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Antitrust Law

Senate Committee Approves Legislation to Ban "Reverse Payments" for Generic Drugs

On February 27, 2007, the Senate Judiciary Committee approved S. 316, the "Preserve Access to Affordable Generics Act," a bill intended to prohibit big pharmaceutical companies from paying manufacturers of generic versions of their products to delay entering the market—thereby preserving the original manufacturer's monopoly.

The bill would amend the Clayton Act by adding a new provision making it illegal for any person to be a party to any agreement resolving a patent infringement claim in which a generic manufacturer receives "anything of value" in exchange

for an agreement "not to research, develop, manufacture, market, or sell [its generic drug] for any period of time." The bill would exclude situations where the only result of the settlement is that the generic manufacturer is permitted to market its product prior to the expiration of the original patent.

The bill was introduced by Senator Herb Kohl (D-Wis.) in response to the Supreme Court's denial of *certiorari* in *Schering-Plough v. F.T.C.*, 402 F.3d 1056 (11th Cir. 2005), *cert. denied* 126 S. Ct. 2929, 165 L. Ed. 2d 977 (2006). In that case, the Eleventh Circuit Court of Appeals overturned a ruling by the Federal Trade Commission (FTC) that an agreement between two pharmaceutical

continued on page 2

Letter from the Editor

Dear Subscribers:

On March 19, 2007, the Supreme Court invited the Solicitor General to submit an *amicus* brief in a case involving alleged monopolization of a pharmaceutical market through settlement payments intended to delay the entry of generic drugs. This has been a rather hot topic of late, and legislation to prohibit this practice of "reverse payments" has been working its way through Congress in the early months of 2007.

The Supreme Court is reviewing the Second Circuit's ruling in *In re Tamoxifen Citrate Antitrust Litigation*, 466 F.3d 187 (2d Cir. 2006), that payments made pursuant to a patent infringement settlement did not constitute a conspiracy to monopolize the market for that drug by suppressing generic competition. The question before the Court is: Under what circumstances is an agreement by a manufacturer of a patented and branded pharmaceutical to share a portion of its future profits with a manufacturer of a generic drug that allegedly infringes the patent on the branded drug, in exchange for the generic's agreement not to market its product, a violation of federal antitrust law?

Very truly yours,
Robert S. Chaloupka
Senior Attorney Editor

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IN THIS ISSUE:

Letter from the Editor.....	1
Antitrust Law	1
Securities Law	5
Employment Law	9
International Law	13
Employee Benefits Law	15
Intellectual Property Updates.....	16
The Calendar	19

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companies that settled a patent infringement lawsuit represented an unreasonable restraint of trade.

In the *Schering-Plough* case, Schering-Plough had developed the leading potassium chloride treatment used for high blood pressure and heart disease, a product known as K-Dur 20.TM While the active ingredient in K-Dur 20 was commonly used, and, therefore, unpatentable, Schering-Plough did obtain a patent in 1986 for an extended-release coating that it applied to each tablet. In 1995, Upsher-Smith Laboratories, Inc. filed to begin the approval process for a generic version of K-DUR 20. Schering-Plough then sued, claiming that Upsher's generic product would infringe its patent. The parties agreed to settle the suit in 1997. Under the terms of the settlement agreement, Upsher agreed to hold off on marketing its generic product until 2001 in exchange for Schering-Plough licensing another Upsher product. Under the terms of the license, Schering-Plough would pay a \$60 million license fee, an additional \$10 million in milestone royalty payments, and further royalties of 10 to 15 percent on sales of the Upsher product. Meanwhile, also in 1997, Schering-Plough entered a settlement agreement in a similar infringement case with another company, ESI Lederle, Inc., in which Schering-Plough agreed to pay \$10 million to keep ESI's product off the market until 2004.

In 2001, the FTC filed a complaint against all the parties to the settlements, alleging that the payments were illegal agreements in restraint of trade, in violation of § 5 of the Federal Trade Commission Act and § 1 of the Sherman Act. In 2002, an administrative law judge (ALJ) at the FTC ruled in favor of the defendants, ruling that, in order to find the agreements to be anticompetitive, he would have to presume that either the Schering-Plough patent was invalid or that the generic products did not infringe that patent. Otherwise, the ALJ ruled that the restrictions imposed by the agreements were no stricter than those that would apply under Schering-Plough's ordinary patent rights—in fact, they were less so, since the patent would not expire until 2006. The FTC's counsel appealed to the commissioners of the FTC, who reversed the ALJ's decision and concluded that the arrangement basically amounted to Schering-Plough making payoffs to potential competitors to keep them out of the market (thereby restricting consumer choice and harming competition in the market).

On this appeal, the circuit court followed the precedent of its own ruling in *Valley Drug v. Geneva Pharmaceuticals, Inc.*, 344 F.3d 1294 (11th Cir. 2003), where the court had ruled, on similar facts, that “monetary payments made to an alleged infringer as part of a patent litigation settlement” did not constitute a per se violation of antitrust law. The court drew a distinction between ordinary agreements to allocate markets, which are clearly anticompetitive, and similar agreements where a patent is involved. In the latter context, the court ruled that “the anticompetitive effect may be no more broad than the patent's own exclusionary power.” While both the ALJ and the FTC commissioners had rejected application of the per se rule and applied a rule of reason standard, the court noted that “neither the rule of reason nor the per se analysis is appropriate” in a case such as this when a patent is involved. The Schering-Plough court noted that patents are inherently anticompetitive and held that this case required

an analysis of the extent to which antitrust liability might undermine encouragement of innovation and disclosure, or the extent to which the patent laws prevent antitrust liability for such exclusionary effects. Therefore, ... we think the proper analysis of antitrust liability requires an examination of: (1) the scope of the exclusionary potential of the patent; (2) the extent to which the agreements exceed that scope; and (3) the resulting anticompetitive effects.

Schering-Plough, 402 F.3d at 1066 (quoting *Valley Drug*, 344 F.3d at 1312).

Applying this standard, the circuit court first held that, since there was no allegation that the patent was invalid, Schering-Plough had the right to exclude infringing products from the market until 2006. While the FTC alleged that the parties were using the patent as a smokescreen to cover a market allocation agreement, the court agreed with the ALJ that such a ruling would require a finding that the patent was invalid, which was not the case here.

Looking to the settlement agreements, the court then agreed with the ALJ's findings, based on testimony and documentary evidence, that the payments made to Upsher and ESI were reasonable estimations of the potential income those companies could derive from putting their products

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on the market. More importantly, since the patent gave Schering-Plough the right to completely exclude these products until 2006, the fact that entry was being delayed until 2001 and 2004, respectively, was well within the scope of Schering-Plough's patent rights. While Schering-Plough could have simply defended those rights, the court also noted that settlement is always preferable to litigation, and that the Supreme Court has upheld the right of parties to a patent dispute to exchange consideration in settling the dispute.

In terms of anticompetitive effects, the circuit court held that the agreements restricting entry into the market were limited specifically to the generic products that fell within the reach of the patent. As such, the agreements fell within a "reasonable litigation compromise." Furthermore, competition was arguably helped by the early entry of the generics, since "if settlement negotiations [had failed] and the patentee [prevailed] in its suit, competition would be prevented to the same or an even greater extent because the generic could not enter the market prior to the expiration of the patent." The court also noted the danger in the FTC's ruling in which it "manufactured a rule that would make almost any settlement involving a payment illegal." The focus in cases such as this must be "the extent to which the exclusionary effects of the agreement fall within the scope of the patent's protection."

Sixth Circuit Finds No Robinson-Patman Violation Where Discounts Were "Functionally Available"

On February 27, 2007, the Sixth Circuit Court of Appeals affirmed a grant of summary judgment in favor of a major tobacco company accused of violating the Robinson-Patman Act by providing discounts to certain wholesalers based on their market share penetration. *See Smith Wholesale Co., Inc. v. R.J. Reynolds Tobacco Co.*, 477 F.3d 854 (6th Cir. 2007).

R.J. Reynolds (RJR), the number-two cigarette manufacturer in the United States, put in place the discount program at issue in this case in the wake of declining sales after the tobacco companies' 1998 Master Settlement Agreement (MSA), which resolved an enormous class-action suit brought by the fifty state governments. According to the facts cited in the case, RJR currently holds a market share in the United States of approximately 28 percent. The general practice in the industry is to divide cigarettes into four categories, based on price. RJR sold products in the first three tiers. Under RJR's program—which it called the Wholesale Partners Program (WPP)—wholesalers were given incentives for focusing on RJR's lower-priced cigarette brands. Under the WPP, all wholesalers received a baseline discount, but there were also two more levels of discounts and rebates, which were based on a comparison of each wholesaler's sales of the "savings brands" as compared to sales of the more expensive cigarettes.

The plaintiffs were RJR distributors who claimed that, to qualify for the highest discount, they had to meet the goal of increasing their sales of RJR's cheaper cigarettes as a proportion of their overall sales of low-cost cigarettes from all suppliers. The distributors alleged that, since they resold to retailers in low-income, rural areas where there was a demand for fourth-tier cigarettes (which RJR did not sell), it was impossible to meet this goal, thus making the highest discount levels unavailable to them.

The district court disagreed and granted summary judgment to RJR, leading to this appeal. The Sixth Circuit began its review with a lengthy discussion of the doctrine of functional availability in a secondary-line price discrimination case such as this one. While the plaintiffs argued that functional availability was an affirmative defense, meaning RJR would have to make some showing that the discounts were, in fact, functionally available, the Sixth Circuit disagreed. The court pointed to the Fifth Circuit's ruling in *Metro Ford Truck Sales, Inc. v. Ford Motor Co.*, 145 F.3d 320 (5th Cir. 1998), which held that "functional availability 'is technically not an affirmative defense, but the negation of an element of the plaintiff's case.'" *Smith Wholesale*, 477 F.3d at 867 (quoting *Metro Ford*, 145 F.3d at 326 n.17). As such, summary judgment may be granted if the alleged discrimination "is negated by evidence showing that a pricing or discount scheme is functionally available to all participants on an equal basis."

The court also pointed out the "dearth of precedent addressing the legality of market-share discount programs." But, on reviewing what precedent does exist, the court stated that the "underlying rationale" of the functional availability doctrine, "that a discount equally and realistically available to all purchasers of a like commodity does not constitute discrimination in price [under the Robinson-Patman Act], ... is no less relevant in judging the legality of market-share discount formulas such as the WPP." *Smith Wholesale*, 477 F.3d at 872.

Applying this rule, the court found that the WPP was available to "all wholesalers using a non-discriminatory formula," and if the plaintiffs did not take advantage of the discount, that was a business decision on their parts. As such, the court found the discounts to be "functionally available." While "application of the WPP program may ultimately cull the number of RJR's distributors ..., the functional availability doctrine does not require a supplier to ensure the success of its customers." *Smith Wholesale*, 477 F.3d at 881.

Sixth Circuit Finds No Parker Immunity in Suit against Michigan Registers of Deeds

On February 22, 2007, the Sixth Circuit Court of Appeals held that the state action doctrine of immunity from antitrust liability did not apply to a policy of the registers of deeds in several Michigan counties that restricted access

to duplicate records without a no-resale agreement. See *First American Title Co. v. Devaugh*, 2007 WL 528086 (6th Cir. 2007).

Under the state action immunity doctrine, first developed by the Supreme Court in *Parker v. Brown*, 317 U.S. 341, 351 (1943), which held that “nothing in the language of the Sherman Act or in its history ... suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature.” As such, “the *Parker* doctrine ‘exempts “anticompetitive conduct engaged in as an act of government by the state as sovereign, or, by its subdivisions, pursuant to state policy to displace competition with regulation or monopoly public service” from Sherman Act control.’ ” *Devaugh*, 2007 WL 528086 at *5 (citations omitted).

The policy in question was the registers’ “practice of conditioning bulk discounts, non-paper reproductions, or reproduction of records generally, on the purchaser’s agreement not to sell the official certified copies [or unofficial copies thereof] to third parties.” The plaintiffs were title insurance companies that regularly purchase records from county registrars in order to create and maintain a “tract index” that listed records by land parcel, rather than the register of deeds’ traditional grantor-grantee index. The plaintiffs then sell this index to their customers and other companies seeking title information in order to help identify and resolve defects in real estate title.

The court noted that the registrars of deeds were elected officials and had an “effective monopoly over the listing of real estate title documents.” Michigan statutes governed the collection and reproduction of records, including provisions allowing registrars to charge \$1 per page for paper copies or a “reasonable” charge for non-paper reproductions. However, as the court pointed out, there was no specific statutory provision that addressed “the [registrars’] authority to regulate or restrict private parties’ resale of record copies or their sale of official copies of those record copies or of information contained therein.”

In raising a monopolization claim under § 2 of the Sherman Act, the plaintiffs alleged that the registrars used their monopoly power to restrict competition in the provision of title information by imposing licensing restrictions and by refusing to provide discounts for bulk purchases of title records. The plaintiffs claimed that the registrars’ intent was to limit the practice of re-selling the records in the tract indices, which competed with the registrars’ own indices.

The district court dismissed the plaintiffs complaint for failure to state a claim, citing the *Parker* doctrine to hold that the state had granted the registrars the “general power to contract,” but it also urged the plaintiffs to appeal to the circuit court for clarification.

On appeal, the Sixth Circuit found that the registrars’ practices did not qualify for *Parker* immunity because they

were not “clearly articulated and affirmatively expressed as state policy,” as required by the state action doctrine case law. Under the Supreme Court’s ruling in *Southern Motor Carriers Rate Conference, Inc. v. U.S.*, 471 U.S. 48 (1985), “a state policy that expressly permits, but does not compel, anticompetitive conduct” may still be “clearly articulated” if the state, acting as sovereign, “clearly intends to displace competition in a particular field with a regulatory structure.” Here, the court found that the state legislature intended for the registers to possess a monopoly on “mandatory acquisition of real estate transaction information from the parties to the transaction, and recordation of the transaction and possession of the original, official title documents thus generated.” As such, the circuit court found that the legislature “clearly intended to displace competition” with the registrars to that extent.

However, this did not mean that the legislature meant to “displace competition in the provision of unofficial duplicate title documents or title information,” which was what the plaintiffs sought to do. The court noted that, while the legislature could have displaced competition in this area, if it had wanted to, “it has not.”

Still, the court was not done with its analysis. It found that, while the legislature had not expressly given the registrars a monopoly on the provision of duplicate documents and title information, *Parker* immunity could still apply if such a monopoly “logically resulted” from the powers that the legislature did expressly grant. Looking at the Michigan statutes on the powers of county governments, access to public records, and county registrars, the court concluded that “it was decidedly not foreseeable” that those express grants of authority would result in the policies implemented by the registrars.

While deciding that *Parker* did not apply, the circuit court was unwilling to weigh in on the merits of the plaintiffs’ monopolization claims against the registers of deeds. As the court stated, “even if the district court determines that the [registrars] have violated the Sherman Act, that will mean only that the registers may not condition bulk discounts, non-paper reproduction, or reproduction of records generally, on the purchaser giving up his right to sell the official certified copies (or unofficial ‘copies of copies,’ or the information therein) to third parties.” 2007 WL 528086 at *20. Furthermore, such a finding would not necessarily “obligate the [registrars] to (1) reproduce records for [plaintiffs] or anyone else, rather than merely providing equipment for the purchaser to reproduce the records himself; (2) offer a bulk discount to [plaintiffs] or anyone else for the reproduction of paper or non-paper records; or (3) make records available to [plaintiffs] or anyone else in non-paper format in the first place.” 2007 WL 528086 at *20 n.22. This was due to other provisions in Michigan law that allowed the registers to determine the medium of reproduction and providing discretion on how to fulfill a title record request.

European Union Warns Microsoft of Noncompliance with 2004 Ruling

On March 1, 2007, the European Commission sent a Statement of Objections to Microsoft for failure to comply with obligations imposed under the Commission's 2004 ruling that found Microsoft had violated European antitrust law. Specifically, the ruling found that Microsoft had infringed Treaty of Rome's rules on abuse of a dominant position (Article 82) by leveraging its near-monopoly in the market for personal computer (PC) operating systems onto the market for workgroup server operating systems. Under that ruling, Microsoft was required to disclose complete and accurate documentation, on "reasonable and non-discriminatory terms," that would allow non-Microsoft workgroup servers to interoperate with PCs and servers using the Windows™ operating system.

Since the 2004 ruling, Microsoft has provided two separate licensing arrangements to companies wishing to obtain the interoperability information in question. The first is a "No Patent Agreement," which allows licensees to use the protocols that together comprise the interoperability information, but which does not provide a license for patents that Microsoft claims as necessary. The second, known as the "All IP Agreement," combines this license with a second license for the disputed patents. Therefore, companies in the EU have a choice of agreements, depending on whether they feel that they need the patent license. Both licenses confirm that an assessment of the reasonableness of Microsoft's prices depends on whether there is innovation in the protocols, and, if there is, what is charged for comparable technologies in the market. For both licenses, Microsoft divided the protocols into Gold, Silver, and Bronze price categories based on the claimed degree of innovation. Microsoft has already agreed that there is a

fourth category of protocols, not necessarily innovative, for which there will be no royalty.

According to the statement, the Commission's preliminary view is that there is "virtually no innovation" in the protocols in the "No Patent Agreement," wherein Microsoft has claimed non-patented innovation, and that Microsoft's current royalty rates for this agreement are therefore unreasonable. This view took into account the advice of both the Monitoring Trustee appointed by the Commission, as well as the Commission's own technical advisors, both of whom opined that there was no innovation in any protocol in the Gold and Silver categories. These protocols represent more than 95 percent of the price of the total Technical Documentation. The Trustee stated that, of the total of 160 claims, only four, relating to relatively minor Bronze protocols, represent even a limited degree of innovation.

For the "All IP Agreement," the Commission assumed that the existence of patents indicated some associated innovation, though third parties remain free to challenge Microsoft's patent claims or to implement software that does not infringe the patented technology. In any event, the Trustee's analysis, adopted by the Commission, was that most of the information related only to solving problems specific to Windows, and hence would not improve the functionalities of the licensee's own operating systems. The Trustee has also provided evidence to the Commission that comparable technologies to these were provided royalty-free.

The Commission gave Microsoft four weeks to reply, after which the Commission may impose a daily penalty for failure to comply with the 2004 decision. The issue of whether the interoperability information is complete and accurate is still under consideration by the Commission.

Securities Law

[*Editor's Note:* The following are summaries of recent cases involving issues raised under the federal securities laws. The discussions were researched and prepared by the staff of the *Securities Litigation and Regulation Reporter*, a monthly newsletter published by Andrews Publications. For more information, see http://west.thomson.com/store/product.aspx?product_id=40234595.]

Military Supplier Executive Pays \$1 Million to Settle Options Backdating Charges

The Securities and Exchange Commission (SEC) has announced a settled enforcement action against one of two executives of Engineered Support Systems charged with enriching themselves to the tune of \$2.5 million by backdating stock-option grants. See *S.E.C. v. Landmann*,

No. 07-270, *settlement announced* (E.D. Mo. Feb. 6, 2007); *S.E.C. v. Gerhardt*, No. 07-271, complaint filed (E.D. Mo. Feb. 6, 2007).

The SEC sued former chief financial officer Gary C. Gerhardt and Steven J. Landmann, its former controller, over the stock-options backdating scheme. Landmann has agreed to settle the charges. Engineered Support manufactures military equipment and electronics mainly for commercial customers.

According to the complaint, Gerhardt instructed Landmann to backdate company stock-option grants in line with historically low stock prices. As the options vested when granted, the two men realized immediate windfall profits of \$2.5 million, the SEC says.

The agency also alleges that Gerhardt directed Landmann to cancel and reissue previous grants to bring them back “in the money.”

A stock-option grant “in the money” has an exercise price below the stock’s price on the day of the grant, thereby giving the employee an immediate gain, which should be recorded as compensation on the books.

Overall, Engineered Support employees and directors received about \$20 million in unauthorized compensation as a result of the backdating, \$15 million of which was received by top executives and directors, the SEC says.

Engineered Support’s financial filings also misrepresented to the SEC and the investing public that all options grants were “at the money,” or granted at the fair market value of the stock on the date of the award. The company also failed to disclose the cancellation and repricing of previous grants, the SEC says.

As a result, Engineered Support overstated its aggregate pretax operating income by about \$26 million, or 21 percent, for fiscal years 1997 through 2002, the complaint says.

Landmann has agreed to settle the charges by paying nearly \$1 million in interest, civil penalties, and disgorgement. He also will be permanently barred from serving as an officer or director of any publicly traded company or practicing as an accountant before the SEC.

District Court Rules That Short-Swing Prohibition Does Not Apply to Backdated Stock Options

A federal district court judge in California has ruled that the prohibition on short-swing trading by corporate executives does not apply to backdated stock options, even if they were sold within the restricted six-month period. *See Roth v. Reyes*, 2007 WL 518621 (N.D. Cal. Feb. 13, 2007).

The derivative suit filed in the U.S. District Court for the Northern District of California sought to disgorge about \$230 million in short-swing profits allegedly received by insiders of Silicon Valley networking company Brocade Communications Systems Inc., including former CEO Gregory Reyes.

Section 16(b) of the Securities Exchange Act, 15 U.S.C.A. § 78s *et seq.*, imposes an absolute rule of strict liability for proceeds from the purchase or sale of stock within a six-month period to prevent corporate insiders from capitalizing on inside information.

Plaintiff Andrew E. Roth asserted that the grants did not qualify for the exemption under SEC Rule 16b-3(d) because the grant dates were not properly disclosed. Rule 16b-3 applies to transactions approved by the board or a committee of at least two independent directors.

The company did not disclose the backdating in its SEC filings, which made the filings illegitimate and not in

the best interests of the company or its shareholders, Roth asserted.

He also argued that the exemption was not available because Reyes acted as a “committee of one” in approving the grants and the board of directors “abdicated its responsibility to oversee the options grants.”

The defendants moved to dismiss, arguing that the stock options, regardless of whether they were backdated, are exempt from the short-swing prohibition because they were issued by the company.

The defendants also contended that the claim was barred by the two-year limitations period. Roth, however, argued that the limitations period should be tolled because the backdating was concealed.

U.S. District Judge Charles R. Breyer sided with the defendants. “[T]his court reject[s] plaintiff’s contention that stock options are necessarily subject to disgorgement under § 16(b) if insiders misrepresent the date on which their options were granted,” he said.

The judge concluded that backdated stock options did not fall under the short-swing prohibitions because SEC Rule 16b-3(d) exempts any issuer-to-insider transfers of company stock as long as the board or its shareholders approved the transaction.

“Simply put, backdating is irrelevant to § 16(b),” the judge said.

Congress enacted the prohibitions to prevent the unfair use of information that may have been obtained by an insider, but the statute was not passed for the “general purpose of forcing insiders to behave well,” Judge Breyer said.

Stock-option grants do not present the same opportunities for corporate officers to profit as stock that insiders have bought and sold on the open market, he added.

The backdating does not implicate the specific danger Congress sought to mitigate by enacting the prohibition because the backdating did not in and of itself exploit inside information, the judge explained.

Judge Breyer declined to expand the reach of § 16(b) to encompass all “illegitimate” or “fraudulent” transactions.

Moreover, Judge Breyer said the plaintiff did not sufficiently allege that the board failed to comply with the SEC’s gatekeeping requirements under Rule 16b-3(d).

He said that given his interpretation of § 16(b), the court need not address the parties’ arguments regarding tolling the limitations period.

The judge dismissed the suit without prejudice and gave Roth until April 30, 2007 to re-file the case.

Judge Breyer noted that the ruling should not be read as an indication that backdating is appropriate or legal, only that there are a host of other securities laws that prohibit any fraud or deception on the investing public.

Reyes already faces criminal charges over the backdating, and the SEC has filed an enforcement action against him.

SEC, DOJ Weigh In on Standards for Securities Fraud Suits

The SEC and the Department of Justice have filed a joint *amicus* brief in a case now before the U.S. Supreme Court concerning the standards for securities fraud class actions. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd., amicus brief filed*, 2007 WL 460606 (U.S. Feb. 9, 2007).

In January 2007 the Court agreed to resolve the circuit court split over the pleading standards under the Private Securities Litigation Reform Act of 1995 and whether courts have been instructed to weigh competing inferences of fraudulent intent.

Under the PSLRA shareholders alleging fraud must plead facts creating a “strong inference” that the defendant acted with scienter, or intent to deceive the investing public.

In the current case, the U.S. Court of Appeals for the Seventh Circuit said it will not weigh competing inferences. A complaint should survive a motion to dismiss “if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent,” the appeals court said.

However, the government says the appellate court diluted the heightened standard designed to thwart unmeritorious suits. A court must consider various explanations of conduct when determining if there is a “high likelihood” that the defendant possessed scienter based on the alleged facts, it argues.

In the original complaint, investors in Tellabs Inc. asserted that the fiber-optic company and CEO/president Richard Notebaert made materially false and misleading statements regarding demand for the company’s networking products between December 2000 and June 2001.

After the company revised its financial projections, the price of Tellabs stock, which reached a high of \$67.13 during the proposed class period, dropped to a low of \$15.87.

The suit sought to recover shareholder losses under § 10(b) of the Securities Exchange Act, 15 U.S.C.A. § 78j(b).

The U.S. District Court for the Northern District of Illinois dismissed the complaint after finding that the allegations did not support a strong inference of scienter on the part of the individual defendants. In particular the court said the alleged “channel stuffing” of the company’s product was defined so broadly as to include innocent conduct such

as providing discounts to customers or extending credit to increase sales.

Channel-stuffing usually involves shipping unsolicited product to suppliers or customers to inflate sales figures.

But the appellate court said that to compare competing inferences of an innocent mental state against any potentially culpable inferences may usurp the role of a jury in violation of the Seventh Amendment. It reversed the lower court ruling, prompting the defendants to appeal to the Supreme Court.

In support of the petitioners, the government says the plain language of the PSLRA requires more than a “reasonable” inference standard. It also says the high court has never concluded that a pleading requirement violated the Seventh Amendment.

In applying the PSLRA’s heightened pleading standard, a court must consider any competing inferences of non-culpable explanations, the government says.

“In determining whether an inference of scienter is ‘strong’ for purposes of the reform act, a court will necessarily have to consider whether the facts alleged in the complaint leave open a range of non-culpable explanations for the defendant’s conduct,” the government said.

District Court Defers to SEC Rule on Short-Swing Trading

After six years of litigation a Delaware federal judge has agreed with the SEC that the stock conversion completed as part of the spin-off of Fairchild Semiconductor Corporation was not illegal short-swing trading under federal securities laws. *See Levy v. Sterling Holding Co., LLC*, 2007 WL 582555 (D. Del. Feb. 13, 2007).

The ruling by U.S. district judge Gregory Sleet granted summary judgment to National Semiconductor Corporation and Sterling Holding Company and dismissed the shareholder suit from the U.S. District Court for the District of Delaware.

In November 2000 a shareholder of Fairchild sued National Semi and Sterling Holding for \$72 million in alleged illegal profits from short-swing trading following Fairchild’s initial public offering (IPO) in August 1999. Short-swing trades are stock purchases and sales within six months by a corporate insider.

Section 16(b) of the Securities Exchange Act, 15 U.S.C.A. § 78p(b), restricts the purchase and sale of stock within that period to prevent corporate officers or directors from taking advantage of information not available to the investing public.

National Semi originally spun off Fairchild and sold it to Sterling in March 1997. Under the related stockholder agreement, both Sterling and National Semi were authorized

to name directors to Fairchild's board and retained large stock holdings in Fairchild.

Prior to the IPO National Semi and Sterling agreed to convert any preferred stock into common stock as part of the recapitalization.

The conversions, which constitute purchases under federal securities laws, were followed by sales of large stock holdings by both National Semi and Sterling in January 2000 or within six months of the IPO.

In the suit plaintiff Mark Levy alleged that the conversion violated the prohibition on short-swing trading by corporate insiders within six months of their stock purchase.

The case then began its long and convoluted history. In February 2002 the district court dismissed the suit after finding that the stock reclassification was not a purchase and therefore not restricted.

Levy appealed that ruling to the U.S. Court of Appeals for the Third Circuit, which reversed the lower court's decision after finding that the stock reclassification was covered by the short-swing-trading restrictions because the conversion was not connected to a compensation-related function.

The three-judge panel also said these transactions still included a risk of abuse by insiders. Both National Semi and Sterling then asked for a rehearing by the full appeals court.

The SEC also urged the court to vacate its ruling but the court refused. In addition the U.S. Supreme Court denied a petition for *certiorari* filed by the defendants.

In June 2004 the parties filed cross-motions for summary judgment in the district court. In addition the SEC issued a proposed amendment to the short-swing-trading rules that would clarify that the prohibition did not apply to stock reclassifications. The SEC said its amendment was necessary to eliminate uncertainty generated by the Third Circuit's opinion.

The court proceedings were stayed pending finalization of the rule, which occurred in August 2005.

Once the stay was lifted, the issues remaining before the federal court were whether the SEC's amendment was entitled to deference and whether it could be applied retroactively to the transaction at hand.

Sterling and National Semi argued that the SEC's amendment did not change the law but only clarified that the restriction did not apply to stock reclassifications.

Levy countered that the SEC's interpretation was not entitled to deference because it was a substantive change in the law. Moreover, he said it should not be applied after the fact.

In his ruling Judge Sleet reviewed § 16(b) and determined that Congress had authorized the SEC to exempt any transaction that did not contain a risk of abuse.

The judge then concluded that the SEC's amendment was entitled to deference and the court could not substitute its judgment for the agency's.

Judge Sleet also held that the amendment was not a substantive change in the law and therefore could be applied to the National Semi's and Sterling's stock conversion even if it was passed after the suit was filed.

The court concluded the reclassification was not covered by the short-swing-trading prohibition and granted summary judgment for the defendants.

District Court Rejects Investor's Third Suit against J.P. Morgan

A Manhattan federal judge has dismissed a derivative lawsuit against J.P. Morgan Chase & Company's directors after finding that the plaintiff investor had failed to convince the board it should take legal action against its own members for the firm's role in the Enron and WorldCom financial debacles. *See Halpert Enters. Inc. v. Harrison*, 2007 WL 486561 (S.D.N.Y. Feb. 14, 2007).

Judge Harold Baer, Jr., of the U.S. District Court for the Southern District of New York dismissed a third amended complaint that shareholder Halpert Enterprises Inc. had brought derivatively on behalf of the investment bank against twenty-four of its officers and directors.

The dismissal was with prejudice, denying Halpert the right to refile or amend the complaint.

Halpert filed its original suit in 2002 alleging that J.P. Morgan's officers and directors failed to prevent the company from engaging in activities, including numerous "forward transactions" with Enron Corporation and WorldCom Inc., that eventually cost J.P. Morgan more than \$4 billion in fines, litigation costs, and settlements.

Forward contracts involve the payment at current prices for the future delivery of a commodity or product. Halpert said J.P. Morgan did not complete sufficient due diligence to determine the precarious financial positions of Enron and WorldCom or that the contracts were bad investments.

Both Enron and WorldCom collapsed under the weight of their own fraudulent conduct and filed for bankruptcy protection in 2001 and 2002, respectively.

U.S. district judge Sidney H. Stein, also sitting in the Southern District of New York, dismissed Halpert's original complaint with leave to amend.

He found that Halpert had failed to allege with particularity why it would have been futile to make a pre-suit demand on the board of directors requiring them

to investigate the plaintiff's allegations and take action to correct any misconduct.

Halpert filed an amended complaint in 2005 adding six new allegations of misconduct by the board of directors. Again it did not make a pre-suit demand on the board because it claimed such a demand would be futile, as its members would have been investigating themselves.

And, again, Judge Stein dismissed the amended complaint, finding that Halpert did not plead facts with particularity to establish that a pre-suit demand would have been futile, as required by governing Delaware law and Rule 23.1 of the Federal Rules of Civil Procedure.

Following Judge Stein's second ruling, Halpert finally sent the J.P. Morgan board a letter demanding that it take up the suit. The board responded by appointing an audit committee to investigate Halpert's allegations.

The committee retained the Sullivan & Cromwell law firm and over the next five months the firm interviewed forty witnesses, examined company documents, and reviewed deposition testimony of J.P. Morgan employees taken in earlier litigation.

The committee concluded that the board should refuse Halpert's demand to sue the directors for four reasons:

- (1) the investigation did not uncover any misconduct rising to the level of gross negligence on the part of any officer or director;
- (2) the board had entered into settlements of all previous lawsuits and enforcement actions in good faith to avoid further litigation;
- (3) the potential costs of the litigation proposed by Halpert outweighed any potential benefits to the company that might arise from it; and
- (4) J.P. Morgan has already undertaken remedial measures to avoid any future repetition of the alleged wrongdoing.

The board accepted the audit committee's recommendations last April, and Halpert filed its third complaint in September, repeating the allegations in its earlier complaints.

In addition the new complaint asserted that the board's rejection of Halpert's demand was wrong because the audit committee failed to undertake "an independent, good-faith, reasonable investigation" of the plaintiff's allegations.

J.P. Morgan again moved to dismiss, and Judge Baer heard the motion this time.

He said the court must review a "refusal of demand" under the "business judgment" rule, which presumes that a corporate board, when making a business decision, acts in good faith and in the honest belief that its actions are taken in the company's best interests.

Here, the J.P. Morgan directors considered the extensive investigation conducted by the audit committee and the four specific reasons the committee offered to explain why J.P. Morgan would not benefit from suing its directors, Judge Baer said.

Under the business-judgment rule, the committee's investigation and recommendations appear to have been reasonable and made in good faith, he ruled.

The judge rejected Halpert's argument that the investigation was not in good faith because the audit committee members "were investigating whether to sue themselves" and thus could not be disinterested.

The mere threat of personal liability for approving an action, taken alone, is insufficient to challenge the independence and disinterestedness of the committee members, Judge Baer said. Halpert failed to allege specific facts that would raise questions about whether specific directors acted in bad faith, he held.

Finally, the judge denied Halpert's motion to amend the complaint yet again, finding it highly unlikely that the plaintiff will find any new facts that would help it overcome the deficiencies of the previous three complaints.

Employment Law

Seventh Circuit Rejects Limits on FMLA Paid Leave Provision

On February 26, 2007, the Seventh Circuit Court of Appeals affirmed a district court ruling that a trucking company violated the Family and Medical Leave Act (FMLA) by requiring an employee to use her vacation and sick days before taking any FMLA leave. *See Repa v. Roadway Express, Inc.*, 477 F.3d 938 (7th Cir. 2007). In its ruling, the court acknowledged that, in some circumstances,

an employee can be forced to exhaust his or her paid leave even if he or she wants to take unpaid leave under the FMLA.

The plaintiff, Repa, broke her ankle in a non-work-related accident and needed to take time off from her job as a clerk in Roadway's Oak Creek, Wisconsin office. The Wisconsin Health Fund, a trust fund established under the Taft-Hartley Act to provide "health and welfare benefits" to union employees, approved Repa's request for \$300 a week

in loss-of-time benefits available to employees suffering a short-term disability. Roadway contributes to the fund under the terms of its collective bargaining agreement with the International Brotherhood of Teamsters. The fund provides benefits that include short-term disability benefits for covered employees who are unable to work after being injured off the job.

For its part, Roadway approved Repa's request for FMLA leave, but upon her return, the company required her to use three weeks of accrued vacation and sick days before allowing her to take any time off under the FMLA.

Section 2612(d)(2) of the FMLA states that an employer may substitute any paid vacation, personal or family leave that an employee has accumulated for FMLA leave, the court said. However, the circuit court pointed out that this provision is "limited by Department of Labor regulations." In particular, the court cited the second sentence of 29 C.F.R. § 825.207(d)(1), which states that, "[b]ecause the leave pursuant to a temporary disability benefit plan is not unpaid, the provision for substitution of paid leave is inapplicable." The circuit court agreed with the district court's determination that Repa was receiving "temporary disability benefits" during the six weeks she took off from work.

The circuit court rejected Roadway's argument that the regulation did not apply because the temporary benefits she received came from a third-party plan rather than a Roadway plan. The court agreed with the district court in concluding that nothing in the cited regulation limited the "outright prohibition" on substituting paid leave for FMLA leave to those situations in which "the temporary disability benefit plan is the employer's plan."

Further, while the *first* sentence of § 825.207(d)(1) notes that disability leave for the birth of a child counts toward the twelve weeks of unpaid leave provided by the FMLA, "the remainder of the regulation belies Roadway's position" that the restriction in the second sentence limiting the substitution of paid leave for FMLA leave applied *only* to maternity leave. The court went on to state that, "[w]hile the first sentence of this regulation focuses on 'disability leave for the birth of a child,' . . . the remaining three sentences of the regulation do not reference the first sentence, but each addresses temporary disability benefit plans."

[Editor's Note: The following are summaries of recent cases involving issues raised under federal and state employment laws. The discussions were researched and prepared by the staff of the *Employment Litigation Reporter*, a monthly newsletter published by Andrews Publications. For more information, see http://west.thomson.com/store/product.aspx?product_id=40234595.]

D.C. Circuit Rules That Federal Labor Laws Apply to Indians Casino on Reservation Land

Applying federal labor laws to an Indian casino on an Indian reservation does not violate tribal sovereignty, and the term "employer" as used in those laws includes tribal governments operating commercial enterprises, a federal appeals court in the District of Columbia has ruled. See *San Manuel Indian Bingo & Casino v. N.L.R.B.*, 475 F.3d 1306 (D.C. Cir. 2007).

"Tribal sovereignty is not absolute autonomy, permitting a tribe to operate in a commercial capacity without legal constraint," the U.S. Court of Appeals for the District of Columbia Circuit said.

Although Congress has not spoken directly to the issue of whether an "employer" also includes Indian tribal governments operating commercial enterprises, the appeals court said that under the generic definition of the term, it was reasonable for the National Labor Relations Board (NLRB) to conclude that the tribe is an employer of its casino workers.

Accordingly, the casino can be held responsible for unfair labor practices it committed when preferring one union to another during organizing activities, the court said.

The San Manuel Band of Serrano Mission Indians owns the San Manuel Indian Bingo & Casino on its reservation in San Bernardino, California. The casino has flourished sufficiently to pull most of the tribe's members out of poverty, the appeals court opinion said.

Two unions competed to become the bargaining unit for the casino employees, many of whom are non-Indians. According to the court opinion, the "great majority" of the casino's patrons are also not Indians.

The Hotel Employees & Restaurant Employees International Union (HERE) complained that the tribe discriminatorily supported the Communication Workers of America (CWA) by allowing CWA representatives access to casino property and employees that HERE did not have.

As a result, HERE filed an unfair-labor charge against the casino with the National Labor Relations Board.

The tribe made a special appearance to ask the board to dismiss the charge for lack of jurisdiction. It argued that the National Labor Relations Act (NLRA), 29 U.S.C.A. § 151, does not apply to the actions of tribal governments on their reservations.

The board disagreed and issued an order that the casino had unfairly denied HERE equal access to casino employees, an unfair labor practice under the NLRA.

The casino appealed to the D.C. Circuit, which denied the petition for review. At the same time, the panel granted the NLRB's cross-application for enforcement of its order against the casino.

The court explained that the San Manuel tribe was engaged in more than governmental functions: It owns and operates a commercial enterprise that employs a number of non-Indians. Therefore, the application of federal labor laws will impinge only slightly on tribal sovereignty or reservation self-government, the panel said.

“We do not think this limited impact is sufficient to demand a restrictive construction of the NLRA,” it said.

Next, the court noted that although there are exceptions to the reach of the National Labor Relations Act, Indian tribes are not included among those exceptions. Therefore, the NLRB could reasonably conclude that Congress’ decision not to include an express exception for Indian tribes in the law was because no such exception was intended or exists, the court said.

Finally, the appeals court rejected the casino’s argument that because the Indian Gaming Regulatory Act of 1988 (IGRA), 25 U.S.C.A. § 2702, allows tribes and states to address labor relations issues, the law contemplates tribal and state control over gaming and implicitly restricts the scope of the National Labor Relations Act.

The IGRA authorized gaming on Indian tribal lands as a means to promote tribal self-development and self-sufficiency. The appeals court panel said it could find no indication that Congress intended to limit the scope of the NLRA when it enacted the IGRA.

Wal-Mart Faces Trial in Failure-to-Hire ADA Case

A federal appeals court in St. Louis has ordered a trial on claims that Wal-Mart refused to hire an applicant for a greeter or cashier position because he has cerebral palsy. *See E.E.O.C. v. Wal-Mart Stores Inc.*, 477 F.3d 561 (8th Cir. 2007).

The U.S. Court of Appeals for the Eighth Circuit said the Equal Employment Opportunity Commission had established that Wal-Mart’s justification for not hiring Steven Bradley was a pretext for disability discrimination and that the company had failed to show Bradley would be a direct threat to himself and others if he were hired.

According to the EEOC’s complaint, cerebral palsy limits Bradley’s use of his legs, but he is able to get around using forearm crutches or a wheelchair. Although he also has limited hand dexterity, Bradley can complete daily living tasks, including carrying laundry or groceries or doing his own housekeeping, the agency said.

In 2001 Bradley applied for a job as a greeter or cashier at Wal-Mart, but was not hired. The company said it did not hire Bradley because his application did not show a history of job stability and because there were limits on his availability for work.

The EEOC charged Wal-Mart with disability discrimination and agreed to sue the retailer on Bradley’s behalf in

the U.S. District Court for the Western District of Missouri. The complaint alleged violations of the Americans with Disabilities Act, 42 U.S.C.A. § 12101.

Wal-Mart moved for summary judgment, arguing that the EEOC failed to show that Bradley was qualified for any available position, including greeter or cashier.

According to Wal-Mart’s expert, Bradley was not qualified for either position because he needs his crutches to climb on and off stools and the crutches prevent him from carrying objects using both hands.

The expert also said Bradley could not walk or stand for long periods, and he had not attempted to perform eight-hour shifts or forty-hour work weeks.

In response the EEOC’s expert on vocational rehabilitation said Bradley could work in either job with reasonable accommodation.

The EEOC’s expert recommended accommodations such as a sit-to-stand wheelchair, an electric scooter, a narrow wheelchair, a hand scanner to scan prices on large objects and a drafting-type high stool with armrests.

The district court granted Wal-Mart’s motion for summary judgment, finding that the EEOC failed to show that Bradley was qualified for any of the available positions or that Wal-Mart’s reasons for not hiring him were pretextual.

The EEOC appealed to the Eighth Circuit, which reversed and remanded the case for trial. First, the panel found that the EEOC had presented sufficient evidence that Bradley was qualified for the jobs of greeter and cashier.

There was evidence that Bradley met the skill, education, and experience requirements for both positions given the fact that their job descriptions state that “no experience or qualification is required.”

The EEOC had also shown that a reasonable accommodation such as a wheelchair would allow Bradley to perform the essential functions of both the greeter and cashier jobs. Even Wal-Mart’s expert had said Bradley was “very stable in a wheelchair,” the panel noted.

Next, the court found that the EEOC had shown that Wal-Mart’s reasons for not hiring Bradley were suspect. The evidence showed that the decision makers at Wal-Mart had changed their rationale for rejecting his application after suit was filed.

A reasonable jury could conclude that a lack of suitable positions did not actually motivate the decision not to hire Bradley, the panel said.

The court reversed the grant of summary judgment to Wal-Mart and remanded for trial.

District Court Finds No Retaliation after Complaint about Magazine

A man who filed a sexual harassment complaint with his employer about a *Hustler* magazine in his company mailbox has failed to convince a federal court that his complaint was the reason his employer refused to offer him another position when his job was eliminated. See *Perugini v. Stryker Orthopaedics*, 2007 WL 601454 (D. Conn. Feb. 22, 2007).

William Perugini said he filed an internal sexual harassment complaint with Stryker Orthopaedics after he found the magazine because he was concerned that his reputation would be damaged if anyone thought that the magazine was his.

Kalamazoo, Michigan-based Stryker manufactures medical products and equipment such as spine implants and hip and knee replacements.

Perugini said that although he requested strict confidentiality should the company conduct an investigation of the incident, Stryker conducted an extensive and very public investigation into the *Hustler* incident.

The company concluded its investigation without determining who had put the magazine in Perugini's mailbox, according to the court opinion.

In the summer of 2004 Stryker decided to reorganize the company's trauma sales business on a company-wide basis. It created two sales associate positions rather than a sales manager and an associate position in that department.

According to the complaint, Perugini worked in the trauma sales department as a local trauma leader, earning about \$180,000 per year. Perugini was responsible for training sales associates and coordinating their activities.

After he was laid off in 2005 as a result of the reorganization, Perugini filed suit against Stryker in the U.S. District Court for the District of Connecticut. He claimed that he was not offered either one of two new entry-level positions in the trauma sales department in retaliation for his complaint about the *Hustler* magazine incident.

He alleged violations of Title VII of the Civil Rights Act of 1964, 42 U.S.C.A. § 2000e. He said the temporal proximity between his complaint about the magazine in May 2004 and the company's decision not to offer him one of two trauma sales positions in October 2004 is sufficient to show that there was a causal connection between his complaint, a protected activity under Title VII, and his discharge.

U.S. district judge Mark Kravitz disagreed, citing evidence that Perugini's performance had been less than stellar over the last two years of his employment.

According to the court opinion, Stryker alleged Perugini had performed inadequately when he had advised a surgeon of the correct method for installing a Stryker implant and

had failed to respond to several attempts by the hospital staff to reach him for further advice.

The company said the incident had "tarnished Stryker's reputation" and supported its decision not to offer him a position in the trauma sales department.

Stryker also pointed out that Perugini himself had previously indicated he was not interested in a sales position with Stryker and took a management job with a competitor within two weeks after he was laid off.

Judge Kravitz said there was no evidence that the *Hustler* magazine incident played any part in Stryker's decision about how to staff the trauma sales department following the reduction in force.

"Other than Mr. Perugini's rank speculation, there is no evidence in the record to link his *Hustler* complaint with the decision not to offer Mr. Perugini an entry-level sales position paying just over one-half of what he was currently earning," Judge Kravitz said.

The judge also noted that eight other local trauma leaders were laid off without being reassigned to other jobs or offered positions as trauma sales managers or associates.

There was also no support for Perugini's contentions that the company's less than confidential investigation of his *Hustler* complaint was retaliatory or that his job duties were cut back after the *Hustler* incident, Judge Kravitz said.

Florida Court Holds Worker Can Be Fired for Refusing Search of Briefcase

A man who was fired for refusing to let his boss inspect the contents of his briefcase is not entitled to unemployment benefits, a Florida appeals court has ruled. See *Leedham v. State Unemployment Appeals Comm'n*, 2007 WL 518438 (Fla. Ct. App. Feb. 21, 2007).

The court said Bradley Leedham would receive no benefits because he was fired for misconduct connected with work.

According to Leedham's lawsuit, he worked as a store manager for the Village Beach Market in Vero Beach, Florida. When he was hired Leedham agreed to abide by the terms of employment in an employee handbook.

The incident that led to Leedham's termination occurred in May 2005. The market suspended him and another worker for one day to resolve a dispute between the two employees.

Before allowing Leedham to leave, his boss asked him to open his briefcase to prove he was not taking any company property with him.

Leedham refused to allow the search, saying he had personal items mixed in with company property. The boss asked several more times to see the contents of the briefcase, and Leedham left.

Village Beach fired Leedham two days after the search incident for refusing to cooperate, a violation of the employer's policy.

When Leedham applied for unemployment benefits, the claims adjuster found him ineligible. Leedham appealed, but the appeals referee also ruled against him as did the full Unemployment Appeals Commission.

Leedham then turned to the Florida Fourth District Court of Appeal, which affirmed the commission's decision.

First, the court rejected Leedham's argument that he was justified in refusing the search because the Village Beach Market's policy was ambiguous.

The policy stated that the company "maintained the right to inspect certain personal belongings" as well as all company equipment. An employee's refusal to allow a search "will be considered a violation of your terms of hire and direct insubordination," the policy said.

The court found no ambiguity in that language.

Next, the appeals court said the referee's interpretation of the policy was consistent with common sense.

The search was not precluded by the presence of Leedham's personal belongings in the briefcase, the court said. The policy clearly stated that the company would inspect "personal belongings" and that "wallets, purses and briefcases" were subject to inspection.

Finally, the court found without merit Leedham's contention that his refusal to allow the search was not "misconduct connected with work." His violation of the policy was willful and deliberate, especially because he admitted that he had company property in his briefcase, the court said.

"A denial of benefits is warranted when the employee's actions are in willful or wanton disregard of the employer's interest as is found in deliberate violation of a standard of behavior which the employer has the right to expect of his or her employee," the court said.

International Law

United States Approves of New UAE Law Controlling Exports

The United Arab Emirates approved a new law that is aimed at controlling exports of sensitive high-technology products to countries such as Iran and Syria, according to the *International Trade Reporter*. See 24 *Int'l Trade Rep.* (BNA) 395 (Mar. 15, 2007). The new law was approved by the UAE's Cabinet on March 9, 2007, and it was to be implemented in the next few weeks.

An economy minister for the UAE, said that the UAE had already been cracking down on illicit export activity in the country and that the new law would only enhance those efforts. She stated that the UAE has already closed twenty-four companies that were found to engage in diversion activities. U.S. officials had recently complained about what they viewed at the UAE's unwillingness or inability to prevent transshipments of sensitive U.S. technology to Iran and Syria.

The Department of Commerce considered creating an additional Country Group C in the Export Administration Regulations that would comprise "Destinations of Diversion Concern" that would subject exports to those countries to a more stringent license review policy. It published a notice in the *Federal Register* of intent, but did not include a list of countries that would be included. See 72 *Fed. Reg.* 8,315 (Feb. 26, 2007). The UAE minister said she was confident that the UAE would not be placed on the list.

District Court Abused Discretion in Assuming Jurisdiction in Foreign Patent Case

Considerations of comity, judicial economy, convenience, fairness, and other circumstances weighed against assuming jurisdiction over a patent holder's foreign patent infringement claims, the Court of Appeals for the Federal Circuit ruled. See *Voda v. Cordis Corp.*, 476 F.3d 887 (Fed. Cir. 2007). The court also held that the law of the federal circuit, rather than the regional circuit, applied to the issue of whether supplemental jurisdiction existed over foreign patent claims.

In the case, Jan K. Voda, M.D. filed a complaint for U.S. patent infringement under 28 U.S.C.A. § 1338. The district court granted Voda leave to amend his complaint to add infringement claims based on infringement taking place outside the United States in violation of patents issued by various foreign countries. The district court found subject matter jurisdiction over the foreign patent claims pursuant to the supplemental jurisdiction statute 28 U.S.C.A. § 1367. Cordis Corporation filed an interlocutory appeal and the district court then certified the order.

Voda had several U.S. patents on certain guiding catheters for use in interventional cardiology that stemmed from a common continuation-in-part (CIP) application filed in October 1992. The foreign patents issued from a common Patent Cooperation Treaty (PCT) application that designated the European Patent Office and Canada as recipients.

Voda sued Cordis in the U.S. District Court for the Western District of Oklahoma alleging infringement of his three U.S. patents and Cordis answered by asserting noninfringement and invalidity of the U.S. patents. Voda then moved to amend his complaint to add claims of infringement of the European, British, Canadian, French, and German foreign patents (granted through the European and Canadian requests). Cordis opposed the motion on the basis that the district court lacked subject matter jurisdiction over foreign patent infringement claims under 28 U.S.C.A. § 1367(a) and its discretion to exercise supplemental jurisdiction under § 1367(c). The district court granted the motion to amend, and the interlocutory appeal followed.

The court of appeals noted that in the case, the parties did not dispute that the Constitution may authorize district courts to hear infringement claims based on foreign patents; the issue disputed was whether there is any statutory basis for this subject matter jurisdiction. The court analyzed the provisions of § 1367(a) in depth and came to the conclusion that because the inherent powers of state courts permit them to hear transitory causes of action that may arise under the laws of foreign sovereigns, supplemental jurisdiction under the statute could include such claims. It then examined whether Voda's claims of foreign patent infringement were part of the same case or controversy.

In this analysis, the court focused on the "common nucleus of fact" test established by the Supreme Court in interpreting § 1367(a). See *City of Chicago v. International College of Surgeons*, 522 U.S. 156, 172-173 (1997). In examining the facts, the court held that the foreign patent infringement claim was not so related to the U.S. patent infringement claims since they involved different patents, the accused devices were different, the alleged acts were different, and the governing laws were different. It did not, however, decide whether Voda's foreign patent infringement claims fell within the scope of the "same case or controversy" requirement.

In reaching its decision, the court of appeals cited its decision in *Stein Assocs., Inc. v. Heat & Control, Inc.*, 748 F.2d 653, 658 (Fed. Cir. 1984), in which the court held that U.S. district courts had no discretionary power to enjoin a party from enforcing a foreign patent before a foreign tribunal. The court noted the issue before it was different, but raised similar concerns, e.g., whether a district court may exercise supplemental jurisdiction pursuant to 28 U.S.C.A. § 1367 over infringement claims based on foreign patents. It determined that the exercise of jurisdiction granted by § 1367(a) was limited by the provisions of § 1367(c) and that the district court's order contained no § 1367(c) analysis and thus it abused its discretion in assuming jurisdiction. It held that considerations of comity,

judicial economy, convenience, and fairness weighed against assuming jurisdiction.

Bill Introduced to Prevent Waiver of Iran Sanctions Act

A bill was introduced into the House of Representatives (H.R. 1400) that would prevent the President from waiving the provisions of the Iran Sanctions Act that imposes sanctions on foreign companies investing over \$20 million a year in the Iran's energy sector.

The Iran Counter-Proliferation Act of 2007 was introduced by Rep. Tom Lantos (D-Calif.) chairman of the House Foreign Affairs Committee and would also expand the sanctions currently in place against Iran. The bill calls for further measures by the United Nations Security Council to tighten sanctions against Iran including preventing new investment in the country's energy sector as long as it is noncompliant with requests to halt its nuclear enrichment campaign. The bill would also extend its program of discouraging foreign banks from accepting Iranian state banks as clients. For more information, including the text of the bill, see <http://thomas.loc.gov>.

Illinois Law Restricting Dealings with Sudan Held Unconstitutional

An Illinois law, the Illinois Act to End Atrocities and Terrorism in the Sudan (Sudan Act), which imposed various restrictions on the deposit of state funds in financial institutions with customers having connections to the Sudan and on the investment of public pension funds in Sudan-connected entities, was found unconstitutional by a U.S. district court. See *National Foreign Trade Council, Inc. v. Giannoulis*, No. 06 C 4251, 2007 WL 627630 (N.D. Ill. Feb. 23, 2007).

The Sudan Act was signed into law on June 25, 2005. The Sudan Act sought to prohibit certain investments in the government of Sudan and companies doing business in or with Sudan in an effort to put pressure on the country's government to end human rights violations in the Darfur region. Specifically, the Sudan Act prohibited the Illinois Treasurer from depositing state funds into any financial institution that had not certified implementation of policies and practices requiring loan applicants to certify that they were not "forbidden entities" as defined under the law. Companies that failed to certify under oath that they did not own or control any property or asset located in the country, provide goods or services to or obtain goods or services from Sudan, or had employees or facilities in Sudan would also be classified as a "forbidden entity." As of January 2006, the state had withdrawn \$275 million from banks that were either unable or unwilling to comply with the Sudan Act.

The court noted the federal government's current policy regarding Sudan is contained in Executive Order No. 13067 of November 3, 1997, which freezes Sudanese government property located in the United States and also prohibits certain transactions, as well as several other laws including the Trade Sanctions Reform and Export Enhancement Act (passed in 2000), the Sudan Peace Act (passed in 2002), the Comprehensive Peace in Sudan Act (passed in 2004), and the Darfur Peace and Accountability Act (passed in 2006). All of the laws provide for the imposition of various sanctions against Sudan as a response to the war in Sudan and the government's failure to enter into a good faith peace process. Each also grants discretion to the President to suspend sanctions or make exceptions if it is deemed necessary.

The National Foreign Trade Council sought to enjoin enforcement of the Sudan Act claiming it was preempted by federal law governing relations with Sudan, interferes with the federal government's ability to conduct foreign affairs, violates the Constitution's Foreign Commerce Clause, and is preempted by the National Bank Act (12 U.S.C.A. §§ 21-216(d)).

The plaintiffs conceded that it was possible to comply with both the federal law relating to business dealings with Sudan and the state law. The court noted, however, that unlike the federal law, the state law contained no provision that would allow for temporary exceptions to the sanctions scheme and no provision regarding suspension or nonen-

forcement. It also prohibited some transactions that were not barred under the federal law, including certain areas of Sudan that are no longer subject to sanctions. The court also cited a U.S. Supreme Court case, *Crosby v. National Foreign Trade Council*, 530 U.S. 363 (2000), that examined a similar scenario where a Massachusetts law sought to prohibit that state and its agencies from doing business with Burma. The Supreme Court noted that a federal law delegating authority to the President to control economic sanctions against Burma preempted the state law.

The court held that, in light of the national government's strong interest in conducting foreign affairs and the lack of any significant recent precedent supporting its position, that the Sudan Act's lack of flexibility, extended geographic reach, and impact on foreign entities interferes with the national government's conduct of foreign affairs and thus was preempted with respect to the banking provisions pursuant to the Supremacy clause. The pension provisions were found to be unconstitutional as applied to state-funded pensions under the foreign commerce clause. That clause gives Congress the power to regulate commerce with foreign nations and preempts state regulations that create a substantial risk of conflicts with foreign governments or impede the federal government's ability to speak with one voice regarding commercial affairs with foreign states. Since the state funded provisions could not be severed from the rest of the pension prohibitions, an injunction was granted against the entire statute.

Employee Benefits Law

DOL Issues Guidance for PPA Statement Requirements

The Employee Benefits Security Administration (EBSA) of the Department of Labor (DOL) issued Field Assistance Bulletin 2006-03 that provides guidance regarding the amendments to § 105 of the Employee Retirement Income Security Act (ERISA) made by the Pension Protection Act of 2006 (PPA) regarding the requirements applicable to the furnishing of pension benefit statements to plan participants and beneficiaries. The amendments include an affirmative obligation to automatically furnish pension benefit statements at least once per quarter for those individual account plans that permit participants to direct their investments. Thus, the first such statement had to be provided for the quarter ending March 31, 2007. Statements must be furnished at least annually in the case of individual plans that do permit participants to direct their investments and at least once every three years in the case of defined benefit plans.

Because representatives of plan sponsors raised questions about the amendments in light of the fact that the requirements were applicable to representatives of plan sponsors, service providers, and others with respect to plan years beginning after December 31, 2006, and no regulations had yet been issued, EBSA issued the bulletin to provide guidelines for good faith compliance. The guidance notes that pending the issuance of further guidance, plans may use multiple sources for benefit statement information provided that plan participants are issued notification that explains how and when information will be furnished. Further, pension benefit statement requirements may be satisfied using electronic media to the extent such form is reasonably accessible to the participant.

With respect to the requirement that the pension benefit statement include an explanation of the importance of the benefits of a well-balanced and diversified investment portfolio, the DOL included an example of language that would constitute good faith. For a copy of the guidance, see <http://www.dol.gov>.

Intellectual Property Updates

Immunity from Patent Infringement Suit under Government Contractor Immunity

In *Sevenson Environmental Services, Inc. v. Shaw Environmental, Inc.*, 477 F.3d 1361 (Fed. Cir. 2007), the Federal Circuit agreed with the district court's grant of summary judgment in favor of defendant, Shaw Environmental, Inc., a government hazardous waste remediation contractor. The plaintiff, Sevenson Environmental Services, Inc. holds U.S. patents covering various hazardous waste remediation methods, including some that claim methods involving the application of phosphoric acid.

Shaw contracted with the Corps of Engineers to clean up and remediate certain property owned by the United States. The contracts contained a consent and authorization clause that stated:

The government authorizes and consents to all use and manufacture, in performing this contract or any subcontract, at any tier, of any invention described in and covered by a United States patent ... used in machinery, tools, or methods whose use necessarily results from compliance by the contractor or subcontractor with (i) specifications or written provisions forming a part of this contract or (ii) specific written instructions given by the contracting officer directing the manner of performance.

Sevenson Envtl. Servs., Inc., 477 F.3d at 1363. The contracts required Shaw to develop a Work Plan containing detailed specifications of the work to be performed. The Work Plan at issue required Shaw to use a stabilization system based on applying phosphoric acid. Sevenson brought suit against Shaw for patent infringement based on the use of this stabilization system. The district court granted summary judgment in favor of Shaw, finding that under 28 U.S.C.A. § 1498(a), and the language of the contracts, Shaw was immune from suit and that the proper defendant was the United States. Sevenson appealed.

28 U.S.C.A. § 1498(a) states, in relevant part,

(a) Whenever an invention described in and covered by a patent of the United States is used or manufactured by or for the United States without license of the owner thereof or lawful right to use or manufacture the same, the owner's remedy shall be by action against the United States ... for the recovery of his reasonable and entire compensation for such use and manufacture.

* * *

For the purposes of this section, the use or manufacture of an invention described in and covered by a patent of the United States by a contractor, a subcontractor, or

any person, firm, or corporation for the government and with the authorization or consent of the government, shall be construed as use or manufacture for the United States.

Shaw was a government contractor, thus, it would be immune from suit for patent infringement if the use was for the government, and if the use was with the government's authorization or consent.

Concerning the "for the government" issue, the Federal Circuit stated that

the "for the government" prong of the definition appears to impose only a requirement that the use or manufacture of a patented method or apparatus occur pursuant to a contract with the government and for the benefit of the government.

* * *

[W]here infringing activity has been performed by a government contractor pursuant to a government contract and for the benefit of the government ... the inquiry has reduced to the "very simple question" of whether the plaintiffs "establish that the government authorized or consented to the ... infringement ... if such infringement in fact occurred." *Auerbach v. Sverdup Corp.*, 829 F.2d 175, 180-81 (D.C. Cir. 1987) ...

Sevenson Envtl. Servs., Inc., 477 F.3d at 1365, 1366.

On the issue of the "authorization or consent of the government" the court stated "[w]here, as here, the government contract contains an explicit authorization and consent clause ... the scope of the government's authorization and consent to liability naturally hinges on the language of that clause." *Sevenson Envtl. Servs., Inc.*, 477 F.3d at 1366-67. In this case, the contract language specifically includes specifications that are made a part of the contract, and Shaw's Work Plan, which called for use of the allegedly infringing stabilization system, was such a specification.

Thus, Shaw's use of the system at issue was pursuant to a contract that was "for the government" and "with the authorization and consent of the government" conferring on Shaw immunity from the patent infringement suit under 28 U.S.C.A. § 1498(a). Therefore, the Federal Circuit affirmed the district court's grant of summary judgment in favor of Shaw.

Amendments to the FTDA after District Court's Decision Necessitate Remand

In *Starbucks Corp. v. Wolfe's Borough Coffee, Inc.*, 477 F.3d 765 (2d Cir. 2007), the circuit court determined amendments to the Federal Trademark Dilution Act

(FTDA) that became effective in October 2006, required the remand of the district court's decision. Starbucks brought a suit alleging that Wolfe's sale of a brand of coffee called MISTER CHARBUCKS or MR. CHARBUCKS infringed and diluted the STARBUCKS trademark. The district court concluded, among other things, that Starbucks had not carried its burden of showing actual trademark dilution under the FTDA, and Starbucks appealed. (This district court case was summarized in this newsletter's March 2006 issue, #235.)

The circuit court vacated the district court's order and remanded the case finding that

[t]he FTDA, as amended effective October 6, 2006, entitles the owner of a famous, distinctive mark to an injunction against the user of a mark that is "likely to cause dilution" of the famous mark. 15 U.S.C. § 1125(c)(1) ... The amended statute applies to this case to the extent that Starbucks has sought injunctive relief on the issue of dilution. *See Havana Club Holding, S.A. v. Galleon S.A.*, 203 F.3d 116, 129 (2d Cir. 2000) (applying intervening statute where plaintiff sought injunctive relief because "when an 'intervening statute authorizes or affects the propriety of *prospective relief*, application of the new provision is not retroactive.'" ...)

Starbucks Corp., 477 F.3d at 766.

In this case, the district court had applied the pre-amendment version of the FTDA, which, under the Supreme Court's decision in *Moseley v. V. Secret Catalogue, Inc.*, 537 U.S. 418, 433 (2003), was construed as requiring a showing of actual dilution, rather than a likelihood of dilution. Therefore, the district court judgment was vacated and remanded for further proceedings in light of the FTDA's amendments.

To Find a Likelihood of Confusion, a Descriptive Mark Needed Secondary Meaning

In *Custom Vehicles, Inc. v. Forest River, Inc.*, 476 F.3d 481 (7th Cir. 2007), the circuit court affirmed the district court's summary judgment in favor of defendant, Forest River. In 2002, Custom Vehicles filed an "intent to use" trademark registration for "Work-N-Play," a van concept where the van's interior could be converted quickly from an office configuration into a camper configuration. An "intent to use" trademark registration requires that the trademark be "used in commerce" within six months. Later that year, Custom Vehicles sold one van, but not under the "Work-N-Play" name. Until 2004, Custom Vehicles sold only one van, the demonstration van, under the "Work-N-Play" name, and that sale was to a family member of the company's owner for a nominal price. In 2004, Custom Vehicles sold six vans and those were its first bona fide "Work-N-Play" van sales. In 2001, Forest River developed a towed van with space to both transport and repair a motorcycle or snowmobile.

This product was called "Work and Play." Its first sales of these vans were in 2002 and by 2004 Forest River's annual sales were over \$10 million.

The circuit court determined that "Work-N-Play" was a descriptive mark, in that it "does more than merely name a brand; it describes the product category to which the brand belongs." *Custom Vehicles, Inc.*, 476 F.3d at 483. As a descriptive mark, it was not eligible for trademark registration unless it had acquired "secondary meaning." Secondary meaning is described by the court as follows.

In time, a term that originally was descriptive may come to signify to consumers a single brand. A new product may require a descriptive name to introduce consumers to it, but if the product catches on, the name may come to be uniquely associated with the original seller Once this happens, the term can be appropriated as a trademark because it has come to denote a single brand, not the entire product, so that use by other sellers of the product would confuse consumers about the source of what they were buying.

Custom Vehicles, Inc., 476 F.3d at 483. In this case, the court found that there was not sufficient evidence to show that "Work-N-Play" had achieved secondary meaning.

Custom Vehicles also asserted that because its trademark was registered, it was presumptively valid under 15 U.S.C.A. § 1115(a). The court stated that

the act of registration merely begins the process that leads to the presumption. Bare registration is not enough. Trademarks cannot be "banked" or "warehoused." ... You must certify that the product is in use in commerce—defined as "bona fide use of a mark in the ordinary course of trade and not made merely to reserve a right in a mark," 15 U.S.C. § 1127—within six months after the trademark was registered. 15 U.S.C. § 1051(d). Within those six months Custom Vehicles sold a grand total of one van and the trademark was not used in the sale. Even if it had been, that would not have been enough to place the trademark in the "ordinary course of trade."

Custom Vehicles, Inc., 476 F.3d at 485. Thus, the circuit court affirmed the district court's grant of summary judgment in favor of Forest River.

Former Employees Misappropriated Trade Secrets; Injunction and Damages, Actual and Punitive, Were Justified

In *Synergetics, Inc. v. Hurst*, 477 F.3d 949 (8th Cir. 2007), the circuit court affirmed the district court's judgment in favor of the plaintiff, Synergetics, in its suit against former employees for, among other things, trade secret misappropriation and breach of contract. Pursuant to a jury's findings, the district court awarded Synergetics

compensatory and punitive damages, and enjoined the defendants from disclosing the trade secrets for two years. The district court also denied the defendants' motions for remittitur and judgment as a matter of law.

Synergetics designs, makes, and sells equipment used in eye surgeries. The major manufacturer of eye surgery lasers used a technology that prevented laser probes made by other manufacturers from being used with its laser. Synergetics spent about four years developing a system to allow Synergetics' laser probes to be attached to and used with this other manufacturer's most widely used laser. The defendants held high-level sales positions in Synergetics with "access to confidential sales, marketing, research, and development information, and they were members of Synergetics' Presidential Advisory Council, the company's most strategic committee." *Synergetics*, 477 F.3d at 953. The defendants signed

confidentiality agreements with Synergetics, in which each agreed that—while employed or after termination of their employments—they would not "disclose or use in any manner whatsoever, any of the Confidential Information" acquired during their employment with Synergetics. The agreements further provided that ... [they] must return all company materials, such as records, files, and photographic materials upon termination of their employment.

Synergetics, 477 F.3d at 953-54.

The defendants, while still working for Synergetics, began implementing a plan to form a competing company. They hired an engineer, who worked on developing products for Synergetics as a consultant, to build a product to compete with Synergetics' laser probe attachment connection system. The engineer, using Synergetics' spare parts, did so in a few hours. At this time, the defendants also entered into talks with a company regarding the manufacture of this product, contacted Synergetics' customers to discuss their new company, and made prototypes of the product for testing. They kept their activities a secret from Synergetics. A few weeks after leaving Synergetics' employ, they formed a new company to compete with Synergetics. Their engineer needed assistance to create the design drawings needed to manufacture the competing laser probe attachment system, and so, with the defendants' knowledge, he solicited help from a current Synergetics' employee, who, for the most part, copied Synergetics' drawings, including measurements and tolerances. Synergetics sued the defendants and a jury found in favor of Synergetics. The district court entered judgment based on the jury's findings and the defendants appealed.

On appeal, the defendants' first argument was that the district court erred by not excluding Synergetics' experts' testimony concerning damages. The defendants asserted that the expert's "opinions were based on an incorrect assumption regarding the number of suppliers in the

relevant market." *Synergetics*, 477 F.3d at 954. The circuit court stated:

"As a general rule, the factual basis of an expert opinion goes to the credibility of the testimony, not the admissibility, and it is up to the opposing party to examine the factual basis for the opinion in cross-examination." *Bonner v. ISP Tech., Inc.*, 259 F.3d 924, 929 (8th Cir. 2001) An expert's opinion should be excluded only if that "opinion is so fundamentally unsupported that it can offer no assistance to the jury." *Bonner*, 259 F.3d at 929-30. ... [Synergetics' expert's] testimony was not so fundamentally unsupported that it could offer no assistance to the jury. ... Appellants had the opportunity to challenge [the expert's] assumptions and methodology, both through cross-examination and by presenting their own expert witness on damages. ... Appellant's mere disagreement with the assumptions and methodology used does not warrant exclusion of expert testimony.

Synergetics, 477 F.3d at 955-56.

The defendants' next argument was that the district court should have granted their motion for judgment as a matter of law. Defendants asserted that Synergetics did not offer evidence that defendants knew or had reason to know that the engineering drawings of their system were copied from Synergetics' drawings. They also asserted that the type of information that they supposedly misappropriated was of a type that becomes outdated quickly, and so the two-year injunctive protection was not warranted. The circuit court disagreed with these assertions finding that there was sufficient evidence supporting the jury's findings of misappropriation of trade secrets regarding the engineering drawings. The circuit also noted that the jury found that Synergetics owned trade secrets regarding "product pricing information, customer-specific product purchases, quantities of products its customers purchased, and prioritization of its products which [defendants] also misappropriated." *Synergetics*, 477 F.3d at 957.

Next, the defendants argued that the district court erred by not dismissing the breach of contract claim for lack of sufficient evidence; however, the circuit court found that the evidence showed that the signed confidentiality agreements were breached. The defendants also argued that the confidentiality agreements were really restrictive covenants and as such were not enforceable because they lacked time and geography limits. The court found this characterization of the confidentiality agreements as restrictive covenants misplaced, and stated that confidentiality agreements do not have to contain time and geography limits.

The circuit court then examined the damages awarded to Synergetics. The court found that the compensatory damages awarded were exactly the amount of damages estimated by Synergetics' expert, and that amount did not "shock the court's conscience." As for the punitive damages

awarded, the circuit court stated that they were “not so disproportionate as to warrant a reversal.” *Synergetics*, 477 F.3d at 960. Finally, the defendants asserted the injunction against using the trade secret information for two years was too long considering that such information outdates quickly. In response, the circuit court stated the following:

A defendant should be enjoined only for the time it would take to produce and market the competitive product, absent the misappropriation.

Evidence adduced at trial supports the conclusion that it took approximately four years for Synergetics

to develop its adapter/connector system and that it would take approximately thirty months to regain lost customers. ... The district court determined that the two-year injunctive period consisted of the time it would have taken [defendants] to independently develop both the scientific and sales data it misappropriated from Synergetics.

Synergetics, 477 F.3d at 961 (citation omitted). Thus, the injunction was upheld.

The district court’s decision was affirmed on all points.

The Calendar

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Contact Alexander Hart, Director, Courses of Study, ALI-ABA, 4025 Chestnut Street, Philadelphia, PA 19104-3099; (215) 243-1630, or (800) CLE-NEWS (toll-free except in PA); Web site: <http://www.ali-aba.org>.

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