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Polymer Advisory

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Protecting Your Intellectual Property

When a company develops a new innovation, it must decide whether to protect it as a trade secret or by a patent. The two methods are nearly polar opposites. While a trade secret provides protection through secrecy, a patent gives the owner an affirmative right to exclude others from practicing the innovation in exchange for public disclosure of the secrets.

Why Trade Secrets?

One attraction to trade secret protection is that it has no time limit. The Coca-Cola formula is the most famous example of this – it was introduced in 1894 and remains a protected trade secret today.

Trade secret protection is also instantaneous. If you come up with an idea, and don't tell anyone, you've got yourself a trade secret.

For most companies, however, the biggest attraction to trade secret protection is the low up-front cost. These low costs can be deceiving, however, because the long term costs of maintaining a trade secret can rise very quickly. The company may need to invest in traditional security measures to protect the secret, such as vaults, alarm systems, and security guards. Moreover, today's security typically involves electronic security, such as firewalls, secure databases, and encrypted files.

Additionally, companies need to establish internal systems and policies that stress the importance of maintaining secrecy. Employees must be taught, on a continuing basis, the importance of protecting trade secrets. When dealing with both employees and outside parties, confidentiality agreements must be drafted – sometimes after a prolonged negotiation.

Why Patents?

Despite the attractions of trade secrets, patents have increasingly become the protection of choice. We are in the midst of a veritable patent boom – over a million patents have been issued in the last six years. This is in stark contrast with the early history of the U.S. Patent and Trademark Office: it took 122 years for the *first* one million patents to be issued.

Although many people associate the patent boom with the computer industry, there is remarkable patent activity in the polymer field as well. For example, each year more than 2,000 patents are classified as "plastic article shaping" patents and more than 6,000 are classified as "synthetic resin" patents. These classes represent just a small portion of polymer-related patents.

So why are companies choosing patent protection? One benefit is the chilling effect they have on competition. A patent carves out a certain technological area for its owner – one that competitors may be afraid to come near. Patents also function as an engine for generating revenue because they can be licensed out to other companies.

There are defensive reasons for applying for patent protection as well. If a company has a patent on an idea, its competitors are precluded from filing a patent on the same idea. This isn't the case with a trade secret – if Company A relies on trade secret protection and Company B later develops the same idea, Company B can patent that idea and prevent Company A from using it.

Business Considerations

The choice between patents and trade secret protection should be determined by several business considerations. The first is the market life of the innovation. Some products, such as toys or other "fad" items, have a short market life. Other products, like polymer compositions, methods for manufacturing, and everyday items, will have a much longer market life. On average, the patent application process takes over two years. If a product will no longer be on the market when the patent issues, the patent won't have much value.

continued on page 2

IN THIS ISSUE:

BENESCH
Friedlander Coplan & Aronoff LLP
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Protecting Your Intellectual Property

continued from page 1

Another consideration is the likelihood that a competitor may develop the same innovation. If the innovation is a physical product, it may be easy for a competitor to reverse engineer the product, and put a copy on the market. However, if the innovation is a process, such as a process for more cost-effectively manufacturing a polymer composition, competitors may not be able to learn the process by merely analyzing the end product. Outside of reverse engineering, a competitor could independently develop the idea. In either scenario, only a patent gives the right to exclude a competitor from bringing a similar innovation to market.

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Lastly, companies need to gauge the difficulty of keeping a secret. One factor is the size of the company. In a small company, it is relatively easy to keep a secret. However, as the company grows, this becomes more difficult. As more people gain access to proprietary information, trade secret protection becomes less viable.

In sum, many legal and business considerations must be taken into account when choosing the appropriate protection for intellectual property. Because the steps for filing a patent application lead in the opposite direction of the steps for maintaining a trade secret, it becomes necessary to take one path over the other at an early stage of the process. It is in your best interest to arrive at that path as the result of a fully informed decision making process.

For more information on this topic, contact Bryan Jaketic at bjaketic@bfca.com or 216.363.4478.

Benesch's e-Document Retention Team: Keeping Information Under Control

Benesch has recently formalized its e-Document Retention Team under the leadership of Howard Levy. Lawsuits in the digital age have become more perilous to companies and their counsel. As digital information and databases expand, the vast amounts of content generated are increasingly difficult to control. The law has certain requirements, and the penalties for failing to have a rational policy for retaining or discarding data have been severe. Our team is already busy assisting clients.

The team's attorneys help clients establish and implement retention policies to avoid legal mishaps and appropriately control relevant business documents. In addition, outside expertise may be needed to determine whether a company is appropriately handling its metadata, disk drives, databases, and other repositories of electronic information. We regularly work with leading technical firms with expertise in this field.

"A number of prominent companies that have failed to maintain electronic documents in the face of discovery, or even when they knew or should have known that a lawsuit was threatened, have faced sanctions," said Dave Mellott, a member of the e-Document Retention Team. He continued, "The old rules of spoliation of evidence – destroying evidence in the face of a lawsuit – are more complicated when storage capacity may be limited. In view of these risks, companies should have a rational e-document retention policy. The goal is to retain documents that are most pertinent to the business while still being able to regularly purge or discard noncritical documents in both hard copy and electronic form."

The digital world continues to expand at a dizzying rate. Estimates place the number of person-to-person e-mails alone between 36 and 40 billion worldwide on an average day. Clearly, managing and properly retaining relevant company information will continue to be a challenging proposition. The legal requirements are also clear – to ignore them or fail to achieve full compliance exposes you to serious risk.

To listen to a podcast by Benesch attorney Howard Levy on this topic, please visit Benesch's Web site at www.bfca.com. Click on The Benesch Beat icon on the home page, and then select "Electronic Document Discovery and Retention."

For additional information regarding e-discovery, please contact Howard Levy at hlevy@bfca.com or 216.363.4508 or Mike Buck at mbuck@bfca.com or 216.363.4694.

A Shift in Fiduciary Duties for Directors of Distressed Corporations

It is generally agreed that the business marketplace is cyclical in nature. The rise of interest rates during the past few years has led experts to debate when we can expect to see increased numbers of distressed companies. We believe it is important that corporate directors understand their fiduciary duties to stockholders and creditors and how such duties may change as a business enters the "zone of insolvency."

Fiduciary Duties for Solvent Corporations

When a corporation is solvent, directors owe the corporation and its shareholders fiduciary duties of care, loyalty, and good faith. A breach of these duties can result in personal liability for the director. In most situations, a director's actions are protected by the business judgment rule, which presumes that "the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[1] To overcome the business judgment rule and recover in a breach of fiduciary duty suit, the plaintiff must demonstrate that the director was self-interested or grossly negligent in making the decision in question.

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Protecting Creditor Interests

While a company is solvent, its creditors are presumed to be protected by the terms of their contracts with the company. But, when a corporation becomes insolvent, a director's fiduciary duties of care, loyalty, and good faith shift to include, and arguably favor, creditors of the corporation. It is well settled that directors must act to address creditor interests when making decisions upon the occurrence of insolvency. This shift is meant to discourage directors from taking unnecessary risks that would potentially benefit a company's shareholders but harm its creditors, such as selling company property at below-market prices.

Defining Insolvency

In the fiduciary duty context, a corporation's insolvency is not determined at the time it files for bankruptcy or receivership. Courts have used two tests to determine the time at which a company becomes insolvent. The "balance sheet" test states that a corporation is insolvent when the fair market value of total liabilities (including contingent liabilities and off-balance sheet losses) exceed the fair market value of total assets. Alternatively, under the "equitable insolvency" test, a corporation is insolvent when it becomes unable to pay debts in the ordinary course of business. It has been suggested that both tests are flawed. Applying a different valuation methodology may alter the results under the balance sheet test and temporary liquidity issues could result in triggering insolvency under the equitable insolvency test. In addition, some courts have attempted to account for business realities when determining whether a corporation is insolvent.

In the "Zone of Insolvency"

The 1991 Delaware Chancery court opinion in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications*[2] is widely cited as first suggesting that director duties shift to creditors prior to actual insolvency and include the period of time when the corporation is in the "zone" or "vicinity" of insolvency. Since *Credit Lyonnais*, cases have defined the zone of insolvency to include the period of time leading up to actual insolvency and also those directorial actions that, once complete, will result in the insolvency of a company.

Balancing Constituency Interests

However, simply because directors are required to consider the interests of the corporation's creditors, it does not mean that other constituencies may be ignored. Upon entering the zone of insolvency, "even though equity is junior to creditors, the views of equity cannot be ignored, but that principle cannot be stretched to also prohibit debtors from giving considerable weight to the views of creditors."[3] The result of such reasoning is that corporations are not required to immediately liquidate assets and distribute profits based on priority upon entering the zone of insolvency. Instead, the standard requires that directors not play favorites when deciding what is best for the corporation. When approaching insolvency, directors must make informed decisions after carefully considering the impact upon all relevant parties.

While it was initially unclear, recent cases have stated that the business judgment rule does protect directors who are making decisions for insolvent or near-insolvent corporations. However, in a case where the directors made a decision that resulted in the insolvency of the corporation based on the best interests of only the shareholders, without considering the best interests of creditors or the corporation, the business judgment rule did not apply and the directors were required to prove the entire fairness of the transaction. In general, the business judgment rule will protect directors when proper inquiry is

continued on page 4

A Shift in Fiduciary Duties for Directors of Distressed Corporations

continued from page 3

made and consideration given to all appropriate parties during board deliberations.

Waiver of the Duty of Care

Another recent case provides that, under some circumstances, a director may be shielded from liability even when arguably violating certain fiduciary duties when the corporation was insolvent or near-insolvent. In *Production Resources Group, LLC v. NCT Group, Inc.*,[4] a creditor claimed that the directors of an arguably insolvent corporation breached their fiduciary duties. The court reasoned that while the creditor had standing to sue for several alleged breaches of fiduciary duties, the recovery should go to the corporation itself and not directly to the plaintiff creditor. In other words, the claim was derivative in nature. As a result, the court ruled that the director was protected from liability for breaches of the duty of care *owed to the corporation* under a provision in the corporation's articles of incorporation waiving liability for duty of care violations in accordance with Delaware General Corporation Law Section 102(b)(7). If future courts follow this decision, directors in states with similar statutes to DGCL § 102(b)(7) will be able to avoid liability for duty of care violations if the corporation's articles include similar exculpatory language.

Consulting Creditors Early

It may also be possible to stop a creditor, or a trustee acting on behalf of creditors, from asserting a breach of fiduciary duty claim by advising the creditor of the financial situation before authorizing the transaction. *In re Brentwood Lexford Partners, LLC*[5] presents a case where a Texas corporation approached its primary creditor to inform it of the company's possible insolvency, but the creditor agreed to allow the company to continue operating as if it was solvent and therefore effectively approved of the corporation's distributions to shareholders. The court reasoned that in this situation, a trustee was estopped from later asserting breach of fiduciary duty claims on behalf of creditors once the corporation filed for bankruptcy. This case suggests that one strategy that directors may take to avoid future liability is to contact creditors regarding key decisions when a corporation is nearing insolvency.

Best Practices for Insolvent and Near Insolvent Boards

Once in the zone of insolvency, directors will reduce the risk of breaching fiduciary duties by:

1. Learning all the facts about the proposed issue before the board and the effects of the decision on creditors and shareholders;
2. Carefully scrutinizing transactions that could be deemed preferential to shareholders, including share redemptions and payment of dividends;
3. Avoiding any appearance of self-dealing, including providing full disclosure of any interest the director may have in a transaction with the corporation;
4. Not taking actions that prefer any one class of creditors over others;
5. Not undertaking transfers for less than fair value; and
6. Reaffirming by resolution that all actions have been taken in good faith after exercising reasonable care.

Summary

As indicated by the preceding discussion, the law defining the responsibilities of directors of corporations that are either insolvent or in the zone of insolvency is constantly evolving. There is no universal test to determine when a director must start considering the interests of creditors, but directors should assume when a company becomes financially distressed that courts will deem it in the zone of insolvency. Personal liability for breach of fiduciary duties is avoidable. Directors merely need to be aware of the fact that fiduciary obligations shift when a company becomes distressed and take precautions to act reasonably and in the best interests of the corporation after considering the implications of a transaction on the relevant parties.

To learn more, please contact Jacob Derenthal at jderenthal@bfca.com or 216.363.4642.

[1] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
[2] 1991 WL 277613 (Del. Ch. 1991).
[3] *In re Adelphia Communications Corp.*, 2003 WL 22316543, *32 (Bankr. S.D.N.Y. 2003).
[4] 863 A.2d 772 (Del. Ch. 2004).
[5] 292 B.R. 225 (N.D. Tex. 2003).

Freight Charges v. Freight Claims: The Set-Off Controversy

Shippers, intermediaries, and motor carriers often find themselves facing the issue of whether or not a shipper's alleged freight claim can be set off against a motor carrier's claimed freight charges. In other words, can a shipper refuse to pay a $5,000 freight bill if the carrier is theoretically liable for freight damage in excess of $5,000? Some shippers view such a right as an essential business tool. Some carriers view such a right as an entirely illegitimate and unfair bargaining tool.

Contrary to the perception of many in the industry, no federal law or regulation currently governs this theoretical right. Rather, the right of set-off is purely a creature of contract or state common law. As a result, shippers, brokers, and carriers should specifically address this right in their transportation contracts one way or the other. In deciding whether and how to address a right of set-off in a transportation contract, the parties should give careful consideration to the following practical issues, among others.

Cash Flow

The right of set-off can dramatically affect the parties' cash flow. This is particularly true when the carrier in question is on the smaller side or sells its accounts to a factoring company. For instance, most factoring companies require the carrier to warrant or otherwise promise that the assigned accounts are not subject to a right of set-off. If the carrier breaches that warranty or promise, the factoring company may be granted significant rights against the shipper or broker under its factoring agreement. Therefore, the parties should carefully consider the extent to which exercising a right of set-off may affect the parties' cash flow and, accordingly, their respective bargaining power.

Cargo Insurance

Cargo insurance can influence the manner in which set-offs are negotiated. On the one hand, many shippers are acutely aware that carriers' cargo insurance policies are often riddled with exceptions and exclusions that substantially limit the ultimate recovery. As a result, shippers rightly recognize that exercising a right of set-off, whether authorized by contract or not, may give them an upper hand in negotiating a resolution to their freight claim. Due to the cash flow considerations mentioned above, a carrier may feel pressure to resolve a cargo claim even though it may do so without giving its cargo insurer adequate notice or the requisite role in claims handling. On the other hand, the carrier's certificate of insurance required by FMCSA means that the carrier has obtained a BMC-32 endorsement to its motor carrier cargo liability policy. This endorsement already gives shippers some limited comfort, at least with respect to very modest claims (under $5,000). However, the obligation to obtain the endorsement may apply only to common carriers. FMCSA is proposing to eliminate it entirely for all carriers of general freight. In any event, the parties should give real consideration to the role of the cargo insurer in resolving freight claims.

The Loss of Freight Charge Discounts

A shipper or third-party logistics provider may find that setting off even a perfectly valid freight claim against a carrier's freight charges results in the loss of a significant freight charge discount. For instance, a carrier's tariff might state that billed freight charges are based on a discounted rate that will be lost or compromised if payment is not made within a certain number of days. In other words, a shipper or broker who is owed only $5,000 in freight charges shortly after the delivery of the damaged goods may find that the freight bill increases to $7,500 if payment is not made within 60 days, regardless of the reason for nonpayment or the fact that the parties are negotiating a resolution to a valid freight claim. Therefore, the right of set-off negotiated between the parties should ensure that the parties fully understand what consequences may follow from exercising the right of set-off.

Attorneys' Fees

Just as a carrier may be entitled to withdraw freight charge discounts when presented with a freight charge set-off, a carrier may include a provision in its contract or incorporated tariff that awards the carrier attorneys' fees incurred in collecting freight charges. As the shipper or third-party logistics provider will inevitably bring a counterclaim for its freight claim, the carrier may be in the unusual position of being able to recover from the shipper the attorneys' fees associated with the defense of its freight claim (assuming for the moment that the insurer is not providing the cost of defense already). The extent to which a carrier can actually recover its attorneys' fees under these circumstances varies from state to state. Shippers may also include provisions relating to the recovery of attorneys' fees in connection with freight claims, although the same state-specific limitations apply.

In summary, shippers, third-party logistics providers, and carriers are all well-served by confronting the possibility of setting off freight charges with a freight claim and memorializing the agreement struck in sufficient detail in the governing transportation contract. The parties should not have any doubts whether the right to set-off has been prohibited or permitted by the contract.

For additional information on this topic, contact Marc Blubaugh at mblubaugh@bfca.com or 614.223.9382.

Current Events

Plastics News Executive Forum 2007

February 25-28, 2007
San Diego, CA

This executive-level conference features top-name speakers from the industry's leading companies. Benesch will moderate the PN Processor of the Year Best Practices Panel.

Flipsides: Intellectual Property Protection in China and U.S. Border Enforcement Against Infringing Goods

March 20, 2007
Cleveland, OH

Bryan Schwartz and Yanping Wang
Cleveland Intellectual Property Law Association

PolymerOhio Network's Legislative Luncheon

June 5, 2007
Columbus, OH at the Statehouse Atrium

This annual meeting brings together leaders from Ohio's government and the plastics industry to discuss the State's polymer industry.

Midwestern M&A Forum

June 6, 2007
Chicago, IL

Learn the latest strategies, trends, and approaches to creative deal making from top performers in the Midwest's deal community. Benesch is co-chairing this event.

For more information on events, contact Megan Crossman at 216.363.4174 or mcrossman@bfca.com.

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