patient “initiates a communication” to the provider by logging on to the healthcare provider’s web page.430 Because McKesson’s claims recite “initiating a communication by one of a plurality of users to the provider . . .” and the patients are not Epic’s customers, it was undisputed that Epic’s customers do not directly perform the “initiating a communication” step.431 McKesson appealed the district court’s grant of Epic’s renewed summary judgment motion after claim construction and the close of discovery.432 The sole issue on appeal was whether the relationship between Epic’s customers (the MyChart providers) and the MyChart users is such that the performance of the “initiating a communication” step may be attributed to the MyChart providers.433 The Federal Circuit panel rejected McKesson’s arguments that the doctor-patient relationship is sufficient to provide attribution. The court found that the doctor-patient relationship does not rise to the level of agency and does not impose on patients a contractual obligation such that the voluntary actions of patients can be said to represent the vicarious actions of their doctors.434 The court also found that, because MyChart users choose whether or not to initiate communications with their providers and are under no obligation to do so, the users’ actions could not be attributed to Epic’s customers, the MyChart providers. In the absence of a single direct infringer, Epic could not be liable for indirect infringement.435

McKesson also argued a vicarious liability theory similar to vicarious copyright liability arising from a defendant’s decision to profit from infringement while declining to exercise a right to limit it, and a joint tortfeasor liability theory where the actions of two parties taken together cause harm to the plaintiff, even where the individual actions taken alone are not wrongful. The Federal Circuit panel

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429 *Id.* at 1282.
430 *Id.*
431 *Id.*
432 *Id.* at 1283.
433 *Id.*
434 *Id.* at 1284.
435 *Id.*
rejected both arguments noting that patent law is a creature of statute and concluding that the notion of indirect infringement already addresses the joint tortfeasor problem. The panel reasoned that while an indirect infringer’s actions alone do not harm the patentee, his actions along with those of another, cause a single harm to the plaintiff. That “single harm” is direct patent infringement, a strict liability offense limited to those who practice each and every element of the claimed invention. The panel further distinguished a patentee who specifically defines the bounds of his or her exclusive rights in a claim from a tort victim who has no ability to define the injurious conduct and, absent joint liability, would stand uncompensated. Finally, the court rejected McKesson’s arguments that liability could attach where one party performed most of the method and left it to another party to complete the method in the absence of contractual obligation or an agency relationship.

7. Akamai and McKesson en banc.

In a concurring opinion in McKesson, Judge Bryson agreed that McKesson was decided consistent with BMC and Akamai, but questioned whether those decisions were correct and suggested that an en banc review of an appropriate case may be warranted. In a dissent, Judge Newman questioned whether the patent incentive has been eliminated from such interactive methods. On April 20, 2011, a mere eight days after the McKesson panel decision, the Federal Circuit announced it had granted en banc review of the Akamai case to hear the following question: If separate entities each perform separate steps of a method claim, under what circumstances would that claim be directly infringed and to what extent would each of the parties be liable? Argument occurred on November 18, 2011. At the same time the Federal Circuit heard arguments in McKesson on the following questions:

(1) If separate entities each perform separate steps of a method claim, under what circumstances, if any, would either entity or any third party be liable for inducing infringement or for contributory infringement? and (2) Does the nature of the relationship between the

\[\text{Id. at 1285.}\]
\[\text{Id. at 1284.}\]
relevant actors – e.g., service provider/user; doctor/patient – affect the question of direct or indirect infringement liability? 443

I. Claim Drafting for Multiple Jurisdictions

In modern networked computer systems, the patented invention may not be one single device, but a system of multiple distinct components whose functions can be distributed over a variety of locations, including locations outside the United States. In *NTP, Inc. v. Research In Motion, Ltd.*, 444 defendant Research in Motion (“RIM”) sought to escape liability for infringement by its Blackberry product, arguing that it lacked the interface or interface switch limitations of NTP’s claims, because the relay component of the accused system was located in Canada. 445 In a complex ruling, which addressed infringement under several sections of the patent statute, the Federal Circuit reached different conclusions concerning infringement of NTP’s apparatus and method claims under 35 U.S.C. § 271(a). Recognizing that a method claim is not infringed unless all the steps of the process are utilized, the court held that RIM did not directly infringe NTP’s method claims under 35 U.S.C. §271(a), since all the steps of the method were not performed within the U.S. 446 However, the court found RIM liable for infringement of the apparatus claims, notwithstanding the Canadian situs of RIM’s relay server. 447 The court distinguished this case from the Supreme Court’s *Deepsouth* decision, which found no infringement where the defendant domestically produced all the components of the invention and exported them from the U.S. for assembly and use abroad. 448 The court noted that in *Deepsouth*, both the act of making and the resulting patented invention were wholly outside the United States. 449 Instead, the court found this case more like that of *Decca Ltd. v. United States*, 450 which analyzed use by the United States under 28 U.S.C. § 1498 of a navigation system with a station in Norway. From the point of view of the user, that court concluded that a navigator in the United States was using the Norwegian station and that such use occurs

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444 *NTP, Inc. v. Research In Motion, Ltd.*, 418 F.3d 1282 (Fed. Cir. 2005).
445 *Id.* at 1313-14.
446 *Id.* at 1318.
447 *Id.* at 1325-26.
449 *Id.* at 529.
450 *Decca, Ltd. v. United States*, 544 F.2d 1070 (Ct. Cl. 1976).
wherever the signals are received and used in the manner claimed.\textsuperscript{451} Noting that direct infringement under 35 U.S.C. § 271(a) was a necessary predicate for government liability under 28 U.S.C. § 1498 in \textit{Decca}, the court applied a similar analysis in finding RIM liable.\textsuperscript{452} Taking its cue from the Court of Claims’ analysis of ownership, control and beneficial use in \textit{Decca}, the Federal Circuit held that the use of a claimed system is the place at which the system as a whole is put into service, i.e., the place where control is exercised and beneficial use of the system obtained.\textsuperscript{453} Thus, the court distinguished between use of the claimed method and use of the claimed system. While RIM escaped liability for infringement of the method claims, it was liable for infringement of the apparatus claims and, as a matter of law, the location of the RIM’s relay server in Canada did not preclude infringement of the system claims.\textsuperscript{454}

\textbf{J. Extraterritorial Enforcement of Software Claims}

In 1984, some years after the Supreme Court’s decision in \textit{Deepsouth},\textsuperscript{455} Congress enacted 35 U.S.C. § 271(f) to close the loophole in U.S. patent law which allowed parties who manufactured unassembled components of patented products in the U.S. to ship those components outside the U.S. for assembly and escape infringement liability. Under 35 U.S.C. § 271(f)(1):

\begin{quote}
whoever without authority supplies or causes to be supplied in or from the United States all or a substantial portion of the components of a patented invention, where such components are uncombined in whole or in part, in such a manner as to actively induce the combination of such components outside the United States in a manner that would infringe the patent if such combination occurred within the United States shall be liable as an infringer.\textsuperscript{456}
\end{quote}


\begin{quote}
whoever without authority supplies or causes to be supplied in or from the United States any component of a patented invention that is especially made or
\end{quote}

\textsuperscript{451} NTP, Inc. v. Research In Motion, Ltd., 418 F.3d 1282, 1316 (Fed. Cir. 2005) (citing \textit{Decca}, 544 F.2d at 1083).
\textsuperscript{452} \textit{Id.}
\textsuperscript{453} \textit{Id.} at 1317 (citing \textit{Decca}, 544 F.2d at 1083).
\textsuperscript{454} \textit{Id.}
\textsuperscript{455} \textit{Deepsouth Packing Co. v. Laitram Corp.}, 406 U.S. 518 (1972).
especially adapted for use in the invention and not a staple article or commodity of commerce suitable for substantial noninfringing use, where such component is uncombined in whole or in part, knowing that such component is so made or adapted and intending that such component will be combined outside the United States in a manner that would infringe the patent if such combination occurred within the United States, shall be liable as an infringer.\(^{457}\)

The application of these provisions to software installed in computers outside the United States was the subject of two cases involving Microsoft in 2005, *Eolas Technologies Inc. et. al v. Microsoft*\(^{458}\) and *AT&T Corp. v. Microsoft Corporation*.\(^{459}\) *AT&T v. Microsoft* was reversed by the Supreme Court in *Microsoft Corporation v. AT&T Corp*.\(^{460}\) In *Eolas v. Microsoft*, the Federal Circuit concluded that the statutory language of 35 U.S.C. § 271(f) extends to every form of invention, not just machines or physical structures, and that every component of every form of invention, including a method step which forms a component of a process invention, deserves protection under section 271(f).\(^{461}\) Reasoning that software code on a “golden master disk is a ‘component’ of the computer program invention,” the court concluded that liability could attach for copies of software made outside the U.S. from “golden master” disks exported from the U.S.\(^{462}\)

In *AT&T v. Microsoft*, the Federal Circuit rejected Microsoft’s argument that a foreign replicated copy of software made from a U.S. originated master version is “manufactured” abroad by encoding a storage medium with the software and is not supplied in or from the U.S.\(^{463}\) Examining the way software is typically supplied, the court noted that copying is part and parcel of software distribution and rejected Microsoft’s contention that liability should only attach to each disk that is incorporated into a foreign assembled computer.\(^{464}\) The court further rejected the proposition that electronically transmitted software must be treated differently from software shipped on disks under 35 U.S.C. § 271(f), concluding that “whether software is sent

\(^{458}\) *Eolas Techs., Inc. v. Microsoft Corp.*, 399 F.3d 1325 (Fed. Cir. 2005).
\(^{459}\) *AT&T Corp. v. Microsoft Corp.*, 414 F.3d 1366 (Fed. Cir. 2005).
\(^{460}\) *Microsoft Corp. v. AT&T Corp.*, 550 U.S. 427 (2007).
\(^{461}\) *Eolas Technologies, Inc.*, 399 F.3d at 1339.
\(^{462}\) *Id.* at 1339, 1341.
\(^{463}\) *AT&T Corp.*, 414 F.3d at 1369.
\(^{464}\) *Id.* at 1370.
abroad via electronic transmission or shipped abroad on a ‘golden master’ disk is a distinction without a difference for purposes of § 271(f) liability.\textsuperscript{465}

On April 30, 2007, the U.S. Supreme Court reversed the Federal Circuit’s decision in \textit{AT&T v. Microsoft}, finding instead that Microsoft was not liable under 35 U.S.C. § 271(f) as currently written.\textsuperscript{466} The Supreme Court concluded that because Microsoft does not export from the United States the copies of Windows installed on the foreign made computers in question, Microsoft does not “supply . . . from the United States” “components” of those computers.\textsuperscript{467}

Attempting to construe the terms of §271(f) in accordance with their ordinary meaning, the Court first discussed when, and in what form, software becomes a “component” under §271(f).\textsuperscript{468} The Court found that abstract software, not on a medium, is an idea without physical embodiment and does not match §271(f)’s categorization: “components” amendable to “combination”.\textsuperscript{469} The Court concluded that software code alone, detached from an activating medium, is “uncombinable” for purposes of the statute and is not a component of a patented device.\textsuperscript{470} The Court explained, “a copy of Windows, not Windows in the abstract, qualifies as a “component” under §271(f).”\textsuperscript{471} Of course, Microsoft exported only a master, not the copies that were installed on the foreign made computers.

The Court next turned its attention to whether Microsoft had supplied from the United States components of the computers involved. Noting that the copies of Windows installed on the computers in question did not exist until they were generated by third parties outside the United States, the Court concluded that “the copies of Windows actually installed on the foreign computers were not themselves supplied from the United States.”\textsuperscript{472} Thus, the Court determined that Microsoft’s shipment of Windows software code either on a “golden master” or by electronic means, which foreign manufacturers use to generate copies to install on foreign made computers, is not shipment of a component under §271(f).\textsuperscript{473}

\textsuperscript{465} \textit{Id.} at 1371.

\textsuperscript{466} Microsoft Corp. v. AT&T Corp., 550 U.S. 427, 437 (2007).

\textsuperscript{467} \textit{Id.} at 442.

\textsuperscript{468} \textit{Id.} at 449.

\textsuperscript{469} \textit{Id.}

\textsuperscript{470} \textit{Id.}

\textsuperscript{471} \textit{Id.} at 451-52.

\textsuperscript{472} \textit{Id.} at 453.

\textsuperscript{473} \textit{Id.} The Court majority did not rule on Microsoft’s footnote contention that even a disk shipped from the U.S. used to install Windows directly on a foreign manufactured computer would not create liability under §271(f).
The Court further explained that any doubt about whether Microsoft’s conduct falls outside the scope of §271(f) would be resolved by the presumption against extraterritoriality. AT&T argued that the presumption against extraterritoriality does not apply to §271(f) because the statute applies only to acts in the U.S., i.e., supplying a patented invention’s components from the United States. The Court countered that AT&T’s reading of the statute would have extraterritorial effects, converting a single act of supply from the United States into a springboard for liability each time a copy of the software was made abroad and combined with computer hardware abroad.

The Court also rejected AT&T’s contention that reading §271(f) to cover only those copies of software actually dispatched from the U.S. created a “loophole” for software makers. The Court concluded that any §271(f) “loophole” is properly left for Congress to consider and close if it finds such action warranted.

III. CONCLUSION

Techniques for obtaining patent protection of inventions in computer hardware and software continue to evolve nearly as fast as the technology. Courts are becoming more active in patent matters as intellectual property values increase, and the scope and reach of patent protection is likely to change over time. Such changes are likely to reward those who take creative approaches to obtaining patent protection.

Much ink has been used over the years trying to define what constitutes patent-eligible subject matter. When striking down the “machine or transformation” test as the sole patent eligibility test, the Supreme Court’s comment that the test may be suitable for the Industrial Age but unsuitable for upcoming technologies telegraphed its discomfort with a rigid, inflexible approach. Recognizing that technologies not yet even conceived of will test our ability to define and protect patentable subject matter, the Court gave little guidance other than to avoid claims which are too abstract and preempt others from applying basic ideas to other physical structures. At least one panel of the Federal Circuit, without providing specific detail, ruled subject matter eligible based on its conclusion that a particular set of claims is not “manifestly abstract.” The approaches taken in these

474 Id. at 454.
475 Id. at 455.
476 Id. at 456.
477 Id. at 457.
decisions suggest that uncertainty in claiming patent-eligible subject matter will continue, at least at the outer edges of defining protectable subject matter. As systems become networked, technology moves to “The Cloud” and more entities participate in carrying out specific functions, the question of “divided” or “joint” infringement has become more pressing. In the presence of such uncertainty, patentees will likely seek to protect their claims in multiple ways using multiple sets of the claims and multiple approaches to achieve the broadest possible coverage.
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A. NORTH CAROLINA SHOULD PLACE THE PROTECTION OF

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ABSTRACT

This article examines the current state of covenant not to compete law in North Carolina and recommends four changes to that law in order to help ensure one of its primary goals of protecting only an employer’s legitimate business interests. The article initially explores the elements of an enforceable noncompetition or customer-based nonsolicitation agreement, discussing how courts have interpreted and applied these elements in a manner that often places specific forms of drafting over the intended substance of properly protecting a company against unfair competition. Those elements consist of the noncompete agreement being in writing and part of the employment “contract,” based on valuable consideration, being reasonable as to time and
territory, and not being against public policy. Given those elements, four recommendations are made to correct the modern tendency of courts to parse apart noncompete language in a manner that holds the drafters of those agreements to an unrealistic standard for them to be enforceable or enforced: (1) reject an undue adherence to specific noncompete language regarding post-termination employment that ignores the larger restrictive covenant purpose of protecting against unfair competition; (2) reject interpreting “look back” periods that define and limit noncompete restrictions in a manner that instead expands their restricted periods; (3) allow competitor-based restrictions to substitute for or supplement geographic areas to satisfy the “reasonable as to territory” requirement of a valid noncompete agreement, especially given how geographic boundaries often do not adequately protect a company’s legitimate business interests in the Internet age; and (4) correct an unreasonably strict adherence to contract severability in a covenant not to compete setting, and adopt a blue pencil or reasonable judicial modification rule that still honors the five elements of an enforceable noncompete agreement. As discussed throughout the article, the time has come to redeem North Carolina noncompete law from its current course of inconsistent and often contradictory holdings based primarily on highly nuanced interpretations of an agreement’s precise wording that leave employers and employees alike in an unsettled state of restrictive covenant guesswork.

I. INTRODUCTION

It usually happens that the world of business develops faster than the universe of case law, and perhaps there is no better example than with covenants not to compete. Often referred to as “noncompetition” or “noncompete” agreements, these restrictive covenants – along with their progeny, “nonsolicitation agreements”1 – provide important legal protection against unfair competition.2 They do so by keeping individuals from working in a competing business for a specific period of time in a particular geographic area (noncompete agreements), or by restricting access to a particular customer or vendor base

1 For the purposes of this article, and for ease of reference, the terms covenant not to compete, noncompetition agreement, noncompete agreement or anything similar are used interchangeably and should be considered as the same. The terms shall also apply to nonsolicitation agreements – and vice versa – unless otherwise expressly stated.

2 See, e.g., infra note 8. North Carolina noncompete law has primarily developed in the employer-employee context, which is the focus of this article. However, covenants not to compete in North Carolina (as in most states) are also allowed with independent contractors and in business-to-business settings. See, e.g., infra note 19.
As a general rule, noncompete agreements protect business interests that a company has spent considerable effort developing and which are vital to its economic health. Those interests range from confidential information to customers, from products and services to research and development, from marketing strategies to market share, and a host of other concerns.

But while North Carolina courts have increasingly recognized the importance of allowing companies to protect against unfair competition, especially in light of today’s Internet age and extremely mobile workforce, it is precisely because noncompetition agreements restrict free enterprise that they are “not viewed favorably in modern law.” That being said, covenants not to compete and nonsolicitation agreements are regularly enforced in North Carolina (like most states), but the critical enforcement inquiry is whether the restrictive covenant is considered an attempt to prevent normal competition.

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3 Nonsolicitation agreements can also serve as “anti-piracy” covenants, primarily restricting the solicitation to hire or hiring of a company’s employees for a period of time after employment ends. Although North Carolina courts have not specifically discussed their enforceability, they have inferred such enforcement by accepting them without comment, allowing them to succeed or fail based on the validity of the larger noncompete agreements in which they appear. See, e.g., Kinesis Adver., Inc. v. Hill, 187 N.C. App. 1, 11, 652 S.E.2d 284, 292 (2007); Precision Walls, Inc. v. Servie, 152 N.C. App. 630, 631, 568 S.E.2d 267, 269 (2002).


7 In fact, the extreme runs from California, where covenants not to compete between employers and employees are prohibited by statute, see, Cal. Bus. & Prof. Code Section 16600, to the state of Florida, whose covenant not to compete statute expressly provides that “[a] court shall construe a restrictive covenant in favor of providing reasonable protection to all legitimate business interests established by the person seeking enforcement.” Fla. Stat. Ann. § 542.335(1)(h) (emphasis added). In between are other states where, despite narrowly construing restrictive covenants and having individualized state law requirements, courts will generally uphold noncompete and nonsolicitation agreements as often as they declare them invalid. The key is whether the agreement has been drafted, executed and is being enforced in a manner that satisfies a particular state’s legal requirements. For an excellent overview of various state law requirements regarding restrictive covenants, see generally Brian M. Malsberger, Covenants Not To Compete: A State-by-State Survey (BNA eds., 7th ed. 2010).
versus contracting against unfair competition. If the former, the covenant will not be enforced; if the latter, it will likely be enforced when proper requisites are met.

Although covenants not to compete are founded on a premise that business, by its very nature, has valid concerns over competition, it is precisely because competition is generally considered “good” for American society that any restriction on that “good” must necessarily be limited. For restrictive covenant purposes, this means that noncompetition and nonsolicitation agreements are valid only to the extent they protect the “legitimate interests” of the enforcing party, which is normally the employer or company that benefits from their restrictions. Determining those interests and any resulting damages from their unlawful breach can be a challenge for any judge or jury. However, almost universally, there is a recognition that unfair competition is a valid business concern that our laws will protect against if addressed in a proper way.

The requirements of an enforceable noncompete agreement are usually interpreted in light of the specific business interests being protected and the particular individual or entity being restrained. This interpretation involves a subjective analysis of the facts and interests at issue within a larger, objective framework of validity – an overlapping inquiry that fills covenants not to compete with potential traps in drafting, execution and enforcement. Avoiding these traps requires a realistic assessment of the interests being protected and those being restrained. This balancing act also requires careful drafting and

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9 See, e.g., A.E.P. Indus., 308 N.C. at 408, 302 S.E.2d at 763 (holding that an employer was entitled to enforcement of the covenant not to compete). But see, e.g., Kadis v. Britt, 224 N.C. 154, 159, 29 S.E.2d 543, 546 (1944) (holding that personal service contract with restrictive covenant is “offensive to public policy” where it does not involve a “legally protectible [sic] subject or because its practical effect is merely to stifle normal competition”); see also Starkings Court Reporting Services, Inc. v. Collins, 67 N.C. App. 540, 313 S.E.2d 614, 615-16 (1984) (invalidating noncompete agreement as an “unreasonable restraint of trade” and an effort to “stifle normal competition”).

10 Kuykendall, 322 N.C. at 649-50, 370 S.E.2d at 380 (quoting Sonontone Corp. v. Baldwin, 227 N.C. 387, 390, 42 S.E.2d 352, 355 (1947)). Kuykendall provides one of the best overviews of the history and development of noncompete law in North Carolina and remains one of the best summaries of its most important legal principles. See Kuykendall, 322 N.C. at 648-53, 370 S.E.2d at 379-82.

11 United Labs., Inc. v. Kuykendall, 322 N.C. 643, 651, 370 S.E.2d 375, 381 (1988) (noting that “protection of customer relationships and good will against misappropriation by departing employees is well recognized as a legitimate protectable interest of the employer”).
execution of the covenant itself, while remembering that noncompete agreements are also governed by certain basic tenets of contract law. Two of the primary tenets include: (1) any ambiguities in the document will be “strictly construed against the drafting party,”\textsuperscript{12} and (2) overly broad or otherwise unenforceable provisions are subject to “severability,” with a restrictive covenant twist that is perhaps best stated by the North Carolina Supreme Court:

If a contract by an employee in restraint of competition is too broad to be a reasonable protection to the employer's business it will not be enforced. The courts will not rewrite a contract if it is too broad but will simply not enforce it . . . . If the contract is separable, however, and one part is reasonable, the courts will enforce the reasonable provision.\textsuperscript{13}

Simply stated, those who draft noncompetition and nonsolicitation agreements must do it correctly or face the unfortunate consequence of potentially having them declared invalid years down the road when they are finally tested and needed most. While this may be a truism of most contract law, it has special importance with covenants not to compete whose litigation tends to focus on drafting and execution as much as any alleged breach. In fact, noncompete litigation often involves injunctive remedies, actual, consequential and exemplary damages, and ancillary claims that go far beyond a mere breach of contract and which, unlike most contract litigation, often depend upon the underlying agreement’s validity. Further, this dynamic is played out before an often unfriendly court, schooled in the admonition that noncompetition and nonsolicitation agreements are “not viewed favorably in modern law.”\textsuperscript{14} While certainly understandable, if considered a restraint on trade, the fact also remains that an approach like this virtually ignores how competitive concerns in the marketplace are “legitimate interests” of a business. Moreover, those legitimate business interests exist independently of whether the agreement’s drafter was clairvoyant enough to anticipate legal developments in noncompete interpretation years in advance or whether the drafter


wrote particular provisions in enough “distinctly separable part[s]” to satisfy some future court looking for ways to defeat it.\textsuperscript{15}

All of which brings us to the purpose of this article. North Carolina’s well-developed law of covenants not to compete has been recently sidetracked by an adherence to such rigid rules of construction that it has not only placed form over substance, it has made “form” the most substantive aspect of that law. And it has done so regardless of whether any legitimate business interests are present. This article first surveys the current state of North Carolina law on covenants not to compete, and then discusses how that law has gone astray in four key areas. It also recommends a path for recovery that, with one possible exception, is in keeping with every related principle our state Supreme Court has established. In the process, it attempts to breathe life into Judge Sanford Steelman’s astute observations about how further guidance from the state’s highest court is greatly needed:

At the time that our law in the area of restrictive covenants was developed, much of our commerce was local, and restrictive covenants were enforced only to protect specific local interests. Any covenants that attempted to protect broader commercial interests were held to be invalid as an improper restraint of trade. However, today’s economy is global in nature . . . The law of restrictive covenants should be re-evaluated by our Supreme Court in the context of changing economic conditions to allow restrictions upon competing business activity for a specific period of time, limited to a specific, narrow type of business, but with fewer geographic limitations.\textsuperscript{16}

Judge Steelman shared those thoughts in a case that invalidated certain restrictive covenants despite involving defendants who “flagrantly violated” their “voluntarily executed” noncompete agreements, and “[t]hen, when confronted with their breach of contract, sought to have the courts relieve them of their contractual obligations.”\textsuperscript{17} As argued below, the path to follow in order to correct that injustice is surprisingly straight. What may at first glance appear to be a radical departure with one recommendation really is not so radical in light of modern business realities and the overall intent of


\textsuperscript{17} \textit{Id.}
noncompete enforcement to recognize and protect only legitimate business interests. In fact, as discussed below, if our courts would simply reject one misguided principle, clarify two more, and then have the courage to adopt a fourth recommendation that better reflects the realities of modern business, then the door would be opened for a redirected law of covenants not to compete. This redirection would not only address Judge Steelman’s concerns, it would place North Carolina squarely on a road to restrictive covenant redemption. The path should be paved as follows:

1. Reject the current practice of adding any pre-termination “look back” period to a defined, post-employment restricted period in order to extend that restricted period and risk making it unreasonably broad;
2. Clarify that competitor-based restrictions already satisfy the long-standing need for geographical territory limitations in a valid noncompete, or that they are a natural outgrowth of current law, and should be allowed as an appropriate restricted “territory”;  
3. Clarify that covenants not to compete which are otherwise enforceable and prohibit a former employee from working in any position for a direct competitor may still be enforceable in certain situations, regardless of the precise language in the noncompete or the position held with the competing company; and
4. Adopt a blue pencil or reasonable judicial modification rule (or both) that allows courts to judicially modify a covenant not to compete in order to effectuate its intent, within the rubric of only protecting legitimate business interests. Further, courts should broaden an overly strict application of the severability rule that has repeatedly surfaced in noncompete cases.

II. THE CURRENT STATE OF NORTH CAROLINA NONCOMPETE LAW

For a noncompetition agreement to be valid and enforceable under North Carolina law, each of the following elements must be satisfied: (1) the noncompete must be in writing; (2) it must be part of the

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18 Nonsolicitation agreements have long been relieved of needing territorial limits based on geography. See, Okuma America Corp. v. Bowers, 181 N.C. App. 85, 89, 638 S.E.2d 617, 621 (2007) (citing United Labs., Inc. v. Kuykendall, 322 N.C. 643, 660, 370 S.E.2d 375, 386 (1988)).
employment contract;\textsuperscript{19} (3) it must be based on valuable consideration; (4) it must be reasonable as to time and territory; and (5) it must not violate public policy.\textsuperscript{20} Each of these elements operates under an overall requirement of only protecting the “legitimate business interest” of the enforcing party – an umbrella-type analysis that, if not satisfied on its own, can invalidate a noncompete agreement no matter how well-written or executed it might be.\textsuperscript{21} Whether a covenant not to compete has satisfied these elements and the legitimate business interest requirement, and is therefore valid and enforceable, are questions of law for the court.\textsuperscript{22}

Those are the requirements as consistently established by the North Carolina Supreme Court. For whatever reason, however, modern North Carolina noncompete law has developed in such a way that the overall “legitimate business interest” requirement has become

\textsuperscript{19} This element is understood as an employment relationship, regardless of whether the employee actually has a larger, written employment agreement containing noncompete obligations. See, e.g., Hejl v. Hood, Hargett & Assocs., Inc., 196 N.C. App. 299, 304, 674 S.E.2d 425, 428 (2009) (holding that a separate noncompete satisfies the “part of the contract of employment” element where there is “‘new’ or ‘separate’ consideration”). Again, the focus of this article is on noncompete agreements within an employer-employee setting that comprises the vast majority of covenant not to compete litigation. However, North Carolina law is clear that covenants not to compete are also allowed in business-to-business settings, such as mergers and acquisitions, Jewel Box Stores Corp. v. Morrow, 272 N.C. 659, 662-63, 158 S.E.2d 840, 843 (1968), and between companies and their independent contractors. Market America, Inc. v. Christman-Orth, 135 N.C. App. 143, 147, 520 S.E.2d 570, 578 (1999), rev. denied, 351 N.C. 358, 542 S.E.2d 213 (2000) (citing Starkings Court Reporting Servs. v. Collins, 67 N.C. App. 540, 541, 313 S.E.2d 614 (1984)) (upholding noncompete agreements with independent contractors).

\textsuperscript{20} Triangle Leasing Co. v. McMahon, 327 N.C. 224, 228, 393 S.E.2d 854, 857 (1990); Kuykendall, 322 N.C. at 649-50, 370 S.E.2d at 380 (citing A.E.P. Indus. v. McClure, 308 N.C. 393, 302 S.E.2d 754 (1983)).

\textsuperscript{21} Kuykendall, 322 N.C. at 650-51, 370 S.E.2d at 380-81 (addressing legitimate business interests of employer as being the framework for any covenant not to compete analysis, and finding those interests grounded in terms of customer-based protections and protecting “valuable [confidential] information as to the nature and character of the business”). See also Medical Staffing Network, Inc. v. Ridgway, 194 N.C. App. 649, 656, 670 S.E.2d 321, 327 (2009) (following Kuykendall and A.E.P. Indus. in observing that customers and valuable [confidential] business information are legitimate interests of the employer for covenant not to compete purposes); Market America, Inc. v. Christman-Orth, 135 N.C. App. 143, 152-53, 520 S.E.2d 570, 578 (1999) (quoting Starkings Court Reporting Servs. v. Collins, 67 N.C. App. 540, 541, 541, 313 S.E.2d 614, 615 (1984) (“Even if the covenant not to compete is permissible in all other respects, ‘the restraint is unreasonable and void if it is greater than is required for the protection of the promisee or if it imposes an undue hardship upon the person who is restricted.’”).

\textsuperscript{22} Kadis v. Britt, 224 N.C. 154, 158, 29 S.E.2d 543, 545 (1944) (stating the rule that a court determines validity and reasonableness of a restrictive covenant).
secondary to an almost myopic analysis of a noncompete agreement’s precise language. In doing so, it has strayed from a proper application of these accepted principles through dicta and slight variations on legal precedent that have an unfortunate consequence with future cases. As just one example of how these principles have mutated, certain Court of Appeals decisions have replaced the long-established, public policy element with the umbrella requirement of only protecting legitimate business interests. This variance began at least as early as 1990 with an incorrect citing of A.E.P. Industries by the Court of Appeals in Young v. Mastrom, Inc. 23 In Young, the court inaccurately listed the fifth element of an enforceable noncompete as “designed to protect a legitimate business interest of the employer,” when the citation to A.E.P. Industries clearly lists the fifth element as “[n]ot against public policy.” 24

This variation, which has been repeatedly adopted by numerous courts 25 demonstrates a Court of Appeals trend that quite arguably goes beyond a mere inaccurate quote. Rather, it shows a willingness in this highly nuanced area of noncompete law to stray from the details by allowing new iterations of that law which then assume lives of their own. One impact of reducing this overall requirement of protecting legitimate business interests to just one of the five related elements for a valid covenant not to compete is that its umbrella nature is therefore compromised, which might help explain certain court decisions that focus more on the form of an agreement rather than its substance. In the process, they allow the precise language of a covenant to control its enforcement rather than whether its wording is a good-faith and reasonable attempt to protect against unfair competition, and then critically assessing as a court whether unfair competition exists. This tendency has perhaps reached its apex in the severability and “look back” issues that this article advocates changing, but as discussed below it has also surfaced in other ways that need correcting as well.

A. The Agreement Must Be In Writing And Must Be Part Of The Employment “Contract”

Perhaps the easiest element to satisfy is that a covenant not to

23 Compare Young v. Mastrom, Inc., 99 N.C. App. 120, 122-23, 392 S.E.2d 446, 448 (1990) (listing “designed to protect a legitimate business interest of the employer” as the fifth element), with A.E.P. Indus., 308 N.C. at 402-03, 302 S.E.2d at 760 (designating “[n]ot against public policy” as the fifth element).

24 Id.

compete must be in writing and must be part of the employment “contract,” which is generally understood as the employment relationship itself. Two observations should be initially made. First, in North Carolina (as in most, if not all other states) a noncompete agreement may stand alone and does not have to be part of a larger written employment agreement governing the terms and conditions of employment. Second, only the restricted party — i.e., the employee in the typical employer-employee noncompete setting — must sign the agreement for it to be valid. In fact, this requirement is statutory in North Carolina:

No contract or agreement hereafter made, limiting the rights of any person to do business anywhere in the State of North Carolina shall be enforceable unless such agreement is in writing duly signed by the party who agrees not to enter into any such business within such territory . . . .

B. The Agreement Must Be Supported By Adequate Consideration (New Employee v. Current Employee Distinction)

The second element of a valid and enforceable covenant not to compete in North Carolina is based upon elementary contract law. To have a valid agreement that restricts an individual’s ability to compete, he or she must be “paid” something of sufficient value for the economic “rights” being forfeited. In North Carolina, courts further distinguish between consideration paid to new employees versus consideration paid to existing employees for signing a noncompete.

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26 Ridgway, 194 N.C. App. at 654-55, 670 S.E.2d at 326. In fact, for litigation purposes there may be good reasons to not draft a larger employment agreement around a covenant not to compete. For example, if the employer has allegedly violated other provisions in the employment agreement (which is often a counterclaim in a breach of employment contract action), its task could be more difficult when trying to enforce the noncompetition clause. The argument is that the company should not be able to enforce a contract that it has breached itself — which even if possible under the law, has a strong jury appeal as a defense.

27 N.C. Gen. Stat. § 75-4 (2011). See also Manpower of Guilford Cnty., Inc. v. Hedgecock, 42 N.C. App. 515, 519-20, 257 S.E.2d 109, 113 (1979) (indicating that the statute does not require that party seeking enforcement of a noncompete must also sign the agreement); New Hanover Rent-A-Car, Inc. v. Martinez, 136 N.C. App. 642, 644-47, 525 S.E.2d 487, 489-91 (2000) (noting that where defendant printed her name on identification line, but did not sign the noncompete agreement in cursive script or make any other writing on signature line, plaintiff was unable to show substantial likelihood of success on the merits and trial court’s issuance of preliminary injunction reversed).

As for new employees, the promise or act of new employment alone is sufficient to support a covenant not to compete. The safest way to demonstrate this consideration is to discuss the noncompete agreement’s terms and conditions during the job application or interview process, provide a copy with any job offer (preferably in writing and referencing the enclosed noncompete), and have the agreement signed on or before the first day of employment. However, a limited but significant exception to this requirement exists where a noncompete agreement’s required execution and material terms were disclosed or discussed in some detail before employment started. In that situation, even if a restrictive covenant is signed much later than an employee’s first day of work, it may still be enforceable. The reason is that it was made “part of an original verbal employment contract” in which the “terms of the verbal covenant . . .[were] agreed upon at the time of employment”. This exception presumably helps protect against any intentional or inadvertent delay in signing that is not the employer’s fault.

However, once the individual starts employment and is then presented with a noncompetition agreement for the first time, North Carolina takes a dramatically different approach. If the restrictive covenant is first presented and then executed after an employee is hired, then a promise of continued employment alone is not sufficient payment. Because consideration is not something that can be “given and taken in the same breath,” the employee could be relieved of the immediate threat of discharge through guaranteed employment for a specific period – presumably because the employment (even if at-will) is something the employee already has where a promise of employment for a definite period is not.

30 Young, 99 N.C. App. at 123, 392 S.E.2d at 448 (citing Stevenson v. Parsons, 96 N.C. App. 93, 97, 384 S.E.2d 291, 293 (1989)).
31 Kadis, 224 N.C. at 162-63, 29 S.E.2d at 548.
32 Id. Cf. states where continued employment alone is sufficient consideration to support a noncompetition agreement. The primary rationale for this approach is that because at-will employees can be discharged at any time for any reason or no reason, including if they refuse to sign a noncompete, then their employment continuation alone provides adequate consideration to support a restrictive covenant since they had no “rights” in their employment to start with. Simko, Inc. v. Graymar, 55 Md. App. 561, 464 A.2d 1104, 1106 (1983); Insurance Assocs. Corp. v. Hansen, 111 Idaho 206, 723 P.2d 190, 191-92 (Ct. App. 1986), aff’d, 116 Idaho 948, 782 P.2d 1230 (1989). That being said, some states have placed a caveat on this analysis, essentially noting that the employment must continue for a material amount of time, similar to the analysis in Kadis, in order to be considered valuable consideration for
But regardless of its form, an existing employee presented with a noncompete agreement for the first time or to replace an earlier version must be provided “new” or “separate” consideration to support the changed relationship of having forfeited future employment rights through that agreement. Further, this “additional consideration” must not be illusory, meaning that it must be sufficiently defined and actually result in a material benefit to the employee in order to support the newly executed restrictive covenant. As for what constitutes new or separate consideration for existing employees to sign a noncompete agreement, courts have found sufficient everything from “continued employment for a stipulated amount of time;” “a raise, bonus, or other change in compensation; a promotion; additional training; uncertified shares; or some other increase in responsibility or number of hours worked.”


35 See, e.g., Milner Airco, Inc. of Charlotte, NC v. Morris, 111 N.C. App. 866, 870, 433 S.E.2d 811, 813-14 (1993) (quoting Wilmar v. Liles, 13 N.C. App. 71, 185 S.E.2d 278 (1971), cert. denied, 280 N.C. 305, 186 S.E.2d 178 (1972)) (holding that execution of noncompete agreement in order to become an account manager if and when the economy improved is illusory consideration which “keeps the promise to the ear while it breaks it to the hope”); Young v. Mastrom, Inc., 99 N.C. App. 120, 124, 392 S.E.2d 446, 449 (1990) (holding that mere promises of increased compensation, vacation and sick leave that were in board of directors’ discretion and stated no actual amounts were “so illusory that they could not provide consideration” for the covenant not to compete).

36 Presumably a covenant not to compete could be supported by continued employment for a guaranteed period of time, essentially replacing the “employment at will” relationship with a contractual relationship governing the terms and conditions of employment. However, this author has found no such case in North Carolina.

37 Hejl, 196 N.C. App. at 304, 674 S.E.2d at 428-29. See, e.g., Whittaker Gen. Med. Corp. v. Daniel, 324 N.C. 523, 527-28, 379 S.E.2d 824, 827-28 (1989) (recognizing how a raise or new job assignment can be new consideration to support a noncompete agreement for an existing employee, and holding that employee’s promotion to full-time salesperson and substantial raise in salary were sufficient to support signing of noncompete). But see, Collier Cobb & Assocs. v. Leak, 61 N.C. App. 249, 300 S.E.2d 583 (1983), disc. rev. denied, 308 N.C. 543, 304 S.E.2d 286 (1983) (no consideration found when long-time employees signed covenants but continued...
The one aspect of this second element that gets relatively little attention from the courts is whether the new consideration is "adequate" or "valuable." The best example of this cursory analysis is also one of the most recent. In Hejl v. Hood, a new and separate $500.00 payment to an existing employee was deemed adequate enough to support the signing of a nonsolicitation agreement. This determination was not made because the amount itself was specifically found adequate in a particular set of facts, but rather because "[t]he slightest consideration is sufficient to support the most onerous obligation, the inadequacy . . . is for the parties to consider at the time of making the agreement, and not for the court when it is sought to be enforced."39

C. The Agreement Must Be Reasonable As To Time And Territory

The next element is probably the most litigated when deciding if a covenant not to compete is valid and enforceable – whether the restrictive covenant is reasonable as to time and territory. As usual, the reasonableness of a particular covenant depends upon the type of activity being restrained and a careful analysis of the circumstances within the context of the employer’s legitimate business interests. If either the length of time or the restricted territory that limits competitive actions after employment ends is determined to be overly broad in a manner that exceeds those interests, the noncompetition or nonsolicitation agreement will be found unreasonable and it will not be enforced.40

Significantly, time and territory restrictions are considered in tandem by following a general rule of inverse relationship: the shorter the time period, the larger the territory that can usually be restricted; their jobs did not change and they did not receive an increase in pay at time of signing).

38 Hejl, 196 N.C. App. at 305, 674 S.E.2d at 429.
39 Id. (quoting Machinery Co. v. Insurance Co., 13 N.C. App. 85, 90-91, 185 S.E.2d 308, 310-12 (1971) (quoting Young v. Highway Commission, 190 N.C. 52, 57, 128 S.E.2d 401, 403 (1925)), cert. denied, 280 N.C. 302, 186 S.E.2d 176 (1972). See also Keith v. Day, 81 N.C. App. 185, 194, 343 S.E.2d 562, 568 (1986) (stating general rule that courts “ordinarily will not inquire into the adequacy of the consideration, unless the contract is a fraud upon the restrained party, for it is up to the parties themselves to determine the adequacy of the consideration to the restraint imposed”).
the longer the time period, the smaller the territory. Although a covenant’s time or territory restriction alone might be reasonable, the “combined effect of the two may be unreasonable.”

Courts will examine the specific facts of a particular situation to help determine if the time and territory restrictions operate together in a reasonable manner. Depending on those facts, the results of what activities may be restricted, where and for how long often vary, but they always reflect this individualized inquiry into the precise situation of a particular case.

41 Farr Assoc’s., Inc. v. Baskin, 138 N.C. App. 276, 280, 530 S.E.2d 878, 881 (2000) (observing how time and territory restrictions must be considered “in tandem . . . . A longer period of time is acceptable where the geographic restriction is relatively small, and vice versa”). See also, Jewel Box Stores Corp. v. Morrow, 272 N.C. 659, 665, 158 S.E.2d 840, 844 (1968) (establishing general rule of time and territory restrictions operating in tandem under North Carolina noncompete law).


43 For examples of cases where the restricted territory was found to be reasonable, see, e.g., Jewel Box at 663-65, 158 S.E.2d at 843-45 (allowing prohibition from operating a jewelry store within a 10-mile radius of Morganton for 10 years after a business acquisition); Asheville Assoc’s., Inc. v. Miller, 255 N.C. 400, 402-03, 121 S.E.2d 593, 594 (1961) (23-county area in western North Carolina found reasonable when it only prohibited defendants from working as insurance salespeople for one year); Kinesis Advertising, Inc. v. Hill, 187 N.C. App. 1, 14-15, 652 S.E.2d 284, 194-95 (2007), rev. denied, 362 N.C. 177, 658 S.E.2d 485 (2008) (two-county area of North Carolina considered reasonable restriction given two-year restricted period); Okuma Am. Corp. v. Bowers, 181 N.C. App. 85, 89-90, 638 S.E.2d 617, 620-21 (2007) (stating general principle of considering time and territory restrictions in tandem, and finding six-month restriction from soliciting customers wherever they are located throughout North and South America reasonable given short duration); Precision Walls, Inc. v. Servie, 152 N.C. App. 630, 637-38, 568 S.E.2d 267, 272-73 (2002) (covenant not to compete covering North and South Carolina was reasonable for one-year period where former employer operated in 12 states; although former employee worked in North Carolina he had exposure to confidential information regarding business operations and customers in both states of the restricted territory); Market Am., Inc. v. Christman-Orth, 135 N.C. App. 143, 153-54, 520 S.E.2d 570, 577-78 (1999) (noncompetition covenant that arguably restricted the entire United States found reasonable despite not identifying any fixed geographic territory, since plaintiff is a national company and the restricted period only lasted for six months after termination of independent contractor agreement); Forrest Paschal Machinery Co. v. Milholen, 27 N.C. App. 678, 687, 220 S.E.2d 190, 196-97 (1975) (350-mile radius of former employer’s business location was reasonable where noncompete restrictions lasted for two years and former employer had almost nationwide and some international business presence).

For examples of cases where a noncompetition agreement’s restricted territory was found to be unreasonably broad, see, e.g., Hartman, 117 N.C. App. at 312-15, 450 S.E.2d at 917-19 (covenant not to compete restricting employee from competitive work in eight states for five years unreasonable); Electrical South, Inc. v. Lewis, 96 N.C. App. 160, 162, 385 S.E.2d 352, 353 (1989) (noncompete that prohibited employee for two years from working anywhere in the world for any continued . . .
1. Reasonable as to time

Of the time and territory tandem, the reasonableness of a noncompetition agreement’s time restriction has generally been the easiest to determine under North Carolina law. At least it was until the Court of Appeals started a misguided “look back” analysis in 1996 that has compromised this straightforward analysis ever since.

First, as a general rule, North Carolina courts in the employer-employee context will enforce post-employment noncompete restrictions of up to two years; three to four years will be closely scrutinized and held to a more rigorous standard; and five years or more will be virtually unenforceable.44 It is also the very nature of noncompetition and nonsolicitation agreements that they address post-employment competitive behavior.45 Although many covenants not to compete are written in a way that also mention how employees cannot compete against their employers during employment,46 that prohibition is such an understood part of the employment relationship that its violation alone is virtually never addressed through actions for breach of contract. Rather, it tends to arise as the basis for claims against the employee such as fraud, breach of fiduciary duty, and unfair and deceptive trade practices under N.C. Gen. Stat. § 75-1.1 et seq., and as a defense to any wrongful discharge claim brought by employees terminated for acting against their employer’s best interests while still employed.47

44 See, e.g., Whittaker Gen. Med. Corp. v. Daniel, 324 N.C. 523, 525-26, 379 S.E.2d 824, 826 (1989) (prohibiting defendant from working for a competing employer for two years following termination of employment with plaintiff was reasonable); Hartman, 117 N.C. App. at 315, 450 S.E.2d at 918 (quoting Eng’g Assocs., Inc. v. Pankow, 268 N.C. 137, 139, 150 S.E.2d 56, 58 (1966)) (holding that only in “extreme conditions” will a five-year restricted period after employment ends be considered reasonable).


46 Id. at 464, 556 S.E.2d at 333 (addressing a covenant requiring the following: “(1) that defendant will not, during employment or after termination of employment . . .”).

47 See, e.g., Dalton v. Camp, 353 N.C. 647, 649, 548 S.E.2d 704, 706 (2001) (addressing a case where a current employee formed a separate entity to directly compete with the employer and was sued for “breach of fiduciary duty of loyalty, conspiracy to appropriate customers, tortious interference with contract, interference with prospective advantage, and unfair and deceptive trade practices . . . .”); Sara Lee Corp. v. Carter, 351 N.C. 27, 29, 519 S.E.2d 308, 309 (1999) (addressing a continued . . .

competitor who also conducted business within a 200-mile radius of Greensboro found unreasonably broad); Manpower of Guilford Cnty. v. Hedgecock, 42 N.C. App. 515, 522-23, 257 S.E.2d 109, 115 (1979) (25-mile radius of any city in country where former employer’s franchisor had an office unreasonably broad where defendant only worked for franchisee with offices in three North Carolina cities).
From this long-established concept of post-employment restrictive covenant time periods came an unexpected development in North Carolina law that simply defies logic – and whose unintended consequence works directly against North Carolina’s strict requirement that covenants not to compete should be drafted in a way that only protects an employer’s legitimate business interests. Over the past fifteen years, the Court of Appeals has repeatedly taken any pre-termination “look back” period for defining those customers affected by a nonsolicitation agreement (such as an employer’s ‘active customers during the twelve months before employment ended’), and for some misguided reason added that period to the post-employment restricted time period. The result in certain cases has been to completely ignore the look back period’s intent to simply define and limit the number of affected customers and instead create a longer and completely unintended restricted period that runs a significant risk of being declared unreasonably broad and therefore unenforceable. As argued in Part III.B. below, this practice should be stopped and expressly rejected by North Carolina courts.

2. Reasonable as to territory

To be reasonable as to territory, a covenant not to compete may restrict competitive actions only in the geographical area where the employer is actively engaged in business. This relatively simple concept has led to a number of cases in which North Carolina courts have wrestled with two related but quite distinct restrictive covenants: (1) noncompetition agreements that prohibit working for a competitor or in any competitive manner; and (2) nonsolicitation agreements that specifically address customer-based protections regardless of any competitor-based restrictive covenant. Directly associated with these similar but quite distinct agreements is a fundamental question of scenario where an employee created separate entities, in violation of a restrictive covenant, to supply parts and services to his employer without reporting the self-dealing and was sued for “fraud, breach of fiduciary duty, and unfair and deceptive practices.”

48 See Prof’l Liab. Consultants, Inc. v. Todd, 122 N.C. App. 212, 219, 468 S.E.2d 578 (1996); Farr Assoc., Inc. v. Baskin, 138 N.C. App. 276, 280-81, 530 S.E.2d 878, 881-82 (2000). Although it has not yet been addressed by North Carolina courts, presumably such an approach would also be taken for any look back period that might apply to a restricted territory, such as a radius of those cities where an employee was assigned during his or her last twelve months of employment. See also, infra, note 119.

49 Safety Equip. Sales & Serv., Inc. v. Williams, 22 N.C. App. 410, 206 S.E.2d 745 (1974) (holding territorial restrictions as reasonable only if plaintiff actively conducts business in those areas).
whether both require a geographical territory restriction in order to be valid.\textsuperscript{50} Although North Carolina courts have not explored this precise question in any substantive detail, as discussed below, they generally enforce customer-based nonsolicitation agreements without defined restricted territories, observing that specific geographical areas are not required in those types of agreements.\textsuperscript{51} However, as also discussed below, that answer has taken a while to develop, thanks primarily to yet another example of some Court of Appeals language whose ripple effect has taken years to settle down.

\textit{a. Restricted territories required in competitor-based noncompetition agreements}

It has long been accepted under North Carolina law that to restrict individuals from working for a competing company for a specific period of time after their employment ends, a noncompetition agreement must also include a defined geographic area in which the restriction applies.\textsuperscript{52} This defined area serves as a limitation on the restrictive covenant, keeping it from operating in areas where the employer does not actively or significantly conduct business, or at times from applying to former employees who were never actively or significantly engaged in the employer’s business in that area.\textsuperscript{53}

To determine whether the geographic area in such a “competitor-based” noncompetition agreement is reasonable, North Carolina courts use six factors to guide their analysis:

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\textsuperscript{50} Both types of agreements are often called “covenants not to compete” or even “noncompetition agreements”, depending on the language of the agreement and the court. See, Wade S. Dunbar Ins. Agency, Inc. v. Barber, 147 N.C. App. 463, 465, 556 S.E.2d 331, 333 (2001) (including both a non-compete and a non-solicitation under the heading of “covenant not to compete”). But as mentioned above (see, \textit{supra}, note 1), restrictive covenants based solely on customer-based restrictions are generally referred to in this article as “nonsolicitation” agreements.

\textsuperscript{51} Okuma Am. Corp. v. Bowers, 181 N.C. App. 85, 89, 638 S.E.2d 617, 620 (2007) (noting that the North Carolina Supreme Court has “recognized the validity of geographic restrictions that are limited not by area, but by a client-based restriction.”).


\textsuperscript{53} See, \textit{e.g.}, Williams, 22 N.C. App. 410, 206 S.E.2d 745 (finding that the territorial restriction of only those areas where plaintiff actively conducted business were reasonable for two-year period); Med. Staffing Network, Inc. v. Ridgway, 194 N.C. App. 649, 656-57, 670 S.E.2d 321, 327-28 (2009) (holding a noncompete agreement was overly broad where it restricted former employee from working for “any parent, division, subsidiary, affiliate, predecessor, successor, or assignee” of plaintiff-employer within a 60-mile radius of Raleigh even though employee’s prior duties may have had “nothing to do with that business”).
(1) The area or scope of the restriction;
(2) The area assigned to the employee;
(3) The area where the employee actually worked;
(4) The area in which the employer operated;
(5) The nature of the business involved; and
(6) The nature of the employee’s duty and his knowledge of the employer’s business operation.\textsuperscript{54}

Needless to say, a noncompete agreement’s geographic territory will more likely be considered “reasonable” the more narrow the area or scope of the restriction, the more the employer actually conducted business in the area, the more the employee was assigned to and actually worked in the area, the more competitive the business, and the more integral the employee was to that business through his or her duties and knowledge of its operations. Conversely, the broader the area and scope of the restriction, and the less the employee or employer satisfies these conditions, the more likely a court will not find the geographic area reasonable.\textsuperscript{55}

As uncomplicated as that analysis might appear, once again a twist has emerged through the Court of Appeals that places anyone drafting a covenant not to compete in the position of threading a form-over-substance needle. In their most conservative decisions, North Carolina courts have found restricted territories to be unreasonably broad, not because of their inverse relationship with restricted time periods, but rather because an employee’s job duties or customer contact were not sufficiently connected with that territory or the customers in that geographic area.\textsuperscript{56 \textit{continued} . . .}

\textsuperscript{54} Farr, 138 N.C. App. at 281-82, 530 S.E.2d at 882 (citing Hartman v. W.H. Odell and Assocs., Inc., 117 N.C. App. 307, 312, 530 S.E.2d 912, 917 (1994)). \textit{Farr} refers to the six factors as a “six-part test”, which may be an overstatement as there is no indication that each factor must be satisfied in some qualitative manner for a reasonable geographical restriction to exist. \textit{Farr}, 138 N.C. App. at 281, 530 S.E.2d at 882. Rather, \textit{Hartman} refers to the factors as simply being “relevant to determining whether the geographic scope of a covenant not to compete is reasonable.” 117 N.C. App. at 312, 450 S.E.2d at 971 (citing Clyde Rudd & Assocs., Inc. v. Taylor, 29 N.C. App. 679, 684, 225 S.E.2d 602, 605 (1976), \textit{cert. denied}, 290 N.C. 659, 228 S.E.2d 451 (1976)). \textit{Clyde Rudd} listed the factors for the first time in a North Carolina case, apparently deriving them from the overall legal discussion in Seaboard Indus., Inc. v. Blair, 10 N.C. App. 323, 178 S.E.2d 781 (1971), which appears to be their original source. \textit{See Clyde Rudd}, 29 N.C. App. at 684, 225 S.E.2d at 605.

\textsuperscript{55} \textit{See, e.g.}, \textit{infra} note 128 (citing Techworks).

\textsuperscript{56} \textit{See, e.g.}, Ridgeway, 194 N.C. App. at 656-57, 670 S.E.2d at 327-28 (finding a noncompete agreement overly broad where it restricted former employee from working for “any parent, division, subsidiary, affiliate, predecessor, successor, or
In essence, those and similar court opinions have examined the individual’s new employment and determined whether it is sufficiently connected with his or her prior employment to justify a restriction on competitive activity.\(^\text{58}\) But lost in the analysis is how protecting a company’s legitimate business interests also includes a prophylactic goal of keeping unfair competitive activity from occurring, especially by protecting its customer base and its valuable business information to the extent it is confidential or proprietary.\(^\text{59}\) When that second prong is considered, any “close nexus” requirement between the employee’s former position and his or her position with the new competing company runs a significant risk of being an impractical sleight-of-hand as it is virtually impossible to monitor any confidentiality violation after the individual is newly employed. And in terms of drafting a noncompetition agreement, that type of requirement places such a burden on the drafter that it again becomes a form-over-substance issue that requires undue attention to the written word rather than legitimate protection against unfair competition. Perhaps one of the best examples of this is Okuma America Corp. v. Bowers, where although the court upheld a noncompete agreement for motion to dismiss purposes it focused on parsing apart the agreement’s precise language rather than on whether unfair competition was occurring. Through its analysis, the court noted how the noncompete’s terms “thread the needle between those in Precision Walls, which were found to be valid and enforceable, and those in VisionAIR, which were struck down.”\(^\text{60}\)

assignee” of plaintiff-employer within a 60-mile radius of Raleigh even though employee’s prior duties may have had “nothing to do with that business”); Hejl v. Hood, Hargett & Associates, Inc., 196 N.C. App. 299, 307, 674 S.E.2d 425, 430 (2009) (holding that a noncompete agreement unreasonably broad and therefore unenforceable where it affects “not only clients, but potential clients, and extends to areas where Plaintiff had no connections or personal knowledge of customers”); Hartman, 117 N.C. App. at 313, 450 S.E.2d at 917 (noting that the restricted territory “should only be limited to areas in which the employee made contacts during the period of his employment”).\(^\text{57}\) This approach is discussed in more detail, infra, as it is yet another example of how a strict adherence to formulistic requirements of the written word can overshadow the protection of legitimate business interests.\(^\text{58}\) See, e.g., VisionAIR, Inc. v. James, 167 N.C. App. 504, 508-09, 606 S.E.2d 359, 362-63 (2004).\(^\text{59}\) United Labs., Inc. v. Kuykendall, 322 N.C. 643, 650-51, 370 S.E.2d 375, 380-81 (1988) (noting that legitimate business interests in employer-employee context are understood in terms of customer-based protections and protecting “valuable information as to the nature and character of the business”).\(^\text{60}\) Okuma Am. Corp. v. Bowers, 181 N.C. App. 85, 91-92, 638 S.E.2d 617, 621-22 (2007) (citing Precision Walls, Inc. v. Servie, 152 N.C. App. 630, 638-39, 568 continued . . .
As discussed in more detail below, while employers should certainly be held to a standard of properly drafting noncompetition agreements, they should not be required to thread needles when doing so in order to protect against the unquestionable legitimate business interest of unfair competition.\textsuperscript{61}

\textit{b. Restricted territories not required in customer-based nonsolicitation agreements}

Until the mid-1990’s, it was generally understood in North Carolina that noncompetition agreements whose intended purpose is only to protect the employer’s customer base do not need a defined geographic territory. Rather, these “nonsolicitation” agreements apply to protect customers wherever they are located; therefore, geography is a secondary concern trumped by the customer relationship itself. For example, \textit{Kuykendall} reversed a Court of Appeals’ holding that a 1982 noncompetition agreement which included customer-based restrictions without any defined geographical territory was overly broad and unenforceable.\textsuperscript{62} As stated by the Supreme Court:

The narrow holding of the Court of Appeals effectively eliminates consideration of an employer’s good will and customer relationships as a basis for enforcement of post-termination restrictions. However, protection of customer relationships and good will against misappropriation by departing employees is well recognized as a legitimate protectable interest of the employer.\textsuperscript{63}

Without even noting how the restrictive covenant at issue did not have any territorial limit on its prohibitions against soliciting customers, the court continued with a detailed discussion of North Carolina’s “‘customer contact’ theory.”\textsuperscript{64} According to this “well recognized” theory, restrictive covenants that protect an employer’s valuable information (such as price lists, catalogs, methods of pricing and customer buying habits and needs), along with its business relationships and goodwill with customers, are valid and enforceable to protect against a former employee’s unfair competition.\textsuperscript{65}

\textsuperscript{61} See infra Part III.A.  
\textsuperscript{62} \textit{Kuykendall}, 322 N.C. at 660, 370 S.E.2d at 386.  
\textsuperscript{63} \textit{Id.} at 651, 370 S.E.2d at 381.  
\textsuperscript{64} \textit{Id.}  
\textsuperscript{65} \textit{Id.} at 651-53, 370 S.E.2d at 380-82.
Kuykendall was followed by Whittaker General, which involved, inter alia, a customer-based restrictive covenant without any specific geographical area other than a territory to be defined by the employee’s future assignment at the time of termination.66 Whittaker General also noted how Kuykendall had held that “customers developed by a salesperson are the property of the employer and may be protected by a contract under which the salesperson is forbidden from soliciting those customers for a reasonable time after leaving his or her employment.”67

From these accepted principles of allowing customer-based restrictions without any specific geographical territory emerged Hartman, supra, and Todd, supra. Together, these Court of Appeals decisions once again placed North Carolina covenant not to compete law on a wayward path. However, unlike the look back period issue, at least this time the path has essentially been corrected through subsequent opinions. Specifically, dicta in Hartman states: “to prove that a geographic restriction in a covenant not to compete is reasonable, an employer must first show where its customers are located and that the geographic scope of the covenant is necessary to maintain those customer relationships.”68 While accurate insofar as it reflects one of the two primary justifications for an employer’s legitimate business interests, a company’s customer base (see discussion, supra), Todd’s dissent picked up on this language and stated in a nonsolicitation agreement context that “[i]t is plaintiff’s burden to demonstrate the geographic scope of its customer base. Plaintiff has failed to do so, leaving the Court with no basis upon which to assess the reasonableness of the territory covered by the covenant.”69

As with the look back period issue, the North Carolina Supreme Court did not address that statement when it adopted Todd’s dissenting opinion per curiam.70 As a result, it became uncertain (at least among the practicing bar) as to whether customer-based nonsolicitation agreements actually require a defined geographical territory in the same manner as noncompete agreements that restrict working for a

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67 Id. at 526, 379 S.E.2d at 826.
70 See generally, Prof’l Liab. Consultants, Inc. v. Todd, 345 N.C. 176, 478 S.E.2d 201 (1996) (reversing the Court of Appeals “[f]or the reasons stated by Smith, J., in the dissenting opinion . . . .”).
It took a number of years before that issue was resolved – but even then it has been in the context of appellate courts enforcing nonsolicitation agreements without specified territory limits rather than an expressed discussion and adoption of the allowance.\(^72\)

In summary, the requirement of reasonable time and territory restrictions for an enforceable covenant not to compete has taken new and unexpected twists from the relatively straightforward days of *A.E.P. Indus.*, *Kuykendall*, *Whittaker Gen.* and *Triangle Leasing*. But these twists have not come through any expressed analysis of the North Carolina Supreme Court – rather, they have come from lower court developments. As mentioned above and more fully explored below, North Carolina needs additional direction from its highest court regarding these and other issues if the state is to have a properly developing law on covenants not to compete. This is especially true given our modern age of highly mobile employees who can and do work from anywhere, and of Internet-based business activities with sales and customers that essentially have no borders.

D. The Agreement Must Not Violate Public Policy

The final requirement for a valid noncompetition agreement under North Carolina law is that it cannot violate public policy. This seldom-used argument is, however, usually the first line of attack when professionals such as doctors are trying to defeat a restrictive covenant, especially when an otherwise enforceable noncompete agreement likely exists.\(^73\) It has also been used by the Court of

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\(^71\) Complicating the development is how *Todd* failed to distinguish what is obviously just a nonsolicitation provision in a larger employment agreement from the broader term “covenant not to compete.” *Todd*, 122 N.C. App. at 212, 468 S.E.2d at 579. Then its dissent proceeded to merge the differing “territory” requirements of both in a manner that once again demonstrates how restrictive covenant nuances and details can be misconstrued in a manner with ripple effects that take some time to disappear.

\(^72\) See, e.g., *Precision Walls, Inc. v. Servie*, 152 N.C. App. 630, 637-38, 565 S.E.2d 267, 272-73 (2002) (finding covenant not to compete that contained both noncompetition and nonsolicitation restrictions reasonable, even though nonsolicitation of customers provision did not have any restricted territory); *Farr Assocs., Inc. v. Baskin*, 138 N.C. App. 276, 281, 530 S.E.2d 878, 882 (2000) (citing *Kuykendall* and stating that “our Supreme Court has recognized the validity of geographic restrictions that are limited not by area, but by a client-based restriction”); *Akzo Nobel Coatings, Inc. v. Rogers*, No. 11 CVS 3013, 2011 WL 5316772, *12 (N.C. Super. Nov. 3, 2011) (acknowledging how in a nonsolicitation of customer agreements “the North Carolina Supreme Court ‘has recognized the validity of geographic restrictions that are limited not by area, but by a client-based restriction.’”).

Appeals in declining to apply New York law to a covenant not to compete, as doing so might circumvent North Carolina’s requirement for an existing employee to receive additional consideration for signing a new noncompetition agreement.\textsuperscript{74}

Public policy is generally considered to be any policy, which, if violated, would have a significant and detrimental effect upon the best interests of the state’s citizens at large.\textsuperscript{75} Although the argument is seldom made, there have been at least some attempts to invalidate covenants not to compete as being against North Carolina public policy because they are a “restraint of trade” almost in and of themselves. This argument is generally based on language in \textit{Kadis v. Britt}, where an employment contract with a restrictive covenant was found to be a restraint of trade and, according to the court, had the effect of “economic peonage” where it not only prohibited the former employee from working for a competitor for two years after his employment ended, but also “his wife and any member of his immediate family.”\textsuperscript{76} Although the court noted that the “strict early common law rule invalidating all restraints [sic] was relaxed [and was] subsequently replaced by the test of the reasonableness of the restraint”, it also observed that:

Contracts in partial restraint of trade do not escape the condemnation of public policy unless they possess qualifying conditions which bring them within that exception. They are still contrary to public policy and void “if nothing shows them to be reasonable” . . . . When the contract is defective for want of a legally protectible [sic] subject or because its practical effect is merely to stifle normal competition, it is as much offensive to public policy as it ever was in promoting


\textsuperscript{75} See, e.g., Beam v. Rutledge, 217 N.C. 670, 9 S.E.2d 476 (1940) (declining to rule that an “arbitrary standard” exists to hold noncompetes between physicians as against public policy; rather, circumstances showed that agreement may be reasonable as applied, and issuance of restraining order until hearing affirmed); Kennedy v. Kennedy, 160 N.C. App. 1, 584 S.E.2d 328 (2003) (upholding noncompete between dentists after finding no substantial harm to public health given level of dental competition in area, and distinguishing between such substantial harm versus mere inconvenience to patients if noncompete was honored); Statesville Medical Group v. Dickey, 106 N.C. App. 669, 418 S.E.2d 256 (1992) (invalidating an otherwise valid covenant not to compete where it restrained a doctor in a rural county needing more physicians from practicing medicine or entering into any business which would compete with his former medical group in that county).

\textsuperscript{76} Kadis v. Britt, 224 N.C. 154, 157, 164, 29 S.E.2d 543, 545, 549 (1944).
monopoly at the public expense and is bad.\footnote{Id. at 158-59, 29 S.E.2d at 545-46.}

_Kadis’_ excursion down the “restraint of trade” and “public policy” path of invalidating a covenant not to compete, outside of a protectable interest such as adequate access to medical care in rural counties, has been seldom followed. But its vitriolic dicta against unreasonable restrictive covenants has resonated with some courts when analyzing the reasonableness of a noncompete’s time and territory restrictions within a purported “public policy” context.\footnote{See, e.g., Electrical South, Inc. v. Lewis, 96 N.C. App. 160, 165, 385 S.E.2d 352, 355 (1989) (“The public's interest in preserving an individual's ability to earn a living outweighs the employer's protection from competition ‘[w]hen the contract is defective . . . because its practical effect is merely to stifle normal competition . . . .’” (quoting _Kadis_, 224 N.C. at 159, 29 S.E.2d at 546)). See also, Welcome Wagon Intern., Inc. v. Pender, 255 N.C. 244, 250-51, 120 S.E.2d 739, 743-44 (1961) (BOBBITT, J., dissenting) (quoting with approval _Kadis’_ admonition that “[f]rom the beginning the argument against restraint of employment was – and still is – more powerful than those based on the evils of monopoly incident to restrictions in sales contracts”).}

However, soon after _Kadis_ was decided, two other North Carolina Supreme Court cases held precisely the opposite, finding the noncompetition agreements at issue both reasonable and valid to protect legitimate business interests of an employer rather than, as coined by _Kadis_, invoking the falling “sword of Damocles” on an employee.\footnote{See _Kadis_, 224 N.C. at 164, 29 S.E.2d at 549.} In fact, both _Orkin Exterminating Co. v. Wilson_, 227 N.C. 96, 40 S.E.2d 696 (1946) and _Sonotone Corp. v. Baldwin_, 227 N.C. 387, 42 S.E.2d 352 (1947) distinguished _Kadis_ while avoiding any direct mention of “public policy” or “restraint of trade.” _Sonotone_, in particular, hammered home the point that covenants not to compete in North Carolina can and do have redeeming qualities:

While the law frowns upon unreasonable restrictions, it favors the enforcement of contracts intended to protect legitimate interests. It is as much a matter of public concern to see that valid engagements are observed as it is to frustrate oppressive ones . . . . In undertaking to change horses for what the defendant regards a better mount, he is reminded of his obligations to the steed which brought him safely to midstream and readied him for the shift. The purpose here is to all his attention to the matter.\footnote{Sonotone Corp. v. Baldwin, 227 N.C. 387, 391, 42 S.E.2d 352, 355 (1947).}

Perhaps it is no surprise that _Sonotone_ also referenced N.C. Gen.
Stat. § 75-4, which states, “No contract or agreement . . . limiting the rights of any person to do business anywhere in the State of North Carolina shall be enforceable unless such agreement is in writing duly signed by the party who agrees not to enter into any such business within such territory . . . .”81 This statute stands in stark contrast and as a pointed qualifier to N.C. Gen. Stat. § 75-1, which says, “Every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce in the State of North Carolina is hereby declared to be illegal.”82 In other words, almost immediately after G.S. § 75-1’s restraint of trade statement is G.S. § 75-4’s express allowance of agreements that limit the ability to work if certain requisites are satisfied.

That broader allowance of enabling a proper restrictive covenant for another type of societal or economic good – protecting a company’s legitimate business interests – is the cornerstone for the remainder of this article. Given that North Carolina courts and statutes do recognize how noncompetition and nonsolicitation agreements help protect those interests, we will now explore how certain formalistic renderings of a covenant’s terms and a failure to account for the fluidity of modern business are keeping North Carolina noncompete law from its intended purpose. We will also examine some proposed solutions, three of which are quite in keeping with established Supreme Court precedent. The fourth, while definitely a departure, is still fundamentally grounded in that precedent and whose time has come.

III. HOW NORTH CAROLINA NONCOMPETE LAW HAS STRAYED FROM ITS PATH – BUT CAN STILL BE REDEEMED

If we accept the premise that protecting against unfair competition is a legitimate business interest under North Carolina law, then courts interpreting covenants not to compete should adopt and follow rules of construction that honor this focus and give those interests a more reasonable chance of being protected. What is especially surprising is how often that basic concept gets lost in the machinations of court opinions more concerned with exact contract-wording than the competitive realities of the facts before them. Although this might be explained by courts seeing themselves as being bound by contract law principles applying as equally to noncompetition and nonsolicitation agreements as they do other written contracts, the ground rules really

81 Id. at 389, 42 S.E.2d at 354 (citing N.C. Gen. Stat. § 75-4 (2011)).
are different when applied to noncompetes. One of the primary differences is that noncompetition agreements, unlike contracts in general, operate under a presumption of being “not viewed favorably under modern law.” In contrast, contracts are generally favored as enforceable agreements between consenting parties, and it is precisely because restrictive covenants restrict the ability to compete that there is a heightened scrutiny of their language. As a result, however, an unintended consequence has been court decisions that often strain for distinctions in order to reach a desired outcome, regardless of whether it works to benefit the employee or the employer.

In particular, four areas of inquiry have laid the foundation for these distinctions, and have had the most influence on North Carolina’s current state of inconsistently enforcing, or not enforcing, covenants not to compete. It is also these four areas, which, if corrected or clarified, could quickly return North Carolina to an appropriate path of protecting legitimate business interests while prohibiting unfair competition. In the process, it would help safeguard both the employers drafting these agreements and the employees who sign them—an overall goal firmly in line with established legal precedent.

The four primary areas of North Carolina covenant not to compete law that need correcting or clarifying are as follows: (1) rejecting an undue adherence to specific noncompete language regarding post-termination employment that ignores the larger restrictive covenant purpose of protecting legitimate business interests against unfair competition; (2) ending the “look back” rule that works completely counter to established principles of defining and limiting noncompete restrictions; (3) allowing competitor-based restrictions to substitute for or supplement geographic areas to satisfy the “reasonable as to territory” requirement of a valid noncompete agreement, which would also resolve those situations where geographic boundaries do not adequately protect a company’s legitimate business interests in the Internet age; and (4) correct an unreasonably strict adherence to contract severability in a covenant not to compete setting, and adopt a blue pencil or reasonable judicial modification rule that still honors the five elements of an enforceable covenant not to compete as stated in Triangle Leasing, Kuykendall and A.E.P. Indus.

A. North Carolina Should Place The Protection Of Legitimate Business Interests Above Its Undue Adherence To Specific Noncompete Drafting Constructs, Provided That The Agreement Demonstrates A Good-Faith Effort in Drafting Reasonable Restrictions

As stated throughout this article, it is axiomatic that North Carolina’s law on covenants not to compete is intended to protect no more and no less than legitimate business interests. Given that a company’s customer base and confidential or proprietary information are the cornerstones of those interests, it is incongruous that court decisions so often focus on a noncompete’s precise language restricting competitive behavior, rather than on whether the noncompete demonstrates good-faith compliance with drafting requirements. As a result, what is frequently lost in the analysis is whether the individual’s post-termination employment actually constitutes or increases the risk of unfair competition. This lack of appropriate focus works for and against employers and employees alike, but in the process it leaves those who draft covenants not to compete in a constant guessing game as to which wording stands the best chance of being upheld regardless of whether all other requisites of an enforceable restrictive covenant are met.

1. Noncompete agreements prohibiting competitive employment

For example, when upholding a noncompete agreement in Okuma, the court observed with approval how the agreement’s drafters had essentially weaved their way through this enforcement minefield:

Moreover, the language of the covenant not to compete does not bar Mr. Bowers from any or all employment in the field of either customer service or machine tooling technology. Rather, he is barred only from employment with a direct competitor, “unless ... in an area of the competitor's business which does not compete with [Okuma America].” By allowing for employment with a direct competitor in a capacity unrelated to Okuma America's business, the terms thread the needle between those in Precision Walls, which were found to be valid and enforceable, and those in VisionAIR, which were struck down.84

What is implied by Okuma is the flip side of the enforcement coin – i.e., if the noncompetition agreement had not specifically allowed working for a competitor in an area of business “which does not compete” with the plaintiff-employer, then the agreement would have been declared unreasonably broad and invalid. The court would have reached this conclusion even though the defendant-employee would be working for the same competitor in the same position that would have been prohibited if the phrase had been included. The end result is that such an approach makes “thread the needle” language controlling over protecting legitimate business interests at the cost of ignoring the competitive interests at stake and whether other key requirements of a valid noncompete agreement have been satisfied.

By contrast, Precision Walls demonstrates how this tortured rule of noncompete construction may be abandoned and still produce a desired result. In Precision Walls, plaintiff’s covenant not to compete restricted defendant from working in two of twelve states where plaintiff operated its business for one year after his employment terminated. According to the noncompete:

During the term of his employment by the Company and for the [restricted] Period, Employee will not, directly or indirectly . . . (b) Within the Territory, be engaged in the Business, or employed, concerned, or financially interested in any entity engaged in the Business . . .

Plaintiff introduced an affidavit that the former employee had gone to work for a competitor within one of the restricted states, North Carolina, performing an almost identical job. The defendant-employee cried foul – not due to lack of consideration, or an unreasonable time or territory restriction, or because he was not actually competing in violation of the agreement, but rather because the language of the noncompete was not drafted to North Carolina’s exacting standards. Specifically, defendant argued that “the scope of the activity prohibited . . . is unreasonable because it prevents him from working in plaintiff’s business in any capacity, not just as an Estimator/ Project Manager.”

86 Id. at 632, 568 S.E.2d at 269.
87 Id. at 638, 568 S.E.2d at 273.
88 Id. at 639, 568 S.E.2d at 273.
89 Id.
But in a remarkable stroke of clarity, the Court of Appeals refused to accept that reasoning. Instead, and perhaps guided by the uncontroverted facts that defendant had resigned, gone to work for a direct competitor within a reasonable restricted territory, and was even working in the same capacity as he had been employed with plaintiff, the court said:

[W]e conclude that defendant would not be less likely to disclose the information and knowledge garnered from his employment with plaintiff if he worked for one of plaintiff’s competitors in a position different from the one in which he worked for plaintiff. If defendant’s new employer asked him about information he gained while working for plaintiff, defendant would likely feel the same pressure to disclose the information. Thus, plaintiff’s legitimate business interest allows the covenant not to compete to prohibit employment of any kind by defendant with a direct competitor.  

This application of business common sense in a noncompete setting was promptly distinguished two years later in VisionAIR. With quite similar facts in terms of uncontroverted competitive behavior that would violate the restrictive covenant if it were upheld, the Court of Appeals this time rejected as overly broad the following covenant not to compete language:

[Defendant] may not ‘own, manage, be employed by or otherwise participate in, directly or indirectly, any business similar to Employer’s . . . within the Southeast’ for two years after the termination of his employment with VisionAIR.

Noting how defendant “would not merely be prevented from engaging in work similar to that which he did for VisionAIR at VisionAIR competitors; [he] would be prevented from doing even wholly unrelated work at any firm similar to VisionAIR [and] from even ‘indirectly’ owning any similar firm,” the court declared the noncompete unenforceable. In doing so, the court ignored Supreme Court precedent that has never focused on “indirectly” or “similar” as being disqualifying noncompete factors due to their purported breadth.

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90 Id. (emphasis added).
92 Id. at 508-09, 606 S.E.2d at 362-63.
– in fact, *Triangle Leasing* stated precisely the opposite:

> We find that the employment contract does not restrict all competition between Mr. McMahon and Triangle throughout the State of North Carolina, but rather only prohibits the direct or indirect solicitation of Triangle’s customers and accounts for the specified two year period. As such, we find the noncompetition clause reasonable as to both time and territory and conclude that its terms are enforceable.\(^{93}\)

Further, the Supreme Court in *A.E.P. Indus., Inc. v. McClure* reversed the Court of Appeals and remanded for a finding of damages after holding that a preliminary injunction should have been issued by the trial court.\(^{94}\) Specifically, the Court held that plaintiff had demonstrated a likelihood of success on the merits of enforcing a noncompetition agreement that *inter alia* prohibited defendant from “[d]irectly or indirectly . . . [being] employed by or render[ing] service to, any corporation, firm, association, or other enterprise which shall market or sell the same or substantially similar products as those marketed or sold by A.E.P. . . .”\(^{95}\)

In addition to ignoring the state’s highest court, *VisionAIR* also selectively quoted *Precision Walls* in order to create an artificial distinction. That creation was based on a cursory observation of how the earlier case involved an employee who had actually gone to work “in an identical position with a competing business” and involved a one-year rather than two-year noncompete.\(^{96}\) These distinctions were made despite the restricted period length not being contested in either case, and despite how *Precision Walls* expressly rejected an “identical position” requirement as discussed above.

This split in the Court of Appeals surfaced again in 2007 when *Kinesis Advertising* refused to follow *VisionAIR* or *Hartman*, and rather cited *Precision Walls* and *Okuma* as having the better rule.\(^{97}\)

Noting that defendants “contend that the ‘similar to’ language [in the noncompete agreement] is impermissibly vague because it does not sufficiently describe the activities they would be barred from


\(^{95}\) Id. at 395, 302 S.E.2d at 756.

\(^{96}\) VisionAIR, 167 N.C. App. at 509-10, 606 S.E.2d at 362 n.1.

pursuing”, the court said, “We find this argument to be unpersuasive.” Then the court explicitly rejected Hartman and VisionAIR by observing how “We have concluded that similar language in other covenants-not-to-compete is not unreasonable as a matter of law.”

So given these divergent opinions, which should govern the drafting and enforcement of covenants not to compete? And does North Carolina law really want to ignore legitimate business interests against unfair competition by placing on employers the burden of having scriveners whose pens are so sharp that they, for example, have to write “same business” instead of “similar business” when defining competition? If they do, what happens at lawsuit time if the two competitive businesses, or job positions, or other activities are not exactly the “same”? Will the restriction then be declared inapplicable because competitive behavior is not truly at issue? Or instead of using the word “indirectly”, should the noncompete drafter create some artificial construct in order to flesh out its meaning and hopefully increase its chance of being enforced – such as “Employee shall not compete with Employer through an agent, representative or other third party acting in concert with him”? According to Precision Walls and Kinesis Advertising, and as certainly implied by cases like Triangle Leasing and A.E.P. Indus., that is precisely what we do not want to do in North Carolina. Such an approach not only rejects established legal precedent on covenants not to compete, it also discards the larger socio-economic goal of restrictive covenants to protect legitimate business interests against unfair competition. And perhaps even more importantly for purposes of drafting and interpretation, it is simply impractical as a matter of business common sense.

In summary, North Carolina courts should expressly follow the Precision Walls / Kinesis Advertising approach of interpreting the precise language of noncompetition agreements in terms of protecting legitimate business interests, and breathe new life into the Supreme Court’s supporting foundation in cases such as Triangle Leasing and A.E.P. Indus. In the process, the courts should expressly reject the VisionAIR / Okuma approach of requiring thread-the-needle language that can easily defeat a covenant not to compete regardless of the competitive interests at stake or having satisfied the five-part elements of an enforceable agreement absent a tortured exercise into becoming a wordsmith. The path for doing so is actually quite clear, as they

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98 Id. at 14, 652 S.E.2d at 294.
99 Id. at 14-15, 652 S.E.2d at 294-95.
100 Arguably, VisionAIR’s analysis is also just another way to prove an unreasonably broad restricted territory. At least that is what the VisionAIR court continued...
simply need to rediscover long-established Supreme Court precedent which refuses to engage in such a form-over-substance analysis that forges the overall noncompete goal of protecting legitimate business interests.\footnote{See, e.g., Triangle Leasing Co. v. McMahon, 327 N.C. 224, 228, 393 S.E.2d 854, 857 (1990). There, a nonsolicitation clause was upheld even though it did not allow the employee to “directly or indirectly solicit or attempt to procure the customers, accounts, or business of Company, or directly or indirectly make or attempt to make car or truck-van rental sales to the customers of Company” within North Carolina or in “any other state or territory in which the company conducts business.” See also, United Labs., Inc. v. Kuykendall, 322 N.C. 643, 645, 370 S.E.2d 375, 378 (1988) (upholding a restriction against soliciting “actual or potential” customers).}

2. \textit{Nonsolicitation agreements prohibiting solicitation or sales to customers}

Although usually not as draconian as the \textit{VisionAIR} or \textit{Okuma} approach with noncompete agreements, North Carolina courts have also parsed apart nonsolicitation agreements to the point where drafting becomes its own art form. \textit{Hartman} is again a good place to start, and its reliance on a case from 1979, when the nation had a quite different business environment, helps explain some unfortunate legal analysis that is frequently repeated through the present. According to \textit{Hartman}, “[w]here the alleged primary concern is the employee’s knowledge of the customers, ‘the [restricted] territory should only be limited to areas in which the employee made contacts during the period of his employment.’”\footnote{Hartman v. W.H. Odell and Assocs., Inc., 117 N.C. App., 307, 313, 450 S.E.2d 912, 917 (1994) (quoting Manpower of Guilford Cnty., Inc. v. Hedgecock, 42 N.C. App. 515, 522, 257 S.E.2d 109, 114-15 (1979)).}

Although this language from \textit{Manpower of Guilford Cnty., Inc. v. Hedgecock} is more applicable to noncompetition than nonsolicitation agreements, its customer-contact rationale is also repeatedly applied in the latter. But the difficulty with this maxim in today’s business world is that knowledge of pricing, discounts, buying preferences and other customer-specific information that is usually confidential and proprietary is often not limited to just those employees who have direct contact with the customers themselves. This potential was implicitly noted in \textit{Precision Walls}, when the court restricted defendant from any position with his new employer as a result of having broad-based knowledge of confidential or proprietary
information that could be shared with a competitor regardless of his job title.\textsuperscript{103} It was expressly addressed in \textit{Okuma} by allowing a nonsolicitation restriction for six months throughout North and South America against the vice president of customer service given his role as “one of the six most senior executives in the company [who] participated . . . in [its] most critical and strategic decisions.”\textsuperscript{104}

When it comes to customer-based restrictions, the tendency is to limit their scope to approximately the following order of decreasing coverage: (1) all of the company’s customers; (2) those customers serviced by specific facilities where the employee worked; and (3) those customers serviced by the employee, or if appropriate (and before the right court), those serviced by the employee and any individuals he or she managed or supervised.\textsuperscript{105} As a general rule, the more an employee knows about the specific details regarding the employer’s customer base, the larger the coverage area allowed—regardless of whether \textit{Hartman’s} and \textit{Welcome Wagon’s} customer-contact requirement for defining a restricted territory is satisfied.\textsuperscript{106}

At one end of the enforcement spectrum are cases like \textit{Farr Assocs., Inc. v. Baskin}\.\textsuperscript{107} In \textit{Farr}, defendant signed a “non-compete agreement” (actually a nonsolicitation agreement) that for three years prohibited him from “directly or indirectly rendering to any current client or customer who was a client or customer of the Company

\textsuperscript{103} Precision Walls, Inc. v. Servie, 152 N.C. App. 630, 639, 568 S.E.2d 267, 273 (2002).

\textsuperscript{104} Okuma Am. Corp. v. Bowers, 181 N.C. App. 85, 91, 638 S.E.2d 617, 621 (2007). \textit{See also}, \textit{Hartman}, 117 N.C. App. at 312, 450 S.E.2d at 917 (noting that courts must consider “the nature of the employee’s duty and his knowledge of the employer’s business operations” when determining if time and territory restrictions of a covenant not to compete are reasonable).

\textsuperscript{105} \textit{See, e.g.}, Hejl v. Hood, Hargett & Associates, Inc., 196 N.C. App. 299, 306-07, 674 S.E.2d 425, 429-30 (2009) (invalidating nonsolicitation restriction where geographic area was not limited to location where former employee serviced customers and regardless of whether he had any “personal knowledge” of employer’s customers there, and where it extended to “potential customers” who had merely been “quoted a product or service”).

\textsuperscript{106} \textit{See, e.g.}, \textit{Kuykendall}, 322 N.C. at 649, 370 S.E.2d at 380 (noting how “intimate knowledge of the business operations or personal association with customers provides an opportunity [for a former employee] . . . to injure the business” of the employer); A.E.P. Indus., Inc. v. McClure, 308 N.C. 393, 408, 302 S.E.2d 754, 763 (1983) (stating how “personal contact” with customers or having held a job position that enabled the employee “to acquire valuable information as to the nature and character of the business and the names and requirements of the patrons or customers” would allow the employee to “take advantage of such knowledge of or acquaintance with the patrons” and create an unfair competitive advantage which supports injunctive relief).

\textsuperscript{107} 138 N.C. App. 276, 530 S.E.2d 878 (2000).
during the two (2) year period immediately preceding the termination date of the Employee’s employment with the Company, services of any kind similar to the services previously or presently rendered for such client or customer.”

After two years of employment defendant resigned to start a competing business, and “immediately began providing consulting services to . . . a client of Farr’s since 1988 that had worked directly with [defendant] while he worked for Farr.”

In summary, defendant was competing with his former employer in direct violation of his restrictive covenant – yet because plaintiff had operations in 461 client offices in North Carolina and 41 other states and four foreign countries, the court found the nonsolicitation agreement’s time and “territory” restrictions unreasonably broad. This was because the plain meaning of the noncompete’s language restricted the solicitation of any client of the entire company for a five-year restricted period (three years post-employment plus the two-year look back period).

Although it is this author’s position that the look back period should not have applied (see discussion infra), it is also true that the customer-based restriction in this case was so broad and without any reasonable relationship to those customers with whom defendant had personally contacted or had particularized knowledge of, that Farr’s decision was proper, absent North Carolina adopting a blue pencil or judicial modification rule as advocated below.

Contrast Farr, however, with Wade S. Dunbar Agency, Inc. v. Barber, where the court upheld a nonsolicitation clause for preliminary injunction purposes that read as follows: “that defendant will not solicit any customers of plaintiff who have an active account with plaintiff at the time of termination or any prospective client whom defendant has solicited within six months preceding the date of termination.” Distinguishing Farr and Hartman without any substantive discussion, the court instead followed Triangle Leasing and its more expansive allowance of direct or indirect solicitation of all plaintiff’s customers and accounts for a two-year period throughout North Carolina, regardless of having had any personal contact with them. In justifying the distinction, the court merely concluded “that the restrictions in Farr and Hartman are far broader than and inapposite to this case” and upheld the preliminary injunction, a

108 Id. at 278, 530 S.E.2d at 880.
109 Id.
110 Id. at 280-83, 530 S.E.2d at 881-83.
111 Id.
113 Id. at 465-469, 556 S.E.2d at 334-36 (2001).
114 Id. at 469, 556 S.E.2d at 335-36.
decision that was perhaps supported by an inferred business presence of plaintiff that appeared much smaller in scope than in either of those cases.\textsuperscript{115}

In between \textit{Farr} and \textit{Wade S. Dunbar} are decisions like \textit{Medical Staffing Network, Inc. v. Ridgway},\textsuperscript{116} in which the specific nonsolicitation language warrants more detailed treatment. Specifically in \textit{Ridgway}, the nonsolicitation clause prohibited defendant:

not only from engaging in business with current or former clients of MSN with whom he developed a relationship, but also prohibits him from soliciting the business of any ‘MSN client,’ which as defined by the agreement, includes clients of any of MSN’s affiliates or divisions outside of the medical staffing business with whom [defendant] would not have had contact.\textsuperscript{117}

Given that plaintiff had not demonstrated any legitimate business interest regarding its affiliates or divisions, or relative to any solicitation by defendant of their clients, the nonsolicitation clause was declared unreasonably broad and unenforceable.\textsuperscript{118}

All of this leads to three final observations concerning the drafting of nonsolicitation agreements. First, while specific language can certainly be as important as with noncompetition agreements, as a general rule there will be more flexibility in enforcing nonsolicitation covenants – primarily due to the narrower nature of customer-specific restrictions not bound by a geographic area. Second, the more an employer can demonstrate that an employee had particularized knowledge of confidential or proprietary information regarding its customer base, and the more direct or supervisory contact the employee had with the customers themselves, the larger the number of customers may be restricted. Third, in merging these two concepts for purposes of enforcement, the \textit{Precision Walls / Kinesis Advertising} approach of interpreting restrictive covenants should also be applied. While good drafting that does not overreach justifiable competitive concerns should still be required in the nonsolicitation context, the emphasis should remain on protecting legitimate business interests – and to the extent that the interpretive analysis found in \textit{Precision Walls} and \textit{Kinesis Advertising} enables that to occur given the facts of a particular case, it should be allowed.

\textsuperscript{115} \textit{Id.}
\textsuperscript{116} 194 N.C. App. 649, 670 S.E.2d 321 (2009).
\textsuperscript{117} \textit{Id.} at 657, 670 S.E.2d at 328 (2009).
\textsuperscript{118} \textit{Id.}
B. North Carolina Should Reject Interpreting “Look Back” Periods That Define And Limit Noncompete Restrictions In A Manner That Instead Expands Their Restricted Periods

As mentioned above in Part II.C.1., the Court of Appeals over the past 15 years has repeatedly interpreted any “look back” period for defining affected customers in a nonsolicitation agreement as an add-on to its post-employment restricted period. The genesis of this look back “rule” was in 1996, when the North Carolina Supreme Court adopted the lower court’s dissenting opinion per curiam and without any discussion in Professional Liability Consultants, Inc. v. Todd. In Todd, Judge Smith’s dissent articulated that because the agreement prohibited solicitation of any clients that did business with the employer during the three years prior to the employee’s termination and five years after termination, the covenant was actually an eight-year restriction. In doing so, he provided the following example:

For instance, if a customer has ended its relationship with plaintiff 2 years and 364 days prior to defendant’s separation date, the customer may not be contacted for five years thereafter. Plaintiff has provided the Court with no compelling reason to uphold such an expansive time restriction, and I find this covenant to be “patently unreasonable.”

Regardless of whether Todd’s five-year post-employment restricted period might itself be unreasonable (which it likely would be with most courts, despite the majority’s analysis), what escapes the dissent is how the very language of the nonsolicitation agreement demonstrates how the look back period was never intended to apply

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119 While this look back rule has not been applied in a competitor-based noncompetition agreement, the practice could easily be transferred. For example, a multi-state company that regularly transfers management between facilities may need to apply its noncompete restrictions to a specific radius of any facility where the employee was based during his or her final two years of employment in order to adequately protect its legitimate business interests. As discussed infra, under the current Court of Appeals approach, that two-year period would likely be added to the post-employment restricted period to create a new and completely unintended restricted period for not working for a competitor whose increased length might then be determined unreasonably broad.


121 Todd, 122 N.C. App. at 219, 468 S.E.2d at 582-83.

122 Id. at 219, 468 S.E.2d at 583.

prospectively in order to expand a length of time. Rather, it was only intended to define and limit the customers being restricted after employment ended:

Accordingly, [Todd] agrees that during the term of his agreement with [plaintiff] and for a period of five (5) years thereafter he will not, unless acting as an officer or employee of the [plaintiff] or with its prior written consent, directly or indirectly: (i) contact or in any way attempt to solicit insurance business from any individual, corporation or organization which is then or during the preceding three years was such a customer or client of [plaintiff], or (ii) disclose any information . . . which would enable any other individual, corporation or organization to solicit insurance business from such customers or clients.124

In short, Todd’s three-year look back was obviously meant to define a customer base for nonsolicitation purposes and help negate any attack that it was overly broad. It did so by reaching back three years before defendant’s employment ended in order to limit the protected customers to only those the company had serviced within that period.125 In fact, if the nonsolicitation agreement had not done so, the defendant could have argued it was unreasonably broad because the agreement failed to define or limit the customer base, thereby including “customers” no matter how long ago they had last conducted business with plaintiff. Yet somehow, the dissent interpreted this act of limitation as one of expansion, and when the Supreme Court adopted the dissenting opinion per curiam this look back analysis grew legs. As a result, Todd’s approach has been repeated in numerous other court decisions that have taken North Carolina covenant not to compete law even further down the path of placing form over substance in terms of protecting an employer’s legitimate business interests.126

124 Todd, 122 N.C. App. at 213, 468 S.E.2d at 579 (emphasis added).
125 See id.
126 See, e.g., Farr Assocs., Inc. v. Baskin, 138 N.C. App. 276, 281, 530 S.E.2d 878, 881-82 (2000) (holding that a three-year nonsolicitation agreement transformed into an unenforceable, five-year restricted period because the agreement restricted defendant from soliciting or selling to any client of plaintiff who had been a client during the two years immediately before defendant’s termination); Hejl v. Hood, Hagett & Assocs., Inc., 196 N.C. App. 299, 306, 674 S.E.2d 425, 429 (2009) (expanding a two-year restricted period to three years due to look back period that prevented a former account executive from providing services to employer’s clients who had been a client or received product or service quotes during the 12 months continued . . .
Because the look back rule has no logical basis and works directly against the mandate to define and limit restrictive covenants so that only legitimate business interests are protected, it should be expressly rejected by North Carolina courts. In fact, the absurdity of its reasoning is even evidenced in Farr, which, as stated above, is one of the cases that followed it. Specifically, after finding that “[t]he real time restriction of the non-compete agreement is therefore five years – three years after the date of termination plus the two-year look-back period”, the same opinion later notes that “the client-based restriction is unduly vague. The covenant does not define whether the term ‘client or customer’ includes one-time attendees of a Farr workshop. And the covenant may extend to clients’ offices that never contacted Farr . . .”.

So on one hand the court chastises the noncompete agreement for not being sufficiently defined, and on the other hand punishes the agreement for its clear attempt at definition. Simply stated, this Hobson’s choice must end, and there is plenty of case law from other jurisdictions to guide North Carolina along the way.

C. North Carolina Should Allow Competitor-Based Restrictions In Lieu Of Or In Addition To Geographical Areas To Satisfy The “Reasonable As To Territory” Element Of A Valid Covenant Not To Compete

We live in a modern age of the Internet, e-mail and other electronic and digital communications. Countless businesses have their own websites and toll-free telephone numbers, selling products and services without regard to where customers might actually be immediate before his employment terminated); Wachovia Ins. Servs., Inc. v. McGuirt, No. 06 CVS 13593, 2006 WL 3720430, at *10 (N.C. Super. Ct. Dec. 19, 2006) (noting in ¶¶ 80-82 that two years should be added to restricted period based on look back provision that prohibited former employee from servicing or soliciting clients to whom he had been assigned during final two years of employment).

127 Farr, 138 N.C. App. at 282, 530 S.E.2d at 882.

128 See, e.g., Techworks, LLC v. Willie, 318 Wis. 2d 488, 504-05, 770 N.W.2d 727, 734-35 (2009) (finding a time restriction reasonable as two-year look back period “significantly restricts the population of [plaintiff’s] customers who are on the no-contact list for two years” after his employment ended); Steam Sales Corp. v. Summers, 405 Ill.App.3d 442, 459-60, 937 N.E.2d 715, 730 (2010) (holding that a two-year look back period regarding customers was as limiting factor in noncompete agreement, with the court observing how defendant “is free to solicit and service customers who have not worked with [plaintiff] in the past two years”); Gallagher Healthcare Ins. Svcs. v. Vogelsang, 312 S.W.3d 640, 654-55 (Tex.App.-Houston [1st Dist.] 2009) (finding a noncompete agreement with two-year restricted period reasonable where look back period of clients with whom defendant had worked during her last two years of employment “limited” those clients to approximately 80).
located on a map. Yet, North Carolina covenant not to compete law still thinks in terms of physical presence. Courts repeatedly strike down noncompetition agreements that do not properly confine their reach to specific geographical areas, then hold employers accountable for including areas in which relatively little business may have been conducted during the time period at issue.129

Resolving this dilemma is actually quite simple. North Carolina courts need only to recognize that naming competitors, whether alone or in conjunction with a restricted geographic area, is also an acceptable means to satisfy the “reasonable as to territory” requirement of a valid covenant not to compete. In fact, naming competitors as the operative prohibition is, in some ways, even less restrictive as the affected employee has much more freedom in terms of future employment opportunities. The foundation for doing so already exists under North Carolina case law, and with some important guidance from other jurisdictions the allowance should be even easier to expressly adopt.

First, as previously discussed, North Carolina already allows nonsolicitation agreements based on customer location rather than a specific geographic territory. (See Part II.C.2(b)) This tacit acknowledgement of how legitimate business interests are not necessarily tied to geography in a competitor-based noncompetition agreement has been best expressed in Okuma, where the following language was upheld in a six-month restrictive covenant that did not contain any specific restricted territory:

[Employee shall not become] employed by . . . a COMPETITOR, unless Employee accepts employment with a COMPETITOR in an area of the COMPETITOR’S business which does not compete with the Company. For purposes of this Agreement, a COMPETITOR shall be defined as any entity operating as a manufacturer, distributor or seller of machine tools

129 Compare Todd, 122 N.C. App. at 219, 468 S.E.2d at 583 (Smith, J., dissenting) (arguing that a restriction that proscribes solicitation of the employer’s “customer base” but does not define who or where those customers are is unreasonable), and VisionAIR, Inc. v. James, 167 N.C. App. 504, 508-09, 606 S.E.2d 359, 362-63 (2004) (finding a non-compete overbroad where it proscribed competition in the “Southeast”), with Hartman v. W.H. Odell and Assocs., Inc., 117 N.C. App. 307, 313-14, 450 S.E.2d 912, 918 (1994) (holding that a covenant was unreasonable where it proscribed soliciting clients in the state of Texas when the employee had no more than five clients in that state), and Heil, 196 N.C. App. at 307, 674 S.E.2d at 430 (finding the geographic territory overbroad where employer had identified where the clients were, but had proscribed solicitation of customers whom were “merely quoted a product or service”).
that are substantially similar to machine tools manufactured, distributed or sold by the Company.\footnote{Okuma Am. Corp. v. Bowers, 181 N.C. App. 85, 86-87, 638 S.E.2d 617, 618-19 (2007).}

In recognizing that the noncompete agreement did not include a geographic territory in which the restrictions operated, the court also observed that:

\[T\]he agreement’s restrictions are limited to “areas in which [Okuma America] does business,” suggesting that it is a client-based, rather than geographic, limitation. Nevertheless, because Okuma America operates throughout both North and South America, the geographic effect of the restriction is quite broad. However, when taken in conjunction with the six-month duration, it is not \textit{per se} unreasonable in light of our courts’ past rulings . . . Rather, we must determine whether the scope is in fact “any wider than is necessary to protect the employer’s reasonable business interests,” . . . in light of where Okuma America’s customers are located, and if the scope is necessary to maintain its existing customer relationships.\footnote{Id. at 90, 638 S.E.2d at 620-21.}

The court then proceeded with its analysis and found the noncompete to be reasonable enough in its time and territory restrictions to survive a motion to dismiss under Rule 12(b)(6) of the North Carolina Rules of Civil Procedure.\footnote{Id. at 92, 638 S.E.2d at 622.}

So whether intended or not,\footnote{Okuma did not expressly discuss the propriety of using a company’s competitors rather than a defined geographic area as satisfying the “restricted territory” element of a valid noncompetition agreement. Therefore, it would be an overstatement to say the Court of Appeals has authorized the development beyond its specific facts.\footnote{Sigma Chem. Co. v. Harris, 586 F. Supp. 704, 707 (E.D. Mo. 1984).}} the Court of Appeals has at least opened the proverbial door to a competitor-based, “restricted territory.” To walk through the door, however, some guidance from other jurisdictions might be helpful – and an excellent place to start is with Missouri, Michigan and Pennsylvania. In \textit{Sigma Chemical}, the noncompete agreement restricted the employee from working for a competitor for two years after his employment ended.\footnote{Sigma Chem. Co. v. Harris, 586 F. Supp. 704, 707 (E.D. Mo. 1984).} Because the employer had a worldwide presence, it effectively created a very large scope that was in danger of being declared unenforceable for being too
broad. However, the Missouri court held that because the restriction was limited to the employer’s competitors, who were discernable from the company’s annual report and who were also operating on a worldwide basis, the restriction was reasonable. As stated by the court, “There is no requirement that a restrictive covenant have some geographic limit to be valid. The requirement is that the geographic scope be reasonable.”

A similar approach to allowing a competitor-based noncompetition agreement based on the intended scope of the restriction occurred in Superior Consulting Co., Inc. v. Walling, 851 F. Supp. 839 (E.D. Mich. 1994). Here, the employer was in the business of providing information systems and management consulting services to large healthcare institutions. The noncompete agreement prohibited the employee, for six months after his employment ended, from engaging in the information systems consulting business as an employee or independent contractor of another consulting company or healthcare provider. Citing Sigma Chemical for the proposition that a geographic limitation is not necessary where the employer can protect its legitimate business interests through a competitor-based restriction, the Michigan court upheld the lack of a specific geographic territory. In doing so, however, the court also noted that the geographic “scope” as expressed through the employer’s identified competitors must still be no greater than needed to protect those interests.

Finally, in Victaulic Co. v. Tieman, the noncompetition agreement contemplated both a competitor-based and geographic-based restricted territory. Specifically, it stated that the former employee “would not sell or distribute the types of items regularly sold (or contemplated for sale) by Victaulic for 12 months (1) within a ten-state Restricted Victaulic Sales Region, or (2) in any area in which Victaulic products are sold on behalf of nine named competitors” of

135 See id. at 710.
136 Id. at 706 (noting that Sigma had five major competitors worldwide).
137 Id. at 710.
138 Id. (emphasis added).
139 Superior Consulting, 851 F. Supp. at 841.
140 Id. at 842.
141 Id. at 847.
142 Id. The competitor-based restriction in Superior Consulting was found to be unreasonably broad because it did not indicate the capacity or line of work the employee was restricted from pursuing. However, it was saved by the state’s “blue penciling” rule which allowed the court to limit the scope to the type of duties the employee had performed while working for the employer. Id.
143 499 F.3d 227 (3rd Cir. 2007).
which his then-current employer was one. 144 Noting how each of the named companies were clearly direct competitors, the Third Circuit applied Pennsylvania law to reverse the district court’s dismissal for failure to state a claim. 145 In doing so, the court also observed the following in rejecting defendants’ argument that a lack of geographical territory for the competitor-based restriction automatically defeated at least that part of the noncompete:

In this Information Age, a *per se* rule against broad geographic restrictions would seem hopelessly antiquated, and, indeed, Pennsylvania courts (and federal district courts applying Pennsylvania law) have found broad geographic restrictions reasonable so long as they are roughly consonant with the scope of the employee’s duties . . . Victaulic has alleged that Tieman developed relationships with customers across North America. From this, it is possible that the geographic scope of the covenant is reasonable. 146

Combined with *Okuma* and North Carolina’s long history of allowing customer-based restrictive covenants without specific geographic areas, *Sigma Chemical, Superior Consulting* and *Victaulic* provide a framework for expressly allowing a competitor-based “restricted territory” for noncompetition agreements in North Carolina. The parameters of that framework should be as follows: (1) the employer must define the products or services that form its competitive business interests; and (2) if competitors are named in addition to or in lieu of a geographic restricted territory, they must be at least substantially engaged in the same business, with the same or similar customer base, and operating in substantially the same geographic areas as the employer.

144 *Victaulic*, 499 F.3d at 230 (emphasis added). The precise language read as follows: I further agree that[,] for twelve (12) months following the date of termination of my employment with [Victaulic] . . . . I will not, within any geographic region in which Victaulic products are sold (which includes all of the continental United States, Canada & Mexico), engage either directly or indirectly in the sale or distribution of the types of items or products regularly sold, offered for sale, or contemplated for sale by [Victaulic] as an employee, consultant or independent contractor for or on behalf of any of the following businesses: Tyco International Ltd.; Star Pipe Products; Anvil International Inc.; Shurjoint Piping Products Inc.; Modgal Metal Ltd.; Viking Corporation & Viking SA; Mueller Industries, Inc.; Viega International; The Reliable Automatic Sprinkler Co., Inc.; and any and all of their subsidiaries, affiliates, or successors. *Id.* at n. 1.

145 *Id.* at 237.

146 *Id.* at 237-38.
D. North Carolina Courts Should Adopt A Blue Pencil Or Reasonable Judicial Modification Rule, While Broadening Their Overly Strict Application Of Severability In A Covenant Not To Compete Setting

Of all the recommendations advocated by this article, adopting a blue pencil or reasonable judicial modification rule (or both) over North Carolina’s current adherence to an overly strict application of contract severability in a noncompete setting is the one that tests legal precedent. But its time has come – and in certain ways, it is a logical next step in a process of increased judicial discretion to address the specific competitive concerns and legitimate business interests invariably at issue in covenant not to compete litigation. Further, North Carolina courts should broaden their current severability regime that unnecessarily mandates a division of terms to a degree not necessarily required by the law. In fact, the severability rule, as currently applied to noncompetition agreements, largely undermines the overall goal of covenant not to compete enforcement – i.e., acknowledging the legitimacy of unfair competition concerns within the rubric of protecting only a company’s legitimate business interests.

1. Severability, blue penciling and judicial modification defined

We start this section by defining what North Carolina does not allow – “blue penciling” or “judicial modification.” Blue penciling in a covenant not to compete setting can have numerous meanings, ranging from striking unreasonable terms from a restrictive covenant to actually modifying those terms (usually time or territory restrictions) to make them reasonable and enforceable. Judicial modification is often an outgrowth of blue penciling, and it can be a separate or analogous term for blue penciling’s broader application of inserting and revising words in addition to deleting them.147

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147 See, e.g., Solari Indus., Inc. v. Malady, 55 N.J. 571, 579, 264 A.2d 53, 57 (1970) (defining and adopting blue penciling as a method by which “offending portions of the covenant can be lined out and still leave the remainder grammatically meaningful and thus enforceable”); Bess v. Bothman, 257 N.W.2d 791, 794-95 (Minn. 1977) (affirming district court’s broad “authority to modify” covenant not to compete in its discretion by supplying limitations to make the restrictive covenants enforceable); Eichmann v. Nat’l Hosp. and Health Care Servs., Inc., 308 Ill. App. 3d 337, 347-48, 719 N.E.2d 1141, 1149-50 (1999) (holding that although Illinois courts may modify a restrictive covenant to help protect legitimate interests, they will not add terms where the agreement is silent, change the plain meaning of words, or conduct any modification where the degree of unreasonableness as drafted renders it unfair or requires such “drastic modifications” as to make it “tantamount to fashioning a new agreement”); The Cmty. Hosp. Grp., Inc. v. More, 183 N.J. 36, 50, continued . . .
The blue pencil rule overlaps and is often confused with long-established law in most jurisdictions about whether contract provisions are severable (or separable). If severable, then as a general rule, the unenforceable provision will be stricken and the court will then look to the remaining contract language and determine if enough material terms remain to constitute an enforceable agreement. If so, the contract survives; if not, it fails. North Carolina law on contract severability is straightforward: When a contract contains provisions which are severable from an illegal provision and are in no way dependent upon the enforcement of the illegal provision for their validity, such provisions may be enforced.\footnote{Am. Nat’l Elec. Corp. v. Poythress Commercial Contractors, Inc., 167 N.C. App. 97, 101, 604 S.E.2d 315, 317 (2004) (quoting Rose v. Materials Co., 282 N.C. 643, 658, 194 S.E.2d 521, 532 (1973)).}

When applying this rule, courts should remember that “[t]he heart of a contract is the intention of the parties. The intention of the parties must be determined from the language of the contract, the purposes of the contract, the subject matter and the situation of the parties at the time the contract is executed.”\footnote{White v. White, 296 N.C. 661, 667-68, 252 S.E.2d 698, 702 (1979) (quoting Adder v. Holman & Moody, Inc., 288 N.C. 484, 492, 219 S.E.2d 190, 196 (1975)).}

In \textit{American Nat’l}, the court found illegal a “pay when paid” clause that violated a North Carolina statute prohibiting contractors from conditioning payments to subcontractors on having first received payment by the property owner.\footnote{Am. Nat’l, 167 N.C. App. at 101, 604 S.E.2d at 317.} This clause appeared within the same sentence and at the end of an otherwise valid contract provision, not separated by commas, or a semicolon or by indenting it as a clearly separate subparagraph.\footnote{See Am. Nat’l, 167 N.C. App. at 99-100, 604 S.E.2d at 317.} Rather, the clause merely concluded the sentence as follows: “and the Contractor shall make payments to the Subcontractor on account of such claims only to the extent that the Contractor is paid thereof by the Owner.”\footnote{Id.} Due to its illegality, the court severed this offending language – which was part of the same sentence as the inoffensive language – while enforcing the remaining obligations.\footnote{Am. Nat’l, 167 N.C. App. at 100-01, 604 S.E.2d at 317.} In doing so, the court noted that the invalid portion “is severable from the rest of the contract and does not defeat the other portions of the contract . . . which are in no way dependent on the...
illegal provision.”

However, despite the relative simplicity of North Carolina’s severability rule, it has been transformed and given new meaning within the context of covenants not to compete. As a result, the courts have yet again inserted nuances into legal precedent that have led to artificial constructs in drafting and interpreting noncompete agreements. Those constructs not only have created increased challenges in working through the unpredictable legal minefield that noncompete litigation in North Carolina has become, they also work directly against the overall goal of allowing employers to appropriately protect against unfair competition.

2. North Carolina’s approach to severability and blue penciling

North Carolina appellate courts have repeatedly distinguished contract severability from blue penciling when analyzing noncompetition agreements, and in the process have developed an approach that does neither justice. While not specifically mentioning “blue penciling” or “severability”, one of the best examples of how not doing either can lead to a result antithetical with protecting legitimate business interests is Electrical South, Inc. v. Lewis. In that case, the court affirmed the trial court’s enjoining of defendant from disclosing plaintiff’s confidential information and its denial of a preliminary injunction regarding a covenant not to compete. The noncompete injunction was denied because the language of the agreement was determined to be unreasonably broad and therefore plaintiff could not demonstrate a likelihood of success on the merits, which is one of the critical elements required for a preliminary injunction to issue. In the words of the court, “Consistent with contract interpretation rules . . . the covenant is not divisible and the Company has no right to

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156 A preliminary injunction is an equitable remedy issued only if the movant can demonstrate: (1) a likelihood of success on the merits; and (2) a likelihood of suffering irreparable harm if the injunction is not issued, or that the injunction is necessary to protect the movant’s rights during the course of litigation. See, e.g., Kennedy v. Kennedy, 160 N.C. App. 1, 16, 584 S.E.2d 328 (2003) (quoting Investors, Inc. v. Berry, 293 N.C. 688, 701, 239 S.E.2d 566, 574 (1977)).
enforcement of the indivisible contract as it is written.\textsuperscript{157}

However, to reach that determination the court declined to sever any provisions that it considered unreasonable, and then engaged in what is perhaps the best example of wordsmith sophistry in North Carolina noncompete law. By parsing apart conjunctions and other grammatical inferences through the general rule that ambiguous terms of a contract are strictly construed against its drafter, the court ultimately found the restrictive covenant unreasonably broad and therefore unenforceable (for preliminary injunction purposes), while ignoring how the defendant had unquestionably accepted employment with a direct competitor within a prohibited geographical radius in which the plaintiff regularly operated, and had even solicited its customers within that restricted territory.\textsuperscript{158} In short, \textit{Electrical South} is virtually a poster child for how not applying a proper severability rule can result in running roughshod over a company’s legitimate business interests in a noncompete context.\textsuperscript{159}

We note that the language of the contract, above, is ambiguous, because of the word “or”: “\textit{or which competes directly or indirectly with the company in such endeavors ...}” (Emphasis added.) Grammatically, ‘or’ in this covenant can be read to mean “\textit{or}” or “\textit{and}.” It can indicate either two types of business ‘concerns’ or one business ‘concern’ with several characteristics. If one reads the covenant so that “\textit{or}” is used in its disjunctive sense (“\textit{either/or}”), the contract language seems to enumerate two types of “[business] concerns” that Employee cannot “\textit{be connected in any manner with}” [sic]: the first ‘\textit{which manufactures,}’ ‘\textit{designs}’ or ‘\textit{repairs}’ industrial solid state electronic equipment within 200 miles of Greensboro, or the second ‘\textit{which competes directly or indirectly with the Company}’ within 200 miles of Greensboro. If, however, we read the “\textit{or}” in its conjunctive (“\textit{and}”) sense, the covenant describes only one type of business ‘concern’ having two prohibited attributes: one that ‘\textit{manufactures or designs,}’ ‘\textit{repairs or services,}’ \textit{and} ‘\textit{which competes directly or indirectly with the Company}’ within 200

\textsuperscript{157} \textit{Elec. South}, 96 N.C. App. at 167, 385 S.E.2d at 356.
\textsuperscript{158} \textit{Id.} at 163, 385 S.E.2d at 354.
\textsuperscript{159} In addition, the court focused so much on obviously unintended drafting nuances that it illustrates yet again why the recommendations discussed above in Part III.A.1. regarding \textit{Precision Walls} and \textit{Kinesis Advertising} are so needed.
miles of Greensboro.’ When the language in a contract is ambiguous, we view the practical result of the restriction by “construing the restriction strictly against its draftsman . . . .” . . . Construing the contract according to this tenet, we interpret the word ‘or’ in its conjunctive sense and do not determine whether the contract has a divisible provision which may be enforceable. A court can “enforce the restrictions in the territorial divisions deemed reasonable and refuse to enforce them in the divisions deemed unreasonable.”

As if this tortured reasoning were not enough, the court continued with a detailed discussion of how the noncompete’s language prohibited associating with plaintiff’s competitors “wherever located.” According to the court, and instead of just severing this offending language upon which the “valid” portions of the agreement did not depend, the consequence was to defeat the noncompete. By doing so, it overrode any concern for defendant’s actual employment with a competitor within the given 200-mile restricted territory around Greensboro, a geographical area whose reasonableness was never questioned and which was obviously all the noncompete intended to accomplish as it was the only territorial restriction being enforced in the lawsuit.

In short, if there was ever a need for a proper application of the severability rule (or as argued in this section, a blue penciling or reasonable judicial modification rule), it is embodied in Electrical South. But additional support is also provided through Hartman and its progeny, which added another unique twist to severability and the refusal to blue pencil or otherwise modify noncompete agreements in North Carolina:

When the language of a covenant not to compete is overly broad, North Carolina's “blue pencil” rule severely limits what the court may do to alter the covenant. A court at most may choose not to enforce a distinctly separable part of a covenant in order to render the provision reasonable. It may not otherwise revise or rewrite the covenant.

The courts will not rewrite a contract if it is too broad but will simply not enforce it

161 Id.
(citations omitted). If the contract is separable, however, and one part is reasonable, the courts will enforce the reasonable provision (citations omitted).

In this case, the trial court correctly overturned the jury verdict and ruled that the covenants could not be saved by “blue penciling.”

Although there is certainly legal precedent in North Carolina requiring contract terms to be identifiable enough to sever, *Whittaker General* never mentioned the word “distinctly” nor any of its derivations, much less associated it as *Hartman* did with the severability of contract provisions within a covenant not to compete by requiring a “distinctly separable part of a covenant in order to render the provision reasonable.” Rather, *Whittaker General* merely observed that the paragraph of the contract at issue prohibiting defendant from soliciting, interfering or diverting plaintiff’s customers “contain[ed] a separate provision which provide[d] that [defendant] will not engage in the ‘business of manufacturing, selling, renting or distributing any goods manufactured, sold, rented or distributed by [plaintiff] during the term of his employment.’”

While noting how plaintiff was not even trying to enforce that provision, the Court held that “the part which is before us is separable and may be enforced by the award of damages.”

*Hartman’s* approach to severability has spawned a number of cases that refuse to sever unenforceable provisions in a covenant not to compete when there is no “distinctly separable part,” whatever that might mean since neither *Hartman* nor any of these other cases define it. The closest our courts have apparently come to defining the

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163 *Whittaker Gen.*, 324 N.C. at 528, 379 S.E.2d at 829; *Hartman*, 117 N.C. App. at 317, 450 S.E.2d at 920.

164 *Whittaker Gen.*, 324 N.C. at 528, 379 S.E.2d at 828.

165 *Id.*


continued . . .
concept is actually in the dissenting opinion to *Welcome Wagon, Inter., Inc. v. Pender.* 167 In that case, the North Carolina Supreme Court in a 4-3 decision reversed the Court of Appeals and, for purposes of ruling that a restraining order should have been continued to hearing, found that the noncompetition agreement at issue was valid. 168 What is most interesting for this current discussion, is that the court in doing so actually engaged in a practice that the dissenting opinion called “blue penciling.” 169 This was due to the court having ruled that one, and depending on a subsequent trial court determination, perhaps two of four specifically numbered alternative geographical restrictions were reasonable. 170 Noting how the majority had approved the first alternative restrictions (“(1) in Fayetteville, North Carolina”), disapproved the third and fourth (locations throughout the United States where plaintiff actively engaged in business), and left the second alternative up to the trial court based on evidence to be heard (“(2) any other city, town, borough, township, village or other place in the State of North Carolina” where plaintiff was operating), Justice Bobbitt’s dissenting opinion called them to task for having applied “in substance, the so-called ‘blue pencil’ rule.” 171

restricted territory that were overly broad, while leaving North Carolina, South Carolina and Georgia intact, but then inserted the words “in competition” which was the only addition actually written into the agreement (i.e., the only words improperly “blue penciled”). Therefore, except for a single addition not in the original covenant not to compete, the trial court in *Hartman* did precisely what North Carolina law permits when severing unenforceable provisions from a contract. See, e.g., Am. Nat’l Elec. Corp. v. Poythress Commercial Contractors, Inc., 167 N.C. App. 97, 101, 604 S.E.2d 315, 317 (2004), and other cases cited above in this section. Unfortunately, the Court of Appeals never acknowledged this but instead charted its own course on severability versus blue penciling in North Carolina. *Hartman*, 117 N.C. App. at 317-18, 450 S.E.2d at 920.

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167 255 N.C. 244, 120 S.E.2d 739 (1961).
168 *Id.* at 248-50, 120 S.E.2d at 741-43.
169 *Id.* at 255-56, 120 S.E.2d at 747-48 (Bobbitt BOBBITT, J., dissenting).
170 *Id.* at 246, 248-50, 128 S.E.2d at 740-43. The specifically numbered alternative restrictions are as follows: “(1) in Fayetteville, North Carolina, or (2) in any other city, town, borough, township, village or other place in the State of North Carolina, in which the Company is then engaged in rendering its said service, (3) in any city, town, borough, township, village or other place in the United States in which the Company is then engaged in rendering its said service, or (4) in any city, town, borough, township or village in the United States in which the Company has been or has signified its intention to be, engaged in rendering its said service.” *Id.* at 246, 120 S.E.2d at 740.
From there, the dissenting opinion provided an example of what this rule might mean for drafting covenants not to compete in North Carolina. In a surprising twist, that has mostly been forgotten by later case law acknowledging how blue penciling is not permitted, Justice Bobbitt observed the following:

[I]f the “blue pencil” rule is adopted, there would seem no reason why the court should not uphold a provision it deems reasonable in respect of time if worded in the alternative, for example, a provision restricting competition (1) for one year, or (2) for two years, or (3) for three years, or (4) for four years, and so on ad infinitum. ¹⁷²

Ironically, this is precisely what has happened despite courts repeatedly observing how the blue pencil rule is not followed in North Carolina. As a matter of practice, the uncertainty of what “distinctly separable part” might mean has caused drafters of noncompetition agreements to devise so many artificial constructs of periods, commas, semicolons, colons, paragraphs and subparagraphs – preferably with “alternative” language inserted – that it borders on the absurd. For example, consider the following hypothetical options for defining a covenant not to compete’s restricted territory for a company with sales operations that, depending on the direction, cover up to a 100-mile radius of two cities:

**Option A**

The Restricted Territory shall be defined as a 100-mile or 75-mile radius of Raleigh, NC, and Columbia, SC.

**Option B**

The Restricted Territory shall be defined as a 100-mile or 75-mile radius of Raleigh, NC, and Columbia, SC, whichever is the greater radius for each such city that a court of competent jurisdiction determines is reasonable and enforceable to protect the Company’s legitimate business interests.

**Option C**

The Restricted Territory shall be defined as a 100-mile radius of Raleigh, NC, and Columbia, SC; or, in the alternative, it shall be defined as a 75-mile radius of

Raleigh, NC, and Columbia, SC.

Option D
The Restricted Territory shall be defined as: (1) a 100-mile radius of Raleigh, NC, and Columbia, SC; or (2) a 75-mile radius of Raleigh, NC, and Columbia, SC.

Option E
The Restricted Territory shall be defined as a 100-mile radius of Raleigh, NC, and Columbia, SC. In the alternative, the restricted territory shall be defined as a 75-mile radius of each such city.

Option F
The Restricted Territory shall be defined as:

1. A 100-mile radius of Raleigh, NC; and
2. A 100-mile radius of Columbia, SC.

In the alternative, and only if a court of competent jurisdiction determines that such territory is overly broad or otherwise unenforceable and invalid, then the Restricted Territory shall be defined as:

1. A 75-mile radius of Raleigh, NC; and
2. A 75-mile radius of Columbia, SC.

The variations are virtually endless, from including specific conjunctions and punctuation to using completely separate paragraphs, sentences and numbering, to adding precise language about reasonableness and enforceability. But quite arguably this is what must be done under Welcome Wagon, whether it is called “blue penciling” or not. Regardless, however, it is scrivening nonsense given how each version uses the same geographical territory limited to the company’s demonstrated areas of operation, and how substantively there is no material difference between Options A and F or any point in between.\(^{173}\)

\(^{173}\) The unintended drafting consequence of not implementing broad severability, or an appropriate blue penciling or reasonable judicial modification rule as also advocated by this article, is perhaps best expressed by the courts in Arizona. That state adopted a blue penciling rule defined as “cross[ing] out over broad, unreasonable provisions in an agreement while keeping in place less onerous, enforceable ones.” Compass Bank v. Hartley, 430 F. Supp. 2d 973, 980 (D. Ariz. 2006). This has led to a widespread practice of using “step-down provisions” as the method of defining territory or time restrictions by providing successively continued . . .
Assume also in this example that, based on the evidence, a court determines that a 100-mile radius of Raleigh but only a 75-mile radius of Columbia is reasonable. Applying a broader severability rule as reflected in American Nat’l, any of Options A through F could be “severed” to achieve this result – including even a strict reading of Option A, by simply severing the larger radius and using the lower, 75-mile area for both cities. But when a strict severability rule is applied, or when it is considered “blue penciling” as in Hartman, the result is quite different. In Hartman, the trial court modified the covenant not to compete in two ways: by deleting certain language that it considered overly broad from the same paragraph in which appropriate restrictions were found, and by inserting the words “in competition” into the paragraph to help clarify the limitations being imposed.\footnote{See Hartman v. W.H. Odell and Assocs., Inc., 117 N.C. App. 307, 309-10, 450 S.E.2d 912, 914 (1994).} The court labeled both actions as having “blue penciled” the covenant, despite the former being quite arguably a mere application of a broader severability rule by striking terms that other portions of the covenant did not depend upon for their validity:

Paragraph (a) of the “blue penciled” or modified covenant submitted to the jury read as follows:

(a) Employee agrees that during his term as an employee of the Corporation and for five (5) years thereafter, he will not, either directly or indirectly, on his own account, or in the service of others, own, manage, lease, control, operate, participate, consult or assist any person or entity providing actuarial services or any other services of the same nature as the services currently offered by the Corporation to the insurance industry and others \{or otherwise compete\} \textit{in competition} against the Corporation in the actuarial or consulting business. This covenant shall be binding upon Employee within the geographic territory of North Carolina, South Carolina and Georgia \{the “Primary Territory”\} and those five (5) states, not including the Primary Territory, from which the Corporation has derived the greatest revenues during the twenty-four (24) month period preceding the decreasing restrictions if a broader one is first deemed unenforceable, similar to the examples given in Options A through F above. \textit{Id.} In other words, once again form is placed over substance in terms of what covenant not to compete law is intended to accomplish.
termination of the Employee’s employment, which five (5) states, along with the Primary Territory, shall constitute the “Restricted Territory.”

Notwithstanding the foregoing, if Employee ceases to be employed by the Corporation, he shall have the right to work as a full-time employee of an insurance company so long as he renders services only for the exclusive benefit of such company.\textsuperscript{175}

However, while severing unenforceable provisions may overlap with blue penciling, the latter provides much more freedom in modifying a noncompete agreement to protect legitimate business interests as evidenced in states like Illinois, New Jersey and Pennsylvania. In those states, both practices are accepted parts of covenant not to compete litigation, and their blue pencil rules have either morphed into or been replaced by a rule of reasonable judicial modification.\textsuperscript{176}

So where does North Carolina go from here? One option is to leave Hartman’s “distinctly separable part” language alone and keep using its rigid understanding of severability in a noncompete setting while continuing to reject blue penciling.\textsuperscript{177} If that course is taken, a court may modify or ‘blue-pencil’ an unreasonable agreement in order to make it comport with the law, or sever unenforceable provisions from a contract.”; Solari Indus., Inc. v. Malady, 55 N.J. 571, 585-86, 264 A.2d 53, 61 (1970) (overturning prior decisions regarding strict application of a severability rule and deeming overly broad noncompete agreements “void per se” in favor of a blue pencil rule that allows courts to modify restraints in order to protect an employer’s legitimate interests); Bahleda v. Hankison Corp., 228 Pa. Super. 153, 157, 323 A.2d 121, 123 (1974) (holding that although covenant may be overly broad in geographic scope to be enforced, it may nevertheless “be modified and enforced as restricted by the modification”). An interesting variation is when the noncompetition agreement specifically authorizes a court to enforce its restrictions to the maximum extent permitted by law. Although this issue has apparently not been addressed under North Carolina law, at least in Illinois such authorization is honored and increases even more a court’s ability to modify and not just sever unreasonable terms from the agreement. See, e.g., Wyatt v. Dishong, 127 Ill.App.3d 716, 719, 469 N.E.2d 608, 610 (1984).

\textsuperscript{175} Id. (emphasis and editing notations in original). See also MJM Investigations, Inc. v. Sjostedt, 205 N.C. App. 468, 698 S.E.2d 202 at *3 (noting how the court “blue penciled” the restrictive covenant by striking its entire first sentence, which consisted of noncompetition rather than nonsolicitation restrictions, rather than referring to the action as severing).

\textsuperscript{176} See, e.g., Pactive Corp. v. Menasha Corp., 261 F. Supp. 2d 1009, 1015 (N.D. Ill. 2003) (“Under Illinois law, a court, at its discretion, may modify or ‘blue-pencil’ an unreasonable agreement in order to make it comport with the law, or sever unenforceable provisions from a contract.”); Solari Indus., Inc. v. Malady, 55 N.J. 571, 585-86, 264 A.2d 53, 61 (1970) (overturning prior decisions regarding strict application of a severability rule and deeming overly broad noncompete agreements “void per se” in favor of a blue pencil rule that allows courts to modify restraints in order to protect an employer’s legitimate interests); Bahleda v. Hankison Corp., 228 Pa. Super. 153, 157, 323 A.2d 121, 123 (1974) (holding that although covenant may be overly broad in geographic scope to be enforced, it may nevertheless “be modified and enforced as restricted by the modification”). An interesting variation is when the noncompetition agreement specifically authorizes a court to enforce its restrictions to the maximum extent permitted by law. Although this issue has apparently not been addressed under North Carolina law, at least in Illinois such authorization is honored and increases even more a court’s ability to modify and not just sever unreasonable terms from the agreement. See, e.g., Wyatt v. Dishong, 127 Ill.App.3d 716, 719, 469 N.E.2d 608, 610 (1984).

\textsuperscript{177} Although this article argues for a broad severability rule in a noncompete context, the North Carolina Supreme Court has at least implied that Hartman’s more limited severability approach is acceptable (although not necessarily required). In Tillman v. Commercial Credit Loans, Inc., a consumer loan arbitration agreement
however, expect attorneys and others who draft noncompete agreements to increasingly become scribes of form over substance, as the “art” of alternative or step-down provisions as allowed in Welcome Wagon will have as many finely-tuned brushstrokes as a Van Gogh painting in hopes that at least one provision will be found enforceable. As one who drafts and litigates these agreements, it is this author’s contention that such an approach not only misapplies a long-standing rule that allows much more freedom with severability, it is also antithetical to protecting the legitimate business interests of employers in an instantly mobile and often borderless modern business environment.

Therefore, I think the answer to this question is two-fold: At a minimum, North Carolina courts should consistently take the severability rule demonstrated by American Nat’l and apply it to covenants not to compete. But even more, North Carolina should adopt an appropriate blue penciling or reasonable judicial modification rule, or both, similar to that found in Illinois, Pennsylvania and New Jersey – with Illinois being particularly recommended.

3. Adopting a blue pencil or reasonable judicial modification rule in North Carolina

For North Carolina to consider a blue pencil or judicial modification rule, it does not have to reject severability. In fact, severability and blue penciling should not only co-exist, they can and do complement each other, just as blue penciling and judicial modification work together when both are properly implemented. As discussed above in Part III.D., an appropriate understanding of severability allows for unenforceable provisions of a contract to be severed and the remaining provisions to be enforced when they do not depend on the illegal portions for validity. North Carolina courts do not need to look beyond their own case law to re-establish those principles in the covenant not to compete context. However, for blue penciling and judicial modification guidance, North Carolina does need to consider the law in other jurisdictions. As mentioned above, three of the best examples of a blue pencil or reasonable judicial

was declared substantively unconscionable and invalid by the majority, which declined to invoke the agreement’s severability clause to remove the offending provisions as it would have required such a large extent of severing that it would “require the Court to rewrite the entire clause”. 362 N.C. 93, 108, 655 S.E.2d 362, 373 (2008). However, in his dissenting opinion, Justice Newby observed that severability should have and could have been applied, citing numerous instances of how courts have stricken offending language within specific clauses without any concern of rewriting or substituting their own terms for those of the parties. Id. at 125-26, 655 S.E.2d at 383-84.
modification rule that would honor North Carolina severability and its other elements of an enforceable noncompetition agreement are in the states of Illinois, Pennsylvania and New Jersey.

Interestingly, New Jersey saw itself as a late-comer to the blue pencil rule – and that was in 1970. The seminal case was Solari, in which the court applied the following rationale about why a new direction was needed, one that 42 years later rings equally true for North Carolina:

As the cited judicial opinions indicate, the rule of divisibility or selective construction has, at the expense of the basic values, exalted formalisms and rewarded artful draftsmanships. In the process individual results have been reached which hardly conform with any sound equitable concepts. In some instances, judges have upheld sweeping noncompetitive agreements . . . In other instances, they have stricken noncompetitive agreements in their entirety, as too broad, though justice and equity seemed to cry out for the issuance of appropriately limited restraints which would simply protect the legitimate interests of the covenantor in reasonable fashion, would not subject the covenantee to any undue hardship, and would not impair the public interest.178

Through Solari, the New Jersey Supreme Court adopted a three-part test that holds a noncompete agreement enforceable if it “protects the legitimate interests of the employer, imposes no undue hardship on the employee, and is not injurious to the public.”179 Through subsequent case law, New Jersey took the blue pencil rule and developed it into a modification rule through which courts have relative freedom to revise noncompete agreements based on the evidence presented in order to effectuate the three-part test of enforceability.180

In Pennsylvania, courts have “broad powers to modify the restrictions imposed on the former employee to include only those

179 Id. at 576, 264 A.2d at 56.
180 See, e.g., Platinum Mgmt., Inc. v. Dahms, 285 N.J. Super. 274, 298, 666 A.2d 1028, 1039-40 (1995) (modifying a restrictive covenant by deleting provision that restricted solicitation of prospective customers); Coskey's Television & Radio Sales & Serv., Inc. v. Foti, 253 N.J. Super. 626, 602 A.2d 789 (1992) (discussing how trial court “did trim or ‘blue pencil’ the covenant in its scope of activity and area of enforceability”, but that such efforts were not enough as the covenant “required substantially narrower enforcement.”).
restrictions reasonably necessary to protect the employer."\textsuperscript{181} Similar to New Jersey, this general rule of judicial modification for covenants not to compete operates within a three-part analysis of enforceability that includes determining whether a covenant is “incident to an employment relationship”, whether its restrictions are “reasonably necessary for the protection of the employer,” and whether those restrictions are “reasonably limited in duration and geographic extent.”\textsuperscript{182} Balancing this inquiry is the “important interest” of the employee “in being able to earn a living in his chosen profession.”\textsuperscript{183}

But of these three states, it is perhaps Illinois that provides the best model for North Carolina. The reason is that Illinois, like North Carolina, has an exceptionally well-developed body of noncompete case law that truly demonstrates an effort to reach fair and proper results for employers and employee alike, whether a restrictive covenant is enforced or not. In addition, when applying its blue pencil and judicial modification rules, Illinois courts have managed to establish guiding principles that keep an appropriate burden on those who draft noncompete agreements to do it right. Any covenant that obviously fails to satisfy the basic elements of enforceability under Illinois law will not be modified by a court in order to save it, but a covenant will not be struck down merely because of formalistic semantics that ignore a proper analysis and the protection of legitimate business interests.

Restrictive covenants are valid and enforceable in Illinois if they are “‘reasonable and necessary to protect a legitimate business interest of the employer.’”\textsuperscript{184} Whether a covenant is reasonable is a question of law for the court after considering “the hardship caused to the employee, the effect upon the general public, and the scope of the restrictions.”\textsuperscript{185} This analysis also requires courts “to consider the propriety of the limitations in terms of their length in time, their territorial scope, and the activities that they restrict”, all of which

\textsuperscript{182} Id.
\textsuperscript{183} Id. See also Bell Fuel Corp. v. Cattolico, 375 Pa. Super. 238, 251-52, 544 A.2d 450, 457 (1988), appeal denied, 520 Pa. 612, 554 A.2d 505 (1989) (stating the rule that “a court of equity may not only remove an offensive term, but may supply a new, limiting term and enforce the covenant as so modified. This unique power to modify the parties’ contract in the restrictive covenant context arises from the general equity powers of the court.”).
\textsuperscript{185} Cambridge Eng’g, 378 Ill. App. at 447, 879 N.E.2d at 522.
“depends on the unique facts and circumstances of each case.”\textsuperscript{186} While courts may modify an overly broad covenant not to compete to make it more reasonable and enforceable, any such reformation must be narrowly applied in order to avoid creating any “incentive to draft restrictive covenants as broadly as possible” and simply rely upon a court to “automatically amend and enforce them” given the “particular circumstances of each case.”\textsuperscript{187} At all times, “the fairness of the restraints contained in the contract is a key consideration.”\textsuperscript{188}

One of the best accounts of implementing these principles within the context of blue penciling or judicial modification is in \textit{Eichmann v. Nat’l Hosp. and Health Care Services, Inc.}\textsuperscript{189} In \textit{Eichmann}, plaintiff filed a declaratory judgment action challenging a noncompetition agreement he had signed while employed with defendant.\textsuperscript{190} The trial court refused to modify the restrictions as requested by defendant, granted partial summary judgment in favor of plaintiff and the Illinois Appellate Court affirmed.\textsuperscript{191} Although the parties and restrictive covenants were somewhat different from typical noncompetition and nonsolicitation provisions in an employer-employee setting, the court used the same type of analysis and discussed the following rules:

- Courts “may modify the restraints embodied in a covenant not to compete” but in doing so, “will neither add language or matters to a contract about which the instrument itself is silent, nor add words or terms to an agreement to change the plain meaning of the parties as expressed in the agreement”\textsuperscript{192}

- Despite the ability to modify restrictive covenants, “\textit{the fairness of the restraint initially imposed is a relevant consideration to a court of equity}.”\textsuperscript{193}

- “A restrictive covenant is unfair where its terms ‘clearly extend far beyond those necessary to the

\textsuperscript{186} Id.
\textsuperscript{187} Id. at 456, 879 N.E.2d at 529.
\textsuperscript{188} Id. at 457, 870 N.E.2d at 530.
\textsuperscript{190} Id. at 339, 719 N.E.2d at 1143.
\textsuperscript{191} Id.
\textsuperscript{192} Id. at 347, 719 N.E.2d at 1149 (citing Sheehy v. Sheehy, 299 Ill. App. 3d 996, 1001, 702 N.E.2d 200, 204 (1998)).
\textsuperscript{193} Id. (quoting House of Vision, Inc. v. Hiyane, 37 Ill.2d 32, 39, 225 N.E.2d 21, 25 (1967)) (emphasis in original).
protection of any legitimate interest’ of the employer or, in other words, amount to ‘unrealistic boundaries in time and space.’”

- Although courts may “modify a restrictive covenant . . . [they] should refuse to modify an unreasonable restrictive covenant, not merely because it is unreasonable, but where the degree of unreasonableness renders it unfair.”

- While “minor” modifications are allowed, “drastic” changes “tantamount to fashioning a new agreement” are not.

- Modification to protect an employer’s legitimate interests should never be implemented in such a way that it “‘discourag[es] the narrow and precise draftsmanship which should be reflected in written agreements.’”

In summary, while Illinois courts are empowered to make minor modifications to a covenant not to compete in order to protect an employer’s legitimate interests, employers are still required to properly draft the agreements and to enforce them in an appropriate manner that only protects against unfair competition. By

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194 Id. (quoting House of Vision, 37 Ill.2d at 39, 225 N.E.2d at 25).
195 Id. (emphasis in original).
196 Id.
197 Id. (quoting Lee/O’Keefe Ins. Agency, Inc. v. Ferega, 163 Ill. App. 3d 997, 1007, 516 N.E.2d 1313, 1319 (1987)). For examples of cases where judicial modification was allowed, see, e.g. Weitekamp v. Lane, 250 Ill. App. 3d 1017, 1027, 620 N.E.2d 454, 461 (1993) (upholding trial court’s modification of covenant not to compete as original covenant “was not extremely unfair nor did it extensively restrain trade”); Arpac Corp. v. Murray, 226 Ill. App. 3d 65, 80, 589 N.E.2d 640, 652 (1992) (upholding slight modification of a restrictive covenant where “the balance of the restrictions were reasonable” to protect the company’s interests). Cf., Arcor, Inc. v. Haas, 363 Ill. App. 3d 396, 404-06, 842 N.E.2d 265, 272-74 (2005) (refusing to blue pencil or modify noncompete agreement without geographical limitations where to do so would effectively create a “blanket prohibition” against competition). See also Eichmann and Sheehy, where the courts declined to modify overly broad restrictions.
maintaining this “reasonable judicial modification” approach, Illinois is able to avoid highly structured drafting requirements that place form over substance, while helping to ensure that proper drafting is still mandated and that employers cannot simply rely upon courts to essentially write or rewrite their agreements for them if a noncompete is challenged. All of this appears to make Illinois’ blue penciling and judicial modification rules a natural fit for North Carolina, which does and should continue to require appropriate drafting, consideration and other elements of an enforceable covenant not to compete under its laws.

4. Applying a blue pencil or reasonable judicial modification rule in North Carolina

While in some ways this may seem like a radical departure from North Carolina legal precedent, in actuality, adopting an appropriate blue pencil or reasonable judicial modification rule – or both – can be seen as a natural outgrowth of how our courts already approach covenant not to compete cases. As previously discussed, North Carolina courts are repeatedly challenged with placing highly nuanced language of a noncompetition agreement into a larger legal framework of what constitutes an enforceable covenant not to compete, then determining that enforceability as a matter of law. This not only involves the five elements reflected in Triangle Leasing, Kuykendall and A.E.P. Indus., it also means that courts are, to a great extent, already using their discretion and fair judgment to reach a particular result. Invariably, that process involves making a determination based on evidence presented at a hearing or trial. Toward that end, the five elements and whether they all operate together to only protect an employer’s legitimate business interests are definitely at issue. If so, then they create an enforceable, or likely enforceable, agreement for purposes of trial or motion, respectively, either of which embodies the court’s discretion in making that determination. In other words, North Carolina courts are already using their discretion and fair judgment anyway, and by applying severability they are using it even more – whether in its current strict form or in the broader sense advocated above. So the foundation already exists for blue penciling and judicial modification, if our courts are willing to go there.

Three examples of how our trial or appellate courts have been willing to “go there” include Welcome Wagon, Redlee/SCS, Inc. v. Pieper,199 and Southeastern Outdoor Products, Inc. v. Lawson.200 As

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previously mentioned, not only did the court in Welcome Wagon engage in what the dissenting opinion labeled as “blue pencil[ing]”, it also observed the following: “[W]here, as here, the parties have made divisions of the territory, a court of equity will take notice of the divisions the parties themselves have made, and enforce the restrictions in the territorial divisions deemed reasonable and refuse to enforce them in the divisions deemed unreasonable.”

Taking notice and ruling accordingly is the embodiment of discretion and fair judgment, and that is precisely what is and should continue to be allowed by our courts in noncompete cases.

In Redlee, a company sued two former employees and their new employer in order to enforce a covenant not to compete. One employee’s covenant expired and was considered moot by the time the Court of Appeals rendered its decision, but the other was still in effect and therefore its likelihood of enforcement was at issue given defendants’ appeal of the trial court’s granting of a preliminary injunction. The remaining covenant was contained in a larger employment agreement governed by Texas law. That law includes a covenant not to compete statute instructing courts to “reform” any unreasonably broad restrictions of time, territory or scope of activity and to “impose a [reasonable] restraint that is not greater than necessary” to protect legitimate business interests. The North Carolina court did so by reducing the covenant’s territorial limitation from several counties to just Mecklenburg County, which was where the remaining individual defendant had worked for plaintiff, and the Court of Appeals approved this reformation in affirming the trial court’s decision.

Redlee’s enforcement in North Carolina of a Texas statute mandating the blue penciling or judicial modification of an overly broad time, territory or activity restriction is another indication that our current prohibition against blue penciling might not be as final as it may appear. For example, if the blue pencil rule is prohibited based on a public policy argument, then Redlee would have refused to reform the covenant despite its being governed by Texas law. That
precise question appears to have only been addressed once in North Carolina, and in *Akzo Nobel Coatings Inc. v. Rogers*,206 the North Carolina Business Court refused to consider as void against public policy a Delaware law allowing liberal blue penciling of noncompete agreements.207 The court did limit its findings to its set of facts alone, but nevertheless applied Delaware’s blue penciling rule to two noncompete agreements because they were “bargained for and should be honored.”208 In contrast, *Cox v. Dine-A-Mate* refused to apply New York law to a covenant not to compete on “public policy” grounds in that North Carolina requires additional consideration for existing employees to sign new noncompete agreement whereas New York does not.209 Whatever the eventual North Carolina rule might be concerning blue penciling or judicial modification, there is at least a good argument that it is not a “public policy” violation of the type described in *Cox* as its rejection has apparently never been couched that way by our courts.

One of the latest examples of rejecting the blue pencil rule serves another purpose as well. That purpose is demonstrating how blue penciling (and here, judicial modification) can lead to a reasonable result that properly protects legitimate business interests when an underlying restrictive covenant would otherwise fail. In *Southeastern Outdoor Products, Inc. v. Lawson*,210 defendant resigned his employment with plaintiff and began working for one of plaintiff’s direct competitors in a geographical area that without question was within his noncompete agreement’s restricted territory. Plaintiff sued and moved for a preliminary injunction.211

After considering the testimony and other evidence at hearing, the trial court granted injunctive relief, but in the process reduced and revised the overly broad restricted territory of North Carolina and South Carolina to read as follows in the injunction: “all North Carolina counties east of Interstate 77 from Virginia to South Carolina to the Atlantic Ocean . . . [and] all counties in . . . South Carolina east of Interstate I-77 to the Atlantic Ocean that border the state of North Carolina.”212

there is no “substantial relationship” with the other state, or there is no other “reasonable basis for the parties’ choice,” or if applying the chosen law “would be contrary to a fundamental policy” of North Carolina).

207 Id. at *8-9.
208 Id.
211 Id. at *1.
Carolina.”212 Quoting Hartman’s distinction between separability and blue penciling, the Court of Appeals reversed because “the trial court ‘rewrote’ the covenant and granted a preliminary injunction based on this ‘blue-penciled’ version.”213 While obviously accurate, completely absent from the court’s discussion was whether this revised restricted territory was now, in fact, reasonable in scope and effectively protected only the plaintiff’s legitimate business interests from unfair competition.

These same comments about the practical and legal effects of an appropriate blue penciling or reasonable judicial modification rule could be applied to and significantly affect the outcome of cases like Electrical South, Todd, Hartman, Farr, VisionAIR and a host of others. In particular, it could affect those cases where noncompete violations and an employer’s legitimate business interests were clearly at stake, but the covenants not to compete were struck down for some meticulous drafting violation that did not satisfy a specific court. As argued above, the time has come to correct that approach and better address the unique challenges of unfair competition in the modern business world. North Carolina is already behind the blue pencil / judicial modification curve regarding covenants not to compete, but it is never too late to change.

IV. CONCLUSION

It is a fact of economic life that today’s employees are highly mobile, can and do work from anywhere with the proper technology, and often change jobs from one employer to another – whether voluntarily or involuntarily. It is also a fact that Internet-based business activities have no meaningful borders; that the product and service areas of companies frequently change with the speed of cyberspace; that trade secrets and other confidential information can be accessed, downloaded and transported in seconds by employees intent on misappropriation; and that employers regularly entrust their employees with training and exposure to confidential and proprietary information, products, services, methods, processes and customers that the employers developed. Given that this investment ultimately leads to product development, sales and customer relationships which remain the economic lifeblood of most companies, employers should be able to provide that information and customer contact with at least reasonable assurance that they can be protected against unfair

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212 Id. at *2.
213 Id. at *3.
competition if an employee leaves to compete against them.

In the legal landscape of covenants not to compete, certain protections already exist through proper adherence to the five elements reflected in *Triangle Leasing, Kuykendall* and *A.E.P. Indus*. However, applying and interpreting those elements has not kept pace with how modern business is actually conducted, assuming of course that North Carolina truly is open to employers protecting their legitimate business interests in a highly competitive, constantly changing and increasingly mobile world.

This article has proposed four ways that our courts can correct that deficiency, three of which can occur merely by revisiting legal precedent and taking a different direction instead of an entirely new path. The fourth will require a new road of sorts – but the foundation already exists and the direction is being repeatedly tested in case after case before our courts. As discussed throughout this article, the time has come to redeem North Carolina noncompete law from its current course of inconsistent and often contradictory holdings based primarily on highly nuanced interpretations of an agreement’s precise wording. Such an approach leaves employers and employees alike in an unsettled state of restrictive covenant guesswork, and there is no better time than now to correct it.
INTELLECTUAL PROPERTY FAVORITISM: WHO WINS IN THE GLOBALIZED ECONOMY, THE PATENT OR THE TRADE SECRET?

Jacob Mackler†

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ABSTRACT

In constructing a socially beneficial innovative policy a nation need consider a seemingly infinite number of variables. Striking a mutually beneficial bargain between an innovator and society for each intellectual property right is only the beginning of this calculus. At a broader level, the scope and attributes of each right must be carefully balanced and meticulously synergized. Where two rights cannot be used concurrently, the more socially beneficial right should be made incentivized. By taking this proactive approach, a nation can harness the choice of the innovator to ensure certain social objectives are achieved. Today, the choice between two competing alternatives for protecting certain forms of proprietary information is found most often among the patent and trade secret.

In the United States, the public disclosure requirement for patents has enjoyed a constitutionally inspired favoritism when compared to the secrecy inherent to the trade secret. As a sovereign creation, however, the monopolistic rights provided by the patent are restricted through strict territorial boundaries. In the emergence of the globalized economy, such limitations pose a substantial obstacle for firms seeking to protect certain forms of innovation and proprietary information. As an alternative, the trade secret has grown
increasingly attractive. With protection premised on commercial dealings rather than monopolistic rights, the presumption against extraterritorial application does not prevent extending trade secret protection to misappropriation occurring, in-part, abroad.

As recent judicial and legislative developments enhance the extraterritorial protection offered by the trade secret and re-affirm the strict territoriality of the patent, firms continue to transition from the former to the latter at increasing rates. If the United States seeks to preserve the longstanding favoritism enjoyed by the patent it should not merely be agnostic in this choice. Through yielding the strict territorial limitations of the patent right to further cover conduct that occurs, in-part, abroad, the patent can be made more attractive and regain its historic position. Alternatively, should the well-justified principles of territoriality remain, it may be time to accept the trade secret as the tool most appropriately suited to protect certain innovations in the international marketplace.

I. INTRODUCTION

On October 11, 2011, the Federal Circuit affirmed the International Trade Commission’s authority to grant relief for domestic injury based, in part, on trade secret misappropriation in China. In a cautioning dissent, Circuit Judge Moore forewarned that “broadening the scope of trade secret misappropriation to the extraterritorial actions . . . gives additional incentive to inventors to keep their innovation secret . . . [and] denies society the benefits of disclosure stemming from the patent system.” These concerns raise the question of whether the preferential benefit provided through patent laws—encouraging innovation and advancement through wide dissemination of technological innovation—has been placed in jeopardy. More importantly, however, is whether such a transition is a necessary element of commercial evolution in a globalized economy.

This paper considers the careful balance that rests between the patent and the trade secret. Part II considers the underlying rationale that has prevented patent protection from extending abroad along with an explanation of certain exceptions within the statutory framework. Part III sets forth the basics of trade secret law. Highlighted in this section is the lack of harmful effects justifying territoriality in the

2 Id. at 1343 (Moore, J., dissenting).
patent system that are not part of trade secret law. After this, certain federal extraterritorial actions in the trade system regiment are discussed. In Part IV, the balance of the trade secret and patent is discussed, followed by a discussion of their competing nature and the historic favoritism towards the patent. After this brief discussion, this paper will highlight the imbalance that has recently occurred in the system and how the trade secret may be more appropriate to protect extraterritorially. Finally, in Part V, the balance is reconsidered by highlighting the need to either strengthen the patent to reach domestic conduct, or embrace the trade secret.

II. PATENT POLICY AND THE PRESUMPTION AGAINST EXTRATERRITORIAL APPLICATION

Throughout history, the patent has proved a powerful force in incentivizing innovation. Akin to a bargain struck between an inventor and society, the patent promises an inventor exclusive property rights for a time in return for the disclosure of a new and useful invention or discovery, instructions for its use, and eventual donation to the public domain. Containing the characteristics of an agreement, the patent bargain binds only the contracting parties, while protecting non-participants.

These principles are the foundational justification that naturally gives rise to the concept of territoriality that resounds in patent law. Although these boundaries are well-justified, the often fragmented and diverse systems they create stand as diverse obstacles facing the modern commercial enterprise in an otherwise openly globalized and

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4 See generally Frank D. Prager, The Early Growth and Influence of Intellectual Property, 34 J. PAT. OFF. SOC’Y 106, 111 (1952) (originating with prizes granted for production of silk in ancient China and rugs in Persia); Frank D. Prager, Brunelleschi’s Patent, 28 J. PAT. OFF. SOC’Y 109–110 (1946) (noting that Filippo Brunelleschi was granted an exclusive right by Florence in 1421). In 1474 Venice enacted a statute that explicitly granted exclusive rights to the inventor of a machine or process, DONALD S. CHISUM ET AL., PRINCIPLES OF PATENT LAW 11 (2004) (“WE HAVE among us men of great genius, apt to invent and discover ingenious devices; and in view of the grandeur and virtue of our city, more such men come to us every day from diverse parts.”).


7 See infra notes 38–49 and accompanying text (giving a brief synopsis of the underlying principles).
interconnected marketplace. 8 This section outlines the underlying rationale that serves as the continuing justification for these principles of territoriality. Afterwards, a brief introduction will be given on certain exceptions within the patent system.

A. The Essence and Complexity of the Patent

The basic construction of any agreement bespeaks the careful pursuit of each party striving to ensure the benefits they receive outweigh the costs they incur. The patent bargain is no different. For the inventor, the promise of exclusive rights to profit from his invention is often worth the cost of public disclosure.9 With this promise, the innovator is able to prevent others from taking a “free ride” off of the fruits of his labor,10 pursue financing during the costly developmental stages, 11 and obtain commercialization in the marketplace. 12 In return, the inventor pays an etymologically straightforward cost: a promise the invention will be open, exposed, and evident.13 This wide dissemination of the invention’s design and the ‘best mode’ of the invention’s use14 facilitates the exploration and

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11 Mazzoleni & Nelson, supra note 3, at 1040 (“[T]he possession of a patent enables the patent holder to go to capital markets to get development financing.”).

12 See id. (patenting at early developmental stages helps ease financial burdens through commercialization backed by the knowledge that the economic rewards can be appropriated).

13 See Webster’s Third New International Dictionary 1654 (1971) (The patent’s Latin ancestor, patens, the present participle of patere, meant “to be open.”); see also In re Bo Thuresson Af Ekenstam, 256 F.2d 321, 323 (C.C.P.A. 1958) (outlining the etymological history of patent).

creation of follow-up products and derivative inventions.\textsuperscript{15}

Though persuasively straightforward, society’s surrender of exclusive rights carries deep-rooted negative consequences.\textsuperscript{16} The provision of the patent entitles the patentee a mini-monopoly, effectively undermining the competitiveness in the marketplace.\textsuperscript{17} With sole control a market participant is free to determine the supply available as well as the price.\textsuperscript{18} Moreover, with several firms pursuing a single right, the winner-takes-all effect may impose a high overall social cost (the forfeited investment of all losing firms), even where a single firm may prosper.\textsuperscript{19}

Notwithstanding these costs, policymakers can utilize several tools, tailored to meet the unique goals and needs of the state, to mitigate this harm.\textsuperscript{20} First, the duration of the patent need only be long enough to incentivize the innovator, at which point it should be turned over to the public.\textsuperscript{21} Second, the breadth of the patent may be carefully narrowed. Otherwise, a patentee with broad patent rights can exclude from the market a broad range of “functionally equivalent”

the specification to contain a written description of the invention, the manner and process of making and using it, and “the best mode contemplated by the inventor of carrying out his invention.”); 35 U.S.C. § 113 (2006) (detailing the requirement of a drawing “where necessary for the understanding of the subject matter sought to be patented.”).

\textsuperscript{15} Mazzoleni & Nelson, \textit{supra} note 3, at 1042 (“[A]n initial discovery or invention is seen as opening up a whole range of follow-on developments or inventions.”).


\textsuperscript{17} \textit{See} OECD REPORT, \textit{supra} note 10, at 9 (granting the patent holder a monopoly allows them to “set a market price higher than the competitive price and limit the total volume of sales.”).

\textsuperscript{18} \textit{See generally} Richard A. Posner, \textit{The Social Costs of Monopoly and Regulation}, 83 J. POL. ECON. 807, 818 (1975) (noting that firms in industries where regulatory agencies limit entry and price have greater ability to maintain supracompetitive prices than firms in the manufacturing sector where price collusion is prohibited by the Sherman Act).

\textsuperscript{19} \textit{Id.} at 812 (explaining that each of ten firms would spend $100,000 in obtaining a patent if each has an equal chance and is risk-neutral; nevertheless, only one will get the patent and find it profitable, the rest lose all and society on the whole gains nothing).

\textsuperscript{20} OECD REPORT, \textit{supra} note 10, at 10.

\textsuperscript{21} The duration of a patent in the United States is twenty years. 35 U.S.C. § 154(a)(2) (2006) (“[S]uch grant shall be for a term . . . [of] 20 years.”).
inventions. Finally, the subject-matter on which it may be granted can be limited through the requirement that it be novel, useful, and non-obvious. Such a restriction ensures that certain professed innovations, which are “part of the storehouse of knowledge of all men . . . [remain] free to all men and reserved exclusively to none.”

B. Policy in Extraterritorial Application of Patent Law

As a long-standing principle, absent affirmative congressional intent, legislation is presumptively concerned with domestic rather than foreign conditions. The nature of the territorial agreement, crafted to reflect a nation’s unique characteristics, presupposes, and convincingly so, that this principle should apply with particular force in patent law. In this section the well-justified presumption of territoriality is briefly discussed, but first, the evolutionary history of innovative patent policy in the United States is provided for context.

1. The United States Experience

As a fledgling nation, the United States required an innovative patent policy, calculated and responsive to changing goals and needs, rather than one evolving fortuitously through happenstance. After a failed experiment preserving individual state autonomy in patent policy, it became evident a centralized guiding force was necessary, and thereafter Congress was constitutionally charged to “promote the progress of science and the useful arts.” The first step was

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24 See Bilski v. Kappos, 130 S.Ct. 3218, 3225 (2010) (quoting Funk Bros Seed Co. v. Kalo Inoculant Co., 333 U.S. 127, 130 (1948)) (“The concepts covered by these exceptions are ‘part of the storehouse of knowledge of all men . . . free to all men and reserved exclusively to none.’”).
26 See Microsoft Corp. v. AT&T Corp., 550 U.S. 437, 454–55 (2007) (“The presumption that United States law governs domestically but does not rule the world applies with particular force in patent law.”).
27 Ryan Thomas Grace, Losing the Forest Among the Trees in the Festo Saga—Rationalizing the Doctrine of Equivalents and Prosecution History Estoppel in View of the Historical Justifications for Patent Protection, 11 J. INTELL. PROP. L. 275, 292 (2004). James Madison and Charles Pinckney suggested the new Constitution should provide for the patent system to be centralized in the federal government to ensure uniformity. Id. at 293.
adopting an approach that emphasized a utilitarian public interest. Although vigorously different than the “natural rights” embraced by more developed nations at the time, such as England and France, it facilitated the enhancement of domestic industry. This early policy sought to encourage domestic invention and discriminated against foreign inventions and inventors. As a result, foreign innovation facilitated the growth of American businesses, free of burdensome royalties. The overall process generated competitive markets with lower prices for the public.

As the economy and industry matured and American inventors could effectively compete on an international level, discriminatory practices were eased and later abolished. The empowered and industrially capable patent bar encouraged the innovative policy’s initial shift to embracing “natural rights.” Accompanying this shift

29 See Graham v. John Deere Co. of Kan. City, 383 U.S. 1, 9 (1966) (“The patent monopoly was not designed to secure to the inventor his natural right in his discoveries. Rather, it was a reward, an inducement, to bring forth new knowledge.”).

30 See Susan Sell, Intellectual Property and Public Policy in Historical Perspective: Contestation and Settlement, 38 Loy. L. A. L. Rev. 267, 286 (2005) (This process created an “asymmetry between British and American patent laws” that strongly “favored inventors in the developing, follower, economy of the USA, rather than the more industrialized, leading, econom[ies].” (internal citations omitted)).


32 Id. (noting that although an American could not appropriate a foreign patent, the invention could be utilized without licensing or other costs); see also Christopher May & Susan Sell, FORGETTING HISTORY IS NOT AN OPTION! INTELLECTUAL PROPERTY, PUBLIC POLICY AND ECONOMIC DEVELOPMENT IN CONTEXT 13 (2006), available at http://www.dime-eu.org/files/active/0/MaySell.pdf (illustrating how the discriminatory process generated great success in the publishing industry. This sort of piracy led to competitive pricing, where a copy of Charles Dickens’ would cost six cents in America, it would be two dollars and fifty cents in England. Ignoring pleas concerning disincentive of American authorship, Congress sympathized with the publishing houses: “All the riches of English literature are ours. English authorship comes to us free as the vital air . . . Shall we build a dam to obstruct the flow of the rivers of knowledge?”).

33 May & Sell, supra note 32.

34 See Khan, supra note 31, at 12, 22, 23 (Patenting fees in the United States were often ten times less than other countries. Despite fees for Americans at approximately $35, foreigners had to pay anywhere from $300 to $500. The Patent Act of 1861 effectively abolished this discrimination).

35 Morriss & Nard, supra note 16, at 146, 148 (emphasizing the natural rights due an inventor in return for the fruits of their labor was encouraged by the growing influence of the patent bar).
was a more outward looking approach, as explained by the Principal Examiner at the USPTO at the Patent Acts centennial: “Our law . . . recognizes to the fullest extent the international character of property in inventions. In this respect . . . the United States may claim to have led the world and to be leading it still.”

Admittedly a glaring contradiction to historical practices, it set the stage for modern innovative policy in pursuit of an international “system in which states would recognize and protect the rights of foreign inventors and artists within states’ own domestic borders.”

2. Sovereignty, Autonomy and Discretion

With many developing countries now in circumstances similar to the nineteenth century United States, the American experience sheds a revealing light on the debate surrounding patent reform initiatives and “the appropriate patent law institutions for developing economies.”

Unquestionably, the level of economic progress and the cultural and political atmosphere each nation should consider in constructing an innovative policy varies considerably. The relative availability and importance of human capital needs to be determined. Equally important is each nation’s respective level of “economic development and comparative advantages in innovation and imitation.”

Moreover, the peculiar emphasis placed on the rights and needs of inventors, competitors, and the public, must be added to the equation.

From these, the state must harness its strengths and address its weaknesses to craft an effective, innovative policy. Clearly, considering the infinite economical, political, cultural, and social variables, there is no one-size-fits-all approach. Nevertheless, carefully accounting for each is paramount, as designing institutions to implement the innovated policy and apportion the appropriate level of incentives and opportunities can be a key determinant of the wealth or poverty of nations.

36 KHan, supra note 31, at 23 (quoting F.A. Seely, Principal Examiner, United State Patent and Trademark Office).
37 May & Sell, supra note 32, at 15.
38 Morriss & Nard, supra note 16, at 144.
39 See, e.g., id. at 184–85 (explaining that an increased investment in widespread free education “played a key role in fostering technological change” and providing a source of human capital).
40 May & Sell, supra note 32, at 22.
41 See id. at 25.
42 See generally Khan, supra note 31, at 47.
43 See May & Sell, supra note 32, at 22.
44 See id. at 23.
Depending on these circumstances, the relative strength of a patent system appropriate for the nation can be determined. Large, open, and accessible markets, vast human capital, and advanced economies are the attributes of developed nations that advocate far-reaching patent systems that offer long-term protection. Countries with smaller economies that lack the human capital and an industrial atmosphere needed to make efficient use of a patent system may have no incentive to implement such a system whatsoever. Historical evidence demonstrates that influencing these latter nations with the policies of the former simply does not foster development more rapidly.

More importantly, encroaching on the sensitive policy choices necessary to craft an efficient system can have far-reaching consequences, especially for developing nations. Imposing strong patent rights into these countries, either through influencing policy considerations or requiring acknowledgment of foreign rights, can undermine their economic growth, innovative capacity, and block indigenous company development.

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46 See id.


C. Extraterritoriality in US Patent Law

As demonstrated above, the autonomy and discretion necessary in developing a patent system legitimizes the emphasis placed upon territoriality in patent laws. These principles have profoundly influenced judicial interpretation for well over a century. Nevertheless, statutory exceptions were developed to protect a domestic patent holder from conduct that occurs in-part abroad. Two of these provisions that have received recent attention are: (1) infringement for supplying components abroad for later assembly under Section 271(f) and (2) infringement for an offer to sell under Section 271(a).

1. Infringement Under Section 271(f) for Supplying Components Abroad

In 1984, Congress amended the Patent Act, adding paragraph (f) to Section 271, creating liability as an infringer for supplying abroad “all or a substantial portion of the components of a patented invention,” for later assembly. However, it was still unclear whether the statute would encompass intangible ‘components.’ In 2005, the Federal Circuit answered this question, finding that “every component of every form of invention deserves the protection of Section 271(f).” Despite this guidance, those who believed this contravened the presumption against extraterritorial application pushed for legislative action. However, the Supreme Court intervened in 1997 in Microsoft Corp. v. AT & T Corp. Though the Court found master

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50 See Brown v. Duchesne, 60 U.S. 183, 187 (1856) (noting, “each nation is the proper judge of its own policy,” in patent laws).


52 Eolas Techs. Inc. v. Microsoft Corp., 399 F.3d 1325, 1339 (Fed. Cir. 2005). In this case the court found that Section 271(f)’s protection of “components” included software code that had been incorporated on a master disk and sent abroad for further incorporation. Id. at 1341. Not only was this a necessary component of the invention, but a “key part” without which the invention would not work at all. Id. at 1339. From a policy standpoint, the same treatment is required under TRIPS to be given to all forms of invention “without discrimination as to the place of invention and the field of technology.” Id. (quoting Agreement on Trade-Related Aspects of Intellectual Property Rights Part II, Section 5, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS 320 (1999), 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994)).


54 Microsoft Corp. v. AT & T Corp., 550 U.S. 437 (2007).
disks containing patented material sent abroad and installed onto computers non-infringing, the Court rested its conclusion on the fact that the defendant had not ‘supplied’ the installed copies.\(^{55}\)

Unfortunately, the Court expressed no opinion on whether intangible components of a method or process fell within the purview of the statute, only that if the method or process was intangible, the combination of its components may be intangible as well.\(^{56}\) However, the Court indicated “that the territorial limit of patents should not be lightly breached.”\(^ {57}\) The Federal Circuit drew upon these principles in *Cardiac Pacemakers, Inc. v. St. Jude Medical, Inc.*,\(^ {58}\) when it considered whether the apparatus utilized to perform the method could properly be considered a component or a ‘step’ in the process.\(^ {59}\) Relying on precedent,\(^ {60}\) common meaning in language,\(^ {61}\) and comparison to Section 271(c),\(^ {62}\) the court concluded that while the method steps were components, the apparatus used in practicing it was not.\(^ {63}\) After finding the word “supplied” required the provision of a physical object, the court noted the intangible steps could not be supplied abroad.\(^ {64}\) Since the apparatus was not a ‘component’ of the process, Section 271(f) simply could not apply to method or process patents.\(^ {65}\)

2. *Offers to Sell Infringement Under Section 271(a)*

Historically, the Patent Act only recognized making, using, or

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\(^{55}\) *Id.* at 453. Thus, “[u]nder a conventional reading of § 271(f)’s text . . . the foreign-made copies of Windows actually installed on the computers were ‘supplied[ ]’ from places outside of the United States.” *Id.* at 452.

\(^{56}\) *Id.* at 452 n.13.


\(^{58}\) *Id.* at 1362.

\(^{59}\) *Id.*

\(^{60}\) *Id.* at 1363.

\(^{61}\) *Id.* ("Component" is defined as “a constituent part,” “element,” or “ingredient.”) (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 466 (1981)).

\(^{62}\) *Id.* at 1363–64 (noting that in Section 271(c) there is a clear contrast between a component of a physical machine, manufacture, or composition, and the apparatus used to practice it in the process). Such a finding is a clear indication that Congress intended the component to be distinct from the apparatus used to practice it. *Id.*

\(^{63}\) *Id.* at 1362.

\(^{64}\) *Id.* at 1364. (noting that the ordinary meaning of ‘supply’ is to “provide that which is required,” or “to furnish with . . . supplies, provisions, or equipment.”) (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 2297 (1981)).

\(^{65}\) *Id.*
sells a patented invention as infringing activities. In 1996, to comply with minimum standards under the TRIPS agreement, infringement for an “offer to sell” was added to the list within Section 271(a). Although the new language could potentially sweep a broad range of conduct as infringement, Congress provided little guidance as to exactly what conduct was covered. In 1999, the question reached the Southern District of Texas as to whether it was sufficient to only have a domestic “offer,” even where the sale was contemplated abroad. Answering in the negative, the court concluded that the new language only provided for an earlier stage of liability, and the act of infringement must be contemplated domestically. In reaching this conclusion, the court relied on the presumption against extraterritorial application of patent law and the competitive disadvantage that would befall American businesses.

Shortly thereafter, the Federal Circuit was presented with the same question in Rotec Industries, Inc. v. Mitsubishi Corp. The court found that the plaintiff’s inability to establish that an “offer to sell” occurred domestically was dispositive, which implicitly suggests that a foreign-anticipated sale would be sufficient. Recognizing this

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66 See 35 U.S.C. § 271 (2006); 35 U.S.C. § 154 (2006); see also, e.g., Schiff v. Hammond Clock Co., 69 F.2d 742 (7th Cir. 1934) (noting infringement on patentee’s right to make, use, or sell); Bloomer v. Gilpin, 3 F. Cas. 726, 729 (C.C.S.D. Ohio 1859) (finding infringement from merely making the machine, even though it was not used or sold); Ketchum Harvester Co. v. Johnson Harvester Co., 8 F. 586, 587 (C.C.N.D.N.Y. 1881) (finding manufacture within the United States to be infringement even where the ultimate sale occurred abroad); Beedle v. Bennett, 122 U.S. 71, 78 (1887) (finding a well constructed in such a way that each time “water is drawn from it the patented process is necessarily used”).

67 See Rotec Indus., Inc. v. Mitsubishi Corp., 215 F.3d 1246, 1251 (Fed. Cir. 2000) (noting new amendment to Section § 271(a) provided for infringement for “whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States ” (emphasis added)).

68 Id. at 1252; see also 35 U.S.C. § 271(i) (“As used in this section, an ‘offer for sale’ or an ‘offer to sell’ by a person other than the patentee, or any designee of the patentee, is that in which the sale will occur before the expiration of the term of the patent.”).


70 Id. (noting an offer to sell, made from the United States, for a foreign sale would not fall under the earlier stage of infringing activity as the contemplated sale itself was not infringement).

71 See id. at 625 (“A reading that requires only that an offer be within the United States . . . may be an impermissible expansion of the territorial scope of U.S. patent laws . . . [and] place a burden on American businesses that would not exist for foreign competitors . . . .” (internal citations omitted)).

72 Rotec, 215 F.3d 1246, 1255.

73 Id. at 1255–57.
uncertainty, Circuit Judge Pauline Newman criticized the approach taken and believed the conclusion should have been based upon “the straightforward ground that there is no issue of infringement under § 271(a) because, as is undisputed, no offer for sale was made whereby the sale itself could infringe the United States patent.”

Lower courts quickly accepted that a domestic offer could be infringing activity, regardless of a foreign sale. In rationalizing their findings, the courts relied on several principles. First, the requirement that the sale itself needs to be infringing would render the “offer to sell” language superfluous. Such a reading left the “offer to sell” language meaning little more than it had previously—a result Congress clearly must not have intended. Second, finding alternatively would do little to bring the United States in sync with international standards, a goal of the “offer to sell” language. Despite these findings, once the Microsoft Court re-emphasized territoriality in patent law, a shift occurred, requiring contemplation of the ultimate sale to be within the United States.

In 2010, the Federal Circuit in Transocean Offshore Deepwater Drilling, Inc. v. Maersk Contractors USA, Inc. stepped in to pick up where it had left off a decade before. The facts before the court were essentially the opposite of those in Rotec: a contract for constructing an allegedly infringing oil rig for delivery and operation in the U.S.

74 Id. at 1258 (Newman, J., concurring).
75 See Wesley Jessen Corp. v. Bausch & Lomb, Inc., 256 F. Supp. 2d 228, 233 (D. Del. 2003) (concluding as sufficient an “offer” made in the United States). Likewise, the ultimate sale need not be intended to occur within the territorial limits of the United States. Id. at 233–34; see also CLS Bank Int’l v. Alice Corp. Pty. Ltd., 667 F. Supp. 2d 29, 38 n.6 (D.D.C. 2009) (“An ‘offer to sell’ within the United States is an independent infringing act and does not require a further infringing act; i.e. an actual sale within the United States, to be actionable.”) (citation omitted); SEB, S.A. v. Montgomery Ward & Co., 412 F. Supp. 2d 336, 341 (S.D.N.Y. 2006) (finding sufficient evidence of infringement even though offer had been made within the United States for a sale to occur abroad).
76 Bausch & Lomb, 256 F. Supp. 2d at 234.
77 Id.
78 Id.
79 See Wing Shing Prods. (BVI), Ltd. v. Simatelex Manufactory Co., 479 F. Supp. 2d 388, 407 (S.D.N.Y. 2007) (finding it necessary for the sale contemplated by the offer be intended to occur in the United States, and if not, dismissal is appropriate); see also Semiconductor Energy Lab. Co. v. Chi Mei Optoelectronics Corp., 531 F. Supp. 2d 1084, 1111 (N.D. Cal. 2007) (“An ‘offer of sale’ may constitute direct infringement only if the contemplated sale is to take place within the United States.”).
80 Transocean Offshore Deepwater Drilling, Inc. v. Maersk Contractors USA, Inc., 617 F.3d 1296 (Fed. Cir. 2010).
Gulf of Mexico had been entered into abroad. Finding it conclusive that the contracting had occurred abroad, the trial court granted summary judgment of non-infringement. The Federal Circuit reversed and ruled that, “[i]n order for an offer to sell to constitute infringement, the offer must be to sell a patented invention within the United States.” After acknowledging it was mindful of the presumption against extraterritoriality, the court noted it would “exalt form over substance” to allow a domestic company to avoid liability for infringement by merely traveling abroad to make offers to sell products back into the country.

III. INTRODUCTION TO TRADE SECRETS

Rather than disclose an invention in return for a patent, an innovator may opt to keep it a secret. Throughout history these “trade secrets” have been an important tool in protecting commercial proprietary information. As a result, the law protects valuable proprietary information if reasonable efforts have been incurred to maintain secrecy. This section briefly introduces the trade secret and

81 Id. at 1307. In Transocean, Maersk, Inc., a Danish company contracted to have an oil rig built in Singapore and subsequently delivered to the U.S. Gulf of Mexico for operation that arguably infringed a patent owned by Transocean. Id. The contract noted the Transocean patents and reserved the right to modify the rig if subsequent court decisions prompted action. Id. (noting that Maersk had contracted to modify the rig before its delivery into the U.S. “in view of court or administrative determinations throughout the world.”). One such case occurred, and Maersk had a casing sleeve installed on the rig to comply with an injunction issued against a different defendant that required the installation of a casing sleeve. Id. (citing Transocean Offshore Deepwater Drilling, Inc. v. GlobalSantaFe Corp., No. H-03-2910, 2006 WL 3813778 (S.D. Tex. Dec. 27, 2006)). At a later date, Maersk, Inc., contracted with Statoil Gulf of Mexico LLC to have the rig operated in the U.S. Gulf of Mexico. Id.

82 Id. at 1307. The court noted the focus should be on the “location of the future sale that would occur pursuant to the offer” rather than the location of the offer itself. Id. at 1309.

83 Id. at 1309.

84 Id.

85 See Robert M. Sherwood, Trade Secret Protection: Help for a Treacherous Journey, 48 WASHBURN L.J. 67, 68–69 (2008) (noting the trade secret provided a valuable tool for commercial enterprises and were commonly used in medieval guilds and the Pakistani rug-making communities); A. Arthur Schiller, Trade Secrets and the Roman Law; The Actio Servi Corrupti, 30 COLUM. L. REV. 837, 838 (1930) (dating the origins to ancient Rome to provide a remedy in actio servi corrupti, for the corruption of a slave, when a competitor influencing another’s slave to divulge business secrets).

86 More specifically, the trade secret is “any information that can be used in the operation of a business . . . that is sufficiently valuable and secret to afford an actual continued . . .
the policies that it is used to promote. In doing so, context is provided for the broader extraterritorial extension as a result of its absence of monopolistic characteristics. After this groundwork is provided, certain examples of its extraterritorial application are given.

A. Trade Secret Basics

Unlike the patent right, the secret can continue indefinitely, as long as reasonable efforts are undertaken to keep it confidential.\(^87\) Once the secrecy is lost, the proprietary information it covered enters the public domain as a matter of law.\(^88\) While in operation, however, it can provide certain benefits. Employers can feel confident in hiring further employees understanding the safety of valuable information.\(^89\) Additionally, the rights bestowed allow contractual commercialization,\(^90\) and promote commercial integrity and fair dealing among market participants.\(^91\) Finally, although the rights gained are not as expansive as under the patent, the promise of some protection can entice innovation.\(^92\)

or potential economic advantage over others.’’ \textit{Restatement (Third) of Unfair Competition} § 39 (1995).

\(^87\) \textit{See}, \textit{e.g.}, ConAgra, Inc. v. Tyson Foods, Inc., 30 S.W.3d 725, 729 (Ark. 2000) (looking at extent of measures taken to guard the secrecy); Elm City Cheese Co., v. Federico, 752 A.2d 1037, 1050 (Conn. 1999) (questioning whether reasonable efforts were undertaken is a ‘highly fact-specific inquiry’ and what may be sufficient in one case may not be in another); Allied Supply Co., v. Brown, 585 So. 2d 33, 36 (Ala. 1991) (finding no reasonable efforts where company lists were not market confidential to at least ten employees, and such lists were kept in duplicate and taken home).

\(^88\) \textit{See} Underwater Storage, Inc. v. U.S. Rubber Co., 371 F.2d 950, 954 (D.C. Cir. 1966) (“The nature of a trade secret is such that, so long as it remains a secret, it is valuable property to its possessor who can exploit it commercially to his own advantage. Once the secret is published to the ‘whole world,’ however, it loses its protected status and becomes available to others for use and copying without fear of legal reprisal from the original possessor.”).

\(^89\) \textit{See} Wexler v. Greenberg, 160 A.2d 430, 435 (Pa. 1960) (“[M]odern economic growth and development has pushed the business venture beyond the size of the one-man firm, forcing the businessman to a much greater degree to entrust confidential business information relating to technological development to appropriate employees.”).

\(^90\) \textit{See generally} Aronson v. Quick Point Pencil Co., 440 U.S. 257, 262 (1979) (“Permitting inventors to make enforceable agreements licensing the use of their inventions in return for royalties provides an additional incentive to invention.”).

\(^91\) \textit{See} Kewanee Oil Co. v. Bicron Corp. 416 U.S. 470, 492–94 (1974) (discussing benefits of promoting sharing of knowledge and industry efficiency through protecting inventor to realize rewards of labor through contracting with a company able to develop and exploit it, as well as encouraging standards of commercial ethics).

\(^92\) \textit{Id.}
The price society pays for the ongoing existence of the trade secret is self-evident. Coupled with the indefinite duration it allows, the secrecy removes any public benefit that would be provided through disclosure. Although the trade secret also receives criticism on restricting mobility in employment, this is often counterbalanced through the employer confidence it creates. Providing significant value otherwise, the trade secret on the whole is a valuable instrument for protecting proprietary information. In recent years, as firms strategize beyond traditional boundaries, this value has continued to increase.

B. Extraterritorial Extension of Trade Secrets

Absent the monopolistic, exclusive rights inherent in the patent, protection offered through a trade secret is more appropriately extended beyond domestic territories. This characteristic, absent in much of patent law, has become appealing to many modern businesses. Below are two instances in which relief can be sought through federal remedies: (1) the Economic Espionage Act, and (2) a complaint through the International Trade Commission.

1. Economic Espionage Act

At the end of the Cold War, government spies had penetrated the private sector, posing a threat to individual businesses and the

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93 See id. at 496 (Douglas, J., dissenting) (criticizing as potentially unconstitutional the genuine inventor being afforded under federal law fourteen to seventeen years of protection, while states allowing perpetual protection articles that were lacking in novelty to receive patentability).


95 See Wexler v. Greenberg, 160 A.2d 430, 434 (Pa. 1960) (acknowledging the competing policies of “the right of a businessman to be protected against unfair competition stemming from the usurpation of his trade secrets and the right of an individual to the unhampered pursuit of the occupations and livelihoods for which he is best suited.”).

96 Id. at 435.


98 Although outside the scope of this article, options are available for a party to bring an action in state court against a foreign defendant if jurisdiction can be attained.
American economy. The absence of any comprehensive federal remedy intensified this danger. Congress responded in 1996 by enacting the Economic Espionage Act. Today, with the value of investment in proprietary information skyrocketing, and increasing use of digitally stored data, the business atmosphere is exposed to substantially greater risk. With an overwhelming portion of the economy reliant upon this intangible value, the danger of misappropriation places individual businesses at risk and threatens the economic strength of the nation.

The intricacies of the Economic Espionage Act are relatively straightforward. Coverage is broken into two different categories of misappropriation. “Economic espionage” requires the intended beneficiary be a “foreign government . . . instrumentality, or . . . agent.” Although this section requires the mental component of knowledge attached to the conduct, it attaches not only to actual theft, but also attempting or conspiring to do so. The Act also

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99 See United States v. Hsu, 155 F.3d 189, 194 (3d Cir. 1998) (In 1996 “studies revealed that nearly $24 billion of corporate intellectual property was being stolen each year.”).

100 Id. at 195.

101 See OFFICE OF THE NATIONAL COUNTERINTELLIGENCE EXECUTIVE, FOREIGN SPIES STEALING U.S. ECONOMIC SECRETS IN CYBERSPACE, REPORT TO CONGRESS ON FOREIGN ECONOMIC COLLECTION AND INDUSTRIAL ESPIONAGE, 2009-2011 4 (2011) [hereinafter CYBER ESPIONAGE REPORT]. For 2008, corporate and government spending on research and development was nearly $400 billion. Id. at 4.

102 See id. at i (“Cyber tools have enhanced the economic espionage threat, and the Intelligence Community (IC) judges the use of such tools is already a larger threat than more traditional espionage methods.”). The increasing use of computers and economic reliance on technology has presented new obstacles that electronic surveillance authorities need overcome. Mark D. Young, Electronic Surveillance in an Era of Modern Technology and Evolving Threats to National Security, 22 STAN. L. & POL’Y REV. 11, 12–13 (2011).

103 See CYBER ESPIONAGE REPORT, supra note 101, at 4 (stating that the wide variety of variables and methods used in calculating losses range widely and are effectively meaningless, rendering values that range from $2 billion to $400 billion.).


107 Id.


109 18 U.S.C. § 1831(a)(4)–(5). These cover not only actual theft, but also instances where the party copies without authorization, including downloading, mailing or destroying, as well as merely receiving, knowing it had been obtained without authorization. Id. at § 1831(a)(1)–(3).
criminalizes “theft of trade secrets” and attaches to “misappropriation of trade secrets for the economic benefit of anyone other than the true owner.” Although such conduct is not limited solely to governmental beneficiaries, three other prosecutorial limitations are in place: (1) an intended economic benefit, (2) knowing the conduct will injure the owner, and (3) information “related to or included in a product produced for or placed in interstate or foreign commerce.”

Rather than burdensome territorial restrictions, the Act is intended to extend abroad.

Though it has a broad reach, the Act does not provide a private right of action. Recently, however, there has been Congressional movement that might provide such an extension as well as more expansive penalties. The Economic Espionage Penalty Enhancement Act of 2011 was introduced to increase the penalties available against offenders. More importantly, however, an amendment to the Currency Exchange Rate Oversight Reform Act would provide “companies the ability to go to federal court to stop misappropriation of trade secrets and allow[] them to seek compensation for losses due to economic espionage.”

2. International Trade Commission

The International Trade Commission has broad authority to prohibit general unfair acts and importation of infringing articles as

111 See id. (quoting 18 U.S.C. § 1832(a)).
112 See 18 U.S.C. § 1837 (2006) (extending jurisdiction abroad when (1) the offender is an American resident or citizen, organization, or political subdivision; or (2) “an act in furtherance of the offense was committed in the United States.”).
115 Press Release, Sen. Herb Kohl, Kohl Offers Amendment to Protect American Businesses (Oct. 5, 2011), available at http://kohl.senate.gov/newsroom/pressrelease.cfm?customel_dataPageID_1464=4775; see also S.A. 729, 112th Cong., 157 CONG. REC. S622930 (daily ed. Oct. 5, 2011) (submitted by Sen. Coons) (providing for federal jurisdiction under Section § 1832(a) of the EEA if the party specifies the “reasonable measures taken to protect the secrecy of the alleged trade secrets in dispute; and include a sworn representation by the party asserting the claim that the dispute involves either substantial need for nationwide service of process or misappropriation of trade secrets from the United States to another country.”).
unlawful activities. Proceedings before the Commission have historically been related to blocking the importation of patent infringing products. In a recent case before the Federal Circuit, *TianRui Group Co. Ltd. v. Int'l Trade Comm'n*, the court affirmed that misappropriation of trade secrets fell under the broader “unfair methods of competition and unfair acts in . . . importation” language even if occurring abroad. In *TianRui*, a domestic company brought a complaint against a foreign manufacturer for importation of a product manufactured through a misappropriated trade secret. Despite an appeal to the presumption against extraterritoriality, the Commission found the foreign manufacturer liable.

On appeal, the Federal Circuit affirmed the extension of authority to reach the misappropriation that occurred in China. Dismissing the presumption against extraterritoriality as non-dispositive and rebuttable, the court offered three reasons for its extension. First, the statute was expressly aimed at imports, an inherently international transaction that demonstrated Congress had more than just “domestic concerns in mind.” Second, the extraterritorial conduct was merely an “element of a claim alleging a domestic injury and seeking a wholly domestic remedy” and thus was not purely extraterritorial. Third, Congress carefully chose to prohibit “unfair methods of competition”...


119 Id. at 1329.

120 Id. The ALJ also addressed TianRui’s argument that the domestic industry requirement had not been met. Id. at 1326. The court noted that even though the domestic industry was not using the proprietary process, the injury could still occur. Id. Current use is not necessary as long as the domestic industry of the owner of the proprietary rights would be substantially injured. Id.

121 Id. at 1329.

122 Id. (quoting Pasquantino v. United States, 544 U.S. 349, 371–72 (2005)).

123 Id. The majority contended that this was a domestic element on the cause of action that the dissent overlooked. Id. at 1330. Rather, the dissent had focused the case as including entirely foreign conduct. Id. at 1330.
which demonstrates the ITC’s permissive consideration of conduct that occurs abroad.\textsuperscript{124}

In conclusion, the court emphasized that such a reading of Section 337 was not inconsistent with the narrow construction on extraterritorial jurisdiction in patent law, a realm covered by a federal statutory scheme not present in the circumstances.\textsuperscript{125} Rather, the Commission had broad authority under Section 337 to prohibit the importation of articles through unfair methods of competition and unfair acts that threaten to substantially injure a domestic industry.\textsuperscript{126} The court then added that this has been applied for a considerable time to grant authority for the misappropriation of trade secrets.\textsuperscript{127}

\textbf{IV. The Balance of Intellectual Property Rights}

Achieving an efficient intellectual property legal framework requires a carefully crafted innovative policy at both the micro (the individual rights themselves) and macro (the rights collectively) level. At the micro level, the peculiar benefits and costs require balancing to construct a mutually beneficial bargain between society and the innovator.\textsuperscript{128} At the macro level, the conflicting and complementary nature of each right should be appropriately aligned and synergized.\textsuperscript{129} Nevertheless, under certain circumstances when different intellectual property protections cannot be utilized concurrently, which is often the case between the patent and trade secret, the balance of each must be considered to ensure the most socially beneficial method remains the most preferential.

\textbf{A. Introducing the Relationship between the Patent and Trade Secret}

From the arsenal of intellectual property protections, only the patent and the trade secret protect information. When this information is patentable, although exceptions exist, an innovator must choose

\textsuperscript{124} \textit{Id.} at 1330–31 (emphasis added). For a discussion of the legislative history of the Act, see \textit{id.} at 1330–31.
\textsuperscript{125} \textit{Id.} at 1333. The court specifically noted that the geographical limitations that had been acknowledged under patent law were not present under trade secret law. \textit{Id.}
\textsuperscript{126} \textit{Id.}
\textsuperscript{127} See \textit{id.} at 1335.
\textsuperscript{128} See supra Part II(A) and III(A).
\textsuperscript{129} Karl F. Jorda, \textit{Patent and Trade Secret Complementariness: An Unsuspected Synergy}, 48 WASHBURN L.J. 1, 13 (2008). Although one intellectual property species can operate as the central, more important tool, other rights can be used to create supplementary value. \textit{Id.}
whether to: (1) maintain it as trade secret, (2) seek a patent, (3) or allow the technology to enter the public domain.\textsuperscript{130} Under these circumstances, the choice is mutually exclusive—an inventor simply cannot utilize the patent and trade secret concurrently.\textsuperscript{131} The disclosure required to obtain a patent removes the protections offered by a trade secret as a matter of law.\textsuperscript{132} The result would be the same even where an application has been made and ultimately denied.\textsuperscript{133}

In the circumstances where patent and trade secret protection are incompatible, a state should complement the option that is the most socially beneficial. These adjustments should be continually undertaken, and a state should take a proactive approach to ensuring the social and economic objectives of the preferred method are furthered. The state should not merely be “agnostic” to a company’s choice of intellectual property protection.\textsuperscript{134} As discussed more fully below, a shift is underway that has made the trade secret appear an attractive alternative to the patent, not only commercially, but as a means of imposing less undue harm on foreign states.

**B. Historic Patent Favoritism**

The innovative policy in the United States has traditionally viewed the social benefits of patent disclosure preferable to the secrecy


\textsuperscript{131} See infra notes 132–35 and accompanying text (explaining the circumstances that render the trade secret and patent mutually exclusive). However, in certain situations the trade secret and patent are complementary. See infra note 166 and accompanying text.

\textsuperscript{132} See Glaxo, Inc. v. Novopharm, Ltd., 52 F.3d 1043, 1050 (Fed. Cir. 1995) (noting the best mode requirement prevents an applicant from receiving a patent while concealing a more preferential form); In re Remington Arms Co., 952 F.2d 1029, 1033 (8th Cir. 1991) (“[O]nce the information . . . is released, the trade secret is lost forever . . . .”); Religious Tech. Ctr. v. Netcom On-Line Commc’n Servs., 923 F. Supp. 1231, 1254 (N.D. Cal. 1995) (“The unprotected disclosure of a trade secret will cause the information to forfeit its trade secret status . . . .”).

\textsuperscript{133} See 35 U.S.C. § 122 (2006) (“[A] patent [application] shall be published, in accordance with procedures determined by the Director, promptly after the expiration of a period of 18 months from the earliest filing date for which a benefit is sought under this title.”).

inherent in the trade secret. The Constitution expressly encourages the use of limited, but exclusive, protection to “promote the progress of science and the useful arts.” No such prompt is given for the trade secret. In fact, some would argue it undermines this objective.

The Supreme Court has addressed this issue and hinted that a trade secret system which threatened the attractiveness of the patent system could present such a risk:

![Inventions] which the owner believes to meet the standards of patentability . . . are ‘the things which are worth to the public the embarrassment of an exclusive patent.’ The interest of the public is that the bargain of 17 years of exclusive use in return for disclosure be accepted. If a State, through a system of [trade secret] protection, were to cause a substantial risk that holders of patentable inventions would not seek patents, but rather would rely on the state protection, we would be compelled to hold that such a system could not constitutionally continue to exist.

Although the Court concluded the risk absent in that case, it stands as a clear signal that if forced to choose, it would be the trade secret left out in the cold.

C. A Change in Tides: Trade Secrets Gain Momentum

Although the historical preference may have been to encourage the innovator to disclose their innovation through a patent, recent trends suggest a change. As Circuit Judge Moore cautioned in TianRui,

135 See, e.g., Kendall v. Winsor, 62 U.S. 322, 328 (1858) (“[T]he inventor who designedly, and with the view of applying it indefinitely and exclusively for his own profit, withholds his invention from the public, comes not within the policy or objects of the Constitution or acts of Congress. He does not promote, and, if aided in his design, would impede, the progress of science and the useful arts.”); Brown v. Campbell, 41 App. D.C. 499, 502 (D.C. Cir. 1914) (“Where an invention is made and hidden away, it might as well never have been made at all,-at least so far as the public is concerned.”).
137 See Mason v. Hepburn, 13 App. D.C. 86, 94 (D.C. Cir. 1898) (noting that persons who “indefinitely and exclusively for his own profit, withholds his invention from the public, comes not within the policy or objects of the Constitution or acts of Congress . . . [and] would impede the progress of science and the useful arts.”).
139 Id. (explaining that “[i]n the case of trade secret law no reasonable risk of deterrence from patent application by those who can reasonably expect to be granted patents exists.”).
“broadening the scope of trade secret misappropriation to the extraterritorial actions . . . gives additional incentive to inventors to keep their innovation secret . . . [and] denies society the benefits of disclosure stemming from the patent system.”  

With a choice between two equally effective protections, an innovator would no doubt choose the option not requiring disclosure of the fruits of his labor. In the following sections, evidence is presented as to the growing attractiveness of the trade secret as compared to the patent.

**Sample Situation:** Altering the facts of *TianRui* ever so slightly, when TianRui acquired the trade secrets, instead of improperly acquiring the secrets from employees of a foreign licensee, it was through contacting an employee within the United States and enticing him to program the methodology of railway wheel production into a computer and sending it abroad. Although the domestic company was actively producing the wheels in the domestic market, thereafter through their joint efforts, the foreign company would manufacture the product and the U.S. employee will solicit foreign orders for foreign delivery, never having the products touch domestic soil.

1. **The Case of the Trade Secret**

   If a complaint is filed with the FBI and suit is brought under the Economic Espionage Act, the conduct of both the employee and the foreign company can be reached. The employee would fall under the Act for intending to steal, appropriate or fraudulently obtain the information. \(^{141}\) Since the employee, in misappropriating the method relating to the railway wheels currently in commerce, sought an economic benefit, knowing full well it would injure the domestic owner, the prerequisites for liability are met. \(^{142}\) As a result, the employee could face up to ten years in prison and a monetary fine. \(^{143}\) Moreover, the foreign company, having clearly satisfied all the same elements, could face substantial monetary penalties of up to five million dollars. \(^{144}\) Although a civil remedy is currently unavailable, this Act would be a powerful tool that would increase companies’

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\(^{140}\) TianRui Group Co. v. Int’l Trade Comm’n, 661 F.3d 1322, 1343 (Fed. Cir. 2011).


\(^{143}\) 18 U.S.C. § 1832(a).

\(^{144}\) 18 U.S.C. § 1832(b) (“Any organization that commits any offense . . . shall be fined not more than $5,000,000.”).
protection of intellectual property through the trade secret.\textsuperscript{145}

2. \textit{Supplying Components Abroad}

If the method had been patented in the example above, then merely coding the method into a non-patented computer and shipping it abroad for later utilization would not give rise to liability. It is evident that the conduct of the foreign company would be beyond reach.\textsuperscript{146} Moreover, the conduct of the employee, although wholly domestic, would not fall under the Patent Act. As interpreted in \textit{Cardiac Pacemakers}, the statute was intended to only cover physical components, not the intangible steps to a method or process.\textsuperscript{147} Since the method contained only intangible steps and was incorporated into a non-patented apparatus, the physical properties of which did not constitute a step in the method, no physical components were supplied abroad in violation of the statute.\textsuperscript{148}

3. \textit{The Case of the Offer to Sell under Section 271(a)}

Similarly, the conduct of manufacturing and selling the railway wheels abroad would not expose either the domestic employee or the foreign company to liability under Section 271(a) infringement for an “offer to sell.” The recent case, \textit{Ion v. Sercel}, demonstrates the inability for both instances of conduct to be reached through the Patent Act.\textsuperscript{149} In that case, a defendant sought to have lost profits damages removed that arose from sales from its French company to foreign buyers.\textsuperscript{150} Although it was clear that the offers to the foreign buyers had been made from the headquarters in the United States, the court relied on the \textit{Transocean} rule to find that the ultimate sale need be within the United States, and thus the plaintiff was not entitled to damages.\textsuperscript{151}

\textsuperscript{145} See 18 U.S.C. § 1832.
\textsuperscript{147} \textit{Cardiac Pacemakers, Inc. v. St. Jude Med., Inc.}, 576 F.3d 1348,1364 (Fed. Cir. 2009).
\textsuperscript{148} See \textit{id.} (finding intangible steps not within physical language “supplied” for purposes of Section 271(f)).
\textsuperscript{149} \textit{Ion, Inc. v. Sercel, Inc.}, No. 5:06-CV-236-DF. 2010 WL 3768110 at *1, *4 (E.D. Tex. Sept. 16 2010) (“Thus, unlike \textit{Transocean}, where the Court answered the question regarding foreign offers for domestic sales, the question here is whether domestic offers for foreign sales fall within the scope of U.S. patent protection.”).
\textsuperscript{150} \textit{Id.} at *1.
\textsuperscript{151} \textit{Id.} at *4.
In 1997, Donald S. Chisum predicted that “the increasing interdependence of the global economy and the growing concern over the cost of multinational intellectual property rights procurement and enforcement—will make territorialism an unacceptable obstacle to international trade.” The continued clinging to unwavering principles of territorialism in patent law, even where the conduct itself is within the territories of the United States, has proved such an unacceptable obstacle for many firms. As a result, this calls into question whether the patent law requires strengthening, or alternatively, whether the ongoing preference needs to give way to the trade secret.

A. The Battlefield

The world has changed dramatically since the original Patent Act of 1790. Today, a firm that fails to adopt a strategic plan designed to capture international benefits and guard against foreign risks is not only incomplete, but often doomed to fail. Although the patent has provided a valuable tool domestically to facilitate a strategy of competitiveness, once the patent has been disclosed in the domestic markets it can be captured and used abroad diminishing the profitability the domestic firm can attain in the foreign market. What is even more troubling is the actions that diminish these opportunities can be undertaken by a domestic firm without recourse.

B. Option One: Extend Protection

Applying the presumption against extraterritorial application of patent laws in the interpretation of two provisions that were specifically designed to reach conduct that occurred in part abroad appears self-contradictory. Nevertheless, extending domestic patent

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153 Cf. Luigi Bonatti, Complementary Research Strategies, First-Mover Advantage and the Inefficiency of Patents 1 (Universita’ Degli Studi Di Trento – Department di Economia, Discussion Paper No. 17, 2007) available at http://eprints.biblio.unitn.it/archive/00001306/01/17_07_bonatti.pdf (explaining that in knowledge intensive industries, secrecy can play an important role to sustaining first mover advantage, as the “knowledge incorporated in production processes and products is difficult to imitate.”).

laws abroad to protect a domestic patent can cause substantial harm to foreign economies and social interests.\textsuperscript{155} Adhering to these principles, it would thus be necessary that in extending protection, it should only reach the conduct that occurs domestically.\textsuperscript{156} This would preserve the important principles, as noted in \textit{TianRui}, of avoiding the “unintended clashes between our laws and those of other nations which could result in international discord . . . and ‘preserv[es] a stable background against which Congress can legislate with predictable effects.’”\textsuperscript{157} Moreover, it shifts the inquiry from focusing on the foreign conduct in its entirety, to being “merely a predicate” to the charge of the domestic conduct at issue.\textsuperscript{158} As a result, any extension of the patent right would need be limited solely to covering the precise conduct solely by a domestic defendant.

A common argument against such an application is to draw upon the ability of the domestic patent holder to acquire a patent abroad. This argument, and its acceptance, poses substantial threats (especially to smaller businesses) as the procurement and enforcement of foreign patents can be exceedingly expensive.\textsuperscript{159} Moreover, many foreign markets do not offer patent protection for many of the products that are domestically patentable.\textsuperscript{160} This would pose a substantial hurdle for defending medical methods, biotechnology and software code.\textsuperscript{161}

As acknowledged by the Supreme Court in \textit{Deepsouth}, imposing liability for conduct places in contention “the right of American companies to compete with an American patent holder in foreign markets.”\textsuperscript{162} Admittedly, such an argument carries substantial merit.

\textsuperscript{155} See supra notes 38–49 and accompanying text (detailing the necessity for discretion in developing a patent system that is unique to the cultural and economic needs of the country).

\textsuperscript{156} Admittedly, the stifling of domestic conduct would also carry secondary consequences through the prevention of the products entering the market. Nevertheless, this harm would be the lesser of two evils when compared to the alternative of extending the reach abroad.


\textsuperscript{158} Id. at 1330.

\textsuperscript{159} One of the inquiries looked at the costs that small businesses endured when seeking to enter a foreign market to receive a patent. \textit{IP SMALL BUSINESS REPORT, supra} note 8, at 9. The study found that these costs, which potentially could be larger than $300,000 for entering four major foreign markets, posed substantial barriers to small businesses in protecting their patent rights abroad. \textit{Id.}


\textsuperscript{161} See \textit{id.} at 964.

\textsuperscript{162} Deepsouth Packing Co. v. The Laitram Corp., 406 U.S. 518, 531 (1972).
In reference to reaching liability under Section 271(f), a common arrangement was for U.S. companies to send abroad instructions, materials, and other knowledge intensive procedures to foreign locations for manufacturing.\(^{163}\) If Section 271(f) is interpreted in such a way, it could create potential liability for companies exporting abroad what are arguably steps to a process, even where foreign competitors are not exposed to such risks.\(^{164}\) Although such concerns carry force, the fact remains that the domestic companies’ ability to draw upon public information to gain a market advantage appears to create disincentive to disclose through the patent system. Under the circumstances above, noting the limited inquiry to “wholly domestic conduct” and the limited harm that would befall the autonomy of foreign states, such an extension seems appropriate.\(^{165}\) Nevertheless, it would be necessary to accept the prominent role of trade secrets in filling these gaps, as it would be inappropriate to diminish their protection.

C. Option Two: Trade Secret Importance

Regardless of whether patent rights are strengthened to include the conduct implicated, undermining the protections of the trade secret would not be an appropriate mechanism to bolster the patent deficiencies. It is evident the trade secret remains an important aspect of business enterprise, and undermining its reach would create substantial consequences. As noted by Professor Mark Lemley, without trade secret law, firms would be required to engage in additional measures to keep certain proprietary information secretive, and more secrecy would be the result, rather than less.\(^{166}\) Under many circumstances, the patent and the trade secret are not conflicting and at times can be used complementarily.\(^{167}\) In these instances, the trade

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163 See Chisum, supra note 152, at 606.

164 Id. at 607. The potential harm that could befall American industries from the products then being imported back into the United States was remedied through the addition of Section 271(g), prohibiting products produced through a patented process to be imported into the United States. See also, e.g., Gemtron Corp. v. Saint-Gobain Corp., 572 F.3d 1371, 1380 (2009) (infringing apparatus manufactured abroad and imported into the United States, even though manufactured abroad, was infringing).


167 See Jorda supra note 129, at 1 (“Patents and trade secrets are not incompatible but dovetail: the former can protect patentable inventions, and the latter, the volumes of important, if not essential, collateral know-how associated with such inventions.”). In fact, Professor Jorda would argue “[i]t is unnecessary and shortsighted to choose one over the other.” Id. at 19.
secret is utilized to protect subject matter that is not patent eligible. In others, certain corollary information or follow-up products to patents require the immediacy that trade secrets provide. Where the position between the patent and the trade secret is viewed in conflict, it has been consistently viewed as subordinate to the complements each bestows on the other. More importantly, diminishing the protections offered through trade secrets will cause harm not merely to the ability of firms to protect themselves, but cause financial and economic consequences. Intangible assets, and the research and development of proprietary information are a substantial portion of company assets. Considering that intellectual property and intangible assets derive a significant value from the rights they possess in excluding others and enforcement, diminishing the enforcement and protection afforded the trade secret could render substantial harm to the balance sheets of firms. From a broader perspective, the trade secret does not carry many of the implications the patent does on extending extraterritorially. Although imposing monopolistic patent rights into another country can have far reaching implications, protecting trade secrets is merely part of ensuring commercial integrity, absent these oft-cited anti-patent consequences.

VI. CONCLUSION

Undeniably, the rights of domestic patentees are constantly in danger from conduct that occurs abroad. Where trade secrets provide a better alternative for protection, the USPTO may see a diminishing application pool as inventors choose to protect the fruits of their labor

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168 See Kewanee Oil Co. v. Bicron Corp. 416 U.S. 470, 485 (“Trade secret law will encourage invention in areas where patent law does not reach, and will prompt the independent innovator to proceed with the discovery and exploitation of his invention.”).

169 See Jorda, supra note 129, at 19 (“Any associated or collateral know-how not required to be disclosed in a patent application can and should be retained as a trade secret.”) (emphasis added).

170 For example, the historical coexistence of the patent and trade secret has been acknowledge by the Supreme Court, where it was emphasized that each tool is an important part of innovative policy and “the operation of one does not take away from the need for the other.” Kewanee Oil, 416 U.S. at 493. Circuit Judge Posner recognized the important position the trade secret maintained in preserving the competitive edge in American industry and for offering an attractive substitute for circumstances in which the patent lacked perfection. Rockwell Graphic Sys., v. DEV Indus., 925 F.2d 174, 180 (7th Cir. 1991).

171 See IP SMALL BUSINESS REPORT, supra note 8, at 32.
through secrecy rather than trade disclosure for exclusive rights. Essentially, a secret can easily be kept from the world, but a patent can only be protected from the country in which it is granted. Without a move towards making the patent a more attractive option, the policy objectives it seeks to promote will be largely undermined. In this light, either the patent needs an instant strengthening, or the trade secret needs to be embraced as the new favorite intellectual property right for information.
“SOLE” SEARCHING: CHRISTIAN LOUBOUTIN’S FIGHT AGAINST YVES SAINT LAURENT—AND THE AESTHETIC FUNCTIONALITY DOCTRINE—TO OWN THE COLOR RED

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The fashion industry relies on color as an indispensible medium in all aspects of design. The question now brewing is simply: can a color itself be protected under the Lanham Act when used within the fashion context? On August 10, 2011, the U.S. District Court for the Southern District of New York held that trademark laws cannot protect a single color within the fashion context because such protections would unduly hinder competition. The District Court relied on the aesthetic functionality doctrine, finding that the color red is ornamental and aesthetic; thus, not a protectable trademark. Christian Louboutin, the world-renowned designer of women’s high-end footwear, is searching for a different answer. Louboutin sued fellow high-end fashion powerhouse Yves Saint Laurent for trademark infringement after Laurent released a line of shoes featuring red outsoles—a signature feature of Louboutin’s shoes. Louboutin has appealed to the U.S. Court of Appeals for the Second Circuit, arguing its lacquered, bright red outsoles are worthy of trademark protection. Louboutin argued that the famous red outsole is a protectable trademark because the color serves the purpose of brand recognition—therefore, a secondary meaning has attached to the use of color.

Regardless of the ultimate holding, the Second Circuit’s ruling will have serious implications on the fashion industry as well as trademark jurisprudence. If affirmed, the trademarked use of color, such as Tiffany’s robin egg blue, will no longer be protected. The fashion industry’s branding efforts will be heavily impacted, as “copycat” replications may legally take place without recourse for the designers. Such a ruling will also drive a sharp wedge in the trademark legal landscape between the fashion industry and other industries—single color use will be unprotected in fashion, yet allowable in other industries. In addition, if affirmed, the Second Circuit will create a unique precedent that finds the higher costs associated with producing a red outsole is in fact a hindrance to competition. This concept goes against the common sense ideal that high costs are normally associated with an economic disadvantage because more money is required to produce a more complicated and intricate mark. As glamorous as the fashion industry may be, the pending litigation between Louboutin and Yves Saint Laurent reminds spectators that the fashion industry is about more than making women beautiful—it is about making money and protecting business interests.
I. INTRODUCTION TO THE MAIN EVENT

A battle is taking place between two French couture fashion houses, but the setting is neither the runways of Paris nor the pages of *Vogue*—it is the courtroom. Christian Louboutin (“Louboutin”), the high-end women’s shoe designer known for its stilettos with the signature, lacquered, bright red outsoles, sued fellow high-fashion heavyweight, Yves Saint Laurent (“YSL”), over YSL’s use of red outsoles in its Cruise 2011 collection.1 Louboutin has owned the U.S. Trademark Registration2 for the use of red outsoles on its footwear since 2008 and demanded YSL stop the sale of its red outsole shoes immediately.3 However, YSL refuses to give up without a fight.

Upon YSL’s refusal to pull its allegedly infringing shoes from the market, Louboutin filed its lawsuit against YSL in April 2011, claiming trademark infringement and unfair competition.4 Louboutin also filed a motion for preliminary injunction to prevent further sales of the YSL shoes.5 A trademark is a word, phrase, symbol or design, or a combination of words, phrases, symbols or designs, that identifies and distinguishes the source of the goods of one party from those of others.6 The essential function of a trademark is to exclusively identify the commercial source or origin of products or services, such that the trademark indicates source or serves as a badge of origin.7 Thus, certain exclusive rights attach to a registered mark,8 which can then be enforced through an action for trademark infringement.9

In denying Louboutin’s request for injunction on August 10, 2011,10 the United States District Court for the Southern District of New York broadly held that no single color could serve as a trademark on an item of fashion because it would unduly hinder competition.11 Specifically, the court relied upon the aesthetic functionality doctrine, opining that the color red, as used on the allegedly infringing YSL products, “serves ornamental and aesthetic functions vital to robust

2 RED SOLE MARK, Registration No. 3,361,597.
3 Complaint and Jury Demand, supra note 1, at 24-25.
4 Id. at 1.
5 Id. at 2.
6 BLACK’S LAW DICTIONARY 1631 (9th ed. 2009).
7 Id.
11 Id. at 454.
competition” in the fashion industry. The district court concluded that, “Louboutin is unlikely to be able to prove that its red outsole brand is entitled to trademark protection, even if it has gained enough public recognition in the market to have acquired secondary meaning.”

The lower court not only declined to grant Louboutin’s motion to bar YSL from producing its red shoes, but it also appeared “ready to cancel Louboutin’s trademark registration outright” in the same proceeding. Judge Marrero, the U.S. District Court judge who presided over the case, felt “[t]he better course is to simply allow the appeal to proceed and halt any further proceedings till we get guidance” from the New York-based federal circuit court. Wasting no time, Louboutin immediately appealed to the U.S. Court of Appeals for the Second Circuit to stay the lower court proceedings. Louboutin submitted its appellate brief to the Second Circuit Court of Appeals shortly thereafter on October 17, 2011. On appeal, Louboutin will contend that the district court’s denial of Louboutin’s injunction largely rested upon the seldom-used doctrine of aesthetic functionality.

The district court stated:

Color alone ‘sometimes’ may be protectable as a trademark, ‘where that color has attained secondary meaning and therefore identifies and distinguishes a particular brand’ . . . [but not] where it is ‘functional,’ meaning that color is essential to the use or purpose of the product, or affects the cost or quality of the product.

The district court not only held that the color red by itself is not a protectable trademark, but also singled out the fashion industry. The

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12 Id. at 449.
13 Id.
17 See Brief for Appellants, Louboutin, 778 F. Supp. 2d 445 (No. 11 Civ. 2381).
18 Id. at 21.
court reasoned that, “for Lanham Act purposes . . . in fashion markets color serves not solely to identify sponsorship or source, but . . . primarily to advance expressive, ornamental and aesthetic purposes.” Thus, the court reasoned that with respect to fashion, the color red falls under the aesthetic functionality doctrine and is rendered without trademark protection.

The Second Circuit’s ruling in Louboutin will have serious implications on the fashion industry and trademark jurisprudence. For example, if the Second Circuit affirms the lower court’s decision, Louboutin’s red sole registration will likely be cancelled. Also, if affirmed, other designers will have a more limited capacity to register or enforce rights on the use of single colors. This thought strikes fear into the heart of a company like jeweler Tiffany’s, who uses a signature color of robin’s egg blue. Simply put, some of fashion’s signature colors—Valentino red, Hermés orange and Tiffany blue—are likely to be compromised if the lower court’s broad ban on a single color trademark is upheld on appeal. As such, certain fashion houses are following the Louboutin case with a particular interest, hoping that this area of law is not disturbed by such a broad new rule of restriction upon single color trademarks.

Because many of the issues on appeal revolve around whether the district court erred in its findings and conclusions of law, the majority of issues on appeal will be reviewed de novo, with no weight given to

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20 Id. at 451.
21 Brief for Tiffany LLC et al. as Amici Curiae Supporting Appellants at 2, Louboutin, 778 F. Supp. 2d 445 (S.D.N.Y. Oct. 24, 2011) (No. 11 Civ. 2381); see id. at 4 (advocating that the “functionality” defense should only be applied after likelihood of confusion analysis is completed, and such confusion is present in this case).
22 RED VALENTINO, Registration No. 3,767,661.
23 COLOGNE HERMÉS EAU D’ORANGE VERTE, Registration No. 3,792,480.
24 In addition to a trademark for its blue box with white ribbon, Tiffany (NJ) LLC owns three U.S. Trademark and Service Mark Registrations for the robin’s egg blue color per se; see Registration No. 2,359,351 (blue on boxes), Registration No. 2,416,795 (blue on shopping bags), and Registration No. 2,416,794 (blue on cover of catalogs).
the lower court’s decision. This note focuses on the impact and implications of the impending ruling by the Second Circuit. Specifically, this note analyzes the effect of the prospective ruling on the application of the functionality defense, including the importance of factors such as aesthetics and production costs.

First, if the Second Circuit affirms the lower court’s ruling, the fashion industry will certainly feel the consequences through its branding efforts. If affirmed, no designer in the fashion industry will be able to have a protectable trademarked color on the grounds that it indicates source, because it will be deemed “functional” and therefore unprotectable. Thus, replication of Valentino’s signature red and Tiffany’s blue boxes will be allowable. In addition, the Second Circuit would create an unprecedented rule that fashion industry consumers—as opposed to other industry consumers—are sophisticated enough to distinguish between similar marks. Such “sophistication” comes from an assumption that luxury goods’ high price points render high-end fashion consumers well researched. However, if reversed, the Second Circuit will fall in line with precedent that holds that aesthetically appealing and desirable marks can still serve as an indicator of source, thus warranting protection under the Lanham Act.

Second, if the lower court’s decision is affirmed, the Second Circuit will be one of the few courts which actually finds that a higher cost of production hinders competition because a trademarked color, like Louboutin’s Chinese Red, makes the final creation more exclusive and costly. If reversed, however, the Second Circuit will make the statement that a higher cost of production yields a non-functional and protectable trademark since such a mark is more complicated and more expensive to produce, thus giving an economic advantage to competitors to produce other goods.

II. LOUBOUTIN LOSES ROUND 1: THE DISTRICT COURT’S REFUSAL TO PROTECT RED SOLES

Before bringing the action against YSL, Louboutin began coloring the glossy red outsoles of its shoes in 1992 to give the line “energy,” and because red—the color of passion—is “sexy.” YSL argued,

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27 See Cnty. of Nassau v. Leavitt, 524 F.3d 408, 414 (2d Cir. 2008) (quoting D.D. ex rel. V.D. v. N.Y. City Bd. of Educ., 465 F.3d 503, 510 (2d Cir. 2006)).
28 Cain, supra note 25.
however, that despite having a trademark on the red outsole, Louboutin was simply copying the red outsole trend that dates back to the days of King Louis XIV.\textsuperscript{31} Even Dorothy’s ruby slippers in \textit{The Wizard of Oz} featured red outsoles.\textsuperscript{32} YSL further argued that it had been producing red outsoles occasionally in its collections dating back to the 1970s, to achieve its “monochromatic” signature look.\textsuperscript{33} After YSL refused to remove its red-soled shoes in its Cruise 2011 collection from the market, Louboutin looked to the U.S. District Court for the Southern District of New York for relief. The claims Louboutin brought included trademark infringement as well as a motion for preliminary injunction to stop YSL’s production of the allegedly infringing shoes.\textsuperscript{34} YSL, in turn, counterclaimed and asked the court to cancel Louboutin’s red sole mark because it was (1) not distinctive, (2) ornamental, (3) functional, and (4) was secured by fraud.\textsuperscript{35} YSL also sued for damages, alleging both tortious interference with business relations and unfair competition.\textsuperscript{36}

\textbf{A. The District Court’s Summary and Application of the Law}

In speaking for the court, District Judge Victor Marrero framed the issue at hand as whether, despite Louboutin’s acknowledged innovation and broad association of the high-fashion outsole with Louboutin as its source, trademark protection should have been granted to Louboutin’s registration.\textsuperscript{37} The court acknowledged at the outset of the opinion that “the law, like the marketplace, applauds innovators” by protecting ingenuity through patents and trademark registration and penalizing unfair competition.\textsuperscript{38} The court then moved into addressing Louboutin’s trademark infringement and unfair competition claims under the Lanham Act. In order for Louboutin to succeed on these claims, it was required to show (1) the red sole mark merits protection, \textit{and} (2) YSL’s use of the same or sufficiently similar mark is likely to cause consumer confusion as to the origin of sponsorship of YSL’s shoes.\textsuperscript{39} The court, however, never reached the second question at issue since it determined the red sole mark did not merit protection.

In finding the first prong of the infringement analysis was not met,
the court first highlighted the language of the Lanham Act, which outlines when a trademark registration is permitted.\textsuperscript{40} Next, the court noted that under 15 U.S.C. § 1057(b) of the Lanham Act, Louboutin’s registration of its mark triggers the statutory presumption that the mark is valid. However, the presumption is rebuttable.\textsuperscript{41} Focusing specifically on color as a trademark, the court stated the landscape of the law currently held that color is protectable as a trademark sometimes if the color alone has attained secondary meaning, and therefore identifies and distinguishes a particular brand, thus indicating its “source.”\textsuperscript{42} However, a color is not protectable if it is functional, meaning the color is essential to use or purpose of the product, or affects the cost or quality of the product.\textsuperscript{43} In quoting the Restatement (Third) of Unfair Competition, the court defined “functional” in this context to be an “aesthetic value” which is able to confer a significant benefit that cannot practically be duplicated by the use of alternative designs.\textsuperscript{44}

While the district court ultimately found Louboutin’s red did not merit protection, it acknowledged that industrial products with a single color—such as green-gold pads used for dry cleaning presses and pink fibrous glass insulation—were able to be trademarked.\textsuperscript{45} The court reasoned that because industrial standards require uniform composition of these goods, the color of such industrial materials simply changes an article’s external appearance in order to distinguish one source from another.\textsuperscript{46}

In setting the tone of the opinion, the court quickly distinguished such industrial products from items within the fashion industry. The court stated that because fashion industry products are not limited by uniform industry standards like the pink insulation, and instead are based on creativity, taste and seasonal changes, color in the fashion industry cannot be a protectable trademark.\textsuperscript{47} To support this point,

\textsuperscript{40} Id. ("The “Lanham Act permits the registration of “trademark” which it defines as ‘any word, name, symbol, or device, or any combination thereof … [,] which a person has a bona fide intention to use in commerce and applies to register . . . , to identify and distinguish his or her goods . . . from those manufactured and sold by others and to indicate the source of the goods.").

\textsuperscript{41} Louboutin, 778 F. Supp. 2d at 450.

\textsuperscript{42} Id.

\textsuperscript{43} Id. (citing Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 163 (1995)).

\textsuperscript{44} Id. (citing Qualitex, 514 U.S. at 170 (1995) (quoting Restatement (Third) of Unfair Competition § 17 cmt. C (1993))).

\textsuperscript{45} Id. (referencing Qualitex, 514 U.S. at 166 and In re Owens-Corning Fiberglas Corp., 774 F.2d 1116, 1123 (Fed. Cir. 1985)).

\textsuperscript{46} Louboutin, 778 F. Supp. 2d at 450-451.

\textsuperscript{47} Id. at 451.
the court reasoned that color is unprotectable namely because it does not serve the acceptable secondary meaning of distinguishing a brand, but instead is *functional*, used primarily to advance “expressive, ornamental and aesthetic purposes.”

Quick to distinguish the color issue at bar from other judicially-held enforceable trademarks, such as Louis Vuitton’s monogrammed pattern and Burberry’s signature plaid, the court signaled that this case is about a *single* color. It is not a “uniquely identifiable mark embedded in goods,” that identifies a product’s origin. Thus, the *single* color does not meet the secondary meaning test warranting trademark protection under the Lanham Act.

**B. The District Court’s Reasoning: The Monet and Picasso Hypothetical**

In perhaps the most controversial portion of the opinion, the court then outlined its reasoning why a single color does not warrant trademark protection under the Lanham Act through a “fanciful” hypothetical of an “imagined case” where Picasso sues Monet for Monet’s use of a distinctive shade of indigo, Picasso’s signature aesthetic. The court compared painting to fashion design, pointing out that both “stem from related creative stock,” both are devoted to appealing to aesthetics, both strive to please patrons with goods that serve commercial and ornamental purposes, and both are simply all about taste.

Noting another similarity, the court pointed out that both the painting hypothetical and the real world fashion industry rely on palettes subject to seasonal change, and such palettes depend on color as an “indispensable medium.” The court concluded its analysis of the Picasso/Monet hypothetical by suggesting color thus performs “a creative function” in its aim to please or be useful, and does not “identify and advertise a commercial source,” a characteristic which would warrant trademark protection.

The court then shifted the focus of its analysis to unfair

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50 *Id.*

51 *Id.* at 451-52.

52 *Louboutin*, 778 F. Supp. 2d at 452.

53 *Id.*

54 *Id.*
competition, finding that Louboutin may not have a monopoly on the color red because painters like Monet and Picasso, and the fashion industry as a whole, need artistic freedom to promote fair competition.\textsuperscript{55} Specifically, the court opined that, “[t]he law should not countenance restraints that would interfere with creativity and stifle competition by one designer, while granting another a monopoly invested with the right to exclude use of an ornamental or functional medium necessary for freest and most productive artistic expression by all engaged in same enterprise.”\textsuperscript{56}

Bolstering the idea that single color trademark in the fashion industry promotes unfair competition, the court then directly addressed the question of whether color is \textit{functional}, relying greatly in part on the aesthetic functionality doctrine. The functionality doctrine, as applied by the court, “forbids the use of a product’s feature as a trademark where doing so will put a competitor at a significant disadvantage because the feature is ‘essential to use or purpose of article’ or ‘affects [its] cost or quality.’”\textsuperscript{57}

To support the idea that color in the fashion industry is functional and thus not protectable under the Lanham Act, the court relied on case law from the previously distinguished industrial context.\textsuperscript{58} Through reliance on industrial case law, the court opined that aesthetic appeal can be functional because society values products for their looks.\textsuperscript{59} In applying this concept, the court focused on the fact that Louboutin himself acknowledged nontrademark functions for choosing red for his outsoles.\textsuperscript{60} Because Louboutin chose red to give the shoes “energy” and sexiness, and because the “pedestrian” outsole becomes an object of beauty through red lacquered decoration, the court held nontrademark functions of color in fashion are present and trademark protection is unwarranted.\textsuperscript{61}

Also, the court found the red outsole affected the cost of the shoe.\textsuperscript{62} Although a higher cost of production is associated with the red outsole, the red is desirable because it makes the final creation that

\textsuperscript{55} Id.
\textsuperscript{56} Id. at 453.
\textsuperscript{57} Id. (quoting Qualitex Co. v. Jacobson Prods. Co., 514 U.S. 159, 169 (1995)).
\textsuperscript{58} Id. Black was functional for a marine outboard engine. Brunswick Corp. v. British Seagull Ltd., 35 F.3d 1527, 1533 (Fed. Cir. 1994). Green was functional for farm equipment because farmers “prefer to match their loaders to their tractor.” Deere & Co. v. Farmhand, Inc., 560 F. Supp. 85, 98 (S.D. Iowa 1982).
\textsuperscript{59} Louboutin, 788 F. Supp. 2d at 453 (citing Eco Mfg. LLC v. Honeywell Int’l Inc., 357 F.3d 649, 653 (7th Cir. 2003)).
\textsuperscript{60} Id.
\textsuperscript{61} Id. at 453-54.
\textsuperscript{62} Id. at 454.
much more exclusive and costly, an opportunity which competitors would be deprived of if the red outsole was protected by trademark.63

As applied here, the court found that YSL was seeking to create a monochromatic color scheme with its challenged shoes. 64 If Louboutin’s claim were to succeed, then YSL and other designers would be prohibited from achieving such design and stylistic goals.65 The court also feared that a “slippery slope” could occur with a limitation on the color red to only one party because designers of other articles, such as gloves, bags and dresses, could stake claims on other colors.66 Because the fashion industry is “ground[ed] on the creative elements,” and “dependent on colors” which change with the season, the court found such monopoly unworkable.67 Thus, the court held that the claim to the color red is “without some limitation overly broad and inconsistent with the scheme of trademark registration established by the Lanham Act.”68

Lastly, the court dismissed Louboutin’s argument that it only wished to protect the mark of a specific shade of red—“Chinese Red” as listed on its registration69—and not the reference to the color red in the general sense, thereby leaving other shades of red available to competitors.70 The court found protecting Louboutin’s mark based on the specific shade depicted in its trademark registration did not provide adequate guidance as to what specific shade was actually applied to the shoe due to “varying absorption and reflection qualities of materials on which color could be applied.”71 Therefore, the court found it would actually be granting protection over a range of hues, a move that is outside the scope of the Lanham Act.72 The court similarly found no reason for validating the mark on grounds that Louboutin’s red is a lacquered red and not just a flat red, because this would cause a court to “pass judgment” on the “degree of buffing a competitor may give to a Chinese Red outsole before it begins to infringe on Louboutin’s rights.”73 Because the lower court

63 Id.
64 Id.
65 Id.
66 Id.69 at 457.
67 Id.
68 Id.
69 Id. at 455 n.5. “Chinese Red” is part of the Pantone Textile color system, a system that assists designers in selecting and specifying color to be used in manufacture of textiles and apparel, as Pantone No. 18-1663 TP. Id. at 455.
70 Id.
71 Id.
72 Id. at 455-56.
73 Id. at 456.
could not agree that the Lanham Act served as a source of protection for such a “broad spectrum” mark, it found Louboutin could not establish a likelihood that it would succeed on its trademark infringement and unfair competition claims; therefore, no injunctive relief was granted on those claims.\textsuperscript{74}

III. REVIEWING THE FIGHT: WILL THE SECOND CIRCUIT FIND THE LOWER COURT MADE THE RIGHT CALL?

Louboutin wasted no time in appealing the lower court’s decision because of the significant ramifications within the fashion industry should the Second Circuit adopt the rule that color alone is an unprotectable trademark. In fact, because of the pressing nature of the Second Circuit’s decision, oral arguments were heard in January 2012.\textsuperscript{75} Whether the lower court’s holding is affirmed or denied, the Second Circuit’s decision will shape trademark law within the fashion industry. The appellate decision will undoubtedly affect the application of the aesthetic functionality defense in future cases. Specifically, the court’s holding will likely implicate the factors of the defense, such as branding efforts by designers and how courts are to measure the cost of production for fashion industry goods when faced with a trademark infringement case for alleged use of a protected color.

A. Aesthetic Appeal and the Functionality Doctrine

1. Branding Implications and Effect on Precedent

First, the Second Circuit’s ruling will likely affect fashion designer’s branding and marketing efforts. If the Second Circuit affirms the lower court’s decision, then it will be setting the precedent that a single color is inherently functional and therefore never protectable as a trademark. Because everything in the fashion industry from shapes to colors to fabrics can be framed as having origins in “aesthetics,” designers will be unable to claim that a colorful mark is actually an indication of source and thus protectable.\textsuperscript{76} Therefore, if

\textsuperscript{74} \textit{Id.} at 457.


\textsuperscript{76} Indeed, this is the exact argument YSL reiterated throughout its original Brief in Opposition to Louboutin’s Motion for Preliminary Injunction (“in the fashion industry, color is inherently functional because essence of fashion is few elements — only color, texture and material give life to design concept.”). Defendants’ Memorandum in Opposition to Motion for Preliminary Injunction at 12, Christian 

\textit{continued} . . .
affirmed, companies like Tiffany’s run the risk of having their single
colored trademarks invalidated by courts despite the fact the
trademarks were registered with the U.S. Patent and Trademark Office
(“USPTO”). Much like Louboutin’s registered “Chinese Red,”
Tiffany’s robin’s egg blue could be held to be an unprotectable
trademark by courts based on the Second Circuit’s precedent, should
they affirm the lower court.

Essentially, if the court affirms, designers in the fashion industry
will be facing an uphill battle if arguing their trademarked color is
protectable because it allows customers to identify the source of the
good. Such a precedent would reshape branding and marketing within
the fashion industry. Fashion brands could no longer trademark a
specific color to signify origin or brand. Instead, competitors would
be allowed to employ Chinese Red on stiletto outsoles and robin’s egg
blue on gift packaging, thus shifting the focus on trademark law within
the fashion industry from protecting creativity and ingenuity to a new
stronger focus on promoting competition.

If the Second Circuit reverses, however, the court’s holding will
more closely fall in line with an array of precedent in the trademark
law landscape, which holds that aesthetically appealing marks may
still serve as an indicator of source and thus invoke trademark
protection under the Lanham Act. Specifically, if reversed, the
Second Circuit will reaffirm the common sense argument that an
infinite number of colors exist for other’s use as to not hinder
competition, a notion previously stated by the U.S. Supreme Court, a
binding authority upon the Second Circuit.

In the Supreme Court case Qualitex Co. v. Jacobson Products Co.,
the plaintiff Qualitex used green-gold color for pads which it sold to
dry cleaners to use in dry cleaning presses. The defendant Jacobson
was a competitor of Qualitex and began selling its own pads, which
utilized a similar color to those used by Qualitex. Because Qualitex
had registered the color of its pads with the USPTO, it sued Jacobson
for trademark infringement. The district court found for Qualitex, but
the Ninth Circuit set aside the judgment, finding that a color alone
could not be registered as a trademark. The Supreme Court in a
unanimous decision by Justice Breyer, overturned the Ninth Circuit’s
decision, holding that the Lanham Act was very broad in its definition of "trademark." Specifically, the Court stated that, "when a color serves as a mark, normally alternative colors will likely be available for similar use by others." Therefore, the Qualitex Court refused to believe the law accepted a "blanket prohibition" on a color as a trademark. Further, the Court made clear that, "if a shape, a sound, and a fragrance can act as symbols why, one might ask, can a color not do the same?" In fact, the U.S. Supreme Court in Qualitex reversed the Ninth Circuit’s prohibition on "color alone" as a trademark, explaining that "customers may come to treat a particular color on a product . . . as signifying a brand," and therefore to act as a mark.

Therefore, if the Second Circuit affirms the lower court’s “blanket prohibition” on a single color as a trademark, it would be carving out a niche for the fashion industry for which the U.S. Supreme Court has not previously created. Because the Qualitex Court reasoned there was little worry of customer confusion because a single color may act as a protected trademark to signify a brand, the lower court’s reasoning is unlikely to be upheld on appeal. Also, if affirmed, the court would be making a sharp distinction between the fashion industry and all other industries in terms of a trademark’s effect on a company’s branding efforts. Essentially, the court would be suggesting that desirability of a product renders it unprotectable, a notion strictly prohibited by the Fifth, Seventh, and Ninth Circuits, and—to some extent—the Second Circuit itself.

The Fifth Circuit has previously held that school colors on apparel were not functional, and thus protectable under the Lanham Act. In Board of Supervisors for Louisiana State University v. Smack Apparel Co., four universities and their licensing agent brought action against a manufacturer of sportswear, alleging trademark infringement when the manufacturer sold t-shirts with the schools’ color schemes, logos and designs. The manufacturer argued the universities’ colors performed

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82 Id. at 162.
83 Id. at 168.
84 Id.
85 Id. at 162.
86 Id. at 163.
87 Id. at 166.
90 Id. at 471-72 (noting each university had a two-color scheme as its school colors—purple/gold for Louisiana State University, crimson/creme for University of
functions unrelated to trademark, specifically through student life programs where the colors were not used solely to identify the universities as a source of the goods.\textsuperscript{91} The Fifth Circuit disagreed, however, finding that the universities’ colors “when used on merchandise create[] secondary meaning tending to identify the Universities in the minds of consumers as the producers, sponsors, or endorsers of the product.”\textsuperscript{92}

Relying upon \textit{Qualitex}, the Fifth Circuit found the only “alleged competitive disadvantage” in selling game day gear with the protected colors “relates solely to an inability to take advantage of the Universities’ reputation,” and “[t]his is not an advantage to which it is entitled under the rubric of legitimate competition.”\textsuperscript{93} Perhaps most applicable to Louboutin’s plight, the Fifth Circuit also held that because “a trademark is desirable does not . . . render it unprotectable.”\textsuperscript{94}

Similarly, the Ninth Circuit rejected the argument that use of Volkswagen and Audi trademarks on key chains and related items was aesthetically functional because trademarks themselves were “the actual benefit that the consumer wishes to purchase.”\textsuperscript{95} In addressing the competition hindrance aspect of color trademarking, the Ninth Circuit found that if “a competitor could adopt the distinctive Mercedes circle and tri-point star or the well-known golden arches of McDonalds, all under the rubric of aesthetic functionality,” simply because a consumer likes a trademark or finds it aesthetically pleasing, then this would lead to the “death knell for trademark protection.”\textsuperscript{96}

Likewise, the Seventh Circuit, through the opinion of Judge Richard Posner, has spoken explicitly on the functionality doctrine and aesthetic appeal’s effects, holding “the fact that a design feature is attractive does not, to repeat, preclude its being trademarked.”\textsuperscript{97} Thus, the Seventh Circuit has found that if an item is aesthetically pleasing, it does not undermine its validity as a trademark, because “an infinity of [colors and patterns] would remain open to competitors”\textsuperscript{98}.

\begin{table}
\begin{tabular}{|c|c|}
\hline
Oklahoma, scarlet/gray for Ohio State University, and cardinal/gold for University of Southern California). \textsuperscript{91} & \textit{Id.} at 486. \\
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\textsuperscript{91} \textit{Id.} at 486. \\
\textsuperscript{92} \textit{Id.} \\
\textsuperscript{93} \textit{Id.} at 488. \\
\textsuperscript{94} \textit{Id.} \\
\textsuperscript{95} Au-Tomotive Gold, Inc. v. Volkswagen of Am., Inc., 457 F.3d 1062, 1064 (9th Cir. 2006). \\
\textsuperscript{96} \textit{Id.} \\
\textsuperscript{97} W.T. Rogers Co. v. Keene, 778 F.2d 334, 343 (7th Cir. 1985). \\
\textsuperscript{98} \textit{Id.}
the narrow defense of functionality, Judge Posner warned that if aesthetic appeal alone is functional, then “functionality would swallow up much, perhaps all, of trademark law.”

Lastly, the Second Circuit itself in *Villeroy & Boch Keramische Werek K.G. v. THC Systems, Inc.*, has previously found that aesthetically appealing and attractive design on high quality china is capable of serving as an indicator of source, and thus a protectable trademark. In *Villeroy*, a manufacturer (“V&B”) sold high quality china for use in homes and restaurants. V&B had a valued pattern on its chinaware known as “Basket.” THC, V&B’s competitor, created an alleged knock-off pattern of “Basket,” named “Bountiful,” where the only difference was an underglaze marking on the back of THC’s china to indicate source—an industry custom.

V&B sued under the Lanham Act for several claims, but the district court found that the “Basket” design was functional as a matter of law and therefore the unregistered mark was not eligible for protection. However, the Second Circuit rejected THC’s argument and the district court’s holding that hotel china is functional as a matter of law, and therefore THC was allowed to copy V&B’s “Basket” design in order to compete in the hotel china supply industry. Instead, the Second Circuit found as a matter of law that V&B’s china pattern was not functional and, even if hotels only purchased its china every seven years, this was not enough to show that THC had a competitive disadvantage. Thus, the court awarded V&B trademark protection over its unregistered china pattern mark.

Therefore, the Second Circuit has previously denied aesthetic functionality and protected an unregistered mark, even when doing so meant a competitor would be unable to solicit clients for seven years at a time. If the court follows its analysis in *Villeroy* and reverses the lower court, it will be following its precedent closely, especially considering that Louboutin’s mark is registered and YSL will not be out of the market for years at a time as was THC’s plight. Instead, YSL can adopt any other outsole color option, as long as it is not the registered Chinese Red shade. In reversing the lower court, the Second Circuit has an opportunity to heed Judge Posner’s warning in

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99 *Id.* at 340.
100 *Id.* at 619, 621 (2d Cir. 1993).
101 *Id.* at 620.
102 *Id.*
103 *Id.*
104 *Id.*
105 *Id.* at 621.
106 *Id.*
not allowing the narrow defense of functionality to “swallow up much, perhaps all, of trademark law” simply because a good is aesthetically pleasing.  

2. If Affirmed: Arbitrary Distinction of Fashion Industry Consumers?

Lastly, the Second Circuit’s ruling could affect branding and marketing efforts directed toward high-end fashion consumers. If the Second Circuit affirms the lower court’s decision, it would be drawing a sharp line between the consumers of high-end fashion and other industrial products, for example. Indeed, the court would essentially be stating that in the fashion industry, consumers of such high-end luxury goods are less likely to suffer likelihood of confusion because of the customer’s sophistication and care they put into such high-end purchases.

Therefore, such a precedent would find trademark protection unwarranted under the Lanham Act for color at this high price point within the context of the fashion industry. Thus, the Court would make the statement that YSL could use red on its outsoles because a high-end fashion consumer does her research and knows the difference between YSL’s monochromatic aesthetic and Louboutin’s lacquered red outsole aesthetic. Characterizing and placing such an emphasis on the consumer in this way is unprecedented, and it would allow courts to draw sharp distinctions between consumers in the high-end context of the fashion industry versus all other industries. High-end fashion designers would be forced to create powerful and unprecedented marketing campaigns to ensure that customers were able to successfully distinguish their products.

B. The Cost of Production’s Influence on Functionality

Secondly, the Second Circuit’s ruling could have an implicit effect in applying the functionality doctrine, especially when cost of production is a factor to be weighed. The lower court found that although a higher cost of production is associated with the red outsole, “the higher cost of production is desirable because it makes the final creation that much more exclusive, and costly.”  

If affirmed, the Second Circuit will step outside the majority rule set forth in case law on the subject, and find that a higher cost of production yields a functional, unprotectable mark because of its hindrance on fair competition. The current legal landscape is in favor of the opposite

107 See W.T. Rogers Co. v. Keene, 778 F.2d 334, 340 (7th Cir. 1985).
finding: a design is non-functional and thus protectable if it complicates and increases the cost of manufacture.

In Adidas-Salomon AG v. Target Corp., the U.S. District Court for the District of Oregon found that toe and sole designs for athletic shoes were non-functional because they increased production costs.\(^{109}\) Similarly, in Asics Corp. v. Wanted Shoes, Inc., the U.S. District Court for the Central District of California granted a preliminary injunction for Asics, a shoe manufacturer, finding that Asics’s Stripe Design mark was non-functional. That court applied four factors of functionality previously adopted by the Ninth Circuit, including (1) whether the design yields a utilitarian advantage, (2) whether alternative designs are available, (3) whether advertising touts the utilitarian advantages of the design, and (4) whether the particular design results from a comparatively simple or inexpensive method of manufacture.\(^{110}\)

Although no one factor is dispositive, the Asics court found that the stripes were non-functional and thus protectable under the Lanham Act for several reasons which included the fact that: innumerable alternative designs are available for shoes not involving the Stripe; no utilitarian advantage came from using the Stripe design; and the stripes complicated and added to the cost of manufacture.\(^{111}\) As such, because of the high costs associated with the stripe, the court found the stripe did not hinder competition because utilizing the infringing stripe would cost competitors more to produce that a shoe without such stripe.\(^{112}\)

Like Adidas and Asics, Louboutin’s registered, lacquered and Chinese Red outsole only causes competitors to spend more to copy this aesthetic. If the Second Circuit reverses the lower court, it will adopt the common sense stance that competition can never be hindered when it costs a competitor more to compete, especially since an infinite number of colors remain available for all luxury shoe manufacturers. Thus, the Second Circuit has the opportunity to declare that Louboutin’s red outsole is not functional, and does indeed warrant protection under the Lanham Act since the outsole allows YSL and other competitors to spend less on their products when marketing to the same clientele as Louboutin.


\(^{111}\) Id. at *5.

\(^{112}\) Id.
IV. Conclusion: Louboutin Refuses to Be Knocked Out

The glitz and glam of this high profile and high-fashion litigation is no doubt a headline-grabber for many reasons. First, lawsuits between such luxury companies are rare because the press is normally relied upon to point out when one high-end designer copies another. Thus, lawsuits are rarely worth the trouble since “the fashion community has already delivered a reputational slap on the wrist.”113 Second, the fashion industry is about much more than making women beautiful—it is about making money. This is especially true for a company like Louboutin whose revenue is forecasted to reach $135 million for 2011.114 What remains to be seen, however, is whether the flash of the Louboutin red sole—on runways or from an Oscar winner emerging from a limousine—will continue to be the only high-end fashion footwear, which broadcasts “chic” through this medium of color.115

PSLRA SAFE HARBOR:  
A NEW PERSPECTIVE ON “IMPORTANT FACTORS”

Joseph Norman†

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ABSTRACT

As pointed out by the Second Circuit in Slayton v. American Express Co., the materiality standard in the Private Securities Litigation Reform Act’s safe harbor for forward-looking statements is unworkable. While prohibiting courts from inquiring into the defendant-issuer’s state of mind, the Act requires courts to determine whether “important factors” have been disclosed. How can importance be determined in the absence of context? Or, how can it be determined if “important factors” have been disclosed, without knowing what the issuer considered important? It cannot. Because of this “thorny issue,” courts have interpreted the PSLRA materiality standard—“important factors” in the Act—in myriad different ways; some ignoring Congress’s prohibition of inquiring into the issuer’s state of mind, and others dismissing outright fraud where the alleged misstatement was accompanied by forward-looking statements. A new perspective on what factors are “important factors” is necessary.

This Comment argues that an objective test based on the categorical factors that investors would consider important is a better test, than the confusing instructions courts currently have. Empirical research shows that investors most fear a large loss on their investment (40%), a below-target return (20%), and business risk of the issuer (18%). It stands to reason that information that would affect these areas of risk is what investors would most want to know; or, in other words, categorical information about these areas are investors’ “important factors.” Because these specific areas of information are objective and can be categorized, a more workable test can be fashioned for materiality under the PSLRA safe harbor. This Comment explains the shortcomings of existing PSLRA materiality and provides an alternative objective approach.
I. INTRODUCTION

To be effective, any attempt to regulate securities or enforce securities law must focus centrally on protecting investors through controlling information.\(^1\) Information is the sole determinant of price. Without information, securities have zero value to the investor. Investors with an informational advantage over the rest of the market will systematically earn higher returns.\(^2\) But the familiar securities regulation question continually arises: what information can investors use to gain an advantage and profit? That is, what information is material?

Material information is information that influences the investor to make the investment decision. Investment decisions, however, are not made upon a single piece of information. Rather, investment decisions are made in the context of all available information about the potential investment opportunity. As a result, the dispositive question is: what information would investors find material given the full universe of existing information about the investment opportunity. Courts have long grappled with this question in the context of Securities Exchange Act Rule 10b-5, which has been resolved by the Supreme Court’s holdings in *TSC Industries, Inc. v. Northway*,\(^3\) and *Basic Inc. v. Levinson*.\(^4\) But in one corner of securities law, safe harbor for forward-looking statements under the Private Securities Litigation Reform Act (“PSLRA”), materiality remains an indeterminate idea.\(^5\)

This Comment seeks to explain the shortcomings of existing PSLRA materiality—called “important factors” under the Act—and provides an alternative approach that clarifies the PSLRA materiality standard.

In 1995, Congress passed the PSLRA to curb abusive securities

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\(^2\) Id. at 2.


\(^5\) At the outset, it is important to point out that this Comment addresses securities fraud liability only in the context of forward-looking statements. Therefore, the analysis and proposal herein, which relates only to forward-looking statements in PSLRA cases, which can be distinguished from the pre-PSLRA rules regarding statements of past or present fact set out in *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 448 (1976) (holding that information is material if there is a “substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”) and *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988) (adopting *TSC Industries*, rejecting a more objective standard for materiality, and holding that “materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.”).
litigation practices by so-called strike suit lawyers bringing suit under Exchange Act Rule 10b-5.\textsuperscript{6} Part of the protection afforded to securities issuers under the PSLRA is a statutory safe harbor for forward-looking statements.\textsuperscript{7} In crafting the safe harbor, Congress explicitly prohibited courts from inquiring into the defendant-issuer’s state of mind.\textsuperscript{8} Congress also required issuers to include “meaningful cautionary statements identifying \textit{important factors} that could cause actual results to differ materially from those in the forward-looking statement.”\textsuperscript{9} As the Second Circuit recently pointed out in \textit{Slayton v. American Express Co.}, Congress’s instructions are logically contradictory. It is almost impossible to determine which factors are “important” without the context of the issuer’s state of mind.\textsuperscript{10} Congress’s logical breakdown provides little real guidance to courts evaluating securities fraud claims under Rule 10b-5.

A new perspective on what factors are “important factors” is necessary. Up until this point, courts have interpreted the PSLRA standard for important factors in myriad ways. Some courts have ignored Congress’s prohibition by inquiring into the issuer’s state of mind, while others have dismissed outright fraud claims where the alleged misstatement was accompanied by forward-looking statements. In short, courts have wrestled mightily with what is an “important factor” under the Act.

To alleviate this confusion, courts should focus on the information’s importance to the investor, rather than the defendant-issuer’s state of mind. Moreover, Congress drafted the PSLRA’s safe harbor to protect issuers against overreaching by strike suit lawyers. Accordingly, courts should keep with legislative purposes and employ an “important factors” test that favors securities issuers. The current “important factors” test fails in this regard. As a result, a new test is needed. This Comment argues that an objective test based on the categorical factors that investors would consider important is a better test.\textsuperscript{11} Importantly, objectivity can simultaneously protect issuers and

\begin{itemize}
\item[\textsuperscript{10}] See \textit{Slayton v. Am. Express Co.}, 604 F.3d 758, 771 (2d Cir. 2010).
\item[\textsuperscript{11}] Throughout this Comment, the term “categorical” is used to denote factors that are absolute in every context—that is, they either fall within the category of “important factors” and they should be included in the objective test or they fall outside the category and should be excluded. In the context of the usage herein, \textit{continued} . . .
fulfill investors’ information expectations.

Empirical research shows that investors assign risk to an investment based on a number of premises: (i) the investor is only concerned about downside risk, (ii) the investor is most sensitive (40%) to a large loss on the investment, (iii) the issuer is significantly concerned (20%) about the risk of a below target return over the investment period, (iv) the investor strongly considers (18%) the business risk represented by issuer-specific information, and (v) the investor recognizes that available information about the security may be imperfect.\(^\text{12}\) Therefore, it stands to reason that investors care most about information regarding these premises, and accordingly, categorical factors that affect these risks are the “important factors” that investors care about.

An objective test based on categorical factors is the most effective method for determining whether “important factors” have been sufficiently disclosed. All three constituencies in a Rule 10b-5 action benefit from an objective test of categorical “important factors.” First, securities issuers—the intended beneficiaries of PSLRA safe harbor protection—subjected to an objective test are relieved of the need to expend precious resources rooting out possible sources of 10b-5 liability. Second, courts can apply and administer an objective test more easily than a subjective standard because the former does not require the application of the latter’s boundless inquiry into the context of the disclosure. Finally, investors—potential 10b-5 plaintiffs—can rely on disclosures by securities issuers knowing that information that will affect the risks of their investment has been sufficiently disclosed to evaluate the primary non-systemic risks. If disclosure does not take place, investors can also take comfort in knowing there is a simple test for whether “important factors” were disclosed rather than a court’s unpredictable determination.

In Part II, this Comment explains SEC Rule 10b-5, its uses and the circumstances that can give rise to liability under the Rule. Part III details the development of safe-harbors for forward-looking statements and gives background on the PSLRA and its interaction with Rule 10b-5. Part IV focuses on the conflict at the crux of this issue: Congress’s inconsistent instructions to courts on whether to inquire into the state of mind of 10b-5 defendants. Part V explains an alternative proposal on how courts should apply the PSLRA safe

categorical factors are the opposite of factors that a court must weigh and consider in each instance.

harbor. Lastly, in Part VI, the Comment concludes that an objective test based on categorical factors is normatively a better test than Congress’s conflicting instructions on the PSLRA safe harbor.

II. BACKGROUND ON RULE 10B-5

A. Securities Regulation and the Role of Rule 10b-5

SEC Rule 10b-5 is the “bedrock” antifraud rule that allows investors to allege securities fraud against an issuer.13 SEC Rule 10b-5, as interpreted by the courts, offers investors a private right of action against securities issuers who:

employ any device, scheme, or artifice to defraud;
make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.14

Because of this broad regulatory language, investors may plausibly allege 10b-5 liability in countless circumstances.

The need for Rule 10b-5 arose in 1942. SEC solicitors in Boston discovered that a company president was simultaneously making public announcements of his company’s poor performance while repurchasing stock from shareholders at lower prices, when in fact the company’s earnings were going to quadruple.15 At that time, the Securities Exchange Act of 1933 only prohibited fraud in the sale of securities.16 The Act said nothing of fraud in the purchase of securities.17 To close the gap, SEC Assistant Solicitor Milton V. Freeman drafted the Securities Exchange Act Rule 10b-5 with language lifted from §17(a) of the 1933 Act adding the words “in

14 17 C.F.R. § 240.10b-5 (2011). Courts often avoid citing the regulation since it is broader in scope than the actual statute.
17 Id.
connection with the purchase or sale of any security.” The SEC approved the Rule without debate pursuant to the catch-all rulemaking authority in §10(b) of the Securities Exchange Act of 1934.

Four years later in 1946, a Pennsylvania federal district court recognized an inferred private cause of action under Rule 10b-5 for the first time. Since then, Rule 10b-5 has been involved in innumerable private actions and SEC proceedings. The Rule has served as the basis for a broad array of claims, including traditional claims alleging misstatements or omissions in SEC filings, claims alleging negligent securities practices, and even allegations of corporate mismanagement. More recently, Rule 10b-5 has been limited to cases involving intentional deception.

B. The Elements of Rule 10b-5

Rule 10b-5 makes it illegal for securities issuers to dispense false or misleading information about its securities. The Rule states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

As it relates to the PSLRA, Rule 10b-5 requires plaintiffs to allege five main elements on which the plaintiff bears the burden of proof: (i) material misinformation, (ii) scienter, (iii) plaintiff’s reliance, (iv) causation, and (v) damages. Therefore, in order to state a claim under Rule 10b-5, a plaintiff must allege that the defendant securities issuer made material misstatements or omissions of material fact, with scienter, and that the defendant’s actions caused injury to the

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18 Id.
19 Id.
20 PALMITER, supra note 13, at 370.
22 PALMITER, supra note 13, at 370.
23 Id.
25 PALMITER, supra note 13, at 384.
26 Scienter is a significant element—and often a troublesome element for plaintiffs—in Rule 10b-5 claims. A 10b-5 plaintiff must prove the defendant acted continued . . .
plaintiff based on plaintiff’s reliance on the statement. If a securities fraud plaintiff fails to show any of the five required elements in its allegation of fraud or misstatements, the claim will fail.

III. PSLRA BACKGROUND

In the early 1990s, securities plaintiffs used Rule 10b-5 to bring innumerable claims of varying merit against securities issuers. In response to these “abusive and meritless suits,” Congress enacted the PSLRA. The House Conference Report shows that securities issuers—possible 10b-5 defendants—presented Congress with extensive evidence of specious litigation. Based on the fear that so-called “strike suits” under Rule 10b-5 could “increase the cost of raising capital and chill corporate disclosure,” Congress recognized the need to provide a safe harbor for securities issuers. Specifically, the Act had three purposes: “(1) to encourage the voluntary disclosure of information by corporate issuers; (2) to empower investors so that they—not their lawyers—exercise primary control over private securities litigation; and (3) to encourage plaintiffs’ lawyers to pursue valid claims and defendants to fight abusive claims.” In other words, Congress intended the PSLRA to be a direct limitation on securities plaintiffs’ ability to utilize Rule 10b-5 as grounds for meritless litigation.

A. Pre-existing Safe Harbors For Forward-Looking Statements

The PSLRA, however, did not introduce the concept of safe harbor protection for securities issuers. In 1979, sixteen years before the PSLRA, the SEC promulgated Rule 175, which provided a safe harbor for certain forward-looking statements made with a “reasonable basis” and in “good faith.” But, as noted in the PSLRA Senate Report, with “a mental state embracing intent to deceive, manipulate, or defraud.”

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29 Id.
30 Id.
31 Id.
33 Id.
34 See H.R. Rep. No. 104-369, at 31; S. Rep. No. 104-98, at 4. It is important to recognize that Congress in providing protection for securities issuers is furthering the societal goal of capital formation.
Rule 175 did not provide meaningful protection.\(^{36}\)

Along with the initial statutory safe harbor in Rule 175, courts created the judicial “bespeaks caution” doctrine\(^{37}\) that provides safe harbor for forward-looking statements accompanied by cautionary language.\(^{38}\) Under the bespeaks caution doctrine, the alleged misstatements of the defendant issuer are deemed immaterial as a matter of law if a “document’s forecasts, opinions or projections are accompanied by meaningful cautionary statements” and “the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the ‘total mix’ of information the document provided investor.”\(^{39}\) As such, courts can dismiss securities fraud actions for failure to state a claim or on a motion to dismiss as a matter of law provided that the challenged statements looked forward, and cautionary language accompanied the statement.\(^{40}\) Essentially, the PSLRA codified the bespeaks caution doctrine and adopted language from judicial opinions and SEC Rule 175.\(^{41}\)

B. Safe Harbor For Forward-Looking Statements Under the PSLRA

Statutory language is the appropriate starting point for analyzing the safe harbor protection under the PSLRA. Three “inlets” are available to securities issuers making forward-looking statements\(^{42}\):

(c) Safe Harbor—

\(^{36}\) S. REP. NO. 104-98, at 16.

\(^{37}\) See In re Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig., 7 F.3d 357 (3d Cir. 1993) (“When an offering document’s forecasts, opinions, or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the “total mix” of information the document provides investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.”).

\(^{38}\) Id.; See, e.g., In re Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994); Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994); Kline v. First W. Gov’t Sec., Inc., 24 F.3d 480 (3d Cir. 1994); Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991); I. Meyer Pincus & Assoc. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991); Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991); Luce v. Edelstein, 802 F.2d 49 (2d Cir. 1986).

\(^{39}\) Trump Casino, 7 F.3d at 371.

\(^{40}\) Donald C. Langevoort, Disclosures that “Bespeak Caution,” 49 BUS. LAW. 481, 482–83 (1994).

\(^{41}\) S. REP. NO. 104-98, at 43; see also Ann Morales Olazabal, False Forward-Looking Statements and the PSLRA’s Safe Harbor, 86 IND. L.J. 595, 618 n.87 (2011).

(1) In general—[In any private action under Rule 10b-5, a securities issuer] shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that—

(A) the forward-looking statement is—

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement—

(i) . . . was made with actual knowledge by that person that the statement was false or misleading . . . 43

Significantly, Congress drafted the three inlets of the safe harbor to be disjunctive. 44 That is, a securities issuer need only find one inlet to the safe harbor, rather than having to enter all three. 45

1. First Inlet: Forward-Looking Statements Accompanied by Meaningful Cautionary Language

The first inlet is an affirmative protective method for securities issuers. If an issuer makes it clear that his forward-looking statement is about future events, and if the statement is accompanied by meaningful cautionary language that identifies “important factors”, then the statement is protected from 10b-5 claims.

“Forward-looking statements” are those statements identified by linguistic cues like “we expect” or “we believe” that are combined with an explanatory description of the company’s intent to designate the statement as a forward-looking statement. 46 Forward-looking

44 Slayton v. Am. Express Co., 604 F.3d 758, 766 (2d Cir. 2010) (“The safe harbor is written in the disjunctive; that is, a defendant is not liable if the forward-looking statement is identified and accompanied by meaningful cautionary language or is immaterial or the plaintiff fails to prove that it was made with actual knowledge that it was false or misleading.”). Contra Freeland v. Iridium World Commc’ns, 545 F. Supp. 2d 59, 71 (D.D.C. 2008) (“No degree of cautionary language will inoculate statements that defendants knew were simply not true when made . . . .”).
45 See generally Olazabal, supra note 41, at 602.
46 Slayton, 604 F.3d at 769; see also Amicus Curiae Brief for Securities and Exchange Commission at 2, Slayton v. Am. Express Co., 604 F.3d 758 (2d Cir. 2010) (No. 08-5442-cv), 2010 U.S. 2nd Cir. Briefs LEXIS 38 at *3 (explaining that including a note at the end of a securities filing which includes “[t]he words continued . . . “)
statements include, but are not limited to, statements “containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items.” Generally, a statement of future economic performance, or management’s plans or objectives are forward-looking statements. Courts have said that “meaningful cautionary statements” are those warning statements that are sufficient to allow an investor to make an intelligent investment decision based on his or her preference for risk. The PSLRA Conference Report states that “[t]he cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as information about the issuer’s business.”

Under the PSLRA, issuers do not have to identify all the factors that could cause actual results to differ materially from projections. Issuers are also not required to identify the actual factor that causes results to differ. Courts, however, have enforced the Conference Committee’s instruction that “boilerplate” warnings that do not change as the risks to the company change are not meaningful cautionary statements. “[C]autions must be tailored to the risks that accompany the particular projections.”

Controversially, where issuers’ forward-looking statements are accompanied by meaningful cautionary language, courts have generally held that the issuers’ actual knowledge and state of mind is irrelevant. The court in *Harris v. Ivax Corp.* reached this

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48 Id.
49 See *Harris v. Ivax Corp.*, 182 F.3d 799, 807 (11th Cir. 1999).
51 Id. at 44.
52 Id. (explaining that the conference report, moreover, that accompanied the PSLRA specified that “[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.”); see also *Harris*, 182 F.3d at 807.
54 *Asher*, 377 F.3d at 732.
55 *Harris*, 182 F.3d at 803.
conclusion by looking to the disjunctive language of the PSLRA. 57 Most significant to the analysis here, the conference report explicitly said that courts should not inquire into the state of mind of the issuer at the time of the statement. 58 The cautionary statement requirement is meant to give investors more information “and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.” 59 Although the terms “meaningful” and “important” are not defined in the statute, Congress intended these terms to create a standard on which a court could decide a 10b-5 case upon a motion to dismiss. 60

2. Second Inlet: Immateriality

The second inlet bars challenges to immaterial statements. 61 Immaterial statements are those statements on which an investor could not reasonably rely, such as puffery. 62 “[S]tatements of subjective analysis or extrapolations, such as opinions, motives and intentions, or general statements of optimism... constitute no more than ‘puffery’ and are understood by reasonable investors as such.” 63

3. Third Inlet: Heightened Scienter Pleading Under the PSLRA

Plaintiffs alleging securities fraud under Rule 10b-5 must satisfy the PSLRA’s heightened pleading requirements “by stating with particularity the circumstances constituting fraud.” 64 Proof of scienter is a required element of a securities fraud claim under Rule 10b-5, therefore “a complaint ‘must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of

56 Id.
57 Id. Courts cite the fact that Congress linked the clauses of the safe harbor with the word “or” rather than the word “and.” See Slayton v. Am. Express Co., 604 F.3d 758, 766 (2d Cir. 2010); see also Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 371–72 (5th Cir. 2004).
59 Id.
60 Id.
61 The “immateriality prong” is not relevant to the analysis in this Comment and will not be addressed.
62 See In re Aetna, Inc. Sec. Litig., 617 F.3d 272, 283 (3d Cir. 2010).
63 Id. (citing In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999) (citation omitted)).
64 Slayton v. Am. Express Co., 604 F.3d 758, 766 (2d Cir. 2010).
This heightened standard is a significant obstacle for 10b-5 claims. A complaint will only survive if a reasonable person could make a strong inference as to the issuer’s intent to commit fraud. “The ‘strong inference’ [of scienter] . . . is met when the inference of fraud is at least as likely as any non-culpable explanations offered.” Significantly, many 10b-5 claims will be dismissed at the pleading stage because the PSLRA scienter pleading standard is higher than notice pleading under Federal Rule of Civil Procedure 8.

IV. PSLRA PROBLEM: WHAT IS AN “IMPORTANT FACTOR”?

Congress’s contradictory instructions in the PSLRA’s statutory language and legislative intent have created a confusing situation for courts when issuers make forward-looking statements about “important factors” that the issuer actually knows will materially affect results. That is, where the company warns of future occurrences that may already be certain. This Comment analyzes such situations, but first it is necessary to clarify and explain the issue.

The Second Circuit Court of Appeals first identified the issue in Slayton v. American Express Co. In Slayton, American Express disclosed that “[t]otal losses on [American Express’s high-yield] investments for the remainder of 2001 are expected to be substantially lower than in the first quarter.” Along with this forward-looking statement, the company included the warning “[f]actors that could cause actual results to differ materially from these forward-looking statements include . . . potential deterioration in the high-yield sector, which could result in further losses in AEFA’s investment portfolio.” The court concluded that the facts as alleged by the plaintiffs indicated that at the same time American Express warned of potential deterioration in the high-yield investments, it knew of actual deterioration. In other words, at the time of the statement American Express actually knew the statement was false.

The Second Circuit had a difficult time reconciling Congress’s

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67 Slayton, 604 F.3d at 766 (citing Tellabs, Inc., 551 U.S. at 324).
68 FED. R. CIV. P. 8.
69 Slayton, 604 F.3d at 770–71.
70 Id. at 768 (citation omitted).
71 Id. at 769 (citation omitted).
72 Id. at 769 (emphasis in original).
explicit prohibition of inquiry into American Express’s state of mind with the likelihood that it had actual knowledge of high-yield portfolio deterioration. The court recognized the inherent contradiction that the safe harbor seemingly protects lies, so long as the lies are accompanied by warnings that the statements might not be true. Rather than focusing on American Express’s actual knowledge, the court instead focused on the meaning of “important” in the first inlet of the safe harbor. Setting out the issue, the court said:

We find Congress’s directions difficult to apply in this case. On the one hand, the Conference Report makes quite plain that it does not want courts to inquire into a defendant's state of mind, i.e., a defendant’s knowledge of the risks at the time he made the statements. At the same time, however, the Conference Report requires cautionary statements to convey substantive information about factors that realistically could cause results to differ materially from projections.

Significant to the analysis here, the Second Circuit identified the logical inconsistency that in assessing whether an issuer has identified the “important factors” under the inlet, some reference by which to determine the realistic factors at the time the statement is necessary. Calling it a “thorny issue,” the Slayton court avoided deciding the case based on the contradictory legislative intent, and invited Congress to give further clarity to guide courts in deciding whether an issuer has identified “important factors.”

Only one other court has discussed the PSLRA safe harbor contradiction, and it too failed to put forth a useful standard. In In re SeeBeyond, the plaintiffs brought a 10b-5 claim against a security issuer, a technology company, which included an allegation that forward-looking statements made in a press release were not accompanied by meaningful cautionary language. Unlike the Slayton court, however, the Central District of California in SeeBeyond delved into the “thorny issue” of whether or not an inquiry

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74 Id. at 772.
75 Id. at 770–71.
76 Id. at 771.
77 Id.
78 Id. at 772.
is allowed in to the speaker’s state of mind.\textsuperscript{80} In dicta, the court said “something like a ‘state of mind’ element in [the first inlet] is already clearly present in the statute. Whether cautionary language is meaningful in that it identifies important factors, can only be understood with reference to the defendant’s knowledge of relevant factors.”\textsuperscript{81} In other words, the \textit{SeeBeyond} court made the same point that the \textit{Slayton} court made: it is impossible to determine what is important without looking in to the state of mind of the speaker. The \textit{SeeBeyond} court backed up that assertion by arguing that the proper standard is \textit{not} an objective inquiry that excludes looking into the speaker’s state of mind:

> whether a specific factor is “important” . . . should not be evaluated by an objective standard (i.e. what the defendant should have known). If an objective standard is adopted for determining whether a factor is “important,” then it seems this would \textit{heighten} the bar of the first prong of the safe harbor provision, making it more difficult for defendants to take advantage of its grant of immunity.\textsuperscript{82}

Instead, the court said a subjective inquiry “with reference to those factors of which the speaker is aware—things that the speaker believes may cause actual results to vary” is the correct standard.\textsuperscript{83} The \textit{SeeBeyond} approach, which contradicts Congress’s instruction and allows inquiry into the speaker’s state of mind, is in the minority.\textsuperscript{84}

\textbf{A. PSLRA Interpretation}

The \textit{Slayton} court’s argument is crucial to the analysis in this Comment, and to understand its importance the argument must be considered in the broader context of PSLRA debate. From the start, the PSLRA and its safe harbor have been controversial.\textsuperscript{85} Lending to

\begin{small}
\textsuperscript{80} \textit{Id.} at 1165–66 n.8.

\textsuperscript{81} \textit{Id.}

\textsuperscript{82} \textit{Id.}

\textsuperscript{83} \textit{Id.}

\textsuperscript{84} The Second, Fifth, Sixth, and Eleventh Circuits have all held that so long as the language accompanying the forward-looking statements is meaningful, the speaker’s state of mind is irrelevant. \textit{See} Slayton v. Am. Express Co., 604 F.3d 758, 771 (2d Cir. 2010); Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 594 F.3d 783 (11th Cir. 2010); Miller v. Champion Enters. Inc., 346 F.3d 660, 678 (6th Cir. 2003); Harris v. Ivax Corp., 182 F.3d 799, 807 (11th Cir. 1999).

\textsuperscript{85} A WestLaw search for citing references to 15 U.S.C. § 78u-5 (Application of safe harbor for forward-looking statements) produces an astounding 6938 hits; one early case recognizing potential problems with the PSLRA and the bespeaks caution doctrine held that a warning was not meaningful if it made “a representation of continued . . .
this controversy is the fact PSLRA protection may be challenged on many different grounds including: whether a statement meets the heightened scienter pleading, whether statements are forward-looking, whether statements are “accompanied by” cautionary statements, whether statements are meaningful, and even whether the inlets of the safe harbor are disjunctive. Therefore, it is helpful to see that the issue being analyzed here—the meaning of “important factors” in the PSLRA statutory text—is just one question in the broader field of PSLRA interpretation. The significance of the Slayton court’s argument is that in all of the commentary, academic literature, litigation, and interpretation of the PSLRA, no one has suggested or even identified a solution to the contradictory instructions in the PSLRA safe harbor. The Slayton court came the closest, but it merely identified the issue, not a solution.

B. What Does the Term “Important Factors” Mean?
The central issue to the analysis in this Comment is: what does the term “important factors” mean in the context of the PSLRA safe harbor? First, the statutory text should guide the interpretation of the term “important factors.” But in this case, the statutory language is not helpful because of the contextual reasons raised in Slayton. The language of the statute explains that important factors are those “that could cause actual results to differ materially from those in the forward-looking statement.” From the statutory language, it can be deduced that important factors are those with more than a de minimis probability of affecting results. However, there is no objective standard to guide the inquiry. Many 10b-5 cases are close cases that turn on a measure of a factor’s importance. An undefined standard is not helpful in those cases.

present fact,” such close cases are typical of those falling under the PSLRA safe harbor. Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1213 (1st Cir. 1996).
89 Rombach v. Chang, 355 F.3d 164, 173 (2d Cir. 2004).
90 See Lormand v. U.S. Unwired, Inc., 565 F.3d 228, 244–45 (5th Cir. 2009) (holding that defendants who have actual knowledge may not obtain the benefit of the safe harbor). Contra Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 594 F.3d 783 (11th Cir. 2010); Miller v. Champion Enters. Inc., 346 F.3d 660, 672 (6th Cir. 2003); Harris v. Ivax Corp., 182 F.3d 799 (11th Cir. 1999) (holding that if a statement is accompanied by meaningful cautionary language, the defendant’s state of mind is irrelevant).
Second, as courts have pointed out, where the statutory language is not dispositive the analysis should turn to the legislative history.\textsuperscript{93} The Committee Report says that important factors are those “that realistically could cause results to differ materially from those projected in the forward-looking statement, such as information about the issuer’s business.”\textsuperscript{94} Congress then provided that “[i]mportant factors means the stated factors identified in the cautionary statement must be relevant to the projection and must be of a nature that the factor or factors could actually affect whether the forward-looking statement is realized.”\textsuperscript{95} As pointed out in \textit{Slayton}, even though Congress provided this guidance, it fails to define the term “important factors.”\textsuperscript{96} Courts have latched on to Congress’s one concrete example of what is \textit{not} a “meaningful cautionary statement about important factors.” The Committee Report makes clear that “boilerplate warnings” are not meaningful cautionary statements about important factors.\textsuperscript{97} The objective nature of this one congressional instruction has made it an attractive ground to base decisions on what constitutes a meaningful cautionary statement about an important factor.\textsuperscript{98} Although Congress provided the boilerplate carve-out, neither the statutory text nor the legislative history defines “important factors.”

With no guidance from Congress on the meaning of “important factors” and a lack of resolution from the two courts that have analyzed the meaning of importance, we are left only to outside sources to try to determine the meaning of “important.” Merriam-Webster’s Dictionary defines important as “marked by or indicative of significant worth or consequence.”\textsuperscript{99} This leads to the question: in the context of the PSLRA, what circumstances make a factor have significant worth? According to the arguments in \textit{Slayton} and

\textsuperscript{93} \textit{Slayton}, 604 F.3d at 771 (holding that “[t]he conference report is generally the most reliable evidence in legislative history of congressional intent because it represents the final statement of the terms agreed to by both houses.” (quoting Auburn Hous. Auth. v. Martinez, 277 F.3d 138, 147 (2d Cir. 2002)).


\textsuperscript{95} Id. at 43–44.

\textsuperscript{96} See \textit{Slayton}, 604 F.3d at 770.

\textsuperscript{97} H.R. REP. NO. 104-369, at 43.


SeeBeyond, that question must be answered by looking at the speaker’s state of mind. As already discussed, however, Congress has prohibited this kind of inquiry. Clearly then, determining exactly what factors Congress intended securities issuers to disclose along with forward looking statements is not an easy analysis, and the courts have struggled with it.

V. PROPOSAL: AN ALTERNATE PERSPECTIVE

Difficulty in dealing with the definition of “important factors” may stem from the fact that, almost uniformly, courts seem to have forgotten to consider the perspective that matters most: the investor’s. In the many cases that turned on whether a statement was “meaningful,” whether a factor was “important,” or whether results might be “materially” different, the investor’s perspective was often overlooked. That is, courts have failed to take a practical approach by asking “what would matter to an investor?” Instead, courts have focused on congressional intent and other legal analyses, which have failed to provide any clear guidance. Failure to think practically is a phenomenon most likely related to the fact that judges are legal practitioners with little expertise in making investment decisions. Suffice it to say, the viewpoint of a federal judge and that of an investment professional are likely miles apart. As a result, disclosures have been judged on importance from a legal perspective and not the importance of the disclosed information in the investment decision.

This is an interesting result in light of the fact that Congress made it clear in the stated purposes of the PSLRA that the act was intended to increase disclosure to allow investors to make better investment decisions. The Senate Report explicitly stated that the purpose of the PSLRA was to “reduce this chill on voluntary disclosures by issuers.” Recognizing that abusive 10b-5 lawsuits de-incentivize disclosures by securities issuers and that investors often receive less information as a result, Congress concluded that Rule 10b-5 made investing more risky in the absence of a safe harbor. The goal of the PSLRA is to help investors make more informed risk assessments in their investment decisions. To meet this goal, courts should look at what factors would be important to an average investor to determine the sufficiency of disclosures under the PSLRA, rather than abstract

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102 Id.
103 Id.
legal analysis.

A. What Matters to the Reasonable Investor?

If courts should analyze the importance of factors to the reasonable investor, a foundational understanding of investing is necessary. First, the analysis should be prospective from the investor’s viewpoint before the investment decision is made. Analyzing the disclosure should be made without the benefit of hindsight. Courts should only consider the factors that the investor considered before making the investment.

Second, the test should be categorical and objective to the reasonable investor. The argument is made for an objective test despite broad agreement among courts, academics, and regulators that objective tests should be rejected in favor of fact-specific findings in 10b-5 cases. For example, SEC Staff Accounting Bulletin No. 99 rejects an objective standard in the form of a per se rule that misstatements or omissions that account for less than 5% of earnings are immaterial:

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions" in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that —

[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.


The Second Circuit in Litwin v. Blackstone Group, L.P., 634 F.3d 706, 716–17 (2d Cir. 2011) adopted the SEC’s reasoning and guidance in SAB-99, holding that determining information’s importance to an investor “is an inherently fact-specific finding, that is satisfied when a plaintiff alleges a statement or omission that a reasonable investor would have considered significant in making [an] investment decision[].”

Confusingly, however, other courts have endorsed objective tests for materiality and importance of information based on stock price reaction under the efficient markets hypothesis. In 2005, the Third Circuit decided In re Merck & Co., Inc. Securities Litigation, 432 F.3d 261, 269 (3d. Cir. 2005), where it explicitly held that materiality can be determined by looking at price movements in the market. “Our . . . standard for measuring the materiality of statements in an efficient market . . . holds that the ‘materiality of disclosed information may be measured post hoc by looking

continued . . .
investment decision-making process of the reasonable investor.\textsuperscript{105} Necessary to this inquiry are two questions: (i) what is the reasonable investor’s decision-making process, and (ii) what categorical factors should be analyzed?

Investment decision-making can take a top-down\textsuperscript{106} or a bottom-up approach.\textsuperscript{107} Either way, security selection is an important step and the one analyzed here. Investors invest in the expectation of future returns, yet investors also prefer to minimize risk.\textsuperscript{108} That is, they want the highest amount of return for the least amount of risk. But, sometimes investors are willing to trade off decreased return for lesser risk or a little risk for greater return; this is known as the risk-return trade-off.\textsuperscript{109}

While the trade-off is often made in the context of the rest of the investor’s portfolio,\textsuperscript{110} security specific risk and return will ultimately determine whether the potential investor chooses to invest. Relevant to the movement, in the period immediately following disclosure, of the price of the firm’s stock.\textsuperscript{119} (citations omitted).

My position is supported by distinguishing between existing materiality standards outside of the PSLRA safe harbor context that reject objective tests, and the standard proposed herein which is in the context of PSLRA safe-harbor protection. For purposes of this Comment’s endorsement of an objective test within the safe-harbor, SAB-99, Litwin, and In re Merck are inapposite. First, each of these rules address misstatements of past occurrences rather than forward-looking statements. Therefore, each is irrelevant to the argument here. Second, even if one wanted to apply these rules to forward-looking statements, under the PSLRA safe-harbor Congress has prohibited the sorts of fact-specific discovery that would be required to apply such rules. That is, congressional intent precludes the Litwin and In re Merck standards in the context of the PSLRA safe harbor for forward-looking statements. As a result, even though courts have rejected objective tests of materiality for past misstatements, objective tests of materiality and “importance” for forward-looking statements have not been addressed.

\textsuperscript{105} The perspective of the reasonable investor should be used as opposed to the average investor, the term often used in determining the efficient investment frontier under the Capital Asset Pricing Model. Even though the financial literature supports using the average investor, this quagmire may be avoided by choosing to use the reasonable investor, with whom courts are already familiar. See Levinson v. Basic, Inc., 786 F.2d. 741 (6th Cir. 1986).

\textsuperscript{106} Top-down investing begins with allocation between asset classes such as stocks, bonds, risk-free securities, etc., and then moves on to security selection. See Top Down/Bottom Up, PRAC. LAW INST. POCKET MBA, Nov. 14, 2007.

\textsuperscript{107} Bottom-up investment strategies focus on specific securities, which appear to be attractively priced relative to their risk. See id.

\textsuperscript{108} ZVI BODIE, ALEX KANE & ALAN MARCUS, INVESTMENTS 10 (7th ed. 2008).

\textsuperscript{109} Id. at 11.

\textsuperscript{110} Robert C. Illig, The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring, 60 ALA. L. REV. 41, 98 (2008) (explaining the modern portfolio theory which posits that the real danger to investors is the lack of sufficient diversification in the portfolio).
to the analysis here is how the investor identifies and assigns a risk measurement to the security. A reasonable investor’s contemplation of investment risk is a function of four elements: possibility of a large loss, possibility of a return below target, business risk, and an investor’s knowledge about an investment.\footnote{Robert A. Olsen, \textit{Investment Risk: The Experts' Perspective}, 53 Ftn. Analysts J. 62, 62–66, Mar.-Apr., 1997, available at http://www.jstor.org/stable/4479986.} Risk of a large loss makes up 40\% of the risk assigned to a security and includes events like loss of principal investment, a large drop in stock price, or a large negative return.\footnote{Id.} Possibility of a return below the target return—20\% of an investor’s attributable risk—is made of events like downward price fluctuations, reduction in dividend, and non-payment of interest on fixed income securities.\footnote{Id.} The issuer’s business risks comprise 18\% of an individual investor’s risk attribution to a specific security.\footnote{Id.} Included in business risks are factors like the issuer’s debt level, cost controls, competitive position in the marketplace, and industry type.\footnote{Id.} Finally, an investor’s comfort with his knowledge about the security makes up 10\% of the risk he assigns to the security.\footnote{Id.} Amount, quality, and timeliness of information all factor into an investor’s assessment of risk associated with knowledge.\footnote{Id.} Conclusions to be drawn from the individual investor’s risk assessment of a security include that: (i) the investor is only concerned about downside risk; (ii) the investor is most sensitive (40\%) to a large loss on the investment; (iii) the investor places significant weight (18\%) on issuer-specific information in the form of business risk; and (iv) the investor recognizes that his information about the security may be imperfect.\footnote{Id.} In focusing on what factors investors think are important, courts should implement this risk assessment information.

In light of the investor’s risk assessment, the crucial question is what categorical factors should be analyzed in determining if an issuer has disclosed the required “important factors?” As addressed below, a new standard is needed to assess these “important factors.”

\section*{B. A Better Standard: Categorical “Important Factors” That Matter to Investors}

Based on how an investor analyzes risk, certain categorical factors
are always going to be important. Therefore, an objective, “important factors” standard based on categorical factors is more workable than the contradictory instructions given by Congress. Categorical factors, as that term is used in this Comment, are absolute factors. In an objective test where the determination is binary—yes or no—categorical factors are either included or excluded based on whether they are one of the included factors. Determination of whether categorical factors have been disclosed is the opposite of a determination in which the court must weigh and consider the facts of each instance. No analysis of categorical factors is needed.

1. Factors That Could Cause Large Loss

In the context of what matters to the average investor, the most important factors are those that could cause a large loss on an investment.119 Logically, an equity investor would be most concerned about bankruptcy, a merger or acquisition on unfavorable terms, or some other company failure.120 In bankruptcy, common stockholders are paid last and often recoup little of their investment.121 Moreover, in a fire sale merger, as were common during the 2007 financial crisis, shareholders may lose over 50% of their investment.122 In other words, investors are most concerned about factors that could bring upon a failure of the company. A list of all the factors would be more than is required; it is acceptable to state that categorical factors that could bring on bankruptcy or insolvency are “important factors.” Such factors are those that involve liquidity, solvency, exposure to trading risk, portfolio asset values, and other factors. Examples are the issuer’s ability to refinance or redeem its debt, the ratio of the issuer’s liquid assets to its outstanding debt, the ratio of the issuer’s current assets to its interest due on debt, or the value-at-risk measurement.123

Clearly, a single set of important factors based on risk of

119 Id. at 64.
120 Id.
122 For instance, shares of Wachovia Bank reached $56.95 on January 1, 2007 and last traded at $5.54 per share on December 31, 2008, representing a 90.27% loss for Wachovia shareholders over a span of two years. See EQUITY HP (Bloomberg Finance L.P.).
123 VAR is a statistical representation of “the most that the portfolio is likely to lose over a given time horizon except in a small percentage of circumstances.” It is a standard measure of financial market risk. Matthew Pritsker, The Hidden Dangers of Historical Simulation, FED. RES. BOARD, June 19, 2001, available at http://www.federalreserve.gov/pubs/feds/2001/200127/200127pap.pdf.
insolvency or bankruptcy will not do for all publicly traded companies, but within industries, certain specific data or information can be determined objectively. For instance, in the financial services industry loan-loss ratios, capital ratios, current or liquidity ratios and revenue by operating segment will pertain to each company’s risk of failure, and the question should be what information would investors looking at companies in that industry consider in their investment decision. In other words, intra-industry companies can be assessed by the same categorical factors.

For risk of large loss, a categorical factor standard is better than a subjective factor for two reasons. First, an objective test based on categorical factors gives more clarity to investors and sets expectations for the types of available investment information. Arguably, this could lead to more efficient markets because all investors are dealing with the same information contemporaneously. Second, companies would not needlessly expend resources searching for data that may expose them to 10b-5 liability. Rather, companies could be more forthcoming with information without the worry of liability, an objective of the PSLRA.\footnote{S. REP. NO. 104-98, at 5 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 684.}

2. \textit{Factors That Could Cause Below-Target Returns.}

When an investor makes an investment decision, part of the risk-return trade-off is calculating the return that is required. Return is simply how much an investor will be compensated for the deployment of his funds to a certain investment. For example, an investor believes Company A’s stock is undervalued at $10 per share. He believes the stock is worth at least $12 per share and that the stock will reach that price over the investment period. Further, Company A issues a $0.25 dividend every quarter. At the end of one year, the investor expects to sell his shares purchased at $10 for $12, thereby earning $2 per share. But the investor will also receive a $1 dividend. Therefore, his total return is $3 on a $10 investment, or 30%.

Calculating target return is a critical part of each investor’s investment decision, and investors are sensitive to changes in target return. As a result, investors will find factors that might affect expected return to be “important factors.” Below target return to the investor may result from a number of factors including a downward price fluctuation or a reduction in dividend.

Price fluctuation is a function of market supply and demand that is subject to “animal spirits”—that is, a security’s price is often based on
the market’s primeval instincts rather than reason.\(^{125}\) Thus, the price of a company’s stock on the market is often out of the hands of the company itself. Beyond controlling capital structure, operational and business risks, the company has very little control over the price at which its stock will trade. Considering these influences, a categorical factors standard on all factors that could push prices down would be difficult implement and administer. Moreover, it is difficult to imagine how securities issuers could give a meaningful cautionary statement about market risk, other than a broad disclaimer that would say “our stock trades in the public market, its price may go down.” Therefore, no standard for “important factors” should be applied to factors that could cause a downward price fluctuation other than those factors related business risk and large loss discussed herein.

On the other hand, dividend policy is also a component of target return. Dividend policy is an important consideration in the investment decision, and it is a factor within the control of individual companies. Therefore, whether or not the company envisions changes to its dividend policy can be a categorical “important factor” to investors. A binary disclosure on future changes in dividend policy can be easily disclosed by securities issuers and easily tested by courts. Therefore, a clear standard would be more efficient and workable for courts than abstract speculation into random factors that might necessitate a change of dividend policy.

3. Factors Affecting Business Risk

The third type of investment risk that investors are most concerned about is business risk.\(^{126}\) Business risk is a function of revenues, expenses, taxes, interest, depreciation, and accounting measures that flow through to the income statement. The Securities and Exchange Commission already requires issuers to include a “Risk Factors” section that discusses the most significant business risk factors that make the investment speculative or risky.\(^{127}\) SEC Regulation S-K is an ex ante determination of the information that investors will always find important.\(^{128}\) In other words, the SEC always requires securities issuers to disclose certain information; the discretionary determination of materiality is removed from the issuer.\(^{129}\) Because a disclosure requirement already exists under SEC rules, an “important factors” test


\(^{126}\) Olsen, supra note 111, at 63.

\(^{127}\) 17 C.F.R. § 229.503 (2011).

\(^{128}\) Choi & Pritchard, supra note 1, at 49; see 17 C.F.R. §229.503.

\(^{129}\) See 17 C.F.R. § 229.503; Choi & Pritchard, supra note 1, at 49.
looking at business risks is made easier to administer.

The same intra-industry categorical factors standard that applies to the risk of large losses, discussed above, also applies to business risk disclosures. That is, factors that could affect the earnings of one company in an industry are likely to affect the earnings of other companies in that industry. As an example, in the energy sector the price of oil is a major determinant of revenue, while crude oil purchases and production and manufacturing are major expenses.\textsuperscript{130} Within that sector, companies could be required to disclose information on factors that might affect energy specific expenses like the amount of remaining oil in their deposits, any expenses related to bringing a new pumping platform online, or any factor affecting the company’s ability to extract oil. Each of those factors could cause a below target return. Clearly then, investors would find those factors to be “important factors.”

Categorical factors standards as to business risk can provide the same efficiencies discussed above: efficiency for issuers and reduced uncertainty for investors. Categorical tests do not require securities issuers to expend resources rooting out possible sources of 10b-5 liability. Meanwhile, investors can take comfort in knowing that the known business risks have been disclosed, and if not, there is a simple mechanism—the proposed categorical factor standard under Rule 10b-5—for redressing the non-disclosure. Moreover, the courts could easily administer a categorical test. Because a requirement to discuss risk factors already exists,\textsuperscript{131} a categorical requirement for disclosing “important factors” could be administered without requiring courts to abstractly inquire into the security issuer’s business.

VI. CONCLUSION

As pointed out in \textit{Slayton}, the PSLRA contains a major flaw in the analysis of “important factors”: how can a court determine what factors are important if it cannot look to the context of the statement?\textsuperscript{132} Although the PSLRA may have been somewhat successful in fulfilling Congress’s intent to curb abusive strike suits, the important factor analysis of the PSLRA safe harbor requires further development. An easier, more reliable, and more efficient method than Congress’s conflicting instructions can be found in an objective test of categorical factors that investors find important. The

\textsuperscript{130} See \textit{Exxon Mobil Corporation, Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934}, 30, 64 (2011).

\textsuperscript{131} 17 C.F.R. § 229.503.

\textsuperscript{132} Slayton v. Am. Express Co., 604 F.3d 758, 770–71 (2d Cir. 2010).
framework for this type of test already exists, but it is up to the securities law bench to adopt the perspective they should have had all along: the investor’s.

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This article considers the effects 17 C.F.R. § 229.1111 (“§ 229.1111”) and 17 C.F.R. § 230.193 (“§ 230.193”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) will have on the use of intellectual property in asset-backed securities. First, it discusses the history and mechanics of intellectual property (“IP”) being used in asset-backed securities (“ABS”). Next, it considers the importance these financial instruments can play for companies in which value creation is heavily intertwined with intellectual property. Then, the article analyzes how the Dodd-Frank Act and § 229.1111 and § 230.193 will impact the issuance of IP ABS, specifically patent ABS, and how this impact will influence the American economy. The article concludes with a discussion of why IP ABS, and specifically patent ABS, should be excluded from the requirements of § 229.1111 and § 230.193.

I. Introduction

Imagine, for a moment, the company Apple does not exist. Imagine the company, and vision Steve Jobs developed, was unable to find the foundation and support to allow Apple and its patents to develop into the company it has become today. Accordingly, the patents that led to products such as the iPod, iPad, iTunes, and the Mac would not have come to fruition. The absence of Apple and the patents it developed would have a drastic effect on the myriad of individuals who own an Apple product, as evidenced by the
company’s $360 billion market capitalization. However, the inexistence of a company like Apple, and more importantly the patents it created, would have even more far-reaching effects on the American economy. A corporation with patents, such as Apple, provides vital innovations to the American economy. Innovation is considered to be a primary driver of long-term growth and economic prosperity for the United States economy. Yet, new rules implemented by the Securities and Exchange Commission threaten to place a significant impediment in the path of many business entities that could provide considerable innovation and development for the American economy.

In this article, I will consider the effects 17 C.F.R. § 229.1111 (“§ 229.1111”) and 17 C.F.R. § 230.193 (“§ 230.193”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) will have on the use of intellectual property in asset-backed securities. First, I will discuss the history and mechanics of intellectual property (“IP”) being used in asset-backed securities (“ABS”). Next, I will consider the importance these financial instruments can play for companies in which value creation is heavily intertwined with intellectual property. Then, I will analyze how the Dodd-Frank Act and § 229.1111 and § 230.193 will impact the issuance of IP ABS, specifically patent ABS, and how this impact will influence the American economy. I will conclude the comment with a discussion of why IP ABS, and specifically patent ABS, should be excluded from the requirements of § 229.1111 and § 230.193.

II. ASSET-BACKED SECURITIES AND THE DEVELOPMENT OF THE ASSET-BACKED SECURITIES MARKET

Securitization is a process that uses assets with normally predictable cash flows and common features and packages them into interest-bearing securities with marketable investment characteristics. Securitization is “a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfer the same to investors either with or without the support of

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further collaterals, and thereby achieve the purpose of financing.”

Essentially, the entity securitizing its assets is selling a stream of cash flows that in the future will accrue for the entity. Thus, a key difference between asset-based lending and traditional lending is where the lender focuses his attention. With traditional lending, the lender chiefly focuses on the borrower’s cash flow, but with asset-based lending, the lender chiefly focuses on the borrower’s collateral. Initially, mortgages were used as the underlying asset for a securitization transaction. Due to the consistent nature of payments found with a mortgage, it was an asset that worked nicely with a securitization transaction.

As a financial instrument, a patent ABS is fundamentally similar to a mortgage-backed security. With a patent ABS, the security is backed by the asset of royalty payments, rather than mortgage payments. The ability of IP to be licensed is fundamental to its use in securitization. In a license agreement, the owner of a patent exchanges his right to exclude others from using the patented technology in exchange for regular license payments. The success of a securitization depends on regular cash flow. Thus, in looking at a patent license agreement from a securitization point of view, the patent

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5 Id.


8 Id.

9 Asset-Backed Security - ABS, INVESTOPEDIA, http://www.investopedia.com/terms/a/asset-backedsecurity.asp#axzz1lqESncTr (last visited Feb. 11, 2012) (defining an ABS as “essentially the same thing as a mortgage-backed security, except that the securities backing it are assets such as loans, leases, credit card debt, a company’s receivables, royalties and so on, and not mortgage-based securities.”).

10 See id.

11 See Nikolic, supra note 7, at 397.

12 See id. at 397-98 (citing Amy L. Landers, Let the Games Begin: Incentives to Innovation in the New Economy of Intellectual Property Law, 46 SANTA CLARA L. REV. 307, 307-08, 308 n.3 (2006)) (“Through licensing the inventor would allow another to profit from his efforts in exchange for regular license payments.”).

13 See Nikolic, supra note 7, at 404.
can be conceptualized “as a potential right to a future series of cash flows” from exclusive use of the patented technology.\textsuperscript{14}

The mechanics of an IP ABS work in the following manner. In using a patent, the debtor-business entity that developed the patented technology (“the originator”) sells that technology to a special purpose entity (“SPE”).\textsuperscript{15} The SPE is a wholly owned subsidiary of the originator.\textsuperscript{16} Next, the SPE appropriates a license back to the originator and to any other entity it would want to be a licensee.\textsuperscript{17} In order for the SPE to pay the originator for the sale of the patented technology, the SPE issues debt securities in the market.\textsuperscript{18} The debt securities issued by the SPE are backed with the future revenue streams from the originator and other licensees.\textsuperscript{19} In essence, the originator is selling future cash flows in exchange for the current proceeds of the debt securities.\textsuperscript{20}

In 1997, the number of known IP ABS transactions totaled $380 million.\textsuperscript{21} By the year 2000, this number had grown to $1.13 billion.\textsuperscript{22} In 2003, Royalty Pharma structured a securitization issuing $225 million in AAA rated bonds backed by biopharmaceutical patents.\textsuperscript{23} More recently, there has been significant activity with IP ABS using trademarks and franchising fees. From 2005 to 2007, companies such as Dunkin’ Brands, Quiznos, Sear’s Holding Corporation, IHOP, and Domino’s Pizza established IP-based ABS backed by trademark and franchise royalties ranging from $200 million to $1.85 billion.\textsuperscript{24} However, patent-based ABS are not nearly as common as the use of trademarks or franchise royalties with ABS.\textsuperscript{25} As Dr. Elliott Fishman,
Managing Director of the consulting firm Astrina Capital LLC, noted, “[a] handful of completed transactions has shown how IP royalty streams can be valued, rated and then securitized like bonds. But the jury is still out whether these transactions will become more universally pursued.”

III. IMPORTANCE OF PATENT ABS TO START-UP BUSINESSES

Even though the jury may still be out on securitizing IP royalty streams, there seems to be continued interest from businesses and the financial community in using IP as a source of financing and collateral. This trend will likely continue as IP assets grow in their recognition as essential business assets and IP owners want to pursue the opportunity of making them profit centers. Combining this trend with the suggestion that intangibles are responsible for seventy percent of the current value of equities in the United States, it appears there will be a continued interest and desire to use patents in ABS. In fact, one of the leading North American financial services providers, Harris Nesbitt, viewed IP ABS as one of the most attractive areas for growth.

A. The Inability for Start-Up Companies to Obtain Traditional Financing

The use and development of IP ABS can be vital to start-up firms that have a majority of their assets related to IP. The patent ABS can

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28 Vani Sharma, Securitization of Intellectual Property Assets, JURISONLINE.IN (June 30, 2011), http://jurisonline.in/2011/06/securitization-of-intellectual-property-assets (“[IP] management, including funding business activities, is now said to be a ‘pillar of [the] corporate approach’.”).


30 Susan Miceli et al., Intellectual Property-Backed Securitization: A Closer Look, U.S. SECURITIZATION GROUP ASSET-BACKED UPDATE, February 2004, at 2, 3, available at http://www.securitization.net/pdf/SecNewsletter_Feb04.pdf (further explaining “[w]hile growth at the onset will continue to be slow, the origination pace should pick up in the foreseeable future.”).
be an essential tool to aid a company in gaining access to capital and funding its growth. The patent ABS provide a very viable option for start-ups and small entities to maintain their courses of business. Consider how a traditional lending transaction is undertaken. In analyzing a traditional lending arrangement from the creditor’s viewpoint, the main focus of the creditor will be the likelihood that the debtor will default.\textsuperscript{31} A key determinant of the likelihood a debtor will default is the debtor’s cash flow.\textsuperscript{32} For this reason, the creditor will typically require the debtor to have significant assets and financial stability before the creditor will engage in a traditional lending transaction.\textsuperscript{33} Many start-up companies have an issue with these requirements because they are attempting to establish significant assets and stabilize their cash flows.\textsuperscript{34} Usually, a more mature company has a greater chance of success in soliciting a creditor for a traditional loan instrument.\textsuperscript{35} Often the start-up company is not considered to be credit-worthy by the creditor.\textsuperscript{36} As a result, many start-up companies do not even qualify for conventional bank financing.\textsuperscript{37}

Even if the creditor is willing to make a traditional lending arrangement, the cost to the business seeking the financing may be too great. Because the start-up company is still attempting to solidify its cash flow and build its assets, a traditional lending arrangement will be seen as more risky.\textsuperscript{38} Moreover, for start-up companies, obtaining financing through conventional methods is often even more unlikely, typically because IP assets will have a more prominent role in the business.\textsuperscript{39} Frequently, the long-term success of many start-up companies is dependent on its IP assets.\textsuperscript{40} Due to these factors, it will be difficult for start-up companies to establish substantial assets to a

\begin{footnotesize}
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  \item \textsuperscript{31} EUR.
\textsuperscript{ Comm’n Directorate-Gen.
  \item \textsuperscript{32} See Nguyen, supra note 6 (“Whereas in traditional lending the bank primarily looks to the borrower’s cash flow.”).
  \item \textsuperscript{33} See Nikolic, supra note 7, at 399-400. \textsuperscript{\textsuperscript{34}} See generally William Pirraglia, \textit{Installment Loans for Startup Businesses}, Houston Chronicle, http://smallbusiness.chron.com/installment-loans-startup-businesses-2388.html (last visited Feb. 26, 2012) (stating “[s]tartup businesses face more challenges than growing organizations, because new companies have no record of success.”).
  \item \textsuperscript{35} See Nguyen, supra note 6, at 14.
  \item \textsuperscript{36} See id.
  \item \textsuperscript{37} See id.
  \item \textsuperscript{38} See id.; see also Nguyen, supra note 6, at 14-15.
  \item \textsuperscript{39} See Nguyen, supra note 6, at 11 (“In many start up companies . . . intellectual property assets are often the single most valuable assets.”).
  \item \textsuperscript{40} See id. at 12.
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degree of the creditor’s liking. The creditor will require a higher return in exchange for engaging in a higher risk transaction. Accordingly, if a start-up business that maintains a prevailing amount of its value and assets in IP can qualify for a traditional lending transaction, it still may be precluded from arranging this transaction due to cost. Consequently, many start-up entities, with most of their assets and value connected to IP, must look to other avenues for financing.

B. The Pitfalls of Equity Financing

Another avenue for the start-up firm with its assets predominantly associated with IP is to obtain financing through equity. This avenue entails the firm selling ownership interests in the company through stock. The benefit of the equity option is that it does not impose a burden on the firm’s cash flow in the form of required debt payments. However, equity financing also has significant disadvantages. Start-up businesses with a multitude of their assets and value wrapped in IP that are unable to obtain traditional debt financing will most likely have to seek equity financing through venture capital. Yet, equity financing with a venture capital firm usually results in the venture capital firm gaining significant control rights, a large equity interest in the business, and a dominant position of influence on the business’s board. The amount of control that a start-up business would be required to relinquish in order to procure financing from a venture capitalist may make this avenue undesirable and even impracticable.
C. Patent ABS and the Broader IP ABS Occupying the Gap

IP ABS, and specifically patent ABS, fills the void between conventional financing and financing from venture capitalists. At a time when equity financing from venture capitalists is undesirable and impracticable, start-up firms that do not qualify for conventional lending, and with significant value and assets tied to IP, can look to IP ABS or patent ABS as a viable option. An IP ABS infuses the start-up firm with the necessary cash it needs in order to continue and expand its operations.48 Also, it is a mechanism through which the start-up firm is able to diversify its assets.49 However, the start-up firm is still able to maintain control over the IP.50 This is due to the fact that once the bonds are paid, the underlying IP rights revert to the start-up firm.51 Therefore, the start-up firm is able to raise financing against the value of its IP assets.52 By not having to rely on the credit of the firm to gain financing, procuring IP-based financing becomes a much more fiscally reasonable option.53 Securitization becomes a natural fit for the start-up company because it is able to get a much lower cost of funds and a much higher advance rate if it goes into the capital markets issuing ABS.54 Moreover, the start-up entity is able to leverage its IP assets.55 Using an IP ABS, and particularly a patent ABS, enables an IP asset to accrue greater incremental capital.56

Additionally, the start-up business can acquire capital without having to give up equity.57 Through the IP ABS, and more narrowly the patent ABS, the start-up company is able to gain the funds it needs to build the growth of the company while not having to tap into the venture capital market.58 This allows the start-up business to maintain

49 Id.
50 Id.
51 Id.
52 See Edwards, supra note 4.
53 See Nguyen, supra note 6, at 14; see also Financial Concepts: The Risk/Return Tradeoff, supra note 42.
54 Interview by David Wanetick with Ronald S. Borod, Chair of Structured Fin. & Member of Brown Rudnick Berlack Israels LLP, & Donald R. Davis, Managing Dir. & Gen. Counsel at CommercialStrategies, LLC (Jan. 2007), http://www.brownrudnick.com/nr/pdf/articles/REPRINT_Structured_Finance_IP_Securitization_Borod_Davis_IncreMental_Advantage_207 (2).pdf.
55 Edwards, supra note 4.
56 Id.
57 Id.
58 Id.
control, which may be essential to the long-term success of the start-up.  

An essential component to the success of most start-up entities is the ability for the start-up to get its employees to feel like founders in terms of ownership, emotional attachment, and responsibility. Having an equity structure to incentivize employees is especially important in a start-up company in a technology-dependent industry. This is a result of the fact that the first few hires of a start-up company in a technology-dependent industry are the engineers and programmers. The engineers and programmers will drive the success of the start-up, so it is important for them to feel vested in the start-up company. Additionally, the equity structure can be integral for the start-up entity to maintain talent.

Lastly, using an IP ABS, and expressly a patent ABS, can place the start-up company in a much better and stronger position if it later feels it can pursue venture capital financing. The funds garnered from the IP ABS, and more particularly the patent ABS, can be used to develop the technology and business of the start-up company. This allows the start-up company to build more leverage to take into a future venture capital deal. Moreover, the use of an IP ABS and a patent ABS “signals both technological sophistication and a legal protection of competitive advantage. It can give important signals about start-up firms that often have difficulties accessing financial markets.”

Overall, an IP or patent ABS can be an essential tool for the success of start-up businesses. It occupies a very important area

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61 Id.

62 Id.

63 See id. (stating the closer employees feel to being founders than employees, the more likely the start-up is to be successful); see also Employee Stock Options, U.S. SEC. & EXCH. COMM’N (Mar. 29, 2010), http://www.sec.gov/answers/empopt.htm (“Many companies use employee stock option plans to compensate, retain, and attract employees.”).

64 EDWARDS, supra note 4.

65 See id.

66 EUR. COMM’N DIRECTORATE-GEN. FOR ENTER. & INDUS., supra note 31.
between conventional financing and venture capital financing. It also provides another option of financing and gives the start-up company more flexibility in determining the best manner in which to pursue financing. This flexibility can be integral to sustaining a start-up business especially in light of the fact start-ups have a small chance of success. It is estimated that first-time entrepreneurs only have a 20.8 percent chance of succeeding. Second-time entrepreneurs only have a twenty to thirty percent chance of succeeding, depending on if the entrepreneur succeeded in his first venture. Furthermore, an IP ABS, and specifically a patent ABS, can be an even more essential tool for success for start-up companies in high-technology industries. The rapid pace of technological progress does not allow for a start-up to have a slow growth curve. Also, many technology companies use capital strategically as a competitive weapon to expedite progress. Therefore, having an IP ABS and patent ABS option for financing can be fundamental to a start-up company’s ability to thrive and survive in a high-technology dependent industry.


In the wake of the Financial Crisis of 2008, the United States government looked to restore responsibility and accountability to the United States financial system. The government decided to take certain measures with the motivation of restoring Americans’ confidence in the United States’ financial system. Through the Dodd-Frank Act, Congress and the Securities and Exchange Commission made profound increases in the regulation of the financial

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67 See Nguyen, supra note 6, at 11-12 (stating start-up companies face a small chance of success).
69 Id.
71 Id.
73 Id.
industry. Two mechanisms used in an attempt to establish additional regulation of the financial industry are 17 C.F.R. § 229.1111 and § 230.193. Both of these regulations deal with the requirements an issuer of an ABS must perform prior to issuing an ABS. An issuer of an ABS pursuant to § 229.1111 and § 230.193 must perform a review of the assets underlying the ABS and disclose the nature of the review. Essentially, the new rules for ABS shift to a public-style disclosure with ongoing reporting. The new rules demand that most ABS be accompanied with loan-level disclosure. More explicitly, an issuer of an ABS must disclose standardized, specific asset-level information concerning each asset underlying the ABS. This disclosure not only must occur at the time of the issuance of the ABS, but also on an ongoing basis. Moreover, the required information on the underlying asset, regardless of the asset type, consists of approximately twenty-eight general fields and additional specified fields for particular asset types. Thus, the rules, in particular § 229.1111, attempt to bolster the previous regulation governing ABS, Regulation AB.

The new regulations coming from the Securities and Exchange Commission (“SEC”) significantly heighten the reporting requirements for any entity considering issuing an ABS. The depth and amount of information that will now be necessary for any ABS

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77 Id.
80 Id. at 10.
81 Id.
82 Id.
will have substantial ramifications for start-up businesses with a majority of assets related to IP, particularly businesses attempting to issue a patent ABS. The most drastic consequence of the new regulations to start-up businesses with a majority of assets related to IP will be the additional costs that must now be incurred to engage in a patent ABS. In fact, the SEC contemplated this outcome in its release of 17 C.F.R. parts 229 and 230. The SEC stated:

“[a]lthough issuers of ABS likely already perform some level of review of the underlying assets and many originators review the assets at origination, ABS issuers in registered offerings may incur additional costs to perform more extensive reviews that are sufficient to comply with the minimum level of review required by the rule . . . .”

Thus, for start-up firms with a majority of assets related to IP, one of the primary advantages of engaging in ABS financing will be eliminated. Furthermore, if these start-up firms are in high-technology industries, the time required to accumulate the information necessary to meet the disclosure requirements and to ensure the continual compliance with the disclosure requirements may also inhibit the issuing of patent ABS. The reality is that, after these new regulations, issuing and maintaining a patent ABS will take considerably more time and effort and could prevent this financial vehicle from being a strategically viable option for these start-up companies. In the high-technology competitive environment, where a rapid growth curve is essential and competitors strategically leverage capital to accelerate progress, increasing the duration it takes to issue a patent ABS can make obtaining a patent ABS an unrealistic option. Ultimately, the start-up entity is left with less flexibility in financing options as a result of the SEC’s regulations.

However, the SEC’s regulations do allow an issuer to use a third party to perform the mandatory reviews with an ABS. This alternative has the potential to make the issuing of a patent ABS more feasible. By drawing on the expertise and resources of a third party

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84 Issuer Review of Assets in Offerings of Asset-Backed Securities, supra note 76, at 4241.
85 See Nguyen, supra note 6, at 13-16; see also Financial Concepts: The Risk/Return Tradeoff, supra note 42; see also Interview by David Wanetick, supra note 54.
86 See A Start-Up’s Financing Strategy, supra note 70.
87 See id.
88 Issuer Review of Assets in Offerings of Asset-Backed Securities, supra note 76, at 4242.
reviewer, the start-up firm could solve the cost and time issues associated with pursuing a patent ABS with the SEC’s new rules. However, there are certain requirements that may deter a third party from conducting the necessary reviews. The deterrence would be even more prevalent for a patent ABS. The reason for this deterrence is that the third party is required to be named in the ABS’s registration statement as an expert.\textsuperscript{89} Many third party reviewers will refuse to expose themselves to the liability associated with being named in the reviews as an expert.\textsuperscript{90} Additionally, the asset class of patents may not even have third parties available to do the reviews.\textsuperscript{91}

A. SEC Regulations and the Benefits They Are Supposed to Provide for Patent ABS

With the considerable curtailment of the attractiveness to start-up companies of issuing a patent ABS, the key question becomes: what benefits can be derived from the SEC’s new regulations regarding patent ABS? By requiring more reviews and more thorough reporting of the underlying assets of the ABS, the regulations are attempting to improve the asymmetric information exchange surrounding an ABS. Asymmetric information exchange involves instances where an individual or entity possesses information that the other party cannot verify or is unable to access.\textsuperscript{92} Fundamentally, asymmetric information relates to quality and uncertainty.\textsuperscript{93} In considering the concept of asymmetric information, economist George A. Akerlof analyzed buyers and sellers in the used automobile market.\textsuperscript{94} Through his examination, Akerlof proposed that a seller would gain a good idea of the quality of the machine after owning it for a length of time.\textsuperscript{95} Therefore, an asymmetry of available information develops.\textsuperscript{96}

A related problem that is created by the existence of asymmetric information is adverse selection.\textsuperscript{97} At the heart of adverse selection is the situation where an individual does business with another person

\begin{itemize}
  \item[\textsuperscript{89}] Id.
  \item[\textsuperscript{90}] See id.
  \item[\textsuperscript{91}] See id.
  \item[\textsuperscript{92}] JAMES R. MCGUIGAN ET AL., MANAGERIAL ECONOMICS APPLICATIONS, STRATEGY, AND TACTICS 368 (Jack W. Calhoun et al. eds., 12th ed. 2011).
  \item[\textsuperscript{94}] See id. at 489.
  \item[\textsuperscript{95}] Id.
  \item[\textsuperscript{96}] Id.
  \item[\textsuperscript{97}] See Gregory Lewis, Asymmetric Information, Adverse Selection and Online Disclosure: The Case of eBay Motors, 101 AM. ECON. REVIEW 1535, 1535 (2011).
\end{itemize}
that in reality he would be better off avoiding. 98 A good example portraying the interaction of asymmetric information and adverse selection can be found in the insurance industry (another market typically used to explain asymmetric information). Generally, insurance premiums are set according to the average risk associated with a group of individuals that meet chosen criteria. 99 For instance, the criteria could be males between the age of 60 and 65 who have diabetes. 100 As a result of asymmetric information, the individuals considering purchasing an insurance policy know if they have a lower or higher risk of needing to claim the insurance. 101

The adverse selection results in individuals that have knowledge that they will be more likely to claim the insurance will likely purchase the insurance. 102 Meanwhile, many of the individuals that have the knowledge they will be less likely to claim the insurance will view the premium of the policy as being costly. 103 Therefore, the premiums set to coordinate with the average risk of the group will not be adequate to cover the claims that will arise under the plan. 104 This is a result of the predominance of individuals who purchased the plan having a higher likelihood of needing to claim the insurance. 105 Raising the price of the insurance policy will not get the insurance company out of this predicament. 106 This is due to the fact that the price increase makes the policy even more unattractive to those who possess the information that they have a lower risk of needing to claim on the insurance policy. 107 Consequently, the insurance company is left with a situation of adverse selection as defined as “a limited choice of lower-quality alternatives attributable to asymmetric information.” 108 Thus, because of the presence of asymmetric information, the insurance company is unable to accurately assess the risk of the policy and, consequently, unable to accurately price the premium.

In the financial markets, the asymmetric information derives from a security holder or originator of a security not being able to credibly

99 See id.
100 Id. (using the age of 55 and smoking).
101 Id.
102 Id.
103 Id.
104 Id.
105 Id.
106 Id.
107 Id.
108 McGuigan et al., supra note 92, at 371.
reveal its intrinsic value to a potential buyer. In securitization, the available information is substantially on the side of the market that produced the financial structures. Accordingly, the asymmetric information about the true value of the asset generates an issue where the buyer is uncertain about the true purpose for the seller to sell the security. The buyer is not in a position to know for certain whether the seller is motivated to sell the security because of a need for liquidity or if the seller is trying to dispose of toxic assets. Essentially, the asymmetric information about the actual value of the asset generates the “lemons problem” that Akerlof proposed in his research. In analyzing the used automobile industry, Akerlof considered a market in which goods are sold honestly or dishonestly and the quality of the goods could be accurately represented or inaccurately represented. Akerlof believed that the presence of people in the market who are willing to offer inferior goods, or lemons, is likely to drive the market out of existence. Akerlof noted that the market being driven out of existence is the major cost of dishonesty because dishonest transactions in the market typically drive out the honest transactions. Consequently, the buyers in the financial market will be left with a situation of adverse selection because the only financial offerings will be the “lemons.” Moreover, most economists are in accordance that a market with asymmetric information is usually not operating at an optimal efficiency.

B. Why the SEC Regulations Do Not Provide Significant Benefits to Patent ABS

The new regulations imposed by the SEC compelling more review

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110 Id.
112 Id.; see also Akerlof, supra note 93, at 495.
113 Id.
114 Akerlof, supra note 93, at 495.
115 Id.
116 Id.
117 See Kirabaeva, supra note 111, at 3.
and disclosure of the underlying asset in an ABS aims to curtail situations of adverse selection resulting from asymmetric information. However, it is questionable whether these regulations will accomplish the purpose for which they were enacted. Regarding start-up companies that predominately have their assets tied to intellectual property, the key consideration is how much the asymmetric information gap can be closed and how prevalent the information is in the patent ABS market, pushing the market towards adverse selection.

1. The Difficulties in Valuing the Patent

It would be difficult to refute an assertion that the start-up entity would have more knowledge of the underlying patent or patents in an ABS structure. Yet, the extent to which this knowledge can lead to adverse selection is limited. The reason for this is the difficulty in valuing the underlying patent or patents. Valuing IP assets is a difficult task because their true value may not be readily apparent.\(^{119}\) One of the significant elements that contribute to the uncertainty of the value of IP is related to the fact that much of the value of an IP asset resides in the negative right to prevent others from doing something they otherwise would be allowed to do.\(^{120}\) For instance, in valuing a company’s patent portfolio, the portfolio may have the greatest value in permitting the company to conduct its business devoid of any concerns of infringement it may otherwise face from third-parties.\(^{121}\) As well, valuing any IP asset can be further complicated by the fact the value is sometimes not static.\(^{122}\)

2. Lack of Standardization for Valuing Patents and IP

Another complicating factor in attempting to accurately assess the value of any IP asset is the absence of any standardization in IP valuation.\(^{123}\) In contrast to valuing a business, which has fairly detailed standards for valuation, IP has no standards delineating the unique factors that must be analyzed when valuing IP.\(^{124}\) In fact, it has been estimated that there are more than fifty different methods in use


\(^{120}\) See id.

\(^{121}\) Id.

\(^{122}\) Id.


\(^{124}\) Id. at 37.
to value IP. A significant reason that so many methods exist is the fact that there are a myriad of IP valuers each with different backgrounds and professional training. The IP valuation community encompasses individuals trained in accounting, economics, and finance, each with its own perspective. However, a standard for IP valuation developed around any one of the particular perspectives could be entirely wrong for certain contexts. Standards developed around a particular perspective would most likely be skewed or inadequate.

It is into this environment that start-up businesses with most of their value associated with IP are thrust when attempting to embark on a patent ABS. Even the start-up firm in possession of the patent is highly susceptible to inappropriate valuations and a lack of understanding of the valuation process. Thus, the start-up entity can be prone to inequities relating to the value of the core asset, the patents. Fundamental to the valuation issues and challenges facing start-up businesses is the inability to establish a benchmark to assist in reducing the subjectivity of any valuation. It is difficult to establish a benchmark because of the nature of the asset being used. The valuation of IP flows from assumptions about the potential business opportunities to derive future revenue streams or develop markets. This results in the inability to have certainty on which to base any valuation. Additionally, because of the innovative aspect of IP, IP valuation is often tied to the creation of new products, technologies, and markets. Thus, it can be extremely difficult and costly to obtain comparable information.

With these circumstances surrounding a start-up business’s valuation of any patent it would use in an ABS, as well as the harm the SEC’s regulations could cause, it does not comparatively appear that

126 See id. at 33.
127 See id. at 32–33.
128 See id. at 32.
129 Id. at 35.
131 Id.
132 Id. at 7.
133 Id. at 8.
134 Id. at 8.
135 Id. at 8.
the gap of asymmetric information will be significantly reduced. As a result of this lack of IP valuation standardization and the considerable impediments start-up businesses face in coming to an accurate appraisal of the patent, combined with the detriments of the regulations, it appears as though the regulations will have a minimal effect on the difference in asymmetric information between buyers and issuers of patent-based ABS. This gap closure seems especially minimal when compared to the potential negative effects of the regulations, which will soon be discussed.

Furthermore, the start-up business’s unique nature and position necessitating the desire to issue a patent ABS assuages the concern over whether the business is attempting to rid itself of toxic assets. The overriding motivation for the start-up engaging in the patent ABS is the need for liquidity. Also, because the companies are start-ups, they will likely need to go back to the markets to gain more financing. It follows that the start-up company will need to maintain a good reputation to procure more financing. This would prevent the start-up company from dumping toxic assets. In light of these considerations, it becomes apparent that with patent ABS, the SEC regulations will not confer the amount of benefits that motivated the issuing of the regulations. The heightened requirements of reviewing and reporting the underlying patent will not significantly limit the adverse selection because the start-up businesses already have deterrents from dumping toxic assets through patent ABS.

V. THE NEGATIVE EFFECTS ON INNOVATION AND THE AMERICAN ECONOMY

The minimal benefits that will be derived from the SEC regulations for patent ABS must be weighed against the negative

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136 See generally Beltran & Thomas, supra note 109 (stating in securitization most of the information is on the side of the seller).
137 See generally Kirabaeva, supra note 111 (stating buyers do not know whether seller is selling because he needs liquidity or is attempting to get rid of toxic assets).
138 See Kalanje, supra note 48.
140 See KEVIN T. JACKSON, BUILDING REPUTATIONAL CAPITAL 1 (2004) (stating reputational capital as the most powerful force behind a business and discussing its ability to be leveraged for strategic advantage and long-term financial performance).
ramifications resulting from the regulation’s hindrances for creating this financial vehicle. The most significant negative effect the regulations will have pertains to the American economy. The American economy and American businesses have shifted towards being heavily dependent on IP. In 2005, it was estimated that the copyright industry and the output of patent intensive industries accounted for 9.2 percent of the U.S. GDP.\footnote{141} This estimate excludes industries that are not considered traditional IP sectors, but still produce goods or services that draw their value heavily from the use of IP.\footnote{142} Furthermore, it has been suggested that intangibles can be held responsible for seventy percent of the current value of equities in the United States.\footnote{143} These facts coincide with the replacement of the brick-and-mortar economy with the economy of ideas.\footnote{144} In the economy of ideas, wealth is developed through generating and capturing the value of knowledge.\footnote{145} Thus, innovative thinking is as valuable as skill.\footnote{146} A firm’s innovative thinking and innovative knowledge management leads to intellectual capital.\footnote{147}

A. The American Recovery and Reinvestment Act
The importance of innovation to the vitality of the American economy is further evidenced by looking at the recently passed, “The American Recovery and Reinvestment Act” (“The Recovery Act”).\footnote{148} A report issued by the White House discussing the reinvestment portion of The Recovery Act emphasized transforming the American economy through innovation.\footnote{149} The report on The Recovery Act emphasizes innovation, noting how the United States, as a leader in discovery and innovation, has been able to change the way the world thinks about government, industry, and technology.\footnote{150} It follows that one of the objectives of The Recovery Act is to invest in the building

\footnote{141}Shapiro & Hassett, supra note 29, at 12. 
\footnote{142}Id. at 12. 
\footnote{143}Id. at 13. 
\footnote{145}Id. 
\footnote{146}Id. at 56. 
\footnote{147}See id. 
\footnote{150}Id.}
blocks of American innovation.\footnote{151}{Id.}

**B. The Key Relationship Between Patents and Innovation**

In particular, patents play an increasingly vital role in innovation and economic performance.\footnote{152}{Org. for Econ. Co-operation and Dev., Patents and Innovation: Trends and Policy Challenges 5 (2004), available at http://www.oecd.org/dataoecd/48/12/24508541.pdf.} Patents can be used to stimulate economic development by facilitating technology transfer and investment and being a catalyst for new technologies and businesses.\footnote{153}{See Shapiro & Hasset, supra note 29, at 2-3, 8, 9.} Markets for technology are becoming more essential to the circulation of knowledge.\footnote{154}{Org. for Econ. Co-operation and Dev., supra note 152.} In the market for technology, patents are positioned in a pivotal role for the development of technology transactions.\footnote{155}{Id.} Additionally, patents are a powerful tool for stimulating ventures into innovations that could lead to new technologies and industries.\footnote{156}{See Shapiro & Hasset, supra note 29, at 8.} Patents provide a mechanism that drives innovation by allowing inventors to profit from their inventions.\footnote{157}{Org. for Econ. Co-operation and Dev., supra note 152, at 9.}

The increased standards of review and reporting required by the new SEC regulations for patent ABS can have dire consequences to the innovation that is a key factor to the health of the United States economy. The regulations will significantly limit a critical financial option for start-up companies with most of their value tied to IP. These small start-up companies with the predominant amount of their value associated with IP have enormous potential to inject innovation into the American economy through their patents.\footnote{158}{See generally Ron Ashkenas, Can a Big Company Innovate Like a Start-Up?, Harv. Bus. Rev. Blog Network (Jan. 25, 2011, 2:05 PM), http://blogs.hbr.org/ashkenas/2011/01/can-a-big-company-innovate-lik.html.} A start-up company with a dominant portion of its value vested in IP is able to more easily innovate, especially regarding disruptive technologies, because it is not held down by outdated values or organizational norms.\footnote{159}{Clayton M. Christensen, The Innovator’s Dilemma: When New Technologies Cause Great Firms to Fail 208-09 (1997); see also Eric Ries, A Startup Inside a Fortune 500 Company? The Nordstrom Innovation Lab, Huffpost Bus. (Nov. 04, 2011, 7:20 PM), http://www.huffingtonpost.com/eric-ries/a-startup-inside-a-fortune-b_1068449.html (stating how after one reads The Innovator’s continued . . .}
subjected to the SEC’s new regulations, the United States economy will likely lose out on the opportunity to reap the benefits of the innovation derived from patents of start-up companies. As innovation is a principal driver of long-term economic growth and prosperity, this loss of opportunity would have significant consequences for the economy of the United States. By comparing the minimal benefits that will be derived from including IP ABS and particularly patent ABS in the stipulations of the regulations of the SEC, it is apparent that the financial vehicles of IP ABS and patent ABS should be excluded from the regulations’ requirements.

In allowing the patent ABS and overarching IP ABS to be exempt from reporting and reviewing requirements of the SEC’s provisions, the American economy will be heeding renowned economist Paul Romer’s keys to economic growth. As Romer states, “economic growth doesn’t arise just from adding more labor to more capital, but from new and better ideas expressed as technological progress.” Many of the novel and useful ideas will come from the innovative patents of start-up companies with significant assets of IP. Hence, the American economy will have a remarkably better chance to grow if those start-up companies are given the tools needed to survive and prosper.

C. Apple and the Innovation From Its Patents’ Effect on the American Economy

Consider the case of Apple, its patents and the innovation it has brought to the United States economy. Apple is unique in that it has grown into a large and global company yet has been able to maintain the culture of a start-up business. In fact, Apple, despite being in business for thirty-five years, still makes a conscious effort to conduct itself in the manner of a start-up business. Professors and

_Dilemma_ one knows how hard it can be for a company that has been successful to invest in disruptive technologies).

160 See _The White House_, _supra_ note 149 (stating innovation as a key driver of long-term economic growth and prosperity).


162 Id.

163 See Nilofer Merchant, _Apple’s Startup Culture_, BLOOMBERG BUSINESSWEEK (June 14, 2010, 2:51 PM), [http://www.businessweek.com/innovate/content/jun2010/id20100610_525759.htm](http://www.businessweek.com/innovate/content/jun2010/id20100610_525759.htm).

researchers Greg Linden, Jason Dedrick, and Kenneth Kraemer analyzed innovation and job creation through Apple’s iPod. Through considering the extent innovation from American companies will have a beneficial effect on American workers, the three professors and researchers analyzed the global value chain that designs, builds, and brings iPods to consumers. The analysis of the global value chain was broken down by examining which countries capture the financial value within the global value chain and how innovation can influence jobs and wages. As a result of the findings, the professors and researchers argue that in the environment of a globalized economy, industries driven by innovation disproportionately benefit the American worker and the United States economy. The report concluded that, notwithstanding the fact the product is produced overseas, innovative products designed by companies in the United States create valuable jobs in America. In reality, the report noted that China, where the iPod is assembled, was not able to capture much of the financial value created by Apple’s global value chain.

It can be concluded that Apple has become an integral part of the United States economy. As recently as this past July, Apple had amassed a cash pile of $75.87 billion. This stockpile of cash actually exceeded the amount the United States government had in its reserves by $2.11 billion. This is not to say that every start-up company will develop into a company of the magnitude of Apple. However, Apple embodies the potential that many start-up companies with the dominant portion of their value related to IP can reach. Many of these start-up companies are capable of developing groundbreaking innovative products and technologies through their patents that may not rise to the caliber of Apple, but still can have significant positive effects on the American economy and American work force. It is the potential for innovation and economic stimulus that outweighs the

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166 Id. at 224.
167 Id. at 226.
169 Linden et al., supra note 165, at 231.
170 Id. at 226.
172 Id.
minimal benefits that would be garnered from including patent ABS and the broader IP ABS in SEC regulations § 229.1111 and § 230.193. The impediments created by the SEC’s new rules should be removed in order to allow start-up entities with valuable IP to procure essential funding.

VI. **HOW CARVING OUT PATENT ABS AND THE BROADER IP ABS CAN HELP THE SEC REGULATIONS**

However, the claim should not be made that patent ABS and the overarching IP ABS should never be held to the reporting and review requirements of the SEC’s new provisions. By not including patent ABS and IP ABS under the purview of the regulations, the SEC may be helping the regulations to be more beneficial to patent ABS and IP ABS in the future. As discussed earlier, one of the most important benefits the new reporting and reviewing rules look to confer is closing the gap of asymmetric information in the market and limiting the market movement towards situations of adverse selection. Yet, because of the limitations of IP valuation and deterrents for dumping toxic assets, closing the gap of asymmetric information in the market and preventing a driving movement towards adverse selection will not outweigh the negative effects of the measures taken to accomplish these goals. Through not including patent ABS and IP ABS in the parameters of § 229.1111 and § 230.193, there will not be the concern that the regulations are too onerous and the IP ABS and patent ABS will not be issued in the market. Thus, the IP valuation community will not have to be concerned about having less data, information, and comparables in the public marketplace to aid in developing valuation standards.

More IP ABS, and particularly patent ABS, can be issued if the constraints of the SEC’s regulations are not imposed. Accordingly, having more of these IP derived financial vehicles will give the IP valuation community more material through which it can move to more standardization. The patent ABS and overall IP ABS can provide more opportunities to develop and potentially put into practice

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173 See supra text following note 118.
174 See supra text accompanying notes 136-37.
175 See Terrence Hendershott & Charles M. Jones, *Island Goes Dark: Transparency, Fragmentation, and Regulation*, 18 REV. FIN. STUD. 743, 744 (2005) (discussing the SEC’s requirement of Island electronic communications network to comply with Regulation ATS motivating Island to go “dark” and causing trading and price discovery to be conducted at much lower levels).
176 Issuer Review of Assets in Offerings of Asset-Backed Securities, supra note 76, at 4241-42.
key standardization principles related to creating a common language and terminology with IP valuation.\textsuperscript{177} Often, terms used in the valuation of IP are not applied in a uniform manner and are undefined, ambiguous, or are unique to the particular area of business or industry.\textsuperscript{178} The patent ABS and overall IP ABS can provide more mechanisms to discern how any valuation standardization system would need to function to best operate in the world of business. For instance, the Business Valuation Standards Committee of the American Society of Appraisers commissioning of the Intellectual Asset Valuation Standards (“IAVS”) subcommittee to develop standards for the valuation of intangible assets provides a compelling circumstance for patent ABS and the broader IP ABS.\textsuperscript{179} A stronger existence of IP ABS, and specifically patent ABS, could bestow more insight into how the standards the IAVS has generated will be able to address the challenges and needs of structuring IP valuation to have substance and specificity, but not be mired in the multiplicity of IP.\textsuperscript{180}

Ultimately, the presence of IP ABS, and more applicable patent ABS, and the way they operate offers a lens into how IP should be valued. They can help to gain a better understanding of the nature and fundamentals of IP. This understanding can be combined with ventures like Ocean Tomo’s IP Exchange and the Intellectual Property Exchange International.\textsuperscript{181} These ventures look to enhance efficiency, transparency, and to deepen understanding of innovation in the economy.\textsuperscript{182}

\begin{itemize}
\item[177] See Sullivan, supra note 125, at 33.
\item[178] See id.
\item[179] See Cromley, supra note 123, at 37.
\item[180] See id.
\item[182] See id.
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