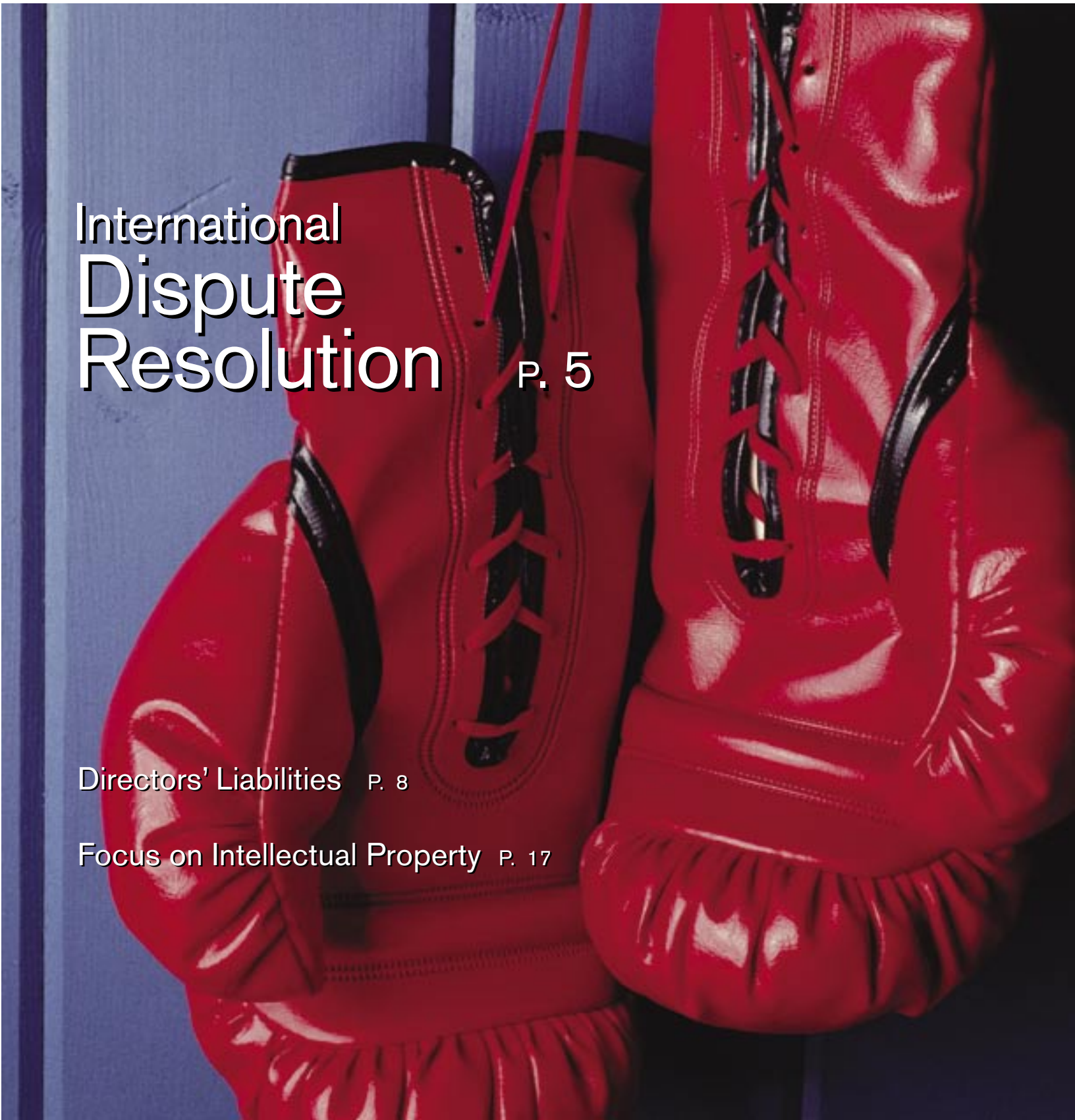
McDermott Will & Emery

winter 2005

# International News



## International Dispute Resolution P. 5

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## features

## focus on intellectual property



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in this issue

Welcome to our Winter 2005 edition of *International News*. As a new year begins, European economies are recovering gradually (some more than others); the private equity sector is booming across Europe; and there is still the global uncertainty posed by the ever weakening U.S. dollar.

Business confidence levels have been comparatively low during much of 2004. However, there is light at the end of the tunnel and growth could be more rapid than projected if oil prices fall significantly, terror is subdued and the global economy regains momentum in 2005.

Against this backdrop, many of our clients are managing their operations across product and geographic boundaries, balancing their global interests with the unique concerns of the countries and regions in which they are operating.

In this edition we focus on a subject close to the hearts of many of our clients because of the competitive advantage it affords them— intellectual property. The articles clearly demonstrate that, as the world is shrinking and you have to take both an international and a local approach to protect your trademarks and intellectual property, there is no substitute for an advisor who understands and works with the laws in local jurisdictions as well as having an international overview and perspective. In a similar vein, we discuss how companies can safeguard against patent infringement internationally and the use of this mechanism as an unfair trade practice. We also address shielding IP license agreements from European antitrust litigation—with 25 Member States in the European Community there are 25 national courts in which antitrust claims can be brought. In addition, we look at tax efficient ways to use your IP rights to maximum advantage. The need for an understanding of local law is again perfectly illustrated in the article on employee invention rights which shows that different approaches are required in each country. For example, from an employer's perspective, the United Kingdom probably has the most favorable laws on employees' inventions in Europe. Finally, we review the regulations relating to an exciting new technology, Voice over Internet Protocol (VoIP), which could transform the telecommunications sector, possibly displacing most traditional voice telephony services.

Our topical features cover countries including Italy, Germany, Spain, Brazil, the United Kingdom and the United States and explore issues as diverse as the need for an international approach to international dispute resolution, directors' liabilities under the new Italian law, the new rules which address due diligence required for export transactions from the United States, private equity opportunities in Italy and the new insolvency regime in Spain.

We extend a special thanks to René Gelman and Adriano Chaves of Machado Associados Advogados e Consultores, based in São Paulo, for their article on Public-Private Partnership Programs in Brazil, which looks at what is happening now that the Brazilian Congress has passed a federal law to establish general rules for the implementation of such programs.

We hope that you find this edition interesting and thought provoking. We very much welcome your feedback and your questions, so please do feel free to contact us through Sarah Hargrove at shargrove@europe.mwe.com.

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# An International Approach to International Dispute Resolution

By John Reynolds

In the late 1990s, the talk was all of 'globalization.' The word has become less widely used since then, perhaps because globalization is now a reality—in virtually every business sector, we have seen expansion and consolidation, to the extent that all the dominant players now have a global footprint. As the nature of commerce changes, so must the means to resolve the disputes that inevitably arise.

Many parties' instinctive reaction is to turn to the court system in the event of a dispute. In London, where I am based, there is a long and strong tradition in the courts of resolving international disputes. To skim through the law reports from the late nineteenth century is to take a tour of the global business enterprises of that time: mining interests in Africa, railways in South America, commodity trading in the Far East. London is as busy a forum for such disputes today as it was then: The Commercial Court in London deals predominantly with disputes between parties who are not incorporated in the United Kingdom and has a growing caseload. Its judges are acknowledged to be of formidable intellect and all have a background of practice in the commercial (and international) legal market. They are appointed (rather than elected) on this basis. In the United States, the Federal Court for the Southern District of New York has a similar tradition and reputation.

Notwithstanding the expertise in these and many other courts around the world, they may not be the suitable forum for the resolution of many international disputes in the globalized market. It is no longer the case that the commercially stronger party can expect to insist upon its own choice of law (frequently English or New York law) and its own jurisdiction clauses. It is not uncommon for an inordinate amount of negotiation to take place over the dispute resolution provisions in complex cross-border agreements. Much of the disagreement stems from a nervousness (justified or unjustified) about subjecting oneself to a system of justice that is an unknown quantity, and there is an unspoken fear that a particular justice system will favor the 'home' party.

The alternative forum for such disputes has, traditionally, been an arbitration tribunal. Arbitration has been an accepted resolution method for international disputes for many years, not least because it lacks national attributes and so avoids the 'home advantage' issue. Of the leading arbitral bodies, the London Court of International Arbitration (LCIA) was established in 1889 and the International Chamber of Commerce (ICC) Court of Arbitration in 1923. What has been noticeable in recent years, though, is how international arbitration practice has adapted to the globalized market and how (perhaps as a consequence) its popularity has grown, particularly among American parties. The position is best illustrated by simple statistics: in the five years to 2003, the annual caseload of the ICC has grown by 27%, the LCIA's by almost 26% and the American Arbitration Association's (AAA) by a staggering 74%. The example of the AAA is particularly illustrative. American corporations have not, traditionally, been big users of arbitration but demand increased to such an extent that in 1996 the AAA formed its International Centre for Dispute Resolution (ICDR) to handle international arbitrations. In 2002, it received 672 requests for arbitration.

The growth of arbitration has meant that a significant number of parties and lawyers are using the system for the first time; these users bring with them a familiarity with other systems and an approach to dispute resolution which is helping, to an extent, to reshape arbitration. American parties and lawyers, for example, come with an expectation of a rigorous discovery procedure involving depositions and the widespread disclosure of documents. Lawyers from civil law systems are accustomed to procedures which are largely by written rather than oral submissions; they do not have a tradition of 'live' witnesses and cross examination. When one brings together parties from two such different legal systems (and perhaps arbitrators from other jurisdictions), a hybrid approach is bound to emerge. That is precisely what has been happening over recent years. International arbitration practitioners have taken it upon themselves to codify certain practices and to find compromises which satisfy the requirements of a broad range of parties. The IBA Rules on the Taking of Evidence in International Commercial Arbitration provide a regime for the disclosure of documents and for witness evidence: they are more restrictive than the U.S. Federal Procedure Rules but more extensive than the approach that would be adopted in, for example, continental European countries. The rules may be incorporated by reference in an arbitration clause or they may be adopted by agreement at the outset of an arbitration procedure.

While the institutional rules (*e.g.*, ICC, LCIA, AAA, UNCITRAL) provide an overall framework, it is for the arbitrator(s) in each case to set the specific procedures that will be followed in each case. In so doing, they can (and do) balance the expectations of the parties against practical expediency, for example by imposing strict limits on the duration of submissions or witness evidence or on the length of briefs and providing for limited document

From 1965 to 2000, only 66 ICSID arbitrations were commenced. However, between 2000 and 2003, that grew to more than 130 cases.

disclosure. It is also significant that the arbitrator(s) themselves can frequently be of a different nationality to the parties; this contributes to the non-national approach to proceedings.

The other area which has boomed on the back of globalization is that of so-called investor disputes. This category of international dispute goes by a variety of names but is characterized by the presence in the dispute of a State or State entity as a party. The investments to which they relate will usually involve the establishment of a business in the 'Host State' by the foreign investor, whether directly or via a joint venture with a local entity (privately or State-owned). The legal rights in issue may be in a formal investment agreement, in a joint venture agreement or in Bilateral Investment Treaty (BIT) between the Host State and that of the foreign investor.

One of the principal treaties underpinning such disputes, the ICSID Treaty (International Centre for the Settlement of Investment Disputes), was established in 1965 (others include the North American Free Trade Agreement and the Energy Charter Treaty). In the 35 years that followed, only 66 ICSID arbitrations were commenced. However, between 2000 and 2003, that grew to more than 130 cases. This is the most stark illustration of the consequences of globalization. The number of BITs has also increased dramatically—there are now over 2000 in existence. BITs are in a fairly standardized form but, for present purposes, the key provisions are the granting to nationals of each state the right to fair and equitable treatment (*i.e.,* freedom from discrimination and expropriation, direct or indirect) and a submission of any resulting disputes to arbitration under the ICSID or UNCITRAL rules. The significance of this, of course, is that it offers investors a fair and neutral forum for the resolution of disputes in circumstances where they might not invest at all if their only recourse was to local courts which they might not regard as impartial.

As you would expect, this jurisdiction is having to develop rapidly and this must continue if it is to prove as effective as it needs to be.

Mediation, too, is changing. The growth in mediation and other forms of Alternative Dispute Resolution has been driven largely by the common law systems (principally the United States, United Kingdom and Australia) but as disputes have crossed over national boundaries, the civil law systems have become more familiar with it. It is now an accepted part of the international dispute resolution framework, with bodies such as the ICC having their own mediation rules. The United States-based CPR Institute for Dispute Resolution recently held a European conference which found overwhelming support for the view that commercial mediation would have a positive effect in stimulating international commerce and European economic growth (full findings will be available soon on www.cpradr.org).

Finally, it is worth mentioning the lawyers. Those lawyers who can think only in terms of their own legal system, its procedures, rules and remedies are of limited use to their clients in this field. Those who are of most use are alive to cultural sensitivities, to legal and procedural differences and, in particular, to the advantages that the approach of other legal systems may offer. A first-class local litigator will not always make a first-class international disputes lawyer.

The evolution of international dispute resolution is the natural consequence of globalization. Those who expect to resolve disputes across the world according to their own rules are confusing globalization with imperialism.

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# New Rules Address Due Diligence Required for Export Transactions

By David J. Levine

United States exports of weapons and other Munitions List items remain subject to strict licensing requirements under the International Traffic in Arms Regulations (ITAR) administered by the U.S. State Department. For dual use items subject to the Export Administration Regulations (EAR) administered by the Commerce Department's Bureau of Industry and Security (BIS), licensing requirements have been relaxed significantly. Fewer items require an export license based solely on the classification of the item and the country of destination. However, two other elements, end-use and end-user, have become critical to the U.S. export controls process, and a license may be required where the end-use or end-user raises concerns about diversion, weapons proliferation, terrorism and other export risks.

The EAR requires U.S. exporters to make this determination. U.S. exporters will be liable for violating the EAR if they export an item without advance authorization when they know or have reason to know that the end-use or end-user presents an export controls issue. BIS has published a set of guidelines called *Know Your Customer* and illustrative red flags on the web to help exporters comply with this standard (available at www.bxa.doc.gov/enforcement/unauthorizedpersons.htm).

## The Proposed New Rule

The EAR imposes various requirements on exporters based on whether the exporter knows or has reason to know facts that trigger the requirement—*e.g.*, that a potential customer has been identified by the U.S. government as a "specially designated terrorist." In order to clarify when these knowledge-based requirements apply, in October 2004 BIS proposed a new reasonable person standard under which BIS would attribute knowledge of the relevant facts or circumstances to the exporter if a reasonable person in the same situation would "more likely than not" conclude those facts or circumstances exist. BIS would retain authority to infer an exporter's awareness of relevant facts if the exporter has shown a "conscious disregard" or "willful avoidance" of facts.

In its proposal, BIS expanded its *Know Your Customer* guidelines and its illustrative list of red flags. BIS has also proposed a procedure that would give exporters a safe harbor from future legal liability. The process would require exporters to submit a report to BIS identifying the facts and circumstances relating to the proposed transaction and setting out the steps taken to resolve any concerns raised by red flags found to exist for the proposed transaction. BIS would plan to respond to such a report within 45 days and, if it agrees that the exporter has properly addressed potential concerns, BIS would provide a safe harbor against an enforcement action arising from the issues the exporter has addressed.

## Due Diligence Responsibility Rests Firmly with the Exporter

Since 9/11, the U.S. government has increased scrutiny on both imports and exports, resulting in a heightened level of enforcement activity in cases of suspected export controls violations. With significant penalties—including possible loss of exporting privileges—at stake, U.S. exporters are well advised to maintain an export compliance policy. At a minimum, U.S. companies should (1) establish the proper classification and relevant licensing requirements for all goods, technology and services intended to be sent to a non-U.S. destination (or to a non-U.S. national/permanent resident, considered a deemed export); and (2) investigate whether the export may be destined to go to an inappropriate end-use or end-user.

Some exporters and trade associations have complained that BIS's proposed clarifications to the definition of "knowledge" and its safe harbor procedure could increase the compliance burdens and potential legal liability for exporters. Some have argued that the current BIS license application process gives exporters a quicker and equally certain ruling for any particular export. BIS officials have defended their proposal as providing a different and meaningful benefit to exporters, but will consider these concerns in finalizing the rules.

In any event, U.S. exporters should ensure that they understand the evolving requirements of U.S. export controls and plan accordingly to ensure their specific transactions meet those requirements. Failure to do so could result in substantial business costs.

David J. Levine is a partner based in McDermott Will & Emery LLP's Washington, D.C. office. He is a member of the Firm's International Trade Practice Group. David practices before international trade organizations, federal agencies and courts regarding international trade and related regulatory matters. He can be reached at +1 202 756 8153 or dlevine@mwe.com.

# Changing Directors' Liabilities Under the New Italian Company Law

By Oreste Marchini

Everyone knows about the financial scandals which rocked the United States in the last few years. They led to substantial corporate governance reforms in the United States in the form of the Sarbanes-Oxley Act of 2002. Across Europe, similar changes are taking place. The *Parmalat* and *Cirio* cases have stirred Italian lawmakers to make reforms to the corporate director law in Italy. The new Company Law includes provisions aimed at making company directors more responsible in performing their assigned duties. The purpose is to prevent further financial scandals and to protect companies and their shareholders. Specifically, the new Company Law provides for directors' liability: a) towards the company; b) towards the company's creditors; and c) towards single shareholders and third parties.

## Director's Liability Towards the Company

Pursuant to article 2392 of the Civil Code, directors must ful-fill the duties and obligations imposed on them by the new law or by the articles of association "with the diligence required by the specific nature of their function." This means that directors are now required by law to act with professional diligence and in the best interest of the company. The failure to fulfill these obligations entails the joint liability of the members of the board of directors towards the company, unless the liability is related to a function which has been specifically entrusted by the board to an executive committee or to one or more directors. In this case, only the directors involved are liable for mismanagement in the exercise of the powers delegated to them. No liability can be imposed on non-executive directors, unless those directors were aware that acts damaging to the company were taking place and did not do anything within their power to stop such acts or to lessen their negative effects.

Regardless of the above, all directors are jointly liable towards the company if they fail to pay attention to all reports provided by executive directors and to ask for any clarifications relating to the company management necessary to allow the board to make an informed decision in the exclusive interest of the company. On the other hand, if a director who is aware of acts which are potentially damaging to the company reports their dissent in the board of directors' records and gives notice of it to the chairman of the board of auditors, that director is not included under the joint liability.

Should directors violate their obligations, then the company is entitled to begin a liability action against them. The action has to be approved by a resolution of the shareholders' meeting. Because the liability of directors towards the company is contractual in nature, the company bringing an action does not have the burden of proving the directors' guilt. The company does, however, have to prove the misconduct of directors who violated their specific obligations, provide evidence of damages suffered by the company, and prove the link (*nesso di causalità*) between the directors' misconduct and the damages.

## Directors' Interests

Under the new company rules, directors must also notify the other directors and the controller body of any interest they have in a transaction undertaken by the company, regardless of whether the director's interest is in conflict with the interests of the company. This is in contrast to the former provisions, under which directors were required to notify other directors of any interest they had only if it was in contrast with that of the company.

According to the new company provisions, if the interested director has no executive powers, then he is permitted to vote on the transaction provided that the other directors are aware of his interest. If, however, the interested director is an executive director, then he cannot carry out any act related to the transactions in which he has an interest and must submit the acts to the board of directors for approval. If the board approves the act in which a director has a vested interest, then it must clearly justify its resolution to approve.

Should the transaction in which the director has an interest cause damage to the company, then the validity of the resolution taken by the board to approve the transaction can be challenged provided that all the following criteria are met: it was adopted with the determining vote of the interested director; it didn't indicate in detail the reasons for which it was adopted; and the interested director did not notify his interest in the transaction to the board of directors. In such cases, the resolution of the board can be challenged within 90 days of its adoption by both the board of auditors and by those directors who voted against the resolution or didn't take part in the meeting at which the resolution was adopted.

In addition, directors are also liable towards the company for any damage resulting from them using any data, information

## Akzo/Akcros Update

On September 27, 2004, the president of the European Court of Justice issued another order in the Akzo/Akcros matter (See "Attorney-Client Privilege Again Up for Review in Europe" by Alexandra Adrot, Jeffrey Bates and Sylvia Kratky, *International News*, Autumn 2004 at www.mwe.com/info/news/int-autumn.pdf#page=5), following the appeal brought against the first instance order. Even though a decision on the application of the legal privilege to internal documents is still the subject of the main proceedings (not yet heard), the president made several procedural findings.

The documents at issue were obtained by the European Commission during their investigation into alleged anti-competitive practices against Akzo Nobel Chemicals and Akcros Chemicals. The applicants argued that the documents were confidential, nevertheless representatives from the Commission looked at the documents. In October 2003, the applicants were granted an interim measure, pursuant to which the Commission was ordered to place previously examined documents into a sealed envelope.

The president annulled this interim measure, on the basis that the required condition of urgency was not satisfied because the Commission agreed not to use the documents as grounds for a final decision should the annulment be deemed unlawful. The president thus found that no irreparable harm would occur. The fact that the Commission had already reviewed the documents during the investigation played a role in the assessment of the urgency criteria.

At the time of going to press, the main proceeding had not been scheduled, because some of the intervening parties have not yet submitted their observations.

or business opportunities that came to their knowledge during the exercise of their mandate to their advantage or to the advantage of a third person.

Among other new provisions introduced by the reform concerning directors' liability towards the company, it is also important to stress that the new article 2393-bis now states that legal action against directors, as well as being resolved by a majority of the shareholders, may also be resolved by a minority of shareholders as long as they represent at least 1/5 of the share capital of unlisted stock companies or 1/20 of the share capital of listed stock companies.

As to limited liability companies, it is worth mentioning that under the new law, each quota-holder, irrespective of the amount of quota he owns, and without a previous resolution of the quota-holders meeting, is entitled to take legal action against directors.

### Directors' Liability Towards the Company's Creditors

Besides being responsible towards the company, directors may also be liable, under article 2394, towards the company's creditors if they do not fulfill their obligations concerning the preservation of the company's assets. This action can be brought by the company's creditors when the company's assets prove to be insufficient to satisfy their claims.

Although there is uncertainty as to the nature of the liability of the directors towards the company's creditors, this liability should probably be regarded as extra-contractual (tortious) in nature, with the consequence that creditors who bring this action must prove not only resulting mismanagement and damage, but also the directors' guilt.

### Directors' Liability Towards Single Shareholders and Third Parties

Finally, under article 2395, directors are liable in torts to single shareholders and third parties for the damages caused to them, either negligently or with intention, while performing their duties. Single shareholders or third parties are entitled to take liability actions against directors—to obtain refunds for damages directly suffered by them as a result of directors' misconduct—within five years from the date when the directors adopted the resolution which was damaging to the shareholder or the third party. This action is extra contractual (tortious) in nature, so, as under the directors' liabilities to creditors, the plaintiff bears the burden of proof not only with respect to mismanagement and damage but also with reference to directors' guilt.

It is necessary to bear in mind, however, that such an action can be taken only in the case of the resolution adopted by directors directly damaging the single shareholder or the third party. Should such parties be damaged only indirectly, then they will have no title to act against the directors.

Should the provisions have their intended effect and reduce the potential for financial scandal in Italy, we can look forward to very smoothly run companies in the future.

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# Private Equity Opportunities in Italy

By Andrea De Pieri and Olimpio Stucchi

Despite overall sluggish growth across Europe, the structure and climate of the Italian economy are providing valuable new opportunities for private equity investors. The Italian economy is dominated by small and medium sized family-owned companies, and by pockets of innovation and growth. The few large industrial companies are lagging behind. With generational change in family-owned companies and problems with other types of instruments for financing growth, private equity investors with the ability to spot good targets can find fertile ground in Italy.

The Italian mergers and acquisitions market is among the largest in Europe. According to Thomson Financial, the total value of completed or unconditional mergers and acquisitions deals in Italy in 2003 was €75 billion, while during the same period in France mergers and acquisitions transactions were worth €66 billion, in Germany €54 billion and in Scandinavia €33 billion.

Traditionally, the Italian mergers and acquisitions market is comprised of corporate-to-corporate mergers and acquisitions. The remainder of Italian mergers and acquisitions is accounted for by two types of players: corporate investor groups and traditional private equity.

The corporate investor groups are mainly standalone corporate and/or family vehicles which invest in companies either directly or through minority syndicates.

The traditional private equity category, which is expanding, includes Italy-based and foreign funds investing in Italian businesses. The private equity market in Italy in 2003 was estimated to be worth $3.64 billion, up from $1.9 billion in 1999, according to data published by the Italian private equity and venture capital association AIFI. Among market participants in 2003, 52% were Italian closed-end funds and other country funds, 21% pan-European funds, 14% captive players and 13% other types of players.

## Private Equity Opportunities in Italy

Italian private equity market deal flow has been accelerating in recent times in many different areas supported by the favorable legal landscape and a number of pressures forcing changes in the Italian market. There are three different kinds of businesses where these pressures are more clearly visible: middle market companies (MMC), privatizations and portfolio restructurings.

### Middle Market Companies

MMCs are normally either family-owned businesses or have fragmented private ownership. Many recent private equity transactions in this sector have involved recently delisted public companies.

Family-owned businesses are inevitably subject to generational transfers where some or all of the family members try to liquidate their assets. In MMCs with fragmented private ownership there is often one shareholder who wants to consolidate his majority.

Additionally, three different kinds of pressures on MMCs can be clearly traced: the loss of traditional financing sources, competitive pressure and regulatory and tax pressures.

Generally, MMCs used to fund their businesses through debt rather than equity, but banks are significantly tightening their lending practices and the Basel II rules will strengthen this trend. Equity financings by existing shareholders are also constrained by the recent recession in the world economy. As a financing source, the Italian capital markets in the last three years have been disappointing due to an under-capitalized stock market and scandals in the fledgling corporate bond market. Finally, a high proportion of companies are over-exposed to banks and need fresh capital injections.

Competitive pressures are caused, among other things, by the advent of the euro and the elimination of currency devaluation which was a tool traditionally used by Italian policymakers to increase the competitiveness of the internal market; the lack of a critical mass of industry consolidations as has been seen in other Western countries; and the progressive opening of the domestic market to multinationals and foreign aggressors. In fact, Italian business investments have traditionally been focused domestically on mid-cap corporates and there is a lack of major Italian multinationals. Tax incentives are based on recently promoted fiscal advantages, such as the elimination of the inheritance tax which took place in 2002 and the capital gains tax cancellation of 2004, which are forcibly driving a climate more conducive to selling. Regulatory pressures have brought more stringent market practices in accounting and more transparency and disclosure, in line with the trend in other Western markets.

The private equity market in Italy in 2003 was estimated to be worth $3.64 billion, up from $1.9 billion in 1999.

### Privatizations

Another field considered fertile by private equity funds is the privatization of state-owned assets. The primary impetus to privatizations in Italy is the orientation towards the free market which the Italian government embraced over the last two decades, and the need to cut the massive Italian public debt. Aside from the government orientation, long-established borrowing practices by the government to state-owned companies are also severely limited by the Maastricht stability pact. This does not allow European countries to have a deficit/GDP ratio of more than 3%, thus making it more difficult for state-owned businesses to take advantage of their traditional financing sources. Municipalities are privatizing their assets as they also face budget constraints arising from the decentralization process occurring in Italy in recent years which limits financial aid from the national government.

### Portfolio Restructurings

Many traditional Italian stakeholders, like banks or private investors, need to restructure their investment portfolios. Key pressures in this direction for private investors are the increased competition from multinational companies which are invading local markets, and the necessity to build economies of scale through consolidation.

The main force behind banks pushing to restructure their investment portfolios is the asset quality concern, *i.e.*, the level of non-performing loans, which in Italy is higher than the rest of Europe (Italian non-performing loans are 6.6%, while the European average is 3.5%). In addition, Basel II standards have increased the regulatory requirements for banks, limiting their lending and investment capacity.

## The Legal Framework

The legal environment for corporate players in Italy is currently undergoing a critical makeover. An important series of reforms began in 1998 with the reform of financial markets and intermediaries (Legislative Decree n.58/1998), and was followed by a major corporate income tax reform (Legislative Decree n.344/2003) and a reform of corporate law (Legislative Decree n.6/2003). Bankruptcy and tax law reforms and new regulations on authorities governing financial markets are still in progress. These reforms have had, and are expected to have in the next few years, a beneficial impact on the private equity market. The main effects of the most recently enacted legal developments have been a reduction of corporate taxation for newly listed companies (Tremonti Decree) and the completion of the legislative process on leveraged buyouts (LBOs) with new rules on how to structure and document LBO transactions (Legislative Decree n.6/2003). The regulation of financial market authorities aims to improve transparency and disclosure of information, protection of minority shareholders, guarantees for private investors and efficiency in the supervision system and in the allocation of control powers.

One of the key reasons the private equity market did not develop sooner in Italy is that the labor market was rigid, and buyers found themselves with cost structures that were difficult to modify. Labor and employment issues are often crucial in the decision of whether to close a deal in Italy. Frequently deals suggest a business plan in which major modifications to the former cost structure are requested, in particular with regards to the cost of personnel. Because of this, the legislation has been modified in order to make the Italian market far more flexible than it was in the recent past.

Key labor-related differences between acquisitions from solvent and defaulted companies of businesses or lines of businesses according to current Italian legislation

| FROM A SOLVENT COMPANY | FROM A DEFAULTED COMPANY |
|---|---|
| All employees pertaining to the business are transferred by law to the purchaser. | With agreement of unions, seller and purchaser can limit the number of employees to be transferred. |
| Employees retain all rights acquired prior to the transfer. | With agreement of unions, seller and purchaser can modify the terms and conditions of employment contracts involved. |
| The purchaser is liable jointly with the seller for employees' credits existing on the date of the transfer. | The purchaser is not liable for employees' credits existing before the transfer. |

In 2000 and 2001, companies' ability to utilize part-time and fixed-term employment arrangements were increasingly widened. The reforms culminated with a profound reform of labor legislation in 2003 (known as the Biagi Law). Companies may now use several flexible arrangements, previously not existing in Italy, such as staff leasing, job on call, job sharing, project agreements, national and international secondments and service contracts. As these reforms take effect, Italian businesses are becoming more competitive and less expensive to run.

With the legislative and regulatory framework increasingly more welcoming to private equity investors, and the pressures on small and medium companies to look for new shareholders, the terrain is fertile. Stories abound of well-known Italian brands, for instance in the luxury goods sector, where growth potential has only been fulfilled through the entrance of skilled investors from the private equity arena. This is a bright spot on the horizon for the Italian private equity market.

## Another field considered fertile by private equity funds is the privatization of state-owned assets.

In transfers of businesses, special provisions limiting costs and the risks connected with transferred employees have also been issued. The Biagi Law allows the parties to create and delineate the line of business to be transferred without it being necessarily linked to the former business situation. The Prodi-bis Law, passed in 1999 (Legislative Decree n.270/1999), which governs a procedure alternative to bankruptcy for insolvent groups of companies, has recently been used to create interesting opportunities for investing in the Italian market and acquiring the entire business or portions of Italian companies under more favorable conditions.

Due to the recent reforms of labor and employment legislation, many factors which in the past represented obstacles to investing in Italy have been removed and/or widely restricted while opportunities have been growing. This is particularly true of distressed companies which continue to have underlying growth potential in their brands.

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# Public-Private Partnership Programs in Brazil—Will They Trigger a New Wave of Investments?

By René Gelman and Adriano Chaves with contributions by Stuart M. Berkson

With a view to fostering new investments in Brazil, President Lula's team and his Workers' Party have worked hard to persuade the Brazilian Congress to pass a federal law that will establish general rules for the implementation of Public-Private Partnership (PPP) programs in Brazil. They succeeded and the law was passed in the last days of 2004.

The bill, which has been discussed for months in Congress, sponsored by the federal government, has sparked fierce criticism from opposing political parties. For this reason, the bill has been subject to significant changes since its introduction. But while Congress discussed the federal government's bill, a few state governments already enacted laws to regulate PPP programs within their states, and even some municipal governments have been discussing laws for local versions of PPP programs. These state laws and local initiatives, however, depended on the enactment of the federal law to establish the general rules and principles for PPP programs. Now that a federal law has been passed, PPP programs can be implemented.

PPP programs have become a top priority for the federal government as it is clear that infrastructure bottlenecks (*i.e.,* constraints in power supply, poor roads, and deficient railroads and ports) are adversely affecting the growth of the Brazilian economy and no significant new investments would be made by the government or by the private sector under the legal and regulatory framework in force before the PPP law.

## The Current Legal Framework

Until recently, all major infrastructure projects in Brazil were implemented under the Public Bidding Law (Law 8,666 of 1993) and the Concession Law (Law 8,987 of 1995). These two pieces of legislation were very important in the past—especially the Concession Law, under which several power plants and roads were built—but they have not been as effective recently in fostering new infrastructure investments.

The federal, state and local governments claim that they do not have the financial wherewithal to meet both the country's social and infrastructure needs. For some time, the Brazilian government has been unable, with its own resources, to implement infrastructure projects under the Public Bidding Law. The Concession Law was an initial response to that inability.

Some of the most profitable and bankable infrastructure projects have already been tendered to the private sector under the Concession Law. For this reason, the federal government believes that the Concession Law is no longer adequate to permit the implementation of many infrastructure projects which, although regarded as strategic and important for the country, may be seen by the private sector as too risky or not as economically viable as other projects. Furthermore, recent economic downturns and unexpected regulatory changes (which together created uncertainties) have reduced the appetite of the private sector for projects where they are supposed to bear all risks. Such projects, which are implemented under long-term concessions, require a predictable regulatory environment for their success.

## The New Legal Framework

Inspired by the success of similar programs abroad, the federal government believes that the PPP programs will be a viable tool with which to overcome the infrastructure bottlenecks and thus encourage sustainable economic growth. The government would ensure the economic feasibility of the projects, but would only make payments if such projects were implemented and operated properly.

In general terms, the PPP program proposed by the federal government establishes a cooperation model, where the risks of the projects would, in principle, be shared between the private and the public participants. The private participant would have to implement and operate the project with its own resources (including borrowed funds), and thereafter would be remunerated either by the government directly or by both the government and the user of the project. However, in this case, it would only be to the extent necessary to permit the private participant to obtain the previously agreed level of return on its investment.

As far as the government is concerned, the PPP programs will permit new projects, which are crucial for the country, to be implemented without significant public spending and operated by the private sector in a, presumably, more efficient manner. As far as the private sector is concerned, the PPP programs will guarantee a return on their investments for the private participants as long as they implement the projects and operate them in accordance with the performance indicators set forth in the PPP contracts.

The process of receiving or collecting payments from the government is widely recognized as lengthy and time-consuming.

Projects to be implemented under the PPP programs are expected to be long-term ones. The bill proposed by the federal government currently provides that the PPP contracts should have a term compatible with the amortization schedule of the required investments, within a range from 5 to 35 years.

## PPP Programs and Project Financing

Like many other capital-intensive, long-term maturing projects, infrastructure projects under the PPP programs are expected to be implemented on a project finance basis. The reliance by the project on payments to be made by the government will have critical implications in the context of financing. Although certain risks relating to the project are expected to be shared between the private and public participants or shifted entirely to the public participants, the so-called political risks associated with the project will be magnified. This is especially important in a country where the process of receiving or collecting payments from the government is widely recognized as lengthy and time-consuming. It is also important to mention that payments to be made by the government under the PPP programs will be subject to certain limits on governmental spending, including those provided by the Tax Responsibility Law (Complementary Law 101 of 2000).

In order to reduce political risks and to secure the government's obligations, the law allows for a number of governmental revenues (tax revenues, for instance, would be excepted) to be bound to PPP programs or for special trust funds to be created. More details regarding these proposed guarantee mechanisms are necessary for one to assess the level of protection they would afford to private participants. Prospective investors and congressmen from opposing parties have already been arguing that these guarantee mechanisms will not be sufficient to mitigate the political risks associated with PPP programs, especially when such programs are to rely on long-term contracts. Given the many economic and political crises Brazil has experienced over the past 35 years, it is indeed very difficult to disregard that concern.

For that reason, these investors and congressmen have proposed, in addition to the attachment of certain revenues to PPP programs or the creation of special funds, that payments under PPP programs be considered as senior to, and thus have a priority over, all other payments due by the government. However, no provision to this effect was included in the final version of the federal law.

But political risks are not the only structural risks expected to arise with respect to projects under PPP programs. The currency exchange risk, for instance, is likely to be substantial as the cash flow from the operation of the projects will be denominated in reals and adjusted for inflation based on local price indexes. Therefore, if such projects are financed with debt denominated in a hard currency (U.S. dollars, euros, yen), any devaluation of the real may cause cash shortfalls.

In addition, any dispute involving the public and private participants under PPP programs are to be resolved by Brazilian courts, which, in practical terms, have been slow and unprepared to deal satisfactorily with complex issues. Although the law contemplates (in general terms) the possibility of arbitration as a dispute resolution method, the possibility of the government and governmental companies submitting to arbitration is still highly controversial in Brazil.

In spite of these hurdles, the federal government is placing tremendous importance on PPP programs. The enactment of a federal law regulating such programs represents an important milestone in the efforts of the government to promote new investments in infrastructure and the sustainable development of the country. It is likely that the creation of PPP programs will attract new investments, but probably not to the extent expected or desired by the government. In fact, the level of new investments into Brazil will also depend on the ability of the government to create a more stable and predictable environment.

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# Employers—Use Your Plan Deficit to Your Advantage

By Steven Hull

Pension Plan deficits are almost daily headline news in the United Kingdom with members and trustees placing great pressure on employers to make good those deficits as quickly as possible. Regrettably, for some employers the obligation proves too great and they fall into administration or insolvency, very often leaving active and deferred members with only a very small fraction of their accrued entitlements. However, for employers that do have sufficient financial strength to be able to fund those deficits, particularly those employers who have significant cash sums available immediately, whether in the United Kingdom or overseas, these circumstances can be used hugely to their advantage.

Unlike the United States, in the United Kingdom employers are very often not able to unilaterally alter the benefits payable to their members. Employees in the United Kingdom almost always have a written contract of employment giving them significant rights and protections against their employer, particularly against employers seeking to reduce pension benefits for their employees.

However, for the employer that has a significant cash sum available to fund quickly any pension deficit, despite a seemingly never-ending flow of bad news for UK final salary pension plans, these employers can seek to make significant reductions in pension costs through reducing pension benefits in return for allocating such funds to the pension plan and reducing the pension fund deficit.

In our experience clients have been able to successfully reduce their pension liability and future service pension costs in return for an accelerated funding regime to settle their pension plan deficit. For these employers, reducing the pension plan deficit was already a commercial aim. Value was added by assisting them through negotiations with their trustees, employee and trade union representatives to negotiate successfully a significant reduction in future service pension costs. In one instance, for example, for an employer with over 1,500 employees in the United Kingdom the reduction in future service pension costs alone was an annual $9 million. The cost of implementing the reduction, including all legal costs, was only a fraction of that sum. The potential benefit is clear.

For those employers that do not have large cash sums waiting to be utilized in this manner, but could allocate additional contributions from its resources on a regular basis going forward, such negotiations should still be considered. Any advance funding ahead of that required by statute will be viewed as a significant advantage by the trustees and one which the employer should seek to exploit.

Many employers in the United Kingdom, including the majority that operate defined benefit pension plans, are seeking to reduce future service pension costs by negotiating with the trustees on the benefit structure for future service. Frequently the result is the adoption of a "career average revalued earnings" benefit structure (CARE). This has proved a very popular compromise between retaining the existing 'final salary' structure and moving to a fully defined contribution benefit structure, which for some employers and certainly for many sets of trustees might be regarded as an overly aggressive approach and one potentially leading to industrial relations difficulties. The CARE benefit structure provides a benefit which is based on the accrued rights of each individual after each year of service based on salary earned in that year, then revalued at an agreed percentage (usually related to the increase in the index of retail prices) rather than the full link to final salary. Although the full link to final salary is lost, there is still a revaluation and the maintenance of a defined benefit structure, which for many employees, particularly senior employees, is regarded as a far more valuable benefit than the more aggressive move to a defined contribution benefit structure.

An employer that does not seek to negotiate with its pension plan trustees and its employees (and potentially their trade unions if applicable) in return for accelerated funding of a pension plan deficit is wasting a huge opportunity.

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# Spain Reforms Its Insolvency Legislation

By Xavier Ruiz

The long-awaited reform of Spain's insolvency regime entered into force on September 1, 2004. The new legislation constitutes a sweeping change of the previous regime, which was anachronistic, obsolete and extremely fragmented. Because it was a combination of rules found in the Civil and Commercial Codes, special laws (*e.g.* 1922 Suspension of Payments Act), and various procedural laws, some of them dating back to 1829, the first success of the new regime is the consolidation of a scattered body of law on a single 230-article statute (*i.e.,* Law 22/2003 or the Insolvency Act), including both substantive and procedural rules.

The Insolvency Act redefines insolvency as a "financial situation which does not allow a debtor to meet its current payment obligations." Creditors' protection may be petitioned by either the debtor or any creditor showing valid title. However, if the protection is sought by the debtor himself, the insolvency does not need to have occurred but may be imminent. The objective is to prevent the deterioration of the debtor's assets. For the same purpose, the new law requires debtors to seek insolvency protection when they become insolvent in the meaning of the law, and subjects them to penalties if they fail to meet the obligation.

Under the new law, one single procedure applies, which may result in a creditors' reorganization or the liquidation of the debtor company. As a departure from the rigidity of the previous legislation, the court now has greater discretion to adopt any measures it deems adequate to protect both the debtor's assets, and the legitimate interests of debtor and creditors.

One of the most significant novelties of the new legislation concerns the effects of the judicial declaration of insolvency on certain collateralized debt, such as pledges and liens on movable assets. Once the debtor is judicially declared insolvent, all pending foreclosure actions are automatically suspended for one year, unless an agreement is reached with the creditors. When this period expires, the foreclosure will be carried on under the supervision of the court handling the insolvency proceedings. The purpose of this provision is to avoid multiple separated foreclosures to the detriment of the debtor's assets. However, this restriction on foreclosure does not apply to mortgages on real estate or certain other assets such as aircrafts and vessels. Likewise, the restriction does not apply to foreclosures which are already underway (as long as the corresponding auction has been publicly announced) and generally, to assets which are not needed to operate the business.

The new law may have a significant impact on financing agreements. While it provides that a declaration of insolvency will not terminate or suspend the effects of financing agreements (except as to interest accrual), the court has absolute discretion to terminate the agreement and include the credit in the debtor's estate. More importantly, the law explicitly provides that provisions in financing agreements which allow the lender to terminate the same solely on the basis of the debtor's declaration of insolvency will be null and void. This means that the customary early termination or acceleration clauses in loans or other financing agreements will no longer be enforceable in Spain if the triggering cause is the declaration of insolvency. Accordingly, the law explicitly allows the early termination or loan repayment acceleration in the event of the debtor's breach of the agreement. Understandably, these provisions on foreclosure suspension and enforceability of financing agreements have given rise to concern among leasing companies and lenders involved in asset-based finance.

Under the old legislation, the declaration of insolvency rendered null and void most of the disposition actions undertaken by the debtor within certain periods of time prior to the declaration. The new statute, however, eliminates this general principle of retroactivity. It provides that only those disposition actions taken within the two years prior to the declaration of insolvency, which had an adverse effect on the debtor's assets, may be rescinded. In some instances, the damage is presumed by the law whilst in others, it must be proven by the petitioner. Affected third parties may invoke defenses based on good faith, public record and other principles.

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# Employees' Invention Rights in Europe and the U.S.

By Dr. Boris Uphoff, Rohan Massey, Clare Sellars, Margherita Barié, Cathryn Campbell and Kathrin Tauber

When employees produce inventions, questions arise regarding the ownership of rights. Who may apply for the patent and who is allowed to commercially exploit the invention—the employer or the employee? The legal situation varies from country to country and quite often businesses are unknowingly exposed to risk by being unaware of their employees' rights when creating inventions.

## United States

In the United States, neither the employer nor the employee has the automatic right to own any inventions made by the employee. With a few exceptions, ownership is determined under state statutory and case law, which may vary between the states. However, there are some fairly standard guidelines applying to inventions made in a business setting.

In the absence of a written agreement which is a condition of employment, ownership is determined by the circumstances under which the invention was made. An employee who was hired to invent or to find the solution to a particular problem is obligated to assign any relevant inventions and resulting patents to his employer whether he made the invention or found the solution on company time or on his own. Furthermore, employers have an equitable right to their employees' inventions which are made on company time or using company resources, regardless of whether or not their job description includes inventive activity. Courts have also found implied agreements to assign rights where the employee holds a position in the company under which he assumes fiduciary duties and where the company has paid the costs of procuring patent rights.

Even in the absence of an equitable or implied duty to assign, the employer may have some rights to an employee's invention under the "shop right" doctrine. Shop rights entitle the employer to use the invention for his own purposes in his own business. If the invention becomes patented, the employer has a non-exclusive license. While the shop right cannot be assigned, it survives the termination of the inventor's employment.

The Bayh Dole Act, which became effective in the early 1980s (35 USC 200-212) specifically requires that institutions receiving federal grants and contracts have written agreements requiring funded employees to disclose and assign to the grantee institution inventions conceived or first brought to practice using federal funds. Most universities impose such obligations on their employees, regardless of the source of funding.

Invention assignment agreements will be enforced by the courts, although they are interpreted restrictively and requirements to assign invention after termination of employment have not been consistently enforced. Employers may regard such provisions as necessary to prevent employees from resigning immediately after conception of an invention. Generally such provisions must be limited in time and relate only to inventions actually related to the former employee's job.

## England

From an employer's perspective, it is probably England which provides the most favorable laws on employees' inventions in Europe. Under English statutory law, ownership of inventions created by employees, as well as ownership of copyright works (including rights in computer software), database rights and registered and unregistered design rights, generally vests in the employer.

From an employer's perspective, it is probably England which provides the most favorable laws on employees' inventions in Europe.

Employees are entitled to seek compensation where a patent obtained over their invention leads to an "outstanding benefit" in money or money's worth to the employer. However, no successful claims for compensation have ever been made by employees. The requirement that it is the registered patent, not the invention, which must lead to the outstanding benefit has created difficulties where the outstanding benefit to the employer has resulted from the combination of the registered patent and additional marketing investment.

Employers should be aware though that this situation may soon change once the new Patents Act 2004 (the Act) comes

The German rule that inventors have to be compensated for their invention in addition to their regular salary is particularly galling for companies with research departments.

into force. Section 10 of the Act will provide that a claim for compensation can be made where the outstanding benefit to the employer derives from the invention patent, the invention or a combination of both.

The UK Patents Act 1977 does not specify any terms in relation to the continuing obligations of employees after their employment is terminated. Because termination of an employment contract ends any contractual arrangements between an employer and employee which are in variance to the statutory position going forward, it could prove hard to enforce any contractual provisions on employee obligations relating to patents created during employment after the employee has left. Moreover, an employee's duty of good faith expires the moment his contract terminates, although there is a continuing obligation not to disclose the employer's confidential information.

## Germany

In Germany, the law is much more employee-friendly. The employer does not automatically become the proprietor of an invention created by an employee. The German Employees' Invention Act 2002 (*Arbeitnehmererfindungsgesetz*) provides that, in the first place, the employee retains full right to and title in an invention which is patentable. These rules may not be altered by employment contracts, so any contradictory clauses which attempt to provide for automatic assignment of rights to the employer are void.

Following the creation of an invention, the employee has an obligation to notify the employer that he has made a patentable invention. Once this notification has been given, the employer has a time limit of four months during which he can either demand title to the invention or waive the right. Unless otherwise regulated by contract, the four month time limit starts when the employee makes the disclosure. Even if the employer does not know about the four month rule, the time for making a decision starts ticking away.

If the employer decides to demand title in the invention, the rights to the invention are assigned by law from the employee to the employer and the employer must pay compensation to the employee in addition to the employee's regular salary. Again, contradictory clauses in employment contracts are void.

Usually the compensation is calculated on the basis of official compensation guidelines issued by the Ministry of Employment. These guidelines take into account criteria such as the economic value of the invention, the respective duty and position of the employee and the employer's contribution to the invention. If the company later achieves substantial earnings with the invention, the employee can retrospectively claim a higher level of compensation than the one initially agreed.

The German rule that inventors have to be compensated for their invention in addition to their regular salary is particularly galling for companies with research departments where employees are specifically hired to invent. Even for these companies, it is impossible to limit or contract-out of the compensation provisions before the specific disclosure of the relevant invention. Only after the invention has been disclosed to the employer can the employee and the employer agree by contract that the employee shall have no right to additional compensation.

If the employer fails to demand title in the invention on time, the employee has legal right to refuse giving up his right in the invention. In this case the employee remains the owner of the invention.

Should the employer waive his right to get the invention assigned from the employee, the employee remains the owner of the invention and there is obviously no need for compensation.

The good news for employers is that the Employees' Inventions Act only applies to employee in a strict sense. It does not apply to company directors or outside contractors and it is relatively easy to reach valid agreements that inventions produced by them shall belong to the company without additional compensation. Since 2002, the new provisions of the Employees' Inventions Act do, however, apply to inventions made by university professors and assistant professors. Accordingly, the university has to be informed about these inventions and the university can then claim them within the four month period.

This has serious effects on research and development agreements between companies and professors which assign all inventions produced under the agreement by the professor to the company. As universities now have the right to claim any inventions made by their professors, they may object to inventions

being assigned to a company. In order to secure their rights therefore, companies should negotiate agreements directly with the university or, preferably, with both the university and the professor. Research and development agreements concluded before February 7, 2002, are also affected by the amendment. A transitional arrangement in the Employees' Inventions Act provides that the new legal provisions apply from February 7, 2003, even for new inventions based on ongoing research and development agreements in place before July 18, 2001. It is therefore necessary to adapt existing agreements by including universities as contracting parties or contractually agreeing that all inventions will be assigned to the company.

Many companies are not aware of, nor do they comply with the legal requirements of the provisions of the German Employees' Inventions Act. They do not even have procedures stating who should be notified about employees' inventions, how the notification should be effected and, if the ownership of rights is to vest in the company, how compensation, if any, will be calculated. In the worst cases, such negligence can lead to the irrevocable loss of important employees' inventions. In order to avoid potential pitfalls, it is important to ensure that employment contracts provide for the transfer of employees' inventions, with particular reference to the procedure for disclosure and employee compensation. Furthermore, contract clauses should provide the legal requirements of notification and timely claiming of employees' inventions.

## Italy

Under the Italian legal system, when an employee develops a patentable invention, the legal ownership of the patent belongs to the inventor, but the right to exploit it rests with the employer. The most debated issue arising from this topic is the employee's right to compensation.

Article No. 23 of Royal Decree No. 1127 of June 29, 1939, as amended, distinguishes three different situations: where compensation is expected and the governing contract expressly provides for it; where compensation is expected and the contract has no such provisions; and where the purpose of the employment or labor contract does not relate to inventive activity.

In the first situation, inventions that are developed in the course of a specifically invention-oriented employment contract and the activity is remunerated fairly, all the rights deriving from the invention belong to the employer, although the inventor gets the intellectual credit. The contract must expressly state that compensation is stipulated and fixed for the inventive activity.

Under the Italian legal system, the legal ownership of the patent belongs to the inventor, but the right to exploit it rests with the employer.

In the second situation, where a specifically invention-oriented employment contract does not detail anything about the employee's remuneration for inventions, rights belong to the employer, but the inventor shall, in addition to his right to be recognized as the inventor, be entitled to fair compensation. If the employer waives his right, the employee will be the exclusive owner of all rights relevant to his invention.

In the third situation, where the employment contract is not based on the inventive activity of the employee, the employer has a specific preemption right concerning the patent. This means the employer must be notified and made aware that a patent will be registered by the employee as the employer has the right to: a) use the invention (exclusively or not) before other third parties or the employee can; b) buy the patent; and c) apply for foreign registration for the invention. If the employer decides to exercise its rights, it has to compensate the employee with a fair and equitable royalty—having deducted the costs saved by the employee using the company's resources (research laboratories for example). Should the employer exercise its right to registration just in Italy, the employee can request to have the exclusive rights to the international registrations.

Any inventions developed up to a year following the termination of the working relationship are included, according to the statute, in the employer's preemption right. There is a legal presumption which states that any inventions filed for registration within a year after the end of an employment relationship are considered to have been developed under the past employment relationship. However, as with any legal presumption, a contradictory case may be made.

Additionally, the employment contract must be in accordance with Italian employment law, as this also determines the ownership of rights under different arrangements, for example, dependent employee, coordinated collaboration or independent collaboration. It is worth noting that, under law No. 383/2001, individuals employed by Italian universities as researchers, and any civil servant employed primarily for researching, are recognized as the exclusive owner of the patent to their invention.

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# Trademarks Go Global

By Dr. Thomas Hauss and Dr. Jonas Ewert

Over the last 18 months, three major events have changed the legal environment for trademark owners. First, in August 2003 U.S. President George W. Bush signed the Madrid Protocol Concerning the International Registration of Marks. In May 2004, the EU enlarged from 15 Member States to 25, and in October 2004 the European Union also signed the Madrid Protocol. What is so significant about these events and how can they benefit trademark owners?

## The Potency of Trademarks

Trademarks are seen as the ambassadors of the company and are recognized as one of the most powerful and valuable instruments in a company's communications with its customers. Trademarks have an important function as guarantor of consistency and quality. Customers, subliminally or consciously, associate superiority with well-known brands. The more an enterprise invests in its trademarks, the more the enterprise will lose, if the trademark is connected with poor quality or faulty products, accidents and environmental scandals.

In recent years, attempts have been made to measure the economic value of trademarks. Although results differ greatly, analysts assess the value of the three most well-known trademarks world-wide—those belonging to Coca-Cola, Microsoft and IBM—to be worth more than $50 billion each. During the last few years, trademarks have become a precious asset to many companies and, consequently, they want to increase their value by expanding their trademarks across borders and to take advantage of launching their trademarks' reputation on global markets.

## Trademark Nationality

A trademark gives the owner the exclusive right to use a specific sign for marking specific goods or services. This right enables the owner to prevent competitors from using the same sign, or a similar one, for marking an equivalent product. Usually the trademark right is granted by the administrative authority of a national state to the trademark applicant. The applicant has to comply with certain administrative requirements and to pay a registration fee. After registration, a trademark is only valid in the territory in which the registration authority is empowered. For this reason, trademarks are usually only valid in one country or, like federal trademarks in the United States, only in certain federal states. Trademarks can be registered in most countries of the world but protection against competitors who illegally use a trademark, or protection against trademark counterfeiting is only available in those countries in which the respective trademark is registered. The economic advantages of using one trademark across jurisdictions are obvious. As well as facilitating market dominance, the same product can be sold all over the world without any changes to appearance or packaging.

## International Trademarks

These economic advantages mean that trademark owners have to apply for registration of their trademark in all jurisdictions. This is, of course, extremely costly in terms of money, time and effort. To limit such costs, several states signed the Madrid Agreement concerning the International Registration of Trademarks as early as 1891. They established a system under which International Trademarks were made available through one application to the then newly founded World Intellectual Property Organization. The system underwent only minor changes and was amended by the Madrid Protocol Concerning the International Registration of Marks. By applying to the World Intellectual Property Organization in Geneva, the owner of one (basic) national trademark can apply for trademark protection in any or all countries that are signatories to the Madrid Agreement or Protocol. The World Intellectual Property Organization will then register "a bundle of similar trademarks" with the relevant authorities in the signatory countries designated by the applicant. The trademark owner then gets an International Trademark valid in all the designated countries, with basically the same legal protection as national trademarks registered in those countries.

## European Community Trademark

In 1996, the European Community Trademark was introduced. A trademark applicant, not necessarily from one of the Member States of the EU, can apply for a trademark which is valid in all the Member States of the European Union. This dramatically cuts down the administrative efforts of registration and administration of trademarks and reduces the application fees. As a rule of thumb, the application for a European Trademark costs about the same as applying to three separate European Member States. The introduction of the European Community Trademark was a major success and now more than 200,000 European Community Trademarks are in force.

The trademark owner then gets an International Trademark valid in all the designated countries, with basically the same legal protection as national trademarks registered in those countries.

## Consequences of European Enlargement

On May 1, 2004, the European Union grew from 15 to 25 Member States. Fortunately, the regime that governs the European Community Trademark is flexible and, as a result of the expansion, all European Trademarks that were valid or applied for at the date of enlargement will have the same legal effect in the 10 new Member States as they had in the former 15 States. This means that the territory in which the European Community Trademark is valid has enlarged without any efforts needed on the part of the trademark applicants or trademark holders.

## U.S. and EU Accession to the Madrid Protocol

In August 2003, U.S. President Bush signed the Madrid Protocol, bringing the United States into the network of International Trademarks countries. This gives some major advantages to U.S. trademark holders and applicants as well as to foreign trademark holders and applicants. Since November 2003, persons or companies may, on the basis of a U.S. trademark, apply for trademark protection in any of the now 76 other states that have signed the Madrid Agreement or Madrid Protocol. A complete and updated list of signatories is published by the World Intellectual Property Organization at www.wipo.int/treaties/en/documents/pdf/g-mdrd-m.pdf. In addition, the holders of any other national trademark of a signatory state of the Madrid Agreement or Madrid Protocol can now designate the United States as a country to which the protection of their basic trademark shall be extended by means of an International Trademark. As of October 1, 2004, the European Community joined the Madrid Protocol with equivalent consequences. A European Community Trademark may now be the basis of an International Trademark application and the holder of an International Trademark may designate the whole European Union (including the recently-joined Member States) as a territory for which he requests trademark protection. As an example, a U.S. company may—on the basis of a national U.S. trademark—now apply for an International Trademark with protective effect in the whole EU for a rather moderate administrative fee and will—if all requirements are met—get trademark protection in all 25 countries of the enlarged European Union.

## Caveat

Applying for an International Trademark is, without a doubt, a simpler and more cost-effective procedure than applying for individual trademark protection in every country a company wishes to be registered. There is, however, still the possibility that an application may fail. This is because each and every signatory country can oppose the application. The risk is aggravated for the designation of the EU by the fact that the trademark applying for registration must comply with the provisions of the national trademark law in all EU member states. If the trademark can not be registered in one of the EU member states, the application across the whole EU will fail.

## Recommendations

We recommend that a professional trademark strategy covering the territorial scope and the actual shape of the mark as well as the goods and services covered by it, should be systematically planned. To minimize the risks that an application for an International or European Trademark fails, the applicant should obtain advice from experienced trademark counsel. Companies that re-assess and optimize their trademark strategy now and take advantage of the International Trademarks with legal effect in the European Union and/or the United States will be well ahead of their competitors.

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# Patent Infringement as an Unfair Trade Practice: Section 337 Proceedings before the U.S. International Trade Commission

By Shamita D. Etienne and Jack Q. Lever

Over the last four and a half years the United States has lost over 3 million manufacturing jobs to locations outside the United States. For the first half of 2004 the U.S. trade deficit for manufactured goods increased 16% over 2003 to $252 billion. There is clear evidence that some of the increase in imports is due to unfair trade practices by companies importing goods into the United States.

Patent infringement can be addressed by a patent holder in U.S. federal district courts. However, companies who import or sell products into the United States should be aware that not only are they subject to litigation in United States federal and state courts, but they may also be subject to proceedings in the United States International Trade Commission (ITC) under Section 337 of the Tariff Act of 1930, 19 U.S.C. §1337, which can result in orders barring foreign goods from the U.S. marketplace. Section 337 proceedings are available in certain instances to remedy 'unfair acts,' which include acts of patent infringement.

Only disputes involving the importation of alleged infringing products can be addressed in a Section 337 proceeding. If the products are not imported, there is no Section 337 jurisdiction. The ITC exists to protect U.S. industry from unfair trade practices so, in order to bring a Section 337 action, the patent holder must either have or be establishing a 'domestic industry' devoted to practicing the patented technology.

## Section 337

Section 337 declares unfair methods of competition and unfair acts in the importation of articles into the United States to be unlawful. The administration of Section 337 is the responsibility of the ITC. The ITC is an independent, quasi-judicial federal agency. It determines whether the statute has been violated due to unfair acts, such as patent infringement, based on a complaint or on its own initiative. Section 337 investigations are themselves adversary proceedings and are akin to patent infringement litigations in federal district courts.

The ITC can only award injunctive-like relief in the form of exclusion and cease and desist orders. Monetary damages for historical infringements are not available from the ITC but instead must be obtained in separate and usually simultaneously filed district court litigation. In spite of the fact that monetary damages are not available, the ability to get an order excluding all imports from the U.S. market can be very attractive to those patent holders who qualify as domestic industries.

The ITC as a general rule is a much faster proceeding than district court litigation. ITC proceedings from start to finish take on the order of 12 months in a normal case and up to 18 months in more complicated cases. The speed of an ITC proceeding greatly favors the patent holder who can prepare its case in advance, putting the named respondents at a distinct disadvantage. While ITC cases generally cost about the same as a standard district court patent infringement case, because they proceed faster, the costs are incurred over the 12-to-18 month period as opposed to a 2-to-3 year period as would be the case in a district court litigation. In addition, although a respondent may assert affirmative defenses against allegations of patent infringement, the respondent is not permitted to assert a counterclaim of patent infringement against the complainant. Any such allegations must be requested for institution in a separate proceeding.

The ITC has nationwide jurisdiction and is an administrative proceeding that is tried before an Administrative Law Judge (ALJ) and not a jury. The ITC's jurisdiction is over the goods, not the parties, so there is no need to obtain personal jurisdiction over foreign importers or manufacturers as there would be in a district court case. The decision by the ITC is subject to presidential review and should the president disagree with the Commission's decision, the president can modify or reject any relief. While the president has rarely overruled the Commission, the possibility still exists. In order to prove a violation of Section 337, a patent holder (referred to as a complainant) must establish the unfair competition or an unfair act (*e.g.,* patent infringement); the importation, sale for importation or sale after importation into the United States of the accused products; and the existence of a domestic industry relating to the product in question.

## Requirements for a Domestic Industry

Section 337 requires that there be an industry in the United States relating to the products at issue. There are factors that relate to proving a domestic industry: an economic prong and a technical prong.

To meet the economic prong under Section 337, a potential complainant needs to demonstrate that, with respect to the products protected by the patent right being asserted, there exists in the United States any one of the following: a significant investment in plant and equipment; significant employment of labor and capital; or a substantial investment in its ex-

Only disputes involving the importation of alleged infringing products can be addressed in a Section 337 proceeding.

ploitation including engineering, research and development or licensing.

To satisfy the technical prong, the complainant must practice or exploit the asserted patent right either directly or through a licensee. Fulfillment of the technical prong of the domestic industry requirement is determined by the articles of commerce and the marketplace.

## Section 337 Investigation Procedure

Unlike district court notice pleading, an ITC complaint must contain detailed information regarding the alleged infringing product or method, the basis for asserting infringement and what the patent owner contends constitutes a domestic injury.

Once a complaint is filed, the ITC has 30 days to determine whether an investigation should be instituted on the basis of the complaint. The investigation is assigned to an ALJ who will set a period for discovery. An ITC investigation involves three parties: the patent holder (the complainant); the accused infringer or infringers (the respondent or respondents); and the ITC's Office of Unfair Import Investigations (OUII). The OUII actually participates in the investigation on behalf of the public and it is treated as any other party involved in the investigation. After the discovery period, the ALJ conducts a hearing, at the conclusion of which, the ALJ issues an initial determination subject to full review by the ITC.

## Remedies

The Commission, by statute, may impose three kinds of remedies: permanent (general and limited) exclusion orders, temporary exclusion orders, and cease-and-desist orders. The permanent general exclusion order directs U.S. Customs to exclude entry of products by any person violating Section 337, and the permanent limited exclusion order directs U.S. Customs to exclude entry of products made or imported by specific firms. A general exclusion order is issued when a limited exclusion order cannot provide sufficient relief.

Temporary exclusion orders are issued to maintain the *status quo* pending the Commission's determination of whether to issue permanent relief. An ITC respondent under a temporary exclusion order can, however, continue to import by posting a bond.

The Commission, in lieu of an exclusion order, may issue a cease-and-desist order to any person violating Section 337. Cease-and-desist orders are *in personam* orders and, therefore, to be effective, *in personam* jurisdiction over the person violating Section 337 is required. The Commission will issue a cease-and-desist order when the complainant proves that commercially significant inventories of infringing products are present in the United States. When enforcing a cease-and-desist order, the Commission will intend to replace it with a limited or general exclusion order and will assess a civil penalty of $100,000 or twice the value of the goods, whichever is higher.

Appeals of all ITC decisions under Section 337 which survive presidential review are heard by the Court of Appeals for the Federal Circuit. Questions of law are reviewed afresh by the Federal Circuit.

Patent holders with sufficient U.S. activities devoted to the practice of patented technology should consider bringing an ITC action to stop alleged infringing activities rather than simply filing a district court case where imported products are involved. The ITC can be particularly attractive when there are multiple alleged infringers and obtaining personal jurisdiction may be problematic. Companies involved in importing into or selling imported products in the United States should be aware that Section 337 proceedings may be an option utilized by an adversarial patent holder and should be ready to take action quickly should an investigation be instituted by the ITC.

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# Shielding IP License Agreements from the Sword of European Antitrust Litigation

By Duncan Curley

There have been a number of high profile disputes about IP license agreements in Europe in recent years. Often, an important weapon in such litigation is European antitrust (competition) law. The legality of a license agreement can be challenged using the antitrust provisions in the EC Treaty, Articles 81 and 82. If successful, such a challenge may render an IP license agreement (and the contractual obligations in it, such as royalty payment clauses) void and unenforceable. In addition, monetary compensation can be recovered if a company's commercial interests have been damaged as a result of a breach of European antitrust law.

To date, relatively few antitrust challenges to IP license agreements have been successful in Europe. However, the battleground has been markedly altered with the advent of modernizing changes to the way in which antitrust claims may be brought (and defended) in Europe. In particular, Regulation (EC) No. 1/2003 (the Modernization Regulation) lays down new rules relating to the application of Article 81 and 82 of the Treaty. In addition, the European Commission has publicly stated that it wishes to see more private antitrust claims being brought in Europe. The Commission is actively looking at ways to encourage companies to bring their private antitrust complaints before the courts of the various European Member States.

The Modernization Regulation states that agreements, including IP license agreements, that are caught by Article 81 shall be prohibited, unless they satisfy certain conditions for exemption. The Modernization Regulation also deals with prohibited abuses of a dominant position under Article 82 without the need for a prior decision to that effect by the European Commission. The Modernization Regulation states that "National courts shall have the power to apply Article 81 and 82 of the Treaty." What this means in a European Community of 25 Member States is that there will be 25 national courts in which antitrust claims under Articles 81 and 82 can be brought. This leads to forum-shopping issues: which of the 25 courts will have jurisdiction in any particular dispute?

When parties are heading for conflict over the legality of the terms of an IP license agreement under European antitrust law, it may be possible to secure tactical advantages depending on the choice of venue in which a dispute is fought. The ability to forum-shop in Europe arises because the national litigation procedures in the courts of the Member States have not been harmonized and there is still a great deal of disparity among them. For example, some jurisdictions, such as the UK and Ireland, have documentary disclosure as an important part of their "cards on the table" litigation procedure. Other civil law jurisdictions, such as France and Germany, do not. Other factors which are considered when selecting a forum for dispute resolution include the readiness of a particular court to award damages and other remedies, the language of the proceedings and, of course, the cost of litigation. In the specific context of disputes involving interpretation of the EC competition rules, the reliability and experience of a particular court in dealing with evidence on questions of economics may be a significant factor in the choice of forum.

There are separate rules that govern when a court may establish jurisdiction over a dispute. The ordinary rule is that if a defendant is domiciled in a European Member State, suit must be brought against him in the courts of that Member State. The ordinary rule can be displaced when, for example, a dispute arises concerning the terms of an agreement, and one of the terms of the agreement provides that a court or courts of a Member State are to have jurisdiction to settle any disputes which may arise. Jurisdiction will then be given to that court or courts. In *Celltech v. Medimmune*, the dispute concerned whether the defendant's Synagis® product fell within the scope of a patent license agreement granted by the claimant to the defendant. In this instance, the UK court was given exclusive jurisdiction under the terms of the patent license agreement.

The rules also provide that a defendant can be sued in a Member State, other than the one where he is domiciled, in matters relating to contract, provided that he is sued in the courts of the Member State where the obligation should, under the contract, have been performed. An equivalent rule for torts provides that a defendant can be sued in a Member State where the harmful event occurred. Where there are multiple defendants domiciled in different Member States, the rules allow the group to be sued in the court of any of the Member States where any one of them is domiciled, provided that the claims against all of the defendants are so closely connected that it is expedient to hear and determine them together, in order to avoid the risk of irreconcilable judgments resulting from separate proceedings.

Although these rules are intended to prevent irreconcilable judgments among the different courts throughout Europe, a ruling on the application of Article 81 to an IP license agreement may only apply to that agreement when set in its particular context of the market conditions prevalent at that time. Because of changing economic circumstances, agreements can move

The Commission is actively looking at ways to encourage companies to bring their private antitrust complaints before the courts of the various European Member States.

in and out of illegality under Article 81. Thus, a judgment in one court will not necessarily be binding on another court, if the conditions of competition are different by the time the second court comes to consider the case (for example, in a fast-evolving market involving new technology). This leaves open the possibility that the same issue under the European antitrust rules could be litigated in different European jurisdictions (multiple jeopardy).

## Protection

How can businesses guard against their IP licenses becoming embroiled in issues such as forum-shopping, multiple jeopardy and litigation in strange and unfamiliar European courts? The Modernization Regulation states that agreements that are caught by Article 81 which nevertheless satisfy certain conditions for exemption shall not be prohibited. Under the new regime, an important tool for determining whether an IP license agreement meets the relevant criteria for exemption under the European antitrust rules is the European Commission's Technology Transfer Block Exemption Regulation. An IP license agreement that is within the safe harbor of the Technology Transfer Block Exemption is presumed to fulfill the conditions required for compliance with European antitrust law. The rationale behind the issue of this (and other) block exemptions is that it allows companies to self-certify their agreements for compliance. Importantly, according to the Modernization Regulation, the courts in the European Member States cannot prohibit IP license agreements either under EC competition law or their own national laws, if the agreement comes within the Technology Transfer Block Exemption.

Of course, it is always possible for a company which is contesting the validity of an IP license agreement to argue that a particular contract is not within the safe harbor of the Block Exemption. Nevertheless, if an agreement appears to comply with the Block Exemption, the burden of proving a violation of the antitrust rules will be significant, unless the agreement is one that blatantly offends against the rules (for example, where it is intended to facilitate price fixing or market sharing).

The Technology Transfer Block Exemption Regulation is a relatively short but complicated piece of European legislation. It requires companies to have an awareness of both the markets in which they operate and the technology available for license from other sources, before it can be applied to any particular licensing arrangement. It also requires familiarity with the types of restrictive contractual clauses that have been designated as "hardcore" by the European Commission in the Block Exemption. Yet with so many IP licenses being worldwide in scope, the importance of the Technology Transfer Block Exemption to businesses wishing to avoid the specter of European antitrust litigation should not be underestimated.

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## Learn More About the Technology Transfer Block Exemption Regulation

Duncan Curley, the author of this article, has written a new book, *Intellectual Property Licenses and Technology Transfer*. It is a practical guide to the new European Technology Transfer Block Exemption Regulation and the impact which the changes in the law will have on IP licenses. The book is intended to simplify this highly complex topic and to provide practical advice on how to apply the block exemption. It will be of interest to all IP lawyers and licensing professionals.

If you would like to receive a copy (paperback £49.95, hardback £59.95), please contact Extenza-Turpin at books@extenza-turpin.com, or + 44 (0) 1767 604951, fax: +44 (0) 1767 601640, or at Extenza-Turpin, Stratton Business Park, Pegasus Drive, Biggleswade, Bedfordshire, SG18 8QB, United Kingdom.

# Tax and IP in the UK—Maximizing Use of IP Rights to Obtain Fiscal Advantages

By Laurence Cohen and Guy Madewell

IP rights are the new frontier for countries that wish to have competitive economies. In prehistoric times, advantage was obtained through fixed agriculture. Then in Roman times, metal and stone working became of paramount importance along with the ability to organize government. When the Roman Empire collapsed, governments remained relatively static until the Industrial Revolution of the 18th century which prioritized heavy industry and the production of goods. After the 1940s, ingenuity supplanted industrial strength and machinery. That became manifest in two almost simultaneous revolutions: the electronics and software revolution pioneered by the United States and Japan and the financial services revolution pioneered by the United States and the United Kingdom. It no longer matters how much you produce in terms of weight or size of articles or crops; what matters is your ingenuity.

While taxes on goods and services have been reasonably easy to obtain and administer, governments have found it more difficult to levy a tax on ingenuity as, rather inconveniently, it tends to be based in the heads of people.

Recognizing that the obtaining and exploitation of IP rights is the ultimate culmination of the research and development process, a number of governments have sought to have their countries as the preferred location for IP rights in order to take greatest benefit from the advantages. These include the need for highly qualified people to be based in the country in order to exploit and administer those rights.

IP rights are generally rights which prevent others from doing something detrimental to your business. The contract with the government and supranational authorities is granted after consideration of disclosure and registration and takes the form of a monopoly limited by time-old traditions. In patents which cover inventions, that monopoly is limited in time to 20 years (subject to minor exceptions), whilst for copyright, it is long-term monopoly of life plus 70 years. Trademarks are for indefinite life and depend on use and payment of renewal fees.

The only right amongst IP rights which is not an exclusionary right (that is, a right to exclude others), is the right based on confidential information, trade secrets and know-how, which essentially mean the same thing. Those rights depend on having knowledge so the person lawfully in possession of the knowledge and know-how has the right to use it, providing the use does not infringe third-party rights such as patents.

There are many IP rights and each can be treated separately. These include patents, trademarks, copyrights, rights in designs, database rights and rights in trade secrets to name some. All of these are capable of independent exploitation.

In 2000, the British government decided that it was going to give tax credits for research and development carried on by small and medium sized companies which generated intellectual property rights. In 2002, this scheme was extended to all companies of whatever size. At the same time, relief was introduced for Intangible Fixed Assets (IP) the cost of which can now be written-off for tax purposes. The IP rights must be new rights, occurring after April 2002, to be eligible for tax relief, so the grandfathering-out of old rights becomes progressively less important. This has created new opportunities and, for the first time, the United Kingdom has become an attractive place from which to exploit IP rights.

Relief was introduced for Intangible Fixed Assets (IP) the cost of which can now be written-off for tax purposes.

This is for a number of reasons. The most important of these reasons from a planning point of view is that, not only does the United Kingdom allow the writing-off of the capital element of IP rights across their effective lives, so tax relief could be obtained on the capital as well as any interest, but the country also has a very good treaty network which means that royalty payments flowing into the United Kingdom are generally subject to no or low withholding. In addition, the country is blessed with universities which are prestigious and prodigious in their research output. Accordingly to a survey in *The Times Higher Education Supplement* (November 5, 2004), the United Kingdom boasts seven of the world's top 50 universities including two in the top 10. Only the United States does better.

The country also has a very good treaty network which means that royalty payments flowing into the UK are generally subject to no or low withholdings.

It also has a pool of skilled administrators, and a tradition of dealing with what is really important in business, namely money, through the financial workings of the City.

Add these factors together and the United Kingdom becomes an interesting and attractive forum through which to direct royalty streams which can be created through each individual intellectual property right.

These following case studies show how, by judicious planning of commercial arrangements, IP rights can be used to manage commercial arrangements extremely efficiently. They illustrate how the benefits of a combination of a well-developed IP system, a well-developed financial services industry and a good tax treaty network, has made the United Kingdom a desirable place through which to operate modern IP brand structuring.

## Case Study 1

Company A is the owner of a database. The operator of the database is a UK company and since the database is licensed to third parties, its income can be described as royalty income and its sales agents as commission agents. It also has trademarks (without which it would have no recognition) and rights under various copyrights which are generated both in its publicity material and in its other works. Licensing the UK corporation and allowing the monies to pass through in consideration of a capital sum, the owners were effectively able to obtain a very large proportion of the expected income arising out of the exploitation products gross, that is free from tax other than the tax to be paid in their own jurisdiction as tax residents.

## Case Study 2

A large multinational has no current brand identity on a global basis. It traded under a collection of local brands, and so had no cohesion throughout the group. It concluded that it needed a global unifying brand, and therefore set up an off-shore subsidiary to find and manage a global identity. It imposed upon its other subsidiaries a duty to use the global brand and enabled its off-shore subsidiary to charge a royalty. The duty to use a global brand brought a number of the subsidiaries to the attention of others within the group and they began to increase business in a synergistic way. Groups of subsidiaries, and individual corporations, who never thought of themselves as belonging to the same group were now able to take advantage of mutual points of interest to increase their businesses. The increase in business resulting from the newly discovered synergies was such that the turnover of the group was expected to show a modest but discernable increase. As a result, a royalty for using the global brand was therefore charged to each of the subsidiaries depending on the nature of their business. The royalties arrangement was set up through a dedicated off-shore company which then sold the rights to a UK company within the group for a large capital sum. The UK company was the recipient of license fees which were expected approximately to match, over the relevant period, the large capital sum paid out. As a result, because the cost of the acquisition to the UK company could be written off against tax for group purposes, when the parent company borrowed the capital sum from the dedicated offshore company, it was able effectively to obtain a loan at a negative effective rate of interest and free of tax. The benefit of this went straight to the bottom line.

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# VoIP: How to Regulate a Transformative Communications Technology

By Dr. Andreas Boos, Shirley S. Fujimoto, David D. Rines and Dr. Ralf Weisser

The telecommunications sector is being transformed by a new technology known as Voice over Internet Protocol (VoIP), which many believe could soon displace most traditional voice telephony services. Using VoIP (also known as internet telephony or IP telephony), any subscriber with a high-speed broadband connection—whether DSL, cable, wireless or power line—can now receive high-quality VoIP service that allows them to make local, long-distance, and international calls, often for a fraction of the cost of subscribing to traditional telephone service.

In general, VoIP—which uses both the public internet and internet protocol-based private lines to transmit voice calls—is not currently subject to the same costly regulation as traditional voice services. This, together with the network efficiency and significantly lower cost involved in providing VoIP service, has combined to make VoIP an increasingly attractive option for both business and residential users of telecommunications services. Companies not only receive reliable, low-cost voice communications services between all of their offices worldwide for a significantly lower cost, but are able to enhance these services with a variety of features such as caller ID and voicemail, as well as use VoIP services for audio and video conferencing.

However, VoIP has raised numerous unanswered regulatory questions. In addition, the decision to either provide or subscribe to VoIP services can raise various business issues, from infrastructure to software licensing to service agreements and contracts. Businesses therefore also should seek counsel in the drafting and negotiation of the various contracts and agreements related to VoIP and other communications/IT services.

## Regulatory Concerns Regarding VoIP

As VoIP's share of overall voice traffic increases, it has become apparent that some form of regulation may be necessary in order to protect certain vital public interests such as access to emergency services, law enforcement assistance and universal service. At the same time, there is concern that over-regulation could impose cost and regulatory burdens on VoIP providers that would stifle the development and deployment of VoIP and other new technologies and services. This is now one of the key questions facing the U.S. Federal Communications Commission (FCC) and communications regulators throughout Europe and Asia.

Public safety concerns regarding VoIP arise from the fact that calls made using VoIP are nearly impossible to trace due to the borderless nature of all internet transmissions, and telephone numbers associated with VoIP accounts are not restricted by the subscriber's geographic location. For example, a VoIP subscriber living in London can request a number with a Miami area code as his or her home telephone number and can send and receive calls via this number from any high-speed internet connection located anywhere in the world. While this has tremendous advantages for subscribers—particularly for those who travel frequently—this would make it nearly impossible for emergency responders to determine the origin of an emergency call or for law enforcement authorities to conduct authorized surveillance as part of a criminal or national security investigation.

Additionally, VoIP services are not currently subject to universal service charges, which are used to support the provision of telecommunications services to rural and other high-cost areas. There is also substantial dispute in the United States over whether VoIP service providers should pay access charges to local exchange carriers (LECs) in order to access the local network, just as a traditional long-distance service provider would. Similar issues have arisen in Europe where, under the regulatory framework of the European Union and its Member States, players are free to enter the market for electronic communications services without prior authorization, provided they abide by the applicable conditions in each Member State. This approach is intended to essentially free all services from any licensing scheme. However, there are many legal points implicated by VoIP which remain unclear and which must be resolved by national regulators, such as Germany's Regulatory Authority for Telecoms and Postal Services (RegTP), and by the courts. One of the most significant issues is whether—and under what circumstances—VoIP should be classified as publicly available telephony service (PATS) with all the attendant regulatory obligations, particularly access to emergency services (and the question of determining a caller's location), universal service obligations, and network integrity. However, imposing these regulatory obligations on VoIP could make it substantially more expensive or technically difficult to provide, thus diminishing many of VoIP's cost and technological advantages.

An excess of regulation could impose financial or technical burdens on VoIP that would stifle its development.

## Regulatory Developments in Europe

In 1998, the European Commission didn't consider VoIP as equivalent to voice telephony because, at that time, VoIP did not offer the same level of reliability and speech quality. For this reason, internet voice transmissions were not subject to the regulatory regime that applied to traditional phone companies. However, this situation has completely changed over the last few years with the emergence of a number of enabling technologies, services and providers that can now deliver a reliable, high-quality solution at very low cost.

The regulatory position of VoIP in Europe now therefore depends on an analysis of the actual service provided based on the various elements that are used to define voice telephony. In Germany, RegTP launched a consultation process in May 2004 and held an oral hearing in October 2004 on proposals for the future regulation of VoIP. National regulators in other European countries are likewise considering how VoIP should be treated.

In 2004, the FCC initiated two separate rulemaking proceedings to address the general regulatory obligations of VoIP service providers, and the specific obligations VoIP providers have to assist law enforcement authorities to conduct authorized electronic surveillance. Final decisions in these proceedings are not expected until later in 2005.

In 2004, the FCC also began issuing its first formal rulings on discrete VoIP-related issues. Of these, the most significant is its November 2004 ruling that certain VoIP services are subject to exclusive federal (*i.e.*, FCC) jurisdiction and therefore cannot be regulated by state public utility regulators. State regulators currently have authority over local and intrastate long-distance telephone services, and several state regulators have recently asserted that this also gives them authority over VoIP providers. By pre-empting the authority of state regulators, the FCC is seeking to ensure that VoIP providers will not be burdened by requirements to comply with different—and potentially contradictory—state regulations and licensing requirements. Congress has also taken up the issue and now has several pending bills on VoIP regulation which could effectively override any decisions the FCC adopts. However, the future of these bills is uncertain, and they could ultimately be swallowed up by a larger telecommunications reform bill that is rumored to be on the 2005 legislative agenda.

Ultimately, the decision on how to regulate VoIP will have a tremendous impact not only on the telecommunications sector, but on all users of telecommunications services. VoIP has been able to develop as a highly-competitive, low-cost alternative primarily because of its unregulated status. If properly regulated, VoIP will, of course, continue to grow and thrive and consumers around the world will be able to reap the benefits of lower communications costs. However, an excess of regulation could impose financial or technical burdens on VoIP that would stifle its development and cost-effectiveness and could prevent it from reaching its full potential.

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