THE MATERIALITY STANDARD FOR INTELLECTUAL PROPERTY DISCLOSURES

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INTRODUCTION

Attorneys are often asked to assist with the preparation and disclosure of financial statements for publicly- and privately-held companies. These attorneys may be concerned because the Securities and Exchange Commission ("SEC") has the power to investigate and seek civil sanctions for suspected violations of securities laws.[1] The SEC, a private stockholder in a derivative suit, or a group of stockholders in a class action suit, may bring an action under SEC Rule 10b-5 for making material misstatements or omissions in connection with the purchase or sale of a security.[2] This may lead to focus being placed on a patent attorney, with the typical question being whether misstatements and/or omissions of a material fact were made within disclosed financial documents relating to patents or other forms of intellectual property ("IP").[3]

The stock market crash of 1929 and the Depression of the 1930's prompted Congress to alter the way securities were traded: swapping the old philosophy of caveat emptor for that of full disclosure and higher ethics.[4]

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[1] *See* Kenneth C. Fang & Brad Jacobs, Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99, 55 Bus. Law. 1039, 1041 (2000).

[2] *See* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2000).

[3] *See Zirn v. VLI Corp.*, 681 A.2d 1050, 1057 (Del. 1996).

[4] *See Wilko v. Swan*, 346 U.S. 427, 430 (1953) (quoting H. R. Rep. No. 85, 73d Cong., 1st Sess. 2).

Congress drafted two main federal security laws, the Securities Act of 1933[5] and the Securities Exchange Act of 1934,[6] to help ensure that accurate information is provided to the investing public.[7] The Securities Act of 1933 primarily governs the registration and initial distribution of securities.[8] The Securities Exchange Act of 1934 created the SEC to govern post-registration market trading.[9] The SEC regulates many public company disclosures including: registration statements, prospectuses, periodic quarterly and yearly reports, proxy statements, as well as other forms of disclosure.[10]

SEC Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> a) To employ any device, scheme, or artifice to defraud,
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> b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.[11]

Thus, in order to state a claim under SEC Rule 10b-5, a plaintiff must allege facts showing that the defendant(s) misstated or omitted a material fact with the requisite scienter upon which plaintiffs relied, proximately resulting in damages.[12]

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5 Securities Act of 1933, Act May 27, 1933, ch 38, Title I, § 1, 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (2001).

6 Exchange Act of 1934, Act June 6, 1934, ch 404, Title I, § 1, 48 Stat. 88, 15 U.S.C. §§ 78a-78mm (2001).

7 See Elisabeth Keller & Gregory A. Gehlmann, A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934, 49 Ohio St. L.J. 329, 342-344 (1988).

8 *See* Louis Loss and Joel Seligman, *Securities Regulations*, 3d § 1-H-2 (2001).

9 *See id*. at 3d § 1-H-3.

10 *See* Fang & Jacobs, *supra* n. 1, at 1040-41.

11 General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2000).

12 *See Mellman v. Southland Racing Corp*., 741 F.2d 180, 181-82 (8th Cir. 1984).

I. THE MATERIALITY STANDARD FOR INTELLECTUAL PROPERTY DISCLOSURES

Problems arise during civil litigation when courts find which facts are considered material. The most widely-adopted test for materiality of an omitted fact was set forth by the Supreme Court in *TSC Indus., Inc. v. Northway, Inc*.[13] The Supreme Court in *TSC Industries* held that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[14] In *Basic Inc. v. Levinson*, the Supreme Court adopted the *TSC Industries* standard for materiality for misstatements within the SEC Rule 10b-5 context by holding "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."[15] In *Basic*, the Court rejected a proposed bright-line rule for determining the materiality of a specific piece of information.[16] In its place, the Court called for a fact-specific case-by-case inquiry.[17]

Because courts have eschewed a bright-line rule for determining materiality, they have historically had a difficult time determining which facts are material. Courts also struggle to determine what is material in intellectual property disclosures. Courts have had this difficulty because they cannot rely on a corporate director's or attorney's subjective interpretation of materiality.[18] Instead, courts must rely on the objective reasoning of a reasonable investor under the *TSC Industries* and *Basic* standards.[19] "[S]ince the importance of a particular piece of information depends on the context in which it is given, materiality has become one of the most unpredictable and elusive concepts of the federal securities laws."[20] "For example, information such as the imminence or status of a patent application may be material, depending on its significance for commercial purposes."[21] Not only do courts, company directors, and attorneys have

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[13] 426 U.S. 438, 449 (1976).

[14] *Id*.

[15] 485 U.S. 224, 240 (1988).

[16] *See id*. at 236.

[17] *See id.* at 239.

[18] *See Zirn v. VLI Corp*., 621 A.2d 773, 779 (Del. 1993).

[19] *See id*.

[20] *SEC v. Bausch & Lomb Inc*., 565 F.2d 8, 10 (2d Cir. 1977) (emphasis added).

difficulty deciding what falls under the materiality standard, but the SEC can experience the same difficulty as well. "The SEC itself has despaired of providing written guidelines . . . and instead has chosen to rely on an after-the-fact, case-by-case approach, seeking injunctive relief when it believes that the appropriate boundaries have been breached."[22]

Materiality is a mixed question of law and fact, ordinarily determined by the fact finder.[23] However, if the "alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds [could] not differ on the question of materiality . . . the allegations [are] inactionable as a matter of law."[24] When assessing materiality, not only the statement or omission must be considered for its importance to a reasonable investor, along with the context in which the statement or omission occurred.[25]

The Supreme Court, in both *Basic* and *TSC Industries*, has been careful not to set too low a standard for materiality. Too low a standard could lead to "an overabundance of information" being supplied to investors, "especially concerning corporate developments of 'dubious significance.'"[26] The rationale of the Supreme Court for assuring that their standard was not too low was their concern that a minimal standard could lead to corporate management simply burying investors in "an avalanche of trivial information."[27] A minimal standard would also force attorneys to disclose every trivial bit of information to investors out of fear of incurring potential liability for failing to disclose those minutiae. This result would hardly be conducive to informed decision making, which is a key goal behind the securities laws.

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21 Barbara Rudolph, Subjective Evaluations of Technology as Bases for Rule 10b-5 Securities Law Violations: Liability for Scientific Consultants, 61 Geo. Wash. L. Rev. 1856, 1876 (1993).

22 *Bausch & Lomb*, 565 F.2d at 10.

23 *See Weiner v. Quaker Oats Co*., 129 F.3d 310, 317 (3d Cir. 1997).

24 *Id*.

25 *See In re Donald Trump Casino Sec. Litig*., 7 F.3d 357, 364 (3d Cir. 1993).

26 *Weiner v. Quaker Oats Co*., 928 F. Supp. 1372, 1384 (D.N.J. 1996) (quoting *Lewis v. Chrysler Corp*., 949 F.2d 644, 649 (3d Cir. 1991)).

27 *Basic*, 485 U.S. at 231 (quoting *TSC Indus*., 426 U.S. at 448-49).

II. SPECIFIC SCENARIOS AND EXAMPLES

A. *Misstatements About the Status of a Patent Application*

Information regarding the status of a patent application can often strongly influence the value of a corporation's stock.[28] This information is especially important when a patent application is a company's sole asset, since misstatements about the status of the patent application under these circumstances can significantly affect the value of the company's stock. In *Pommer v. Medtest Corp.*,[29] the sellers of a company having just one asset, the intellectual property in a self-administered cervico-vaginal cytology testing process, aided the sale of the company's stock by representing that the process was patented, although the patent had not yet issued.[30] The process was ultimately patented two years after that sale of stock.[31] The Seventh Circuit held that misstatements concerning the patent's status are material under the Supreme Court's materiality test from the *TSC Industries* and *Basic* decisions.[32] The court also held that "[t]he securities laws approach matters from an ex ante perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true."[33]

This holding makes intuitive sense because Medtest's patent application might never have issued, leaving the buyers of Medtest stock with a much less valuable asset due to their reliance on fraudulent misstatements. Therefore, the court acknowledged "[e]ven a small probability of [the occurrence of] a bad event may be material, if that event is grave enough."[34]

Similarly, the Federal Court for the Southern District of Florida held omissions and misrepresentations regarding the status of a corporation's patent application to be material.[35] In *Alna Capital Assocs. v. Wagner*,

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28 *See Alna Capital Assocs. v. Wagner*, 532 F. Supp. 591, 600 (S.D. Fla. 1982).

29 961 F.2d 620 (7th Cir. 1992).

30 *See id*. at 622.

31 *See id*.

32 *Id*. at 623.

33 *Id*.

34 *Id*.

35 *See Alna Capital Assocs.*, 532 F. Supp. 591, 600 (S.D. Fla. 1982).

plaintiff Nahmed purchased a large block of shares from the president of a publicly traded company.[36] The defendant/president of that company, Wagner, had informed Nahmed that the already high profit margin on the "Chargefaster" refrigerant-enhancer invention would continue because a patent would soon issue.[37] Soon after Nahmed purchased a 38% stake in the company,[38] his accountants informed him that the "high profit margin" turned out to be much lower than Wagner had indicated.[39] In addition, Nahmed learned that the Patent and Trademark Office had initially rejected the patent application for "Chargefaster" because the product was not novel, and that at least four different inventors had previously produced equivalent products.[40] Nahmed subsequently brought this suit under SEC Rule 10(b)-5 for misrepresentations within the 8-K financial forms filed with the SEC, and for omissions related to the "Chargefaster" patent application status.[41] The district court concluded that because "Chargefaster" had become a major contributor to the earnings of the company, and because it would continue to be profitable if it could be patented, the omission concerning the rejection of the "Chargefaster" patent application was "highly material" to a reasonable investor.[42] Unfortunately, the district court's opinion did not address whether or not a response to the rejection on first office action had ever been filed.[43] Rejections of patent applications on first office actions are quite common, and may often be overcome with convincing arguments or by adding amendments to the patent applications. Final rejections of patent applications however tend to be more difficult to overcome and may make obtaining patent protection for the invention more difficult. Because final rejections tend to have greater impact on the likelihood that an application will issue as a patent, statements and omissions regarding final rejections may be more likely considerably material than statements and omissions regarding initial rejections, which tends to issue as a matter of course. The holding in *Alna*, however, seems to indicate that the status of a patent application for an invention that is of singular importance to a corporation’s viability will be material: even status about an initial rejection of the patent application.

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36 *Id*. at 593-94.

37 *See id*. at 594.

38 *See id*.

39 *See id*. at 594-95.

40 *See id*. at 596.

41 *See id.* at 597-99.

42 *Id*. at 600.

43 *See id*. at 596.

Small start-up corporations often rely on a single patent to protect their proprietary technology and to generate significant earnings.[44] Because of the *Pommer* and *Alna* decisions, courts have recognized that when a "potential patent" is entwined with the success of a company, representations made to the SEC or the general public about that "potential patent" should be accompanied by a statement of the exact status of the "potential patent" in the prosecution process.[45] Therefore, the materiality standard may vary depending upon the patent's prominence in a corporation's expected earnings. The status of a patent application, critically entwined with the company's financial viability should be disclosed if a reasonable investor would believe that such information would significantly alter the "total mix" of information available to him when trading stocks.[46] In general, a corporation should disclose to its shareholders the status of any given patent application. If a patent application is undergoing prosecution, however, it may be prudent for a corporation not to mention facts regarding that patent application at all until a final allowance or rejection on the merits has been received, so long as that patent application is not entwined with the success of the corporation. Furthermore, the status of a single patent application among thousands owned by a large Fortune 500 corporation may be immaterial to a reasonable investor if that application is not entwined with significant earnings of the corporation.

Indeed, what is most important under the Securities and Exchange Acts is simply accuracy and full disclosures, not "half-truths" or partial disclosures.[47] The *Pommer* court stated "[r]isks are ubiquitous. Disclosures assist investors in determining the magnitude of risks."[48] Therefore, if a corporation feels that the status of the corporation's intellectual property is material to investors then full and accurate disclosure is usually warranted.

The Second Circuit addressed a situation where a letter describing the status of a patent application as "patent applied for" was sent to company's shareholders.[49] In fact, the application had been finally rejected three years earlier for inoperability, and the application had been abandoned.[50] As a defense to a misrepresentation charge, the defendants

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44 *See e.g.*, Jonathan M. Barnett, Cultivating the Genetic Commons: Imperfect Patent Protection and the Network Model of Innovation, 37 San Diego L. R. 987, 1012 (2000).

45 *See e.g.*, *SEC v. Research Automation Corp.*, 585 F.2d 31, 35-36 (2d Cir. 1978).

46 *See TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

47 *See* Keller & Gehlmann, *supra* n. 7, at 342-344

48 *Pommer*, 961 F.2d at 624.

49 *See SEC v. Research Automation Corp.*, 585 F.2d 31, 34 (2d Cir. 1978).

50 *See id*. at 34-35.

argued that a patent was still pending in Canada.[51] The Second Circuit, following the *TSC Industries* materiality standard, held that the application's rejection in the United States was a fact that reasonable investors would have believed to be material.[52] The court asked, "[w]ho could not regard as vital the denial of U.S. patent protection for RAC's principal product on the grounds that it was 'inoperable'?"[53] The court further found that any reasonable investor would have believed the "patent applied for" letter meant the patent application was filed in the United States, not in Canada.[54]

B. *Misstatements and Omissions Concerning a Patent's Claim Coverage*

The Fifth Circuit has recently discussed the materiality of misstatements and omissions in terms of a patent's claim coverage in connection with a Rule 10b-5 complaint.[55] That court found that a corporation's statement that it has a patent covering the use of a new pharmaceutical to imply to a reasonable investor that the patent covers *any* use of the formulation and not just a particular *method* of using the formulation.[56]

The defendant corporation issued a press release, which stated,

> Zonagen, Inc. announced today that it has received notification from the United States Patent and Trademark Office that the *patent covering its use of VASOMAX (TM) as a treatment for erectile dysfunction (impotency) has been allowed.* The Company noted the *approval was granted for the first of two separate applications associated with VASOMAX (TM).* The second, more recent application is still pending. 'The *approval of our U.S. patent*, the VASOMAX (TM) IND submission and the selection of our Phase III development team are crucial events in our commercialization strategy,' declared Joseph S. Podolski, President and CEO, Zonagen, Inc. . . .(emphasis added).[57]

The court noted that a reasonable investor would find a broad claim to the underlying pharmaceutical composition (Vasomax) considerably more material than simply a method claim covering use of the composition for

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[51] *See id*. at 35.

[52] *See id*. at 35-36.

[53] *See id*. at 35.

[54] *See id*.

[55] *See Nathenson v. Zonagen, Inc*., 267 F.3d 400, 422-426 (5th Cir. 2001).

[56] *See id*. at 425.

[57] *See id*. at 423.

absorbance solely through the mouth tissues.[58] The misstatement regarding the true nature of the patent method claim was material particularly because the corporation had consistently touted the administration of the pharmaceutical *via capsule or tablet ingestion*.[59] The court noted that the patent stated in part, "for purposes of the present invention, 'transmucosal delivery' generally refers to delivery of the drug to the oral or pharyngeal mucosa and includes buccal delivery, sublingual delivery, and delivery to the pharyngeal mucosa, *but not to the stomach*."[60]

Not surprisingly, the court also noted that misstatements concerning Vasomax were more likely to be material due to the fact that the company "was essentially a one product company, and that product was Vasomax and that substantially all of the Company's efforts and expenditures over the next few years will be devoted to Vasomax and that the Company's future prospects are substantially dependent on Vasomax and was undeniably the most significant contract" in the company's history.[61] The court also took note that a recent S-3 filing stated "the Company's ability to compete effectively with other companies is materially dependent on the proprietary nature of the Company's patents and technologies."[62]

In light of *Zonagen*, a practitioner would do well to characterize corporate disclosures of patent protection in terms the actual claim scope. If the patent covers a composition of matter, then the disclosure should reveal exactly that. In contrast, if the patent covers only a method of use, then the disclosure should include the method of use language. Characterizing patent disclosures in terms of the actual claim scope becomes increasingly important where a company's patent is its sole revenue producer. In such a case, even minor information disclosed about the patent would likely be deemed material to a reasonable investor.

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58 *See id*. at 422-423.

59 *See id*. at 423.

60 *See id*. at 422-423 (emphasis added) and U.S. patent No. 5,565,466 to Gioco, et al. (issued Oct. 15, 1996).

61 *Id. at* 425.

62 *Id*.

C. *Misstatements Concerning a Corporation's Patent Licensing*

Courts have generally found misstatements about whether a company has a patent, or a license from a patent holder, to be material to a reasonable investor.[63]

The court in *SEC v. InterLink Data Network of Los Angeles, Inc.*, found that at least five materially false and misleading representations or omissions were used by the defendants to sell InterLink securities to the public.[64] The investors were falsely told that the defendant "held an 'exclusive license' to use as many as 16 patents pertaining to video telephone technology, including patents to an optical switch used in fiber-optic cable lines."[65] The court held that "the defendants disseminated false and misleading information and failed to disclose material facts to induce potential purchasers to invest in the securities of defendant issuers."[66]

The SEC has the power to bring a suit against the directors of a publicly held corporation when misrepresentations are made about the amount of licensing revenues that are earned from intellectual properties.[67] Misrepresenting the actual revenue that was earned from licensing modem patents in 10-Q quarterly reports was deemed to be a "material misrepresentation" made by company directors in *SEC v. Caserta*.[68] In *Caserta*, Spectrum licensed its patented modem technology to national brand modem companies in exchange for the national brands' agreement to advertise the Spectrum logo on any modems they sold.[69] Spectrum reported the licensing revenues in its 10-Q quarterly reports, but failed to record the advertising costs that Spectrum had agreed to pay to each of its licensees until much later.[70] Furthermore, Spectrum issued press releases reporting the large licensing revenues it was earning from the national brand modem

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63 *See, e.g.*, *SEC v. InterLink Data Network of Los Angeles, Inc*., No. 93 3073 R, 1993 U.S. Dist. LEXIS 20163, at *45 (C.D. Cal. Nov. 15, 1993).

64 *See id*. at *12.

65 *Id.* at *12-14.

66 *Id.* at *45.

67 *See SEC v. Caserta,* 75 F. Supp. 2d 79, 90 (E.D.N.Y. 1999).

68 75 F. Supp. 2d 79, 93 (E.D.N.Y. 1999).

69 *Id*. at 84-85.

70 *See id*. at 85.

companies.[71] Spectrum neglected to mention however, that most of its reported revenue was used to pay the national brand modem companies for advertising the Spectrum logo on the national brand modems.[72] When Spectrum restated its quarterly earnings to reflect the advertising fees, its stock price plummeted.[73]

The *Caserta* court, relying on the *Basic* and *TSC Industries* standards,[74] concluded that Spectrum's misrepresentations in its SEC 10-K reports were material because "treating the licensing fees as revenue allowed Spectrum to suggest to investors that its patents were quite valuable to the telecommunications industry . . . ."[75] The court also stated that "[a] reasonable investor could have believed that all this information augured well for Spectrum's future, and accordingly could rationally have purchased or retained Spectrum stock."[76] In other words, because of Spectrum's misstated SEC filings, a reasonable investor may have been misled into purchasing Spectrum stock.

D. *Misstatements and Omissions about Patent Expirations*

The Western District Court for the District of Missouri dismissed a case brought by investors alleging that material omissions occurred when patent expiration dates on certain key pharmaceutical products had not been disclosed.[77] The court warned that the plaintiffs had not specified which patents on which products would be expiring.[78] The court, however, found that the defendants' 1991 Annual Report indicated that Marion Merrell Dow, Inc. ("Marion") had generally disclosed the termination of patents and regulatory exclusivity, as well as the resulting potential from generic competition with regard to Marion's key pharmaceutical products.[79] Therefore, since the information concerning the status of Marion's patents

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71 *See id*. at 86.

72 *See id*. at 86-87.

73 *See id*. at 88.

74 *See id*. at 92.

75 *See id*. at 93.

76 *Id*.

77 *See In re Marion Merrell Dow Inc*., No. 93-0251-CV-W-6, 1994 U.S. Dist. LEXIS 10062, at *22-23 (W.D. Mo. July 18, 1994).

78 *See id*. at 23.

79 *Id*.

had already been released to the public, the court held that no material omissions had been made and dismissed the case.[80]

E. *Misstatements and Omissions about a Patent Attorney's Opinion*

Attorneys' patentability opinions may be material when disclosed by corporate directors. The Delaware Supreme Court decided that partial disclosure of a patent attorney's opinion, regarding possible patent reinstatement, was a fact material to a reasonable investor.[81] Although *Zirn v. VLI Corp*. was not decided under Federal securities laws but under Delaware state equitable fraud laws,[82] the court applied the *Basic*/*TSC Industries* standard for determining materiality.[83] The class action representative, Zirn, alleged that the VLI directors had made misleading partial disclosures in the Schedule 14D-9 they filed with the SEC prior to a tender offer, in order to drive the price per share down as low as possible.[84] The 14D-9 disclosures indicated that patent reinstatement was unlikely, even though VLI's patent attorney had advised VLI directors that reinstatement of the patent was likely and VLI had "an excellent case on the merits."[85] The company directors argued that since "no aspect of patent counsel's advice standing alone was required to be disclosed," their failure to disclose their patent attorney's opinions was not material.[86] However, the court rejected this defense stating, "the disclosure of even a nonmaterial fact can, in some instances, trigger an obligation to disclose additional, otherwise non-material facts in order to prevent the initial disclosure from materially misleading the stockholders."[87] The court stated, "Once defendants traveled down the road of partial disclosure . . . they had an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events."[88]

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80 *See id*. at 22-23.

81 *Zirn v. VLI Corp*., 681 A.2d 1050, 1057 (Del. 1996).

82 *See id*. at 1060-61.

83 *See id*. at 1056. At least one commentator has also noted that "Basic solidifies the TSC Industries standard as 'the definition' of materiality, even in state law claims." Bradford D. Bimson, *Zirn v. VLI Corp*.: The Far-Reaching Implications of Loquacity, 19 Del. J. Corp. L. 1067, 1083 (1994) (italics added).

84 *See Zirn*, 681 A2d at 1053.

85 *Id*. at 1054.

86 *Id*. at 1056.

87 *Id*.

88 *Id*. (quoting *Arnold v. Society for Sav. Bancorp., Inc*., 650 A.2d 1270, 1280 (Del. 1994).

Consequently, it is important to recognize that even though a fact may not be a required disclosure by the SEC, an immaterial fact may become material, and required, upon its partial disclosure. Certainly, this may help prevent the buying public from being misled by partial disclosures that are designed to shade the truth or slant facts in a company's favor.

F. *Misstatements and Omissions About the Status of Patent Litigation*

Not only can partial disclosures of a patent's status be considered material, but partial disclosures of the existence of a pending patent infringement suit can also be material. In *Gearhart Indus., Inc. v. Smith Intl., Inc.*, shareholders filed an action for, in part, alleged misstatements and omissions in a SEC Schedule 14E form that had been filed with a proxy for a tender offer for outstanding shares of a target corporation.[89] The SEC requires submittal of Schedule 14E form when a proxy is solicited from an individual shareholder.[90] The SEC also requires that the full and accurate disclosures of the Schedule 14E accompany the proxy materials to the shareholders.[91] The tender offer initiated by Smith was contingent upon the share price remaining high.[92] Therefore, news of a potential judgment in a patent infringement suit would have precluded the tender offer.[93]

Section 14E of the Williams Act provides, in pertinent part:

> It shall be unlawful for any person to make any *untrue statement of a material fact or omit to state any material fact necessary* in order to make the statements made, in the light of the circumstances under which they are made, not misleading or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.[94]

The Schedule 14E form filed with the SEC did in fact disclose the patent infringement suit, but nowhere in the account of the litigation did Smith advise shareholders that infringement had already been admitted and that the suit was final except for a court ruling as to the amount of damages.[95] Gearhart asserted that Smith concealed the potentially devastating damages

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[89] 741 F.2d 707, 714 (5th Cir. 1984).

[90] *See* Loss and Seligman, *supra* n. 9 at § 6-C-3

[91] *Id*.

[92] *See Gearhart Indus., Inc. v. Smith Intl., Inc.*, 592 F. Supp. 203, 218 (N.D. Tex. 1984).

[93] *Id*. at 221.

[94] 15 U.S.C. § 78n(e) (emphasis added).

[95] *See Gearhart Industries, Inc.*, 741 F.2d at 714.

that could have been awarded, as well as the preliminary injunction that had already been issued.[96] Smith countered by asserting that he had meritorious defenses left to assert, even thought the suit was over as to the merits.[97]

The Fifth Circuit affirmed a trial court's conclusion that Smith, in stating that there were meritorious defenses left, implied that the company might have been able to escape all liability for infringement.[98] The Fifth Circuit found, therefore, that these misstatements and omissions were likely to be material, and "that the want of disclosure was of a serious nature, likely to mislead a reasonable shareholder in deciding whether to tender his shares"."[99]

Shamrock Holdings, Inc., v. Polaroid Corp. is a case where disclosure of the fact of a pending patent litigation suit was found to be both material and sufficient.[100] Polaroid was attempting to head off a hostile acquisition by making a self-tender offer to its shareholders for the repurchase of sixteen million shares of outstanding stock.[101] Shamrock brought suit, disputing whether Polaroid had fulfilled its fiduciary duties in making the self-tender offer.[102] Polaroid had disclosed a pending patent litigation suit filed against Kodak.[103] SEC Rule 13e-4 requires an issuer making a self-tender offer to disseminate to all of its shareholders the source of the funds for the offer, the purpose of the offer, certain financial data and any plans or proposals of the issuer that relate to or would result in the acquisition or disposition of any securities of the issuer and any material change in the issuer's corporate structure or business.[104]

Shamrock contended that Polaroid's disclosures concerning the pending litigation overstated the potential recovery in order to convince shareholders to sell their shares into the self-tender offer, and therefore to "stay the course" with Polaroid's current management.[105]

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96 *See id*.

97 *See id*.

98 *See id*. at 716.

99 *Id*. (citing *TSC Indus. Inc*., 426 U.S. at 449).

100 709 F. Supp. 1311, 1320 (D. Del. 1989).

101 *See id.* at 1315.

102 *See id*. at 1316.

103 *See id*. at 1318 & n. 10.

104 *Id*. at 1317. *See also* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.13e-4.

105 *See id*. at 1319.

Polaroid responded by arguing "the amount of the *Kodak* judgment is inherently uncertain at this point."[106] Therefore, "speculation about the judgment is 'soft' information that has not ripened into fact and that [therefore,] need not be disclosed under the securities laws."[107] The court stated "[c]ourts are to determine whether there is a duty to disclose asset valuations and other soft information on a case-by-case basis, 'by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note.'"[108] The court went on to state, “[t]he factors a court must consider in making such a determination are: the facts upon which the information is based, the qualifications of those who prepared or compiled it; the purpose for which the information was originally intended; its relevance to stockholders' impending decision; the degree of subjectivity or bias reflected in its preparation; the degree to which the information is unique; and the availability to the investor of other more reliable sources of information.”[109]

The court decided that, upon application of these factors, and in view of the materiality standard of *TSC Industries*, the disclosure by Polaroid was sufficient.[110] The court stated,

> [t]he Offer described the history of the litigation, its current status and the parties' positions as to damages. It presented a number of tables to indicate a range of per-share, after-tax dollar amounts based on various possible recoveries, and did not purport to predict an outcome or guarantee that a certain amount would be passed on to shareholders. Moreover, the applicable section of the Offer is replete with warnings about the uncertainty of the amount of recovery.[111]

Referring to ongoing communications between Polaroid and its patent counsel regarding the status of settlement talks, the court stated,"[t]o require comprehensive disclosure of such information would be to hamstring Polaroid in its efforts to maximize its judgment against Kodak."[112]

Essentially, the court reasoned that Polaroid's filing concerning the litigation with Kodak was not material information, and therefore the disclosure was sufficient. To require more would have misled investors and compromised Polaroid's chances at recovery.

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106 *Id*.

107 *Id*.

108 *Id*. at 1319. (quoting *Flynn v. Bass Bros. Enters., Inc*., 744 F.2d 978, 988 (3d Cir. 1984)).

109 *Id*.

110 *See id*. at 1320.

111 *Id*.

112 *Id*.

III. Disclosures of a Company's Patent Position Accompanied By Cautionary Language May Render the Disclosure Immaterial as a Matter of Law

Cautionary language accompanying a disclosure about a company's patent position might be sufficient to prevent a violation of securities laws.[113] The use of cautionary language to render disclosures immaterial is commonly referred to as the judicially-created "bespeaks caution" doctrine.[114] This doctrine provides that when "forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the 'total mix' of information" provided to investors.[115] In other words, cautionary language, if sufficient can make the alleged material omissions or misrepresentations immaterial as a matter of law.[116]

In 1995, Congress codified the "bespeaks caution" doctrine by enacting the Private Securities Litigation Reform Act.[117] The Reform Act contains a statutory safe harbor for forward-looking written or oral statements.[118] Under that provision, an issuer is not liable for a material forward-looking statement if it is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[119]

Not all disclaimers, however, are rendered immaterial by applying the "bespeaks caution" doctrine.[120] "Vague or blanket (boilerplate) disclaimer(s) which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation."[121] In order for a disclaimer to fall within the protection of the "bespeaks caution" doctrine, the cautionary statements must be substantive and tailored to the specific

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113 *See In re Trump*, 7 F.3d at 369 (holding bondholders could not prove alleged misrepresentation was material when facts showed prospectus contained an abundance of warnings and disclaimers).

114 *Id*. at 371.

115 *Id*.

116 *Id*.

117 *See* 15 U.S.C. § 78u-5 (2001).

118 *Id*.

119 *See* 15 U.S.C. § 78u-5(c)(1)(A)(i) (2001).

120 *See id*.

121 *Id*.

future intellectual property projections, estimates, or opinions.[122] "A cautionary statement must discredit the alleged misrepresentations to such an extent that 'the risk of real deception drops to nil.'"[123] The "bespeaks caution" doctrine is most commonly applied to "prospectuses, offerings and other 'forward looking' statements."[124]

In *Steinburg v. PRT Group, Inc.*,[125] the District Court for the Southern District of New York found that cautionary language in a prospectus was sufficient to warrant dismissing a claim against the defendant for alleged misrepresentations and omissions concerning the nature of their intellectual property.[126] The court stated that under the "bespeaks caution" doctrine, a misrepresentation or omission would not be deemed material if "surrounded by cautionary language sufficiently specific to render reliance on the misrepresentation unreasonable."[127] The court also stated that the "doctrine only applies to forward-looking statements, however, and the language cited 'must precisely address the substance of the specific statement or omission'" that is alleged to be material.[128] "Moreover, the doctrine does not apply to misstatements or omissions concerning historical or current facts."[129]

The plaintiffs in *Steinberg* alleged that at several points in the prospectus, the defendant implied or stated that it had proprietary software.[130] The court found that "these isolated references, even if not 'literally true,' are not material, in light of the entire prospectus."[131] The prospectus repeatedly discussed the defendant's use of third-party software and disclosed the fact that the defendant did not hold any patents or registered copyrights at the time of the initial public offering.[132] The prospectus made no material

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[122] *See In re Trump.*, 7 F.3d at 371-72.

[123] *See EP Medsystems, Inc. v. Echocath, Inc.*, 30 F. Supp. 2d 726, 760 (E.D.N.J 1998) (citing *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991)).

[124] *See Pearl v. Geriatric & Med. Ctrs., Inc.*, No. 92-5133, 1995 U.S. Dist. LEXIS 5475, at *8 No. 92-5113, 1995 WL 243675, at *2 (E.D.Pa. 1995).

[125] 88 F. Supp. 2d 294 (S.D.N.Y. 2000).

[126] *Id*. at 311.

[127] *Id*. at 300 (citing *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 230 (S.D.N.Y. 1999)).

[128] *Id*. at 301 (*quoting In re Prudential Sec. Inc., Ltd. Partnerships Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996) (citation omitted)).

[129] *Id*. (*citing In re APAC Teleservices, Inc. Sec*. Litig., No. 97 Civ. 9145(BSJ), 1999 WL 1052004, at *8 (S.D.N.Y. 1999).

[130] *Id*.

[131] *Id*. at 302.

[132] *Steinberg v. PRT Group, Inc.*, 88 F. Supp. 2d 294, 302 (S.D.N.Y. 2000).

representations about any proprietary software or rights, but rather, mentioned them only in passing.[133] The court held that in view of the prospectus as a whole, the defendant's scattered references about its reliance on third-party software and its lack of currently owned patents or registered copyrights were not materially misleading to a reasonable investor.[134] In effect, the cautionary language of the defendant's prospectus rendered the intellectual property disclosures immaterial to a reasonable investor under the "bespeaks caution" doctrine.[135]

In *Parsons v. Hornblower & Weeks-Hemphill, Noyes*,[136] the District Court for the Middle District of North Carolina also decided a case concerning the effect of cautionary language accompanying patent position disclosures.[137] The plaintiff alleged that there was no "state of the art" patent search conducted to determine the video tape cartridge company's patent position and its potential exposure to patent claims asserted by others.[138] The plaintiff further alleged that this proximally led to the company's bankruptcy and stock devaluation.[139] The court adopted the *TSC Industries* materiality standard to decide whether certain omissions and misstatements were material in the prospectus filed in anticipation of company stock sales.[140] Relying on language in *TSC Industries*, the court stated, "if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information."[141] In deciding whether the information was material and sufficiently disclosed, the court noted that the cautionary language contained in the prospectus indicated there was no assurance the company would obtain patent protection.[142] Although not expressly referring to the "bespeaks caution" doctrine, the court in effect employed this doctrine in finding that

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133 *Id*.

134 *Id*.

135 *See id*.

136 447 F. Supp. 482 (M.D.N.C. 1977).

137 *Id*. at 490.

138 *Id*. at 489.

139 *Id*.

140 *Id*.

141 *Id*. at 489-90.

142 *Id*. at 490.

the defendant did not violate the securities laws because of cautionary language in its prospectus.[143]

The court in *EP Medsystems, Inc. v. EchoCath, Inc.*,[144] found cautionary language in a prospectus issued in connection with an initial public offering of stock sufficient to render statements about the company's patent position immaterial.[145] The prospectus contained an abundance of warnings and cautionary language, which bore directly on the risky, perhaps even speculative, nature of the investment.[146] The plaintiff, EPM, alleged that EchoCath made material misrepresentations to induce EPM to purchase 280,000 shares of preferred stock.[147] EchoCath took the position that within the broad, yet detailed warnings of the prospectus, the alleged misrepresentations made against them were, at worst, harmless.[148] Specifically, the patent position cautionary language was:

> There can be no assurance that [EchoCath's] pending patent applications will issue as patents, that any issued patents will provide [EchoCath] with significant competitive advantages or that challenges will not be instituted against the validity or enforceability of any patent owned by [EchoCath.] . . . [T]here can be no assurance that others will not independently develop similar or more advanced technologies or design around aspects of [EchoCath's] technologies which may be patented or duplicate [EchoCath's] trade secrets.[149]

The court stated that among other statements, the warnings about the possibility of EchoCath's patent applications failing to issue as valid patents were, like other disclaimers, sufficient to put a reasonable investor on notice that investing in EchoCath was speculative and risky.[150]

Cautionary language can be an effective tool to render accompanied disclosures immaterial. Depending on the degree of risk perceived by a reasonable investor, the use of cautionary language by a corporation can differ dramatically. For an example of cautionary language used by a large corporation such as IBM, which received more issued U.S. patents in 1998 than any other corporation, see a recent 10-Q quarterly report filed with the

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143 *See id*. at 491.

144 30 F. Supp. 2d 726 (D.N.J. 1998) *rev'd*, 235 F.3d 865, 876-80 (3d Cir. 2000) (reversing decision finding a fact issue existed as to whether the statements were actually forward-looking statements subject to the "bespeaks caution" doctrine").

145 *Id*. at 772.

146 *Id*. at 746.

147 *Id*. at 738.

148 *Id*. at 746.

149 *Id*. at 735 (quoting EchoCath Prospectus, Jan. 17, 1996, at 9).

150 *See id*. at 766-72

SEC in March 2000.[151] Compare IBM's one sentence of disclosed intellectual property cautionary language with Amazon.com's pages of detailed cautionary language concerning its intellectual property in its March 2000 quarterly 10-Q report.[152] Amazon.com's lengthy and detailed use of

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151 Except for the historical information and discussions contained herein, statements contained in this Form 10-Q may constitute 'forward looking statements' within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, including the company's failure to continue to develop and market new and innovative products and services and to keep pace with technological change; competitive pressures; failure to obtain or protect intellectual property rights; the ultimate effect of the various Year 2000 issues on the company's business, financial condition or results of operations; quarterly fluctuations in revenues and volatility of stock prices; the company's ability to attract and retain key personnel; currency and customer financing risks; dependence on certain suppliers; changes in the financial or business condition of the company's distributors or resellers; the company's ability to successfully manage acquisitions and alliances; legal, political and economic changes and other risks, uncertainties and factors discussed elsewhere in this Form 10-Q, in the company's other filings with the Securities and Exchange Commission or in materials incorporated therein by reference.

Int'l Bus. Machs. Corp., SEC Form 10-Q (March 31, 2000) (emphasis added).

152 WE MAY NOT BE ABLE TO ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY RIGHTS OR MAY BE ACCUSED OF INFRINGING INTELLECTUAL PROPERTY RIGHTS OF THIRD PARTIES.

We regard our trademarks, service marks, copyrights, patents, trade dress, trade secrets, proprietary technology and similar intellectual property as critical to our success, and we rely on trademark, copyright and patent law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. We have been issued a number of trademarks, service marks, patents and copyrights by US and foreign governmental authorities. We also have applied for the registration of some other trademarks, service marks, copyrights and patents in the US and internationally. In addition, we have filed US and international patent applications covering certain of our proprietary technology. Effective trademark, service mark, copyright, patent and trade secret protection may not be available in every country in which our products and services are made available online. The protection of our intellectual property may require the expenditure of significant financial and managerial resources.

Third parties that license our proprietary rights, such as trademarks, patented technology or copyrighted material, may take actions that diminish the value of our proprietary rights or reputation. In addition, the steps we take to protect our proprietary rights may not be adequate and third parties may infringe or misappropriate our copyrights, trademarks, trade dress, patents and similar proprietary rights. Other parties may claim that we infringed their proprietary rights. We have been subject to claims, and expect to continue to be subject to legal proceedings and claims, regarding alleged infringement by our licensors and us of the trademarks and other intellectual property rights of third parties. Such claims, whether or not meritorious, may result in the expenditure of significant cautionary language may be indicative of the perceived risk associated with obtaining or protecting its intellectual property.

IV. RECOMMENDATIONS FOR PRACTITIONERS

Disclosure of intellectual property information to the SEC and to the general public is only required if it is material information. Most courts have adopted the materiality standard of TSC Industries and Basic, even when interpreting the materiality of intellectual property disclosures.[153] Therefore, practitioners should consider omissions and misstatements to be material if a reasonable investor would place significance on the withheld or misrepresented information in deciding whether to trade shares, or if such omissions would alter the "total mix" of information available. If the practitioner determines that certain intellectual property information would be material to a reasonable investor, then the practitioner must endeavor to disclose the information as fully and accurately as possible. This corresponds with the policy behind the Securities Exchange Act to provide investors with the ability to rely on the accuracy of disclosed corporate information.

Furthermore, even information that is not material should be disclosed as completely and accurately as possible. Otherwise, partial disclosures can turn what was once immaterial information into material information. Once a practitioner proceeds down the path of disclosure, stopping halfway is not advised.

Whether detailed information concerning a company's patent is considered material may depend on the company’s level of financial dependence on the patent. Often a corporation's sole asset and revenue generator may be intellectual property in patents or licenses for those patents. If the corporation's principle revenue producer is a patent, the information will almost always be considered material. On the other hand, detailed information concerning each of a large global corporation's patents and patent applications is unnecessary. For example, an IBM press release revealed that:

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financial and managerial resources, injunctions against us [sic] or the imposition of damages that we must pay. We may need to obtain a license from third parties who allege that we have infringed their rights, but such license may not be available on terms acceptable to us, or at all.

Amazon.com, SEC Form 10-Q (March 2000).

153 *See e.g. Pommer.*, 961 F.2d at 623; *Alna Capital Assocs.*, 532 F. Supp. at 599; *Caserta*, 75 F. Supp. at 92; *Parsons*, 447 F. Supp. at 489-490.

> IBM was awarded the most U.S. patents in 1998 for the sixth consecutive year, shattering the previous record by more than 40 percent.
>
> The company received 2,658 U.S. patents in 1998 from the U.S. Patent and Trademark Office. . . . IBM is the first company ever to break the 2,000 U.S. patent issuance barrier in a single year.
>
> . . . [O]ther companies in the top ten for 1998 were Canon with 1925; NEC with 1628; Motorola with 1406; Sony with 1315; Samsung with 1305; Fujitsu with 1190; Toshiba with 1171; Eastman Kodak with 1125; and Hitachi with 1094.[154]

Obviously, the disclosure of detailed information concerning each of IBM's 2658 U.S. patents issued in 1998 would overwhelm IBM's investors in a deluge of trivial and immaterial information. In contrast, detailed information concerning the critical "Chargefaster" patent application in *Alna* was found to be material and important to the reasonable inventor.

Cautionary language should also accompany any disclosure that will warn potential investors of the uncertainties involved with patent litigation or patent prosecution. In sum, intellectual property disclosures are usually considered material when a reasonable investor would place significance on the intellectual property information in deciding whether or not to trade his or her shares.

[154] IBM Press Release, IBM Receives Most U.S. Patents for Sixth Consecutive Year: Shatters Previous Record by More than 40 Percent (January 11, 1999) <http://www.haifa.il.ibm.com/IP_1.html>.