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United States

Directors' responsibility for intellectual property in US corporations

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IP management is not often considered a primary issue for oversight by directors. The company management, rather than the board, operates the company on a day-to-day basis, and IP issues generally reach board level only when litigation is on the horizon. However, this situation may be changing, as the increasing importance of intellectual property and the growing scrutiny faced by the board require directors to revisit IP oversight policies.

This chapter explores some reasons why the fiduciary responsibilities of directors may encourage them to oversee IP assets more closely – a topic that has received surprisingly little attention. The standard of director care and practical bases of liability are outlined, followed by a discussion of trends in case law. An analysis of the risks related to IP litigation is then presented, with a discussion of directors' and officers' insurance coverage and corporate indemnification limits. The chapter concludes by briefly summarising some best practices and setting out suggestions for IP oversight that should help to minimise liability.

Scope of a director's fiduciary duty: case law

A plaintiff challenging a director's decision must overcome the presumption under the business judgement rule. This rule recognises that directors owe duties of care and good faith to a corporation and its shareholders, and that generally business decisions should not be overruled by the courts. Accordingly, a court will not substitute its own view for good-faith decisions made by an independent board acting with due care.

At the same time, a board cannot ignore its oversight responsibilities. If a loss may be attributed to a board's failure of oversight, the court may apply the standard articulated in *In re Caremark International Inc Derivative Litigation* (698 A2d 959 (Del Ch 1996)). In *Caremark* the court noted, in the context of approving a settlement, that a board has an obligation to stay reasonably informed concerning the corporation and, consequently, a good-faith duty to ensure that an adequate corporate information and reporting system exists. While the *Caremark* decision initially caused significant concern over increased liability exposure, commentators have observed that the case has not had the impact that was originally predicted. In *Caremark* the court itself observed that a claim for failure to monitor "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment".

Subsequent cases have followed this precedent, creating a high bar for anyone bringing a claim under *Caremark*. For example, in *Pereira v Cogan* (294 BR 449, 532-33 (Bankr SDNY 2003)), the court found that the board's failure to establish procedures to monitor and manage loans to corporate employees, or even discuss whether controls needed to be put in place, was a "grave inattention" to the board's duties. This standard is difficult, and requires egregious and detailed facts to be alleged in order to claim that the board failed to satisfy its duty to provide oversight.

Another theory of liability against a board for failure to manage intellectual property is the doctrine of waste. Under Delaware state law, directors are liable for waste only when "what the corporation has received [in return for an asset transfer] is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid" (*Saxe v Brady*, 184 A2d 602, 610 (Del Ch 1962)). Waste claims, like claims asserting a violation under *Caremark*, are extremely difficult to maintain under Delaware law. Therefore, as a general matter, these claims are rarely viable under Delaware law.

A third possible basis for a suit is a claim that the board did not act in good faith by failing to monitor the company's intellectual property. The duty of good faith remains somewhat ephemeral under Delaware law,

although it was recently analysed by the Delaware Chancery Court's decision in *In re The Walt Disney Co Derivative Litigation* (CA No 15452, 2005 Del Ch LEXIS 113 (Del Ch August 9 2005)). The post-trial decision by the court in *Disney* is the latest twist arising from the hiring and firing (just a year later) of Michael Ovitz by the Walt Disney Company – a saga that has led to a severance package of more than US$100 million for Ovitz, a best-selling book, a multitude of press articles and a seven-year litigation.

In discussing the definition of 'good faith', the court found that in order to "act in good faith a director must act at all times with an honesty of purpose and in the best interests of the corporation". In an effort to clarify this concept further, the court gave three examples of actions not taken in good faith:

- intentionally acting with a purpose other than advancing the best interests of the corporation;
- acting with the intent to violate applicable law; and
- intentionally failing to act in the face of a known duty to act.

Each of these examples requires intent or knowledge of wrongdoing – a difficult standard to show in the IP context. However, one possible exception to this is where the board is informed of the risk that it may be infringing upon a patent or other IP assets of a competitor. Depending upon the disclosures to the board, a situation could arise where the board is informed that the company faces a risk (or even a likelihood) that its products violate another company's intellectual property, but still decides to proceed and risk a defeat in court. The question is whether such a situation could be considered to be "acting with the intent to violate applicable law" and thus subject the directors to potential claims of breach of the duty of good faith.

Another issue arising out of the *Disney* decision is the court's consideration of liability on a director-by-director basis, rather than by reviewing the board as a whole. As the court explained, "director liability must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director". This means that directors with special knowledge of IP issues may potentially be subject to greater risk, as they presumably have special knowledge about a particular decision. These emerging standards can create some significant risks for directors.

If the practical standard of director liability from a breach of fiduciary duty in the oversight function is a showing of bad faith – in other words, an extreme breakdown in the exercise of due care – is the level of exposure low for boards in connection with the oversight of IP assets? Perhaps, but the financial and business risks of IP disputes and infringement actions can be enormous, and always lead to risk in the boardroom.

Consider the recent judgment in *NTP Inc v Research in Motion Ltd* (2004 US App LEXIS 25767 (Fed Cir Dec 2004)), in which the US Court of Appeals for the Federal Circuit upheld a previous judgment against Research in Motion (RIM). The lower court awarded NTP damages of US$53.7 million and imposed on RIM an obligation to pay an ongoing royalty of 8.55 per cent of all BlackBerry sales in the United States. The lower court also issued a permanent injunction barring RIM from manufacturing or selling BlackBerry devices and services in the United States – the foundation of its business. On appeal the court stayed the injunction pending the outcome of proceedings on remand to the lower court, but largely upheld the damages section of the order.

RIM created a reserve of US$58.6 million in the fiscal year 2003 and US$35.2 million in the fiscal year 2004, and sought to settle the case for more than US$450 million – significant figures compared to its current year revenues of US$595 million. Although RIM is a Canadian corporation (thus director liability is determined by Canadian law), if a similar verdict were issued against a Delaware corporation based on analogous facts would the directors face a risk of exposure? How aware of the potential risk were the directors in the *RIM* case? These are just two of the issues that a board must think about when considering the company's IP assets, particularly where a substantial part of the company's value comes from its intellectual property.

Personal liability

The certificate of incorporation of most Delaware companies indemnifies directors from personal liability under Section 145(a) of the Delaware General Corporation Law. However, Section 145(a) permits indemnification only for actions made in good faith, and Section 102(b)(7) specifically prohibits corporations from limiting or eliminating liability "for acts or omissions not in good faith". Delaware law also gives companies the authority to purchase directors' and officers' liability insurance to reimburse directors for personal losses for which they are not indemnified by the company. Typically these policies also contain exclusions relating to active, deliberate or wilful dishonesty. Therefore, if a court finds that the directors failed to act in good faith (either by not meeting their duty of oversight or otherwise), they may lose their right to indemnification and/or insurance coverage.

IP risk factors

Today, all industry sectors embrace intellectual property. Even service industries have become IP conscious, especially since the Federal Circuit decision in *State Street Bank & Trust Co v Signature Financial Group Inc* (149 F3d 1368 (Fed Cir 1998)), which upheld the viability of business method patents in the financial product and services industries. Many service corporations are now seeking patents to protect innovative methods and processes.

IP protection, especially regarding patents and trademarks, has become increasingly important in most industry sectors in the United States. This is demonstrated by the rise in IP litigation costs. According to an article published in the January 2005 issue of *IP Law and Business*, in 2003 companies with at least US$10 billion in revenue saw their overall legal costs rise by six per cent – but their IP litigation costs rose by 32 per cent. IP litigation has increased significantly among competitors (particularly among patent-holding companies) against targets ranging from single companies to entire industries. In the electronics industry, the phenomenon of patent-holding companies asserting their IP rights is probably the single most significant change in the IP landscape.

Detailed IP statistics can be found in "Why directors must take responsibility for intellectual property" (Robert Greene Sterne and Trevor J Chaplick, *Intellectual Asset Management* magazine, February/March 2005, Issue 10). In summary, the number of patent applications filed and patents issued in the United States almost doubled between 1990 and 2003. In the same period, the number of copyright, patent and trademark lawsuits filed in US district courts increased significantly, as did the number of investigations by the US International Trade Commission under Section 337 of the Tariff Act 1930 (19 USC 1337). Reported damages awards, settlements, licences and buyouts in patent, copyright and trademark litigation and trade secret misappropriation have also increased dramatically, with several sums reaching close to US$1 billion. There is no question that in today's market the premature loss of patent protection for a valuable proprietary product or service can be devastating.

Proposed IP board strategy

The board's IP strategy must balance competing considerations that, by definition, are not easily reconcilable. Intellectual property is a complex, nuanced areas with critical judgement calls and highly confidential – and often privileged – information. The board does not want to usurp the prerogatives of senior corporate officers or engage in nitpicking oversight of the IP function. However, the board does have a fiduciary duty to devote sufficient oversight to the management of IP assets.

In light of these considerations, it is not realistic to aim for a 'one size fits all' strategy for IP oversight. Intellectual property is a potential high-risk area that calls for board oversight, like other critical areas of the company. There should be regular IP updates at board meetings, and the board minutes and other corporate records should reflect these updates. Since IP law is complex and rapidly changing, IP seminars for directors may be useful. Benchmarking of the IP activity of competitors (eg, number of patents issued per measurement period normalised for revenue or profits) may be needed to support the management's IP strategy. Periodic meetings with in-house and/or outside IP counsel may be advisable. In summary, it must appear to an outside observer that the board has engaged in reasonable involvement with the IP strategy and the execution of that strategy by the company.

Briefing the board

The company management should work together with corporate and IP counsel to set the parameters of the IP agenda for board meetings. Both the overall IP strategy and specific IP issues may need to be addressed. Potential topics could include:

- budgets and reserves;
- assessments of the proprietary position of key products and services, as well as 'freedom to operate' issues;
- a competitive analysis of the IP position and enforcement by competitors; and
- legal developments and industry trends in intellectual property.

The waiver of attorney-client privilege and/or work-product immunity can occur in IP disputes, especially if litigation has begun. What constitutes a waiver varies according to the law of different states. Under general corporate law rules, board meeting discussions and the resulting minutes are not privileged unless legal advice is being sought or rendered and counsel leads the discussion. It is prudent to have outside counsel lead the discussion of legal disputes because case law has reduced the attorney-client privilege where the briefing is given by inside counsel. In fact, according to some observers the whole concept of attorney-client privilege in the corporate context is being eroded. The introduction of an IP agenda item to board meetings could result in an unintended waiver.

Consequently, corporate and IP counsel and company management must carefully evaluate the best approach to briefing the board on intellectual property. They also

need to address the best approach to documenting IP agenda items in minutes and other corporate records and disclosures. IP audit letters to outside auditors deserve special attention.

Recommendations and predictions

IP litigation has increased significantly in the last 10 years, with a substantial increase in the size of settlements and judgments. At the same time, the strategic importance of intellectual property and the risk of liability from IP litigation exist at a time when the potential liability of directors for the inadequate oversight of management has never been higher.

The primary focus of directors should be the thoughtful and appropriate oversight of management. Intellectual property should be subject to regular board oversight, in the same way as critical financial or other issues. The *RIM* case demonstrates how significant potential liability can be in the event of IP infringement. Directors should understand the fiduciary obligations of care, loyalty and good faith to the corporation and its shareholders, and also take the time and effort to provide the necessary oversight of management. Boards should seek counsel to ensure good process occurs and is appropriately documented. Finally, in the context of IP oversight, directors should regularly review the company's IP assets and related IP strategy as benchmarked against industry practice, engaging qualified counsel and other technical professionals to assist in the evaluation and protection of IP assets.

In addition, directors should actively review the terms of their company's directors' and officers' liability insurance policy, preferably with the assistance of counsel. They should also consider personal insurance policies. In today's environment, the potential risks to directors are simply too great either to ignore these risks or not to implement some type of policy to protect directors against such risks.

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