Los Angeles lawyers David W. Wensley (right) and Amir Sadr review the current regulatory framework governing medical and recreational cannabis in California and analyze how its operation may affect the state’s real estate.
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BUSINESS VALUATION • LOSS OF GOODWILL • ECONOMIC DAMAGES • LOST PROFITS
To all of you who just reported your MCLE compliance, I say: I hope you learned something useless. I don’t mean that sarcastically. I genuinely hope you learned something of no apparent application to your practice at all. I know I did, and it was worth it.

This year I spent a few hours learning wine law from some CEB programs. I don’t practice wine law. I don’t plan to practice wine law. I don’t even really want to practice wine law. But despite (or perhaps because of) that, I enjoyed those CEB programs more than any others.

As attorneys, so much of our learning is driven by practical necessity. Being a litigator, I learned how to draft pleadings, motions, and discovery not out of idle curiosity but because I had to. I research legal issues as they arise and show their relevance to a matter. This type of learning has its own rewards. As we develop our practice skills, there is a pride and often enjoyment in mastering the tools of our trade. We are lucky that law is a profession that allows us to continue learning, even over decades, and most of us would not be attorneys unless we had both a skill and a thirst for learning new things.

But the second of those qualities—the thirst—applies not only to overtly practical learning but also to a kind whose purpose is less clear. We should nourish that thirst, and quench it at every opportunity. For most of us, it is an innate quality that helped us persevere through years of schooling, the bar exam, and the difficult—often frightening—early years of practice, when so much felt beyond our knowledge, our skills, and our control. View it this way and it is not hard to see a practical purpose for ostensibly “useless” learning.

The love of learning is like a muscle. It must be exercised, but unless you mix up your exercise routine, you risk getting bored and having your commitment flag. I was a bit bored that day I watched my first wine law program. Afterwards, I felt more reinvigorated than if I had whiled away an hour on the Internet. (For me, the Internet is a conundrum in that it enables me to consume so much information and to retain so little. At dinner, my wife may ask if I read anything interesting that day, and though I spent an hour or more online, I feel hard pressed to say anything. Perhaps because the Internet is always there—at our desks, on our phones—and tends to broadcast in bite-sized bits, browsing is more a distraction, too passive and diffuse to constitute actual learning. It is far different to affirmatively commit to something that promises to teach us something, however “useless.”

Finally, here is another practical purpose for useless learning. Clients, judges, juries, coworkers, opposing counsel—they are all just people. While some are lawyers like ourselves, everyone is different. The more we know about the world and the human experience, the better we can relate to these different constituencies, and the better we are at what we do. So, let’s go out there and learn something useless today.

John Keith is the 2017-18 chair of the Los Angeles Lawyer Editorial Board. He practices business litigation with the law firm of Fenigstein & Kaufman in Century City.
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**John H. Haney** Director, California Indian Law Association

**What is the perfect day?** Spending time with my wife, running, and playing guitar.

**Do you play guitar in a band?** No, but I sat in for LACBA’s Big Band of Barristers.

**You are one of nearly 19,000 members of the Seminole Nation of Oklahoma. What does that mean to you?** My culture means everything to me.

**Is your family involved in Native American culture?** My father served a term as a chief. My mother is an attorney practicing Indian law. My brother works for the San Manuel Band of Mission Indians.

**Is saying “Indian” inappropriate?** Indian, Native American, and American Indians...those are all interchangeable to me.

**Your practice includes tribal law and federal Indian law. How do they differ?** With tribal law, you are looking at a tribe as a government creating law. Federal Indian law governs the relationship between the federal government and tribes.

**The term “Seminole” derived from the Spanish word *cimarrones* meaning runaways or free people. Is that pejorative?** I like the term “free people.” It sums us up well. Native American tribes have endured over centuries, withstanding adversity.

**The Seminole Nation of Oklahoma is a federally recognized Native American tribe. What does the process entail?** There are over 500 federally recognized tribes. There are various complex tests for petitioning for the federal acknowledgement.

**Why all the lawsuits about tribal membership?** Tribes can set their own blood quantum levels for membership. That’s just a matter of sovereignty.

**Why are there so many complaints about the Bureau of Indian Affairs?** The bureau is empowered as a liaison between the federal government and tribes. It also executes the federal government’s trust responsibilities to the tribes.

**What would you say is the biggest difference in the Seminole religious ceremonies and Judeo-Christian religious ones?** It comes down to the Creator. Historically, there is no Bible, but it’s very spiritual about loving the earth and protecting the earth for future generations.

**Do you speak Muscogee Creek, a language of the Seminoles?** I tried; I wish there were a Rosetta Stone for it.

**Do Seminoles have pow-wows?** We do. They are based around a circle, with the traditional dancers in the middle, celebrating culture and celebrating life.

**In 1976, the United States awarded a land claims settlement to the Seminole tribes valued at $16 million for approximately 24 million acres of lands seized by the U.S. government in Florida in 1823. Was that a good deal?** Nothing can redress the atrocities of Indian removal policies.

**Negotiations lasted more than a decade. Why?** Maximizing recovery or relief is reasonable. There were disputes as to the allocations of funds between the Seminole Nation of Oklahoma and the Florida Seminoles.

**The Seminole Nation of Oklahoma covers 633 square miles. What does that include?** Within boundaries—established by treaty—are tribal trust lands, fee simple lands owned by the tribe, individual restricted allotments, and fee simple lands owned by non-Indians.

**Does the Seminole Nation have a clan system?** Yes. Members within each clan are considered to be close kin. I am of the Sweet Potato clan.

**In the 1900s, the Seminole were still mostly full bloods because intermarriage with whites was discouraged. Is that the same today?** It’s not discouraged today.

**Will the blood lines “run out”?** No, it goes again to blood quantum. At some point, obviously the blood quantum levels can get lower, so there’s this idea not to legislate a tribe out of existence.

**What are the greatest challenges facing the Indian community?** Preserving culture and resisting threats to tribal sovereignty.

**You went to Columbia as an undergradu-**
ate and UCLA School of Law. Why did you want to become a lawyer? To help people.

You are a director in the California Indian Law Association. What are the organization's goals? To serve as the representative of the Indian law profession in California, to educate the public, and to support Indian law practitioners and law students.

How many Native American attorneys are there? It's a very small world.

Recently, Los Angeles replaced Columbus Day with Indigenous Peoples Day. What are your thoughts on that? Love it.

What was your best job? This one.

What was your worst job? Car washer

What characteristic do you most admire in your mother? As an attorney, her brilliance. As a mom, her caring.

Who is on your music play list? My three favorite musicians are all jazz guitarists: Grant Green, Joe Pass, and Pat Martino.

What scared you the most about your first case? On my first day at the job, I was assigned to draft and file an answer on that same day. I was terrified of handling the case myself.

What is your favorite vacation spot? Idyllwild, California, to get away from the world.

What is your hidden talent? I make Native American flutes. My grandpa was a flute maker. He added Native-designed beadwork to enhance the flute visually. I consider flute-making his gift to me.

What is your favorite sport? Running, maybe 15 hours per week. I've done two half-marathons.

Which television show do you record? Game of Thrones.

Which person in history would you like to take out for a beer? My namesake: Thlocklo Tustenuggee, which translates as “Great Warrior.” We often are given Indian names shortly after birth.

What are the three most deplorable conditions in the world? War crimes, poverty within Indian country, and violence against women.

Who are your two favorite U.S. presidents? Not Andrew Jackson.

What is the one word you would like on your tombstone? Tustenuggee.
How Ginger and Fred Settled the Battle Between Two “Empires”

**THE NINTH CIRCUIT COURT OF APPEAL** recently weighed in on a dispute between two empires: one real, the other fictional. In *Twentieth Century Fox Television v. Empire Distribution*, Fox sought a declaratory judgment that its television show *Empire* and related marketing and merchandising did not violate the trademarks of Empire Distribution, Inc.1 Debuting in 2015, *Empire* chronicles the saga of a New York City-based record label, Empire Enterprises. Empire Distribution is a San Francisco-based hip hop, rap, and R&B music label founded in 2010.

The court held that Fox’s use of the “Empire” mark is protected by the First Amendment and therefore immune from suit for trademark infringement. The ruling is notable for two reasons. First, the court formally extended the First Amendment’s protections for expressive works to advertising and merchandising materials bearing the work’s name, including the sale of consumer goods. Second, the court declined to adopt a requirement that an expressive work incorporating a mark actually refer to the original trademarked work or entity. With respect to the court’s first holding, Empire Distribution argued that advertising and merchandising efforts were not protected expression and thus subject to Lanham Act trademark infringement claims. The First Amendment protects expressive works from Lanham Act claims. Under the *Rogers* test,2 “the Lanham Act should not be applied to expressive works ‘unless the [use of the trademark or other identifying material] has no artistic relevance to the underlying work whatsoever.’”3

Empire Distribution conceded the *Empire* television show is an expressive work but argued that Fox’s merchandising—e.g., *Empire* T-shirts, champagne glasses—are not and are not entitled to the First Amendment protections laid out in *Rogers v. Grimaldi*. The court noted that those “promotional efforts technically fall outside the title or body of an expressive work” but reasoned that the First Amendment protections afforded to a work’s title would be severely undermined if the work could never be advertised or marketed by that name. Thus, the court formally extended *Rogers* to protect advertising and marketing of expressive works, including use of the work’s title in consumer merchandise.

The court also held that an expressive work’s use of a mark need not refer to the same referent as the protected trademark. Empire Distribution argued that inherent in the *Rogers* test was a requirement that the junior work—here, *Empire*—refer to the senior work, viz. Empire Distribution. That was the case in *Rogers*. Ginger Rogers sued the producers of the Federico Fellini film *Ginger and Fred* for using her and her late acting and dance partner’s names. The title indeed referred to Ginger Rogers and Fred Astaire, but it was relevant to the film, which told the fictional story of two Italian cabaret dancers who became known in Italy as “Ginger and Fred.” By contrast, *Empire* did not refer to Empire Distribution but rather the show’s setting in the Empire State and the fictional music and entertainment business empire at the heart of the show.

Despite the court’s ruling, Empire Distribution has not altogether given up on protecting its mark. The company has repeatedly sought a declaratory judgment that its television show is not “empire” and that the would-be defendants were infringing. The ruling is notable for two reasons. First, the court formally extended the First Amendment’s protections laid out in *Rogers*, for example, a parody of an original work can be a privileged fair use, but the parody incorporating the original work must comment on that work in some way.4 If a work borrows from an original work to comment on something else entirely, then it is unprotected satire.

Nonetheless, the court rejected Empire Distribution’s proposed rule and held that for purposes of First Amendment protections under the *Rogers* test, it is irrelevant what the use of a mark in a work’s title refers to, so long as it is artistically relevant to the underlying work. The court was right to reject Empire Distribution’s proposed requirement: adopting such a rule would be antithetical to the Lanham Act’s goal of preventing consumer confusion.5

When a trademark uses an English word to identify a particular product or service, the mark can be wielded to prevent competitors from using the same mark to confuse consumers, but the trademark does not operate as a monopoly on the underlying generic word or concept. For example, Apple, Inc. can fiercely defend its mark in the technology arena, but it cannot enjoin the sale of apples in the produce aisle. The rule proposed by Empire Distribution flips this logic on its head: an expressive work could freely refer to the specific trademarked good or service, but the work would be barred from evoking the mark’s common or generic meaning. For example, a movie released with the title *Amazon* would be entitled to greater First Amendment protections if were a fictional story about the Internet commerce company rather than a tale set in the Amazon rainforest. But that result would promote, rather than prevent, consumer confusion: consumers almost certainly would be more likely to believe that Amazon, the e-commerce company, had a hand in sponsoring or producing a film about itself than in creating a film set in the South American rainforest that has nothing to do with the Seattle-based company.

Thus, as result of the court’s holding in *Empire Distribution*, it is clear that the First Amendment protects merchandise advertising an expressive work from Lanham Act claims to the same extent it protects the work itself. It is also clear that there is no requirement that the expressive work refer to the same referent as the mark to qualify as a protected use.

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1 *Twentieth Century Fox Television v. Empire Distribution*, Inc., No. 16-55577 (9th Cir. Nov. 16, 2017) (publication pending).
2 *See Rogers v. Grimaldi*, 875 F. 2d 984, 999 (2d Cir. 1989).

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The Determinants of Class Certification After In re Tobacco II

CLASS ACTIONS ARE A POWERFUL TOOL for consumer plaintiffs who believe they were harmed by a defendant’s false advertising, since they enable the aggregation of large numbers of claims that, if prosecuted separately, might be too small to justify the costs of litigating. Indeed, a court’s denial of class certification is commonly viewed as the death knell of the litigation. In California as elsewhere, there are various prerequisites to obtain certification of a class action. These include that there be “a well-defined community of interest” among the class members, which, in turn, “embodies three factors: (1) predominant common questions and law or fact [i.e., commonality]; (2) class representatives with claims or defenses typical of the class [i.e., typicality]; and (3) class representatives who can adequately represent the class [i.e., adequacy].”

When prosecuted as a class action, a claim under the “fraudulent business practice” prong of California’s Unfair Competition Law (UCL) is a powerful tool for consumers to attack false advertising. To state such a claim, “it is necessary only to show that members of the public are likely to be deceived,” and the claim traditionally “has been understood to be distinct from common law fraud,” which requires a showing of deception. While a false advertising class action under the UCL is potentially a very powerful tool, the UCL was far more threatening to business than it is today. Prior to the 2004 passage by California voters of Proposition 64, “the UCL authorized any person acting for the general public to sue for relief from unfair competition” without regard to the requirements governing class actions, and “[s]tanding to bring such an action did not depend on a showing of injury or damage.” In other words, just about anyone could bring a claim against any business about almost anything without ever interacting in any way with the business. After Proposition 64 passed, “a private person has standing to sue only if he or she has suffered injury in fact,” and representative UCL actions must comply with the requirements governing all class actions.

In re Tobacco II

In 2009, in In re Tobacco II, a UCL case that had been pending in the trial court when Proposition 64 passed, the California Supreme Court held that the trial court improperly decertified a class of California smokers based on the change in the law and that the trial court should presume that absent class members relied on some type of misrepresentation by the tobacco company defendants concerning the risks of cigarettes. Since then, plaintiffs’ counsel have relied on Tobacco II to argue that their clients may proceed on a class-wide basis founded upon only the named plaintiffs’ individual experiences with the advertising at issue, without regard to whether absent class members suffered actual injury caused by a defendant’s allegedly fraudulent business practice. The decision has been hailed by plaintiffs’ lawyers and derided by defense counsel as opening the door to unfettered California false advertising class actions. However, the California Supreme Court’s ruling was not so broad as many thought, and opinions issued in the wake of Tobacco II show that state and federal courts in California have been careful to limit the case’s application.

Much of the confusion that has occurred in the wake of Tobacco II can be attributed to “standing” and “commonality” being conflated, even though they remain separate and distinct requirements for the maintenance of a class action. While Tobacco II may have tilted the playing field in favor of plaintiffs with regard to the issue of standing, defendants can still defeat class certification on the issue of commonality if the plaintiff cannot prove that class members were necessarily exposed to the advertisement that forms the basis of the UCL fraud claim.

In Tobacco II, a group of plaintiffs comprised of smokers in California filed a class action against several tobacco companies. The complaint alleged a cause of action under the UCL based on a claim that the plaintiffs had become smokers after being exposed to the companies’ false advertising and deceptive marketing activities within the state of California. After Proposition 64 passed in November 2004, the tobacco companies filed a motion to decertify the class action claims under the UCL, arguing that “each class member was now required to show an injury in fact…as a result of the alleged unfair competition.” The trial court granted the motion, and the California Supreme Court subsequently granted review.

On review, the California Supreme Court addressed two specific questions: 1) Who in a UCL class action must comply with Proposition 64’s standing requirements, the class representatives...
or all unnamed class members, in order for the class to proceed? and 2) What is the causative requirement for purposes of establishing standing under the UCL? The court answered these two questions by ruling that 1) only the class representatives, and not absent class members, must meet standing requirements of actual injury and causation, 2) only the class representatives must establish actual reliance in accordance with fraudulent inducement principles in order for the class action to proceed, and 3) the class representatives do not independently have to show reliance on particular advertisements or marketing materials with unrealistic specificity. In short, Tobacco II held that class certification cannot be defeated solely for lack of standing by absent class members.

While the California Supreme Court expressly limited its ruling in Tobacco II to the issue of standing, plaintiffs cite to language in the opinion for the notion that courts may presume reliance on some type of false or misleading representations when there is evidence of “an extensive and long-term advertising campaign.” In Tobacco II, the court presumed all class members relied on some type of misrepresentation based on the decades-long campaign of the tobacco industry to conceal the health risks of its product while minimizing the growing consensus regarding the link between cigarette smoking and lung cancer.

The court in Keegan v. American Honda Motor Company, Inc. made a similar presumption, on different facts. There, the plaintiffs moved for class certification on claims that the automobiles they purchased had defective rear suspensions, and they cited to Tobacco II as support for their argument that plaintiffs are permitted to prove a UCL violation with “general evidence that Defendants’ conduct was ‘likely to deceive’ members of the public.” The court in Keegan held that plaintiffs satisfied the commonality requirement for class certification because “all class members received the same information from defendants regarding the purported defect—which is to say, no information concerning the possibility of premature and excessive tire wear.”

While many might have predicted that Tobacco II and Keegan were the beginning of a new trend, they remain the only two cases in which all class members were presumed to have been exposed to some type of false representation (or in Keegan, the absence of representations about the defect), and there is no language in either of these cases that suggests they apply beyond their unique facts. Of course, that has not prevented plaintiffs from relying on them to seek class certification, but courts have consistently denied such motions if they seek to expand Tobacco II and Keegan beyond their unique facts.

For a defendant seeking to limit the impact of Tobacco II and Keegan on a court’s decision on class certification, properly framing the inquiry as a question of commonality (exposure) and not a question of standing (reliance) will be key. A number of courts now have held that class certification in a UCL case is inappropriate when plaintiffs cannot show that members of the class were exposed to the same misrepresentations or any omissions.

In Cohen v. DIRECTV Inc., the plaintiff alleged that DIRECTV advertised its high-definition satellite service “without the intent to provide the customers” with the advertised levels of resolution, and also that the defendant “switched its HDTV channels to a lower resolution, reducing the quality of the television images it transmits to subscribers.” The Cohen court affirmed the denial of class certification because the class would include subscribers: 1) who never saw DIRECTV advertisements of any kind before purchasing HD services, 2) who only saw or relied upon DIRECTV advertisements that contained no mention whatsoever of technical terms regarding resolution, or 3) who purchased DIRECTV HD primarily based on word-of-mouth or because they saw DIRECTV’s HD in a store or at a friend or family member’s home. The court explained: “[W]e do not understand the UCL to authorize an award for injunctive relief and/or restitution on behalf of a consumer who was never exposed in any way to an allegedly wrongful business practice.”

Similarly, in McAdams v. Monier, Inc., the court reversed a denial of class certification and remanded the matter to the trial court to determine whether the class representative could demonstrate standing under the Tobacco II standard but offered the following proviso: “The members of these classes, prior to purchasing…had to have been exposed to a statement along the lines that the roof tile would last 50 years, or would have permanent color, or would be maintenance free.” The day after the McAdams decision, another court of appeal issued its decision in Pfizer Inc. v. Superior Court, reversing the trial court’s certification of a class consisting of “all persons who purchased Listerine, in California, from June 2004 through January 7, 2005.” The court in Pfizer found that 19 of the 34 Listerine mouthwash bottles did not include a label with the alleged misrepresentation, and that, although Pfizer ran four different television commercials with the alleged misrepresentations, “the commercials did not run continuously and there is no evidence that a majority of Listerine consumers viewed any of those commercials.”

In Mazza v. American Honda Motor Co., Inc., the Ninth Circuit reversed the certification of a nationwide class of consumers who purchased or leased cars equipped with a Collision Mitigation Braking System (CMBS) during a three-year period, holding that “[i]n the absence of the kind of massive advertising campaign at issue in Tobacco II, the relevant class must be defined in such a way as to include only members who were exposed to advertising that is alleged to be materially misleading.” The plaintiffs had alleged that certain advertisements misrepresented the characteristics of the CMBS and omitted material information on its limitations. In reversing class certification, the court in Mazza noted that “Honda’s product brochures and TV commercials that were alleged to have been misleading and deceptive fell short of the ‘extensive and long-term [fraudulent] advertising campaign’ at issue in Tobacco II [and] [that the] difference is meaningful.” For everyone in the class to have been exposed to the [alleged] omissions... it is necessary for everyone in the class to have viewed the allegedly misleading advertising.”

The court ultimately held that “the limited scope of [Honda’s] advertising [made] it unreasonable to assume that all class members viewed it.”

**Theory of Common Exposure**

For a defendant opposing certification of a UCL false advertising class action, presenting evidence that disrupts the theory of common exposure is critical. While the plaintiff certainly has the burden of establishing uniform exposure, defense counsel should, if at all possible, not merely rely on arguing that representative plaintiffs cannot establish uniform exposure. Affirmative evidence should be developed to drive the point home. Evidence of nonuniform exposure might include: various product labels for an offending product that do not contain alleged misrepresentations, advertising circulation data showing limited publication of advertisements, Internet data establishing that website views are far less than product sales, deposition testimony and declarations to the effect that purchasing customers were not exposed to offending representations, and expert witness testimony on the limited reach of an advertising campaign. This type of evidence creates significant roadblocks to named representatives establishing that a putative class was uniformly exposed to false or misleading representations.

Following Tobacco II, to establish stand-
ing on behalf of a class, named plaintiffs in a UCL representative action need only establish their own reliance on an alleged false advertisement. However, as one court observed, “Tobacco II does not stand for the proposition that a consumer who was never exposed to an alleged false or misleading advertising or promotional campaign is entitled to restitution.”34 Accordingly, when a UCL complaint involves a fraud claim, courts have consistently held since Tobacco II that class representatives must show, at a minimum, that absent class members were actually exposed to the alleged misrepresentations. That courts have done so has presented defendants with a roadmap to opposing class certification, and plaintiffs’ counsel with a bit of a Hobson’s choice: define a class narrowly to encompass only those purchasers who in fact were exposed to a specific alleged false advertisement (and sacrifice the more lucrative possibilities of a larger class), or define it to more broadly cover purchasers of a product (and risk having class certification denied).  

1  In re Tobacco II Cases, 46 Cal. 4th 298, 313 (2009).
3  Tobacco II, 46 Cal. 4th at 313 (citing Fireside Bank v. Superior Ct. 40 Cal. 4th 1069, 1089 (2007)). See also CODE Civ. PROC. §382.
4  “The UCL defines unfair competition as ‘any unlawful, unfair or fraudulent business act or practice....’” ([BUS. & PROF. CODE] §17200.) Therefore, under the statute there are three varieties of unfair competition: practices which are unlawful, unfair or fraudulent.” Tobacco II, 46 Cal. 4th at 311. “A violation of the UCL’s fraud prong is also a violation of the false advertising law ([BUS. & PROF. CODE] §§17500 et seq.).” Tobacco II, 46 Cal. 4th at 312.
5  Tobacco II, 46 Cal. 4th at 312.
6  Id. at 314.
7  Id.
8  Id. at 298.
9  Id.
10  Id.
11  Id. at 306.
12  Id.
13  Id. at 321-29.
14  Id. at 328 (“[W]here...a plaintiff alleges exposure to a long-term advertising campaign, the plaintiff is not required to plead with an unrealistic degree of specificity that the plaintiff relied on particular advertisements or statements.”).
15  Id.
17  Id. at 533-34 (quoting Plascencia v. Lending 1st Mortgage, LLC, 259 F.R.D. 437, 448 (N.D. Cal. 2009)).
18  Id.
19  Cohen v. DIRECTV Inc., 178 Cal. App. 4th 966, 981 (2009) (finding Tobacco II to be irrelevant to the court’s analysis of whether or not class certification was properly denied because the issue of standing is simply not the same thing as the issue of commonality); Pfizer Inc. v. Superior Ct., 182 Cal. App. 4th 622, 625 (2010) (“[t]he circumstances herein stand in stark contrast to those in Tobacco II, where the tobacco industry defendants allegedly violated the UCL ‘by conducting a decades-long campaign of deceptive advertising and misleading statements about the addictive nature of nicotine and the relationship between tobacco use and disease.’”); McVicar v. Goodman Global, Inc., No. 13-1223, 2015 WL 4945730 at *11 (C.D. Cal. Aug. 20, 2015) (“This case is different from cases like Tobacco II and Keegan where all class members may be presumed to have been exposed to some type of representations...[and] more like Cohen, where many members of the proposed class ‘who never saw [] advertisements or representations of any kind before deciding to purchase the company’s product would have been swept into the class definition.’”).
20  Cohen, 178 Cal. App. 4th at 981 (common issues did not predominate when the class would include subscribers who never saw [allegedly misleading] advertisements and representations of any kind before deciding to purchase the company’s services); see also Stearns v. Ticketmaster Corp., 655 F. 3d 1013, 1020 (9th Cir. 2011) (“A presumption of reliance does not arise when class members were exposed to quite disparate information from various representatives of the defendant.”).
22  Id. at 969-70.
23  Id. at 979.
24  Id. at 980.
26  Id at 192-93.
28  Id. at 632-33.
30  Id. at 585.
31  Id. at 596.
32  Id.
33  Id.
Parental Liability for Copyright Infringement by a Minor Child

IT IS NO SECRET THAT MINOR CHILDREN actively download protected material from the Internet illegally through various applications on their laptops and home computers. As a result, an issue has arisen as to whether there is a basis to impose parental liability for the illegal copyright infringement by their minor children. One factor contributing to the problem of whether to impose parental liability is the generational gap between parents and their children when it comes to technology. Parents could be wholly unaware that their children are engaged in illegally downloading material from the Internet, and there is no mechanism in place that would notify parents of infringement by their minor children. Under California state or federal law, is there a basis to impose parental civil liability for a minor child’s illegal downloading of protected works through the Internet?

The federal Copyright Act grants the copyright holder exclusive rights to use and to authorize others to use the work in specified ways, including reproduction of the copyrighted works in copies. However, any individual may reproduce copyrighted work for fair use. The Copyright Act affords the owner of a copyright with multiple remedies against an infringer of his or her work ranging from an injunction to destruction of reproductions made of the work, statutory damages, and attorney’s fees.

Proof of direct copyright infringement under the Copyright Act has two elements: demonstrating ownership of the allegedly infringed material and that the alleged infringer violated at least one of the exclusive rights granted to copyright holders. Applying the Copyright Act to impose liability on a parent for a minor child’s infringement would be difficult because the act does not provide a basis to impute infringement. Thus, although parents may monitor their minor child’s computer use and may even have actual knowledge of the infringing conduct, direct copyright infringement would undoubtedly be difficult to impose because the parent does not personally engage in any infringing conduct.

While the Copyright Act does not provide for secondary infringement liability, such liability emerged from common law and is now generally accepted. When infringement pertains specifically to illegal downloading from the Internet, the Ninth Circuit case A&M Records, Inc. v. Napster, Inc. remains the most well known. Napster was a platform in which its users were able to download MP3 files to individual computer hard drives available for other Napster users. Napster attempted to assert a fair use defense against the direct copyright infringement, claiming its users did not directly infringe plaintiff’s copyrights because the users were engaged in “fair use” of the material. The Ninth Circuit rejected the argument and concluded that Napster’s users were direct infringers because they actually exchanged the copyrighted songs. Not only were Napster users found liable, but also Napster itself was found liable for contributory and vicarious copyright infringement.

The basis for imposition of copyright infringement liability upon Napster is similar to the type of infringement that occurs when a minor illegally downloads material from a home computer. But there is one major distinction—there is no exchange of the material illegally downloaded as between the parent and the minor child. Relying on the holding in the Napster case, the Supreme Court in Sony Corp. of Am. v. Universal City Studios, Inc. held that without constructive knowledge of the fact that material illegally downloaded as between the parent and the minor child. Relying on the holding in the Napster case, the Supreme Court in Sony Corp. of Am. v. Universal City Studios, Inc. held that without constructive knowledge of the fact that

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California has taken a broader approach.

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of Torts.\textsuperscript{16} The Restatement, however, slightly limits the scope of liability provided under Section 1714.1 by requiring a parent to exercise reasonable care over a minor child to prevent him or her from intentionally harming others when the parent has knowledge and the ability to control the child.\textsuperscript{17} The California Supreme Court defines the term “knows” as knowledge of dangerous habits and the ability to control the child as prerequisites to parental liability.\textsuperscript{18} Case law has laid down principles adopting a more expansive approach.

In Robertson v. Wentz, the minor child robbed a bookstore and subsequently shot and killed the victim.\textsuperscript{19} Robertson conceded that while no common law vicarious liability is imposed upon parents for torts of their children, a parent might become liable for an injury caused by the minor when the parents’ negligence contributed or caused the injury.\textsuperscript{20}

While other jurisdictions have eliminated negligent parental liability, California has taken a broader approach. Under the Restatement, as applied in Robertson, one who takes charge of a third party and knows he is likely to cause harm has a duty to exercise reasonable care.\textsuperscript{21} Thus, without a parent’s active negligence that enables the child to cause harm, parental liability will not attach.\textsuperscript{22}

Robertson pointed out that the purpose of the law is to provide a remedy to innocent third parties injured by a minor when none is otherwise available under the Civil Code.\textsuperscript{23} The Robertson court concluded that the statute intended an expansive scope for parental liability but with limited damages as a compromise when a minor child causes damage through willful misconduct.\textsuperscript{24} Because control of the minor is the crucial determining factor for imposition of negligence liability, a showing of custody is necessary.\textsuperscript{25}

But the Robertson court reasoned that an interpretation of the statute to require “actual” physical control would not further the objective of the imposition of such liability and concluded the Legislature intended mere legal custody sufficient to trigger parental liability.\textsuperscript{26} Thus, the court rejected an interpretation of the statute to require actual physical control of the child as a prerequisite for imposition of statutory liability. Ultimately, the Robertson court decided that although the mother had legal custody of the minor, it was not determinative of her parental liability because it was undisputed that the minor obtained the gun from the home of his father, the noncustodial parent. The mother had no knowledge of the availability of firearms in the father’s home and did not leave the firearm accessible to the minor. Under these circumstances, the court found that notwithstanding a lack of legal custody of the minor, the father could be found liable under a parental negligence liability theory.\textsuperscript{27}

The analysis in Robertson stands in stark contrast to the earlier opinion of Costello v. Hart, which held a guardian need not possess extensive prior knowledge of a child’s dangerous tendencies in order to trigger parental liability.\textsuperscript{28} In Costello, a grandmother was held liable for the conduct of her minor grandson when he ran out from underneath a rack of clothing causing the plaintiff to sustain an injury of the femur.\textsuperscript{29} Costello emphasized that the defendant need not have knowledge of the child’s dangerous tendencies for any particular length of time so long as the knowledge was acquired in a timely manner sufficient to take reasonable measures.\textsuperscript{30} The court held that evidence of the child’s misbehavior in that case was conspicuous and continuous for an appreciable amount of time in the presence of defendant and that the defendant had reared the boy, having care and custody of him, which supports a verdict for the plaintiff.\textsuperscript{31}

Based on the foregoing theories of common law and statutory parental liability, it would be difficult to impose parental liability for a minor child’s copyright infringement without the actual knowledge of the parent of that infringement. On the other hand, if a plaintiff could prove that the parent was actually aware of a prior incident of such illegal conduct and failed to take preventative action to enjoin similar future conduct, a court then might find the parent liable.

But what about liability under a secondary liability theory? The California Supreme Court adopted the theory of contributory liability in 1975 by repudiating the “all or nothing” rule of contributory negligence.\textsuperscript{32} More specifically, the Supreme Court decided to utilize the “pure” form of comparative negligence, which apportions liability in direct proportion to fault.\textsuperscript{33} This theory was further refined a few years later by permitting apportionment of liability in accordance with a tortfeasor’s comparative fault.\textsuperscript{34}

California case law has applied the general theory of contributory liability to copyright infringement. Contributory liability may be imposed when the individual has knowledge of the infringing activity and induces, causes, or materially contributes to the infringing conduct of another.\textsuperscript{35} However, the California Supreme Court long ago rejected the application of contributory liability to a parent based solely on the parent-child relationship.\textsuperscript{36} Moreover, it would be difficult to impose contributory liability on a parent for his or her minor child’s infringement because there is no material contribution by the parent other than access to a computer.

But what if the parent provides the minor child with access to a computer with actual knowledge that the child has and will continue to access and illegally download copyrighted material? This factual scenario has not been addressed by the courts.

Contributory liability as applied to copyright infringement requires that the secondary infringer fail to act “knowingly” or “have reason to know” of direct copyright infringement and material contribution.\textsuperscript{37} Thus, a case could be made for parental secondary liability if the parent is aware of prior illegal downloading and does nothing to prevent future illegal conduct.

But imposition of civil parental liability in the copyright infringement context poses specific complications. Under Section 1714.1, civil parental liability is limited only to willful or intentional conduct of a minor child. Most copyright infringement by a minor is rarely willful or intentional.

Moreover, what is generally at issue in illegal downloading by minors is a parent’s constructive knowledge or knowledge that is imputed to the parent simply as a result of the nature of a parent-child relationship. Sony v. Universal addressed imposition of vicarious liability based on constructive knowledge and the fact that the equipment used for the infringing activity was owned by the defendant, but this basis for vicarious liability was adamantly rejected by the U.S. Supreme Court.\textsuperscript{38}

In the context of copyright infringement, vicarious liability has generally been applied when there is a financial incentive for the secondary infringer and a failure to prevent the infringing activity.\textsuperscript{39} Thus, if a parent could be proven to have had actual knowledge of their children’s infringing activity, a failure to prevent future infringement and an economic incentive to avoid payment for the materials downloaded by their child, an argument could be made that secondary liability should be imposed under the current case authority.

Currently, there are few cases that have directly addressed parental liability for a minor child’s infringement. In the case of Sony v. Tenenbaum, the defendant was a student at Goucher College who installed the Napster peer-to-peer network on his desktop at his family’s home in Rhode Island.\textsuperscript{40} Once Napster was shut down, the defendant started using alternative peer-to-peer networks for the same illegal purpose.\textsuperscript{41} The defendant’s father knew
I just had to form a new corporation, and it’s just so damn perfect!

John McIlwee, Entertainment Business Manager
Shepherd McIlwee Tinglof

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that his son was illegally downloading because prior to leaving for college his son showed him the songs he had downloaded. Soon thereafter, the defendant's father instructed his son to cease illegally downloading the material and not to engage in such conduct in the future. The defendant was also sent direct warnings by Goucher College, his family's Internet service provider, and even the potential plaintiffs themselves. The behavior of the defendant in Tenenbaum was clearly intentional, willful, and direct copyright infringement. But while the First Circuit imposed liability on the defendant, it did not impose liability on defendants’ parents.42

Nevertheless, the more prevalent the downloading and sharing of applications become, the more likely it will be that minors will share with others the materials they have downloaded, providing another wrinkle in the analysis and an incentive for legal proceedings by the copyright holder. Given the foregoing, it will not be long before courts are required to directly address parental complicity in their children's illegal downloading of copyrighted and protected materials under some form of secondary liability, especially as the older generation attains a higher level of sophistication with computer technology and the Internet.

1 Section 106 of the Copyright Act provides:
Subject to sections 107 through 118, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following:
1. To reproduce the copyrighted work in copies or phonorecords;
2. To prepare derivative works based upon the copyrighted work;
3. To distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
4. In the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
5. In the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.

3 Id. §§502-505.
6 4id. at 1011.
7 Id.; see also, 17 U.S.C. §107. (“[T]he fair use of a copyrighted work…is not an infringement of copyright.”)
8 A&M Records, Inc., 239 F. 3d at 1021.
9 Id.
11 Gissen v. Goodwill, 80 So. 2d 701, 704 (Fla. 1955) (citing Buellke v. Levenstadt, 190 Cal. 684, 689 (1923)).
12 Dillon v. Legg, 68 Cal. 2d 728, 752 (1968).
13 “Any willful misconduct of a minor that results in injury or death to the property of another shall be imputed to the parent or guardian...the joint and several liability of the parent or guardian having custody and control of a minor [shall] not exceed twenty-five thousand dollars ($25,000)...” CIV. CODE §1714.1.
15 Id.
16 RESTATEMENT (SECOND) OF TORTS §316 (1965) [hereinafter RESTATEMENT].
17 Id.
19 Robertson, 187 Cal. App. 3d at 1285.
20 Id.
21 Id. at 1287.
22 Id.
23 Id. at 1293.
24 Id.
25 Id. at 1294 (quoting Costello v. Hart, 23 Cal. App. 3d 898, 901 (1972)).
26 Robertson, 187 Cal. App. 3d at 1293.
27 Id. at 1295.
28 Costello, 23 Cal. App. 3d at 900 (quoting RESTATEMENT §316).
29 Costello, 23 Cal. App. 3d at 900.
30 Id.
31 Id.
32 Li v. Yellow Cab Co., 13 Cal. 3d 804, 809 (1975).
33 Id. at 827.
36 Dillon v. Legg, 68 Cal. 2d 728, 752 (1968).
38 Sony, 464 U.S. at 439.
39 Grokster, 545 U.S. at 930.
40 Sony BMG Music Entm’t v. Tenenbaum, 660 F.3d 487, 492 (1st Cir. 2011).
41 Id.
42 Id. at 515.
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With voter approval of Proposition 64, the Adult Use of Marijuana Act (AUMA), in November 2016,1 the recreational use of cannabis by adults age 21 and older became legal in the state of California. Over 56 percent of voters expressed their approval of AUMA,2 indicating that a significant portion of California’s population no longer stigmatizes cannabis use, even for recreational purposes. Broad voter support may also suggest that commercial property owners view the cannabis industry as a legitimate opportunity to secure new tenants and increase returns on their investments.

As of January 1, 2018, when the state began issuing temporary licenses for recreational cannabis operations, the growing consensus is that the legal cannabis industry will develop exponentially. The rise in consumer demand for legal cannabis has led to increased prices for raw land and industrial buildings for grow operations, industrial facilities for manufacturing and distribution, and retail space for the sale of cannabis and cannabis-related products. Annual gross revenue projections for the nation’s legal cannabis industry are estimated to grow from approximately $6.7 billion per year in 2016 to more than $20 billion by 2021,3 and California is expected to garner a material share of the country’s overall cannabis market.4

Legalized recreational cannabis use and operations are expected to provide significant opportunities for a broad range of property owners looking to cash in on California’s budding cannabis industry. The unique risks and legal landscape governing real estate transactions for cannabis operations also will cause an increase in demand for legal counsel specializing in this area of law. Since the statutory and regulatory climate governing the cannabis industry at the federal, state, and local levels is rapidly evolving and not entirely clear, the current environment raises legal and ethical issues for attorneys considering whether to represent property owners in connection with cannabis operations. Attorneys must exercise caution in delving into this practice area, as the laws, regulations, and policies governing cannabis operations are still in the developing stages and subject to the unpredictable impulses of federal, state, and local officials.5

Regulatory Framework
In 1996, voters passed Proposition 215, the Compassionate Use Act, making California the first state to legalize the medical use of marijuana. In 2016, the passage of Proposition 64 established the Adult Use of Marijuana Act (AUMA), allowing for the cultivation, sale, and use of marijuana by adults aged 21 years or older.

Legal cannabis operations require compliance with a host of regulations and licenses to operate. As of January 1, 2018, the California Department of Food and Agriculture (CDFA) began issuing temporary licenses for recreational cannabis operations. These licenses allow for the limited cultivation and sale of cannabis and cannabis products, subject to the conditions and requirements outlined by the CDFA and state laws.

Space to Grow
Legalization of marijuana presents significant opportunities for property owners looking to cash in on California’s budding cannabis industry. The unique risks and legal landscape governing real estate transactions for cannabis operations also will cause an increase in demand for legal counsel specializing in this area of law. Since the statutory and regulatory climate governing the cannabis industry at the federal, state, and local levels is rapidly evolving and not entirely clear, the current environment raises legal and ethical issues for attorneys considering whether to represent property owners in connection with cannabis operations. Attorneys must exercise caution in delving into this practice area, as the laws, regulations, and policies governing cannabis operations are still in the developing stages and subject to the unpredictable impulses of federal, state, and local officials.

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of cannabis. In 2003, the California Legislature passed Senate Bill 420, the Medical Marijuana Program Act, creating a regulatory framework for the medical use of cannabis. Subsequently, in 2015, the state revamped its medicinal cannabis statutes with the passage of the Medicinal Cannabis Regulation and Safety Act (MCRSA), which created a state licensing system and updated and clarified statutes governing medicinal cannabis.

With the passage of Proposition 64, state regulators faced a dilemma whether to continue with two separate regulatory tracks for legalized cannabis—one for medical use under MCRSA and another for adult recreational use under AUMA—or to consolidate them. In June 2017, Governor Jerry Brown signed the Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA), which called for merging the medical and recreational laws into one unified system. Under MAUCRSA, three regulatory agencies govern legal cannabis in California: 1) the Department of Consumer Affairs, Bureau of Cannabis Control, 2) the Department of Food and Agriculture, Manufactured Cannabis Safety Branch; and 3) the Department of Public Health, CalCannabis Cultivation Licensing. Acting as the lead regulatory agency, the Bureau of Cannabis Control is tasked with issuing state licenses for dispensaries, distributors, testing labs, and the many anticipated microbusinesses that will develop to serve the industry and consumers. The California Department of Food and Agriculture is responsible for issuing state licenses to cannabis cultivators and operating a “track-and-trace” system to track the seed-to-sale process for cannabis in the state. Finally, the Department of Public Health issues state licenses to businesses that manufacture cannabis products such as edibles, oils, lotions, and other cannabis-containing products. Cannabis operators may apply for and obtain one or more of the various available business license types, with the exception of test lab operators, which are prohibited from licensure for any other commercial cannabis activity.

**Local Jurisdiction Licensing**

California’s cannabis laws grant local governments the authority to allow, limit, or ban the number of cannabis operations within their city or county limits. State agencies may only issue a temporary or permanent license to a cannabis operation if the applicant has a valid permit, license, or other form of authorization issued by their local jurisdiction. Therefore, ultimate control over a prospective cannabis operator’s ability to conduct business lies with the city or county.

The lack of uniform laws among cities and counties across California means property owners interested in leasing to a cannabis operation must first determine if their local jurisdiction permits cannabis operations within its borders. If cannabis operations are locally permissible, property owners and their legal counsel must carefully examine the intricacies of local requirements and restrictions for the property and cannabis business type in question. For example, many local jurisdictions impose greater limitations than those set forth under MAUCRSA, including, without limitation, requirements limiting proximity to schools and government buildings, hours of operations, the onsite use of cannabis in open areas and the total number or concentration of cannabis operations within a city or county. A locality may also require the cannabis operator to show proof that it is current on local, state, and federal taxes. Finally, many local jurisdictions require evidence of sufficient funds to operate a cannabis business.

Legal counsel must also consider specific restrictions under MAUCRSA, including, among other things, the fact that cannabis operations must be located at least 600 feet away from a K-12 school or youth center, the licensed premises must contain digital video surveillance throughout the space and retailers may only sell and operate between the hours of 6:00 a.m. and 10:00 p.m. Pacific Standard Time. Also, under MAUCRSA, an applicant may obtain more than one cannabis license type for a specific location, provided the licensed premises at the location are “separate and distinct.” As of early December 2017, what qualifies as separate and distinct had not been established by the three regulatory agencies in California and will likely be determined on a case-by-case basis through the licensing application process. Commercial property owners and cannabis applicants must consider the potential costs in connection with constructing demising walls and additional entrances to meet the “separate and distinct” standard. Furthermore, under MAUCRSA, the cultivation licensing application requires the cannabis operator to meet the “average electricity greenhouse gas emissions intensity required by a local utility provider” under California’s existing Renewables Portfolio Standard Program.

**Lease Provisions and Considerations**

To operate a cannabis business, a prospective tenant must first overcome three major hurdles: 1) whether the type of cannabis operation being considered for the property is permissible by the locality, 2) whether the property is properly zoned for the specific type of operation or whether the requisite land use permits and/or approvals may be obtained, and 3) whether the prospective tenant qualifies for applicable state and local cannabis business licenses.

**License Contingency or Condition Subsequent Clause.** Once the cannabis operator has overcome the aforementioned hurdles, in order to apply for a California state license the prospective tenant/operator must obtain a signed lease or alternative form of authorization from a property owner granting permission to operate a cannabis business on the subject premises. However, possession of a valid license by the state is a prerequisite for the cannabis business to operate from the subject premises in compliance with applicable law. This condition creates a dilemma for landowners because the landowner must enter into a signed lease with a prospective cannabis operator who is not yet, and may never be, authorized to operate its cannabis operation. This circumstance mandates that the lease or other agreement between the landowner and cannabis operator contain a license contingency or condition subsequent provision, which provides for a unilateral (in favor of the landlord) or a mutual (in favor of both the landlord and tenant) right to terminate the lease should the cannabis operator ultimately fail to obtain the requisite state and local licenses within a specified time.

As in any commercial lease, landowners should also consider security or collateral for the tenant’s surrender and restoration obligations of the leased premises. Many prospective cannabis businesses will likely require possession of the landlord’s property prior to obtaining the necessary state and local licenses to plan construction, security, and business operations. Therefore, the license contingency or condition subsequent provision should incorporate appropriate surrender and restoration terms so the landlord may recover possession of its property in an acceptable condition if the operator fails to obtain the applicable business licenses necessary to operate in compliance with state law. The landlord should also endeavor to defer payment of any broker commissions, tenant improvement allowances, or performance of any other landlord obligations until all licensing requirements are satisfied.

**Compliance with Applicable Laws.** Most boilerplate lease agreements require the landlord and tenant to act and comply in accordance with all applicable laws. While cannabis operations...
may be legal under California state and local laws, the federal government has not legalized cannabis use. The possession, cultivation and distribution of medical or recreational cannabis remains illegal under the federal Controlled Substances Act (CSA) and cannabis remains categorized as a Schedule I drug. As a Schedule I drug, cannabis is treated as a substance that has a “high potential for abuse” and “no currently accepted medical use in treatment in the United States.”

The U.S. Department of Justice (DOJ) maintains authority to prosecute state legal cannabis businesses under various federal laws, including federal drug and money laundering statutes. Moreover, related businesses and professionals working in or with the cannabis industry may also be prosecuted as co-conspirators or aiders and abettors under the federal statute. As discussed in the Los Angeles Lawyer article, “High Time,” federal enforcement of cannabis laws is currently uncertain. During the Obama administration, the DOJ adopted a set of guidelines commonly referred to as the Cole Memo on “Guidance Regarding Marijuana Enforcement,” which set recommendations on enforcement policies and practices related to cannabis operations. However, on January 4, 2018, Attorney General Jeff Sessions rescinded the Obama-era Cole Memo guidelines and instead granted federal prosecutors with the authority to decide how to enforce federal laws prohibiting cannabis operations in states where its use has been legalized.

Yet, pursuant to an amendment to the omnibus spending bill commonly referred to as the Rohrabacher-Blumenauer Amendment (originally the Rohrabacher-Farr Amendment), the U.S. Court of Appeals for the Ninth Circuit ruled that DOJ is prohibited from spending funds to prosecute individuals engaged in conduct that strictly complies with state medical marijuana laws. It is not clear if this ruling extends to recreational use of cannabis or whether the DOJ will be granted funding to implement Attorney General Session’s enforcement policy.

Regardless, the Ninth Circuit’s ruling coupled with the Attorney General’s latest position creates a quandary for property owners and cannabis operators. Property used to facilitate the cultivation, distribution, and manufacturing of cannabis may still be subject to federal asset forfeiture laws, and there is a risk that the federal government could seize such property. Property owners can also be charged with aiding and abetting a violation of the CSA. Simultaneously, however, as noted, under MAUCRSA, the authorization of a property owner by lease, license, or other arrangement is a prerequisite to obtain a license and comply with state law. This creates a significant legal issue for property owners because by signing a lease with a cannabis operator, a commercial landlord cannot claim ignorance as to the cannabis operation on their property and avail themselves of the so-called “innocent landlord defense” under federal law. Consequently, the applicable law provision in any lease for a cannabis operation should be modified to include a carve-out for the CSA and its underlying regulations.

Rent, Security Deposit, and Collateral Issues. Due to the extensive regulations and jurisdictional control over cannabis businesses, properties suitable and available for cannabis operations may, due to limited supply vis-à-vis increasing demand, command greater rents. As witnessed in a number of states where cannabis operations are legalized, property owners will likely demand higher rents and greater security to offset the perceived risks in leasing to a cannabis operator as opposed to a more traditional tenant. These risks include the possibility that the cannabis business will not be able to maintain its required licenses and will be shut down by governmental authorities; the federal government will no longer refrain from prosecuting federal laws against California cannabis operators despite compliance with state and local laws; and the fear of potential negative stigma for surrounding tenants and businesses mandating additional consideration from property owners that lease to a cannabis operator.

To address these risks, in addition to higher rents, property owners should also consider whether extraordinary security or collateral to secure performance by the cannabis operator is warranted. A larger security deposit, letter of credit, or personal guaranty of a financially creditworthy party should be considered to secure the cannabis tenant’s obligations to pay rent, comply with applicable laws, and surrender and restore the premises timely upon lease expiration or earlier termination.

Unique Use Controls. Whether through traditional agricultural means or industrial indoor grow operations, cannabis growers present unique issues that property owners need to consider. For example, indoor cannabis farming operations typically require extraordinary electricity and water use beyond that of other indoor industrial uses. These extra costs are typically passed through to the operator in a single-tenant scenario, however in a multitenant project the lease should address methods for measuring and charging the cannabis operator appropriately for its potentially extraordinary use.

In addition, cannabis businesses remain largely cash-based due to the illegality of cannabis operations under federal law. It may be appropriate to consider drafting lease provisions that recognize the significant amounts of cash that may be held on the premises and necessitate unique protections or increased security at the property to mitigate potential vandalism and theft. Under MAUCRSA, alarm systems, commercial grade locks, secure storage, and 24-hour video surveillance are required for any area containing cannabis and cannabis products. Leases should be drafted to appropriately allocate the burden of such additional risks and costs as between the landlord and the cannabis operator.

For multitenant projects and buildings, property owners and their legal counsel must examine whether the intended cannabis operation is permitted under existing private covenants, including CC&Rs (covenants, conditions, and restrictions) and leases with other tenants at the property. Many institutional quality projects are encumbered by private restrictions or leases that may prohibit cannabis operations. In the retail arena, many national and regional retail operators insist on imposing restrictions on the landlord against various “undesirable” uses, which may expressly or by implication include cannabis operations.

Required Licenses and Notice. Lease agreements with cannabis operators, as noted, should include an express covenant requiring the operator to obtain and continuously maintain any and all necessary permits, licenses, or governmental approvals required for use of the premises. These leases should also include a provision requiring the cannabis operator to provide the landlord with a copy of all permits and impose an obligation to notify the landlord of receipt of any notice from federal, state, or local authorities relating to the tenant’s cannabis operations.

Operations/Odor/Nuisance/Loitering. As the smell and nature of the cannabis plant is distinct, a lease should include strict language protecting against issues relating to nuisance, odor, and pests in and around the premises. Landlords may wish to consider requiring above-standard ventilation and filtration systems to prevent the odor and other forms of nuisance from impacting adjacent tenants and businesses. In addition, the lease should include language to prevent loitering by customers and the presence of persons under the influence or appearing to be under the influence in and around the premises.
Lending. Since cannabis remains illegal at the federal level, a pressing challenge for real property owners and investors considering leasing to a cannabis operator is the impact of a potential “illegal use” on the property owner’s existing or contemplated real property financing. Most, if not all, real property loan agreements, deeds of trust, mortgages, and related security agreements contain provisions requiring the borrower to keep the subject property in compliance with all applicable laws and advising that the subject property may not be used for illegal activities. Consequently, most traditional lenders are presently unwilling to lend on property leased for cannabis operations and such an operation could be a violation of the express terms of the governing loan documents. Attorneys should discuss with their clients whether there is existing or contemplated financing for the property, and, if so, the client should be advised that leasing to a cannabis operator may run afoul of their obligations to their lenders and compromise their financing arrangements.

Conflicting State and Federal Laws
As of December 2017, the California State Bar had not published a formal opinion whether an attorney may ethically represent a client under California’s cannabis laws or as to any party engaging in business with cannabis operators. However, the Los Angeles County Bar Association and the Bar Association of San Francisco have issued formal opinions on the matter. Both bar associations have concluded that an attorney may ethically advise a client on how to comply with California cannabis laws but may not advise the client to violate federal law and must advise the client that conducting business relative to cannabis operations may violate federal law.34

Attorneys should consider all of the above issues, particularly the conflict in federal and state laws, and be aware of the potential risks associated with representing a real estate client leasing property to a cannabis operation. Attorneys should incorporate specific language addressing these risks in any engagement letter with a prospective client desiring to conduct business with a cannabis operator or seeking to operate a cannabis business. The engagement letter should clearly state that cannabis currently remains a Schedule I substance under the CSA and is illegal at the federal level. Second, the engagement letter should clarify that representation will not be construed as aiding in the commission of an illegal act or violation of federal law. The engagement letter should also include a caveat that such legal representation is limited to advising the client as to compliance with current California law. Finally, due to the ever-evolving nature of California state and local cannabis laws, as well as the uncertainty of federal enforcement policies, it is recommended that the engagement letter include a statement regarding the risks of the potential unenforceability of leases and other agreements involving the cultivation, distribution, possession, or use of cannabis.

Progressing Landscape
Whether one favors or opposes legal cannabis, most Californians can agree that legal cannabis operations will have a significant impact on the state’s economy and its commercial real estate industry. Commercial cannabis activity in California is expected to add significant tax revenue to state and local government through licensing fees and taxes. Property values in cities and counties permitting cannabis businesses have already skyrocketed in California and will likely continue to do so until supply matches demand. Factories, warehouses, and self-storage facilities, among other property types, have been transformed into cultivation sites for cannabis grow operations. Retail storefronts have been repurposed to top-quality cannabis dispensaries with finishes comparable to those of other more traditional major retail tenants. Real property owners and state agencies alike must continue to evaluate this progressing landscape in search of ways to legally profit from the cannabis industry.

It is important to understand that all commercial real estate contracts and transactions are unique, as is the real property involved. Cannabis laws in California at the state and local levels are rapidly changing. Effective representation of commercial real property owners contemplating leasing property to a cannabis-related business or a cannabis operator will require an expertise in this area of law and the ability to stay apprised of new developments for a quickly evolving and highly regulated industry. ■

14 Id.
15 Id.
17 See CAL. CODE REGS. tit. 16, §§5000 et seq. A youth center is defined as “any public or private facility that is primarily used to host recreational or social activities for minors, including, but not limited to, private youth membership organizations or clubs, social service youth club facilities, video arcades, or similar amusement park facilities.” HEALTH & SAFETY CODE §11353.1.
18 BUS. & PROF. CODE §26053.
28 U.S. v. McIntosh 833 F. 3d 1163 (9th Cir., 2016).
31 See BUS. & PROF. CODE §19311-19312, 26300-26303.
33 See CAL. CODE REGS. tit. 16, §§5000 et seq.
by Megan Lisa Jones

Start-Up Opportunities

The Internal Revenue Code permits the exclusion of certain gains from qualified small business stock

MOST business owners and founders are aware of the basic forms of corporate structure such as C corporations, S corporations, limited liability companies, and limited or general partnerships. However, their related decision-making often ignores alternatives that may offer similar protections but greater advantages or that supplement these core structures. These alternatives include qualified small business stock, dual classes of stock, and various tax incentives targeted at encouraging research and development.

Under Internal Revenue Code Section 1202, certain gains on stock that meets the definition of qualified small business stock (QSBS) are excluded from tax when sold if certain conditions are met.1 This provision became permanent with the passage of the Protecting Americans from Tax Hikes (PATH) Act on December 18, 2015.2 If stock qualifies, part or all of the total gain on the sale of the stock is excluded from federal tax depending on when the initial stock investment was made.

If the stock was acquired before February 18, 2009, the exclusion is 50 percent;3 if between February 18, 2009 and September 27, 2010, the exclusion is 75 percent;4 and if acquired thereafter, the exclusion is 100 percent.5 In application, this means that only 50 percent, 25 percent, and zero percent of the respective sales proceeds will be subject to tax, with the

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remaining amount being tax-free. If only a partial exclusion applies, the capital gain rate that applies to the nonexcluded percentage is 28 percent, assuming that the taxpayer is in the 15 or 20 percent bracket for long-term capital gains.6 A per-issue limitation on eligible gain exists, which limits the aggregate amount of eligible gain under Section 1202 to $10 million or 10 times the aggregate bases during the taxable year.7

To qualify as QSBS, the corporation must be a domestic C corporation (not an S corporation or LLC) and it must have been a C corporation for substantially all of the time that the shares were held.8 The corporation cannot have over $50 million in assets when the stock is initially issued or immediately thereafter.9 Furthermore, the stock must have been acquired at its original issue and not on the secondary market.10 Also, during substantially all of the time the stock was held, at least 80 percent of the corporation’s assets must have been used in the active conduct of a qualified business.11

The active business definition12 excludes a number of business types from the benefits of Section 1202. Investment vehicles, banking, insurance, financing, and leasing are not active businesses. Service businesses are excluded and are defined to include health services, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, consulting, and any other business in which the principal asset of the business is the skill or reputation of one or more of its employees. Farming is also excluded, as well as any business that produces a product subject to percentage depletion. Finally, operating a hotel or restaurant does not constitute an active business.

Additionally, the stock must have been held for five years prior to sale for Section 1202 to apply.13 Interestingly, should the company be bought by another company before the five-year holding period has passed, the shares might still qualify for the Section 1202 exclusion. If the acquirer uses its own stock in exchange for the stock of the target company, the resulting shares of the acquirer could become QSBS shares to the extent of gain as of the date of the transaction.14 Only the gain that occurs after the transaction date would be taxed under the normal rules. Gains can also be rolled over from one QSBS to another under Section 1043. To qualify under Section 1043, the QSBS must have been held for more than six months and the sales proceeds must be invested in another QSBS within 60 days of the first sale.15

State tax and the alternative minimum tax (AMT) for individuals still apply to gains on the sale of QSBS. California formerly offered preferential tax treatment for QSBS but ended the preference for tax years following 2012.16

The Section 1202 federal exclusion applies to both investors and company employees, as long as the requisite conditions are met. Thus, angel investors and some venture capital investors benefit from the provision. However, the holder of the stock must be an individual and not a corporation. This structure is popular in the venture capital infrastructure in which LLCs and partnerships have yet to gain a foothold. Traditionally, these investors aimed for an initial public offering (IPO) of their portfolio companies, for which a C corporation structure was required. Even as IPOs have been partially replaced by acquisitions for a variety of reasons, many companies and investors still favor the C corporation structure and benefits of Section 1202. For companies on this path, the Section 1202 option is a powerful incentive.

Clients should be advised to document any potential QSBS investments carefully. As many small or starting companies do not always keep meticulous records, documenting a path later may not be possible. Especially important is documenting that the company had less than $50 million in assets immediately after the initial purchase and that at least 80 percent of the assets were used in the active conduct of a qualifying business. Clients should also obtain a stock certificate issued to them and keep a copy of the cancelled check or other documentation showing the initial investment.

Dual Classes of Stock

Historically, different classes of stock have been used for a variety of purposes. For estate planning purposes, dual classes of stock were used as part of “estate freeze” strategies,17 which were designed to allow a transferor to retain voting rights and a nonappreciating economic interest in a company, while transferring to a younger generation an interest in the business that will appreciate. Chapter 14 of the Internal Revenue Code was enacted to limit these types of strategies. Titled “Special Valuation Rules,” Chapter 14 provides guidance for valuing a variety of interests for estate and gift tax purposes. For transfers of interests in corporations, the rules under Chapter 14 would require the value of the transferred interest in the company, for gift tax purposes, to include the value of the non-appreciating interest that the transferor retained, resulting in a high valuation and defeating the estate planning strategy.18 In adding these estate and gift tax valuation rules, the government effectively limited how company owners could allocate the appreciation in their stock going forward. Although the rules under Chapter 14 have limited taxpayers’ ability to use dual classes of stock to achieve certain estate planning benefits, dual classes of stock remain an important option for taxpayers starting new businesses to consider, depending on their objectives. Today we still see companies using dual classes of stock to delink voting rights from economic rights in the corporation. Recently, multiple classes of shares have been utilized in the tech industry to allow company founders to retain control, with Google creating Class C shares with no voting rights19 and Snap selling only nonvoting shares in its recent IPO.20 Other companies have been using this strategy for many years. For example, with Ford’s long-standing dual class of stock capital structure, the family retains 40 percent of the voting rights through ownership of the company’s Class B shares, even though those shares represent only a small percentage of the company’s total equity.21 Berkshire Hathaway is well known for its two classes of shares—Class A and Class B. Although better known for the difference in price between the Class A and Class B shares, the company’s Class A shares have more voting rights than the Class B shares and can be converted into B shares,22 with both classes of common stock trading separately on the stock exchange.

Typically, this structure creates two classes of stock, with differing voting rights. For the sake of this discussion, they shall be labelled A and B. An example of a common structure would be to give the Class A shares 10 times the voting rights of the Class B shares, with the Class A shares owned by the company founders or other select shareholders, and the Class B shares sold to the public. Additionally, liquidation provisions may specify a liquidation preference for the Class A shares. However, only C corporations, and not S corporations, can have dual classes of stock that differ with respect to rights to distributions or liquidation proceeds.23

This structure can have multiple benefits. For company founders trying to expand their start-up business, this structure allows the founders to retain control of the corporation while being able to obtain financing from new investors. A class of stock with little or no voting rights also has the advantage of allowing a company’s management to reward and incentivize employees by compensating them
1. Qualified Small Business Stock (QSBS) is always excluded from tax, regardless of circumstances.
   True. False.

2. To qualify as QSBS, a corporation must be a C corporation; an S corporation or other flow-through entity does not qualify.
   True. False.

3. Under Internal Revenue Code Section 1202, service businesses (e.g., law and accounting) are included in the definition of eligible businesses under QSBS requirements.
   True. False.

4. Shares of a corporation qualify as QSBS after the company is sold to another company if the acquirer uses its own stock in exchange for the stock of the target company.
   True. False.

5. The Internal Revenue Service has limited the use of estate-freezing techniques for estate planning purposes.
   True. False.

6. The application of dual classes of stock is a new phenomenon that started with “hot” online companies such as Facebook.
   True. False.

7. Only C corporations may have dual classes of stock.
   True. False.

8. Stock in the same class may have different voting, but not preference, rights in the capital structure.
   True. False.

9. The use of dual classes of stock may allow management to retain voting control over a corporation while still raising outside funds.
   True. False.

10. Investors view dual classes of stock favorably, preferring that management retain voting control of the company while allowing inside investors to benefit from upside potential.
    True. False.

11. Qualified research and experimentation expenditures have been reduced under the new Tax Cuts and Jobs Act.
    True. False.

12. Research and experimentation expenditures may include expenditures for activities that further develop and expand upon an existing, legacy product and that are already certain to work.
    True. False.

13. Research and experimentation expenditures may include attorney's fees and costs incurred in obtaining a patent.
    True. False.

14. Internal Revenue Code Section 41, concerning research tax credits, was repealed in the Tax Cuts and Jobs Act.
    True. False.

15. Research tax credits are allowable when they include in-house research expenses of a start-up if the principal purpose of the expenditure is to use the results of the research in the active conduct of future trade or business.
    True. False.

16. Qualified research includes nontechnological aspects of a product, e.g., market research and advertising.
    True. False.

17. Net operating losses can still be carried back under the Tax Cuts and Jobs Act.
    True. False.

18. The Tax Cuts and Jobs Act allows for 100 percent expensing of certain business assets acquired after September 27, 2017.
    True. False.

19. Under The Tax Cuts and Jobs Act, the time for capitalization and amortization for research conducted outside the United States will be 10 years.
    True. False.

20. The new corporate tax rate is 21 percent under the Tax Cuts and Jobs Act, which encompasses only C corporations and not S corporations.
    True. False.
with company stock, without the risk of new investors coming in and diluting management's control. From an estate planning perspective, although the Internal Revenue Code now limits the estate and gift tax advantages to issuing dual classes of stock, this structure also allows a founder to retain voting control while transferring economic ownership of the business to younger generations.

However, for companies looking to use this structure to raise outside funds, this type of structure might be a cause for concern for potential new investors. Investors want a degree of control when they invest money into an entity. Thus far, recent companies that have used this structure have been the “hot” ones, which are likely to be dictating terms. Nonetheless, this concern of investors has caused the company behind the Russell 3000 index not to include Snap Inc. stock in that or other closely watched indices.

Although the estate-planning benefits of dual classes of stock have been limited by Chapter 14 of the Internal Revenue Code and companies must be C corporations in order to be able to issue multiple classes of stock, this structure can still be a valuable tool for a company with a clear vision and execution plan.

**Start-Up Businesses**

The Internal Revenue Code offers certain tax benefits and incentives that can be especially helpful to taxpayers during the early years of trying to get a new business off the ground and turning a profit. These provisions include incentives targeted at encouraging development of innovative new products, intellectual property, and other intangibles.

One such incentive provision applies to research and experimentation expenditures paid or incurred by a taxpayer in connection with the taxpayer’s trade or business. Under Section 174 of the Internal Revenue Code, taxpayers have the option of electing to treat qualifying research and experimentation expenditures as currently deductible expenses. When such expenses are taken as a current deduction, there is no recapture upon the subsequent sale of the resulting technology. Under the new Tax Cuts and Jobs Act, effective for amounts paid or incurred beginning after December 31, 2021, specified research or experimental expenditures will be capitalized and amortized over a five-year period. The time allowed for capitalization and amortization will be 15 years if the research is conducted outside the United States. This capitalization and amortization requirement applies to certain types of activities, including software development. Additionally, under this act, the application of the new provision is treated as a change in the taxpayer’s method of accounting under Internal Revenue Code Section 481, but no adjustment is made for research or experimental expenditures made before January 1, 2022.

Research and experimentation expenditures, herein defined as “research and development costs in the experimental or laboratory sense,” generally include all such costs incident to the development or improvement of a product. For example, attorneys’ fees incurred in obtaining a patent are considered research and experimentation expenditures. The regulations under Section 174 explain that expenditures represent research and development costs in the experimental or laboratory sense if they are for “activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.” Uncertainty is considered to exist if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.

The Internal Revenue Code also offers business tax credits for certain research activities that can be used by companies incurring research and development costs. Designed to encourage research, the research tax credit under Section 41 is a nonrefundable credit for a percentage of qualified research expenses. These expenses generally must be paid or incurred “in carrying on” an established trade or business of the taxpayer; however, there is an exception to this requirement that allows in-house research expenses of a start-up to qualify if the principal purpose of the expenditures is to use the results of the research in the active conduct of a future trade or business.

The credit is available for qualifying research activities related to the development or improvement of a business component. For purposes of this discussion, the definition of “qualified research” can be distilled into a four-part test: 1) the research must be for one of the following permitted purposes: creating new, or improving existing, functionality, performance, reliability, or quality of a business component; 2) it must be undertaken with the intent of eliminating uncertainty concerning the development or improvement of the business component; 3) it must be a process of experimentation; and 4) the process must be technological in nature, defined as relying on principles of the physical or biological sciences, engineering, or computer science.

If these conditions are met, then the business generally qualifies for a research and development credit. The regulations elaborate on this oversimplification and provide concrete examples. Wages, supplies, and contract research are not qualified expenditures for the credit. These credits can be carried forward 20 years and back one.
Net operating losses (NOLs) can also be utilized to save taxes on income earned after the development stage of a company. NOLs are loss amounts incurred by companies during their down years that can be deducted against future and past earnings to lower taxes paid. Under the Tax Cuts and Jobs Act, these losses can be carried forward indefinitely, but can no longer be carried back.35

New Planning Opportunities

The Tax Cuts and Jobs Act has created more opportunities for corporations and their business cohorts, partnerships and LLCs, to use the tax code to maximize their financial results and options. The 21 percent corporate rate36 is a tremendous advantage, especially given that capital gains and dividends are still taxed at a preferred rate. While the dividends-received deduction for corporations37 has been reduced, it still exists, meaning that corporations with dividend income will pay an even lower effective tax rate. Double taxation can be avoided at the shareholder level by holding stock in a Roth IRA or by holding the stock until death, at which point heirs get a step-up basis in the stock. The 20 percent deduction38 allowed to point heirs get a step-up basis in the stock. By holding the stock until death, at which level by holding stock in a Roth IRA or taxation can be avoided at the shareholder level by holding stock in a Roth IRA or by holding the stock until death, at which point heirs get a step-up basis in the stock. The 20 percent deduction38 allowed to point heirs get a step-up basis in the stock. By holding the stock until death, at which level by holding stock in a Roth IRA or taxation can be avoided at the shareholder level by holding stock in a Roth IRA or by holding the stock until death, at which point heirs get a step-up basis in the stock.


27 I.R.C. §41(d); Treas. Reg. §1.41-4.

I.R.C. §172.

28 Pub. L. No. 115-97, §13302(b).


I.R.C. §199A (new), as created in the Tax Cuts and Jobs Act.

I.R.C. §199A (new), as created in the Tax Cuts and Jobs Act.


I.R.C. §381(b)(1)(D); Treas. Reg. §1.1361-1(l)(1).


27 I.R.C. §41(d); Treas. Reg. §1.41-4.

I.R.C. §172.

28 Pub. L. No. 115-97, §13302(b).


I.R.C. §199A (new), as created in the Tax Cuts and Jobs Act.

Exhausting the Possibilities

After the Impression Products v. Lexmark ruling, manufacturers still may have legal avenues to enforce single-use restrictions on their products.

THE U.S. Supreme Court’s unanimous decision in Impression Products, Inc. v. Lexmark International, Inc. reflected an increased adherence to the doctrine of patent exhaustion. Although the opinion, authored by Chief Justice John Roberts, roundly rejected Lexmark’s attempts to limit use of its patented ink cartridges after their initial sale, analysis of the opinion suggests that there may still be options going forward. Lexmark attempted, but failed, to protect its patented product after sale. Yet, there may still be ways to use a patent to legally protect a patented product downstream in the marketplace.

In the present case, Lexmark made and sold patented ink cartridges in the United States and abroad for use in Lexmark printers. Some of Lexmark’s cartridges were sold subject to a single-use restriction, also referred to as a no-resale restriction, which sought to require that the purchaser return the spent cartridges to Lexmark. Impression Products collected spent Lexmark cartridges previously sold in the United States and abroad, and resold the restricted cartridges in the United States in violation of the imposed restriction. The Supreme Court ruled that the doctrine of patent exhaustion precluded a finding that the actions of Impression Products were patent infringement.

Patent exhaustion is effectively a patent law parallel to the well-established property law abhorrence of anti-alienation restrictions on a seller’s disposition of an entire interest in a chattel. Patent exhaustion declares that a patentee’s rights in an individual patented article are “exhausted” once a patentee-authorized sale has occurred, thus enabling a purchaser to use the purchased individual article in any otherwise legal manner. Accordingly, the resale of a lawfully purchased patented good is free from restrictions under U.S. patent law under the patent exhaustion doctrine.

Because restrictions precluded by patent exhaustion would otherwise be burdensome to purchasers, the Supreme Court’s decision in Impression Products appears to be ulti-
Furthermore, the holding of *Impression Products* appears to align with the rationale for intellectual property law generally. For example, the U.S. Constitution authorizes Congress “[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” Accordingly, it seems that any legal precedent that eliminates a class of restrictions on devices embodying patented discoveries based upon extra-statutory limitations imposed by the patent owner itself, as accomplished by the holding of *Impression Products*, serves to ensure that the balance struck by Congress is maintained. The goal is to do enough to promote innovation without strangling commerce.

Because the holding of *Impression Products* provides a benefit to consumers while also providing a legal environment that still promotes technology-advancing inventions, it seems that the Supreme Court achieved the correct result. However, it is not entirely clear that the Supreme Court’s decision completely bars companies from contracting with their customers to retain patent rights in downstream patented items.

In reviewing the decision of *Impression Products*, a couple of issues are presented. First, what actions should patent owners consider as a result of the decision, regardless of whether such actions promote the progress of the useful arts? Second, what changes in the law would better serve the progress of the useful arts?

Companies like Lexmark can conceivably structure customer agreements, including a no-resale restriction, in the form of a license agreement. However, because establishing a license agreement with an ordinary customer seems to undermine the spirit of the Supreme Court’s decision in *Impression Products*, the Supreme Court may need to go further, perhaps to overturn previous Supreme Court decisions that provide a legal distinction between customers and licensees, should the right case come before it.

**Prior Supreme Court Decisions**

A number of Supreme Court decisions touch upon the doctrine of patent exhaustion, some dating back as far as the middle of the nineteenth century. Some of the decisions have provided more extensive rights to patentees, even when those rights conflicted with the underlying notions of patent exhaustion.

The 1912 Supreme Court decision of *Henry v. A.B. Dick Co.*, which has since been overruled, served as a high point for the rights of patentees seeking to place restrictions relating to the post-sale use of their patented product (just as Lexmark sought to do with its patented ink cartridges). Furthermore, the facts presented to the Supreme Court in *A.B. Dick*, if adjusted for advancements in technology, seem to mirror the facts presented in *Impression Products*.

In *A.B. Dick*, the patent holder, A.B. Dick, sought to restrict the rights of a purchaser regarding the use of A.B. Dick’s patented product. The patented product sold was a mimeograph machine, which had a license restriction attached to it declaring that the machine was “sold by the A.B. Dick Company with the license restriction that it may be used only with the stencil, paper, ink, and other supplies made by A.B. Dick.”

The Supreme Court held, 4-3, that A.B. Dick’s tie-in restriction was a legitimate and enforceable restriction on the basis of the inherency doctrine. The inherency doctrine states that because a patentee’s rights are exclusionary (e.g., “the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States,” as stated in 35 USC Section 154(a)(1)), the patentee has no obligation to allow the patented item to be sold at all. The majority held that, logically, this right must inherently provide a lesser right to sell the patented item subject to any otherwise lawful terms and conditions that the patentee may choose.

Chief Justice Edward Douglass White wrote for the dissent, explaining that what the majority’s holding meant “is that the patentee has the power, by contract, to extend his patent rights so as to bring within the claims of his patent things which are not embraced therein, thus virtually legislating by causing the patent laws to cover subjects to which, without the exercise of the right of contract, they could not reach.” That is, Chief Justice White believed that a contractual agreement should not be able to provide further protection under patent law.

The rationale of the dissent was ultimately determined to be sound legal reasoning, as *A.B. Dick* was eventually overturned by *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, which held that particular restrictions (i.e., tie-in restrictions requiring purchase of unpatented products) are improper and unenforceable under patent law. Specifically, *Motion Picture Patents* stated that “it is not competent for the owner of a patent...to in effect extend the scope of its patent monopoly by restricting the use of it to materials necessary in its operation, but which are no part of the patented invention” noting that “the cost, inconvenience, and annoyance to the public which the opposite conclusion would occasion forbid it.”

Had there never been a need to overturn *A.B. Dick* (that is, had the reasoning of the dissent in that case prevailed), a bright-line test likely would have resulted. Then, Lexmark’s current patent infringement claims would not have had any merit. Indeed, it is hard to envision the form of an argument legally distinguishing A.B. Dick’s tie-in restriction regarding the ink used with their patented mimeograph machine from Lexmark’s tie-in restriction regarding the ink used with their patented printer cartridges—in neither case was the ink covered by the subject patents claims.

Further muddying the waters in this area of patent law is another Supreme Court case, *General Talking Pictures Corp. v. Western Elec. Co.*, which the Supreme Court may need to revisit this case to provide further clarity regarding what restrictions can be legally made in accordance with patent law. In *General Talking Pictures*, the Supreme Court upheld field-of-use limitations as being in accordance with patent law. Field-of-use limitations allow a patentee to restrict an authorized licensee from using patented objects outside of a defined field of use as specified by the patentee. Specifically, the Supreme Court held that the patentee could legally require that the licensee sell patented amplifiers only in the field of home radios.

More important, for determining how to advise a client in a position similar to that of Lexmark in light of *Impression Products*, the Supreme Court in *General Talking Pictures* held that the patentee could also sue a noncontracting purchaser that obtained a patented amplifier from the licensee and that made use of the amplifier outside the field of home radios if it could be demonstrated at trial that the purchaser was simply aware of the terms of the agreement between the patentee and licensee. The rationale of the court was that because the licensee knowingly made sales that were outside the scope of its license and because the purchaser knew of the patentee-imposed restrictions, the sales were therefore a breach of the terms of the subject license. Because the terms of the license were breached, the sales must therefore be treated as if no license had ever been granted by the patentee, the patentee could therefore sue both the licensee and the purchaser for infringement in accordance with the patent laws (as opposed to suing based on a theory gov-
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erned by contract law).  

Accordingly, although the Supreme Court indicated in Motion Picture Patents that patent law may not generally be used to enforce post-sale restrictions on a purchaser of a patented item, the Supreme Court indicated that the opposite is true in General Talking Pictures when post-sale restrictions are enforced based on an agreement with a licensee. This disparate treatment of licensees and general purchasers seems to effectively weaken the patent exhaustion doctrine, and therefore may negatively affect the promotion of the useful arts.

**Licensees vs. Contracting Purchasers**

The unavoidable conclusion that licensees and contracting purchasers should be treated differently may have driven the thought process of the two-judge dissent for the Federal Circuit in Lexmark International, Inc. v. Impression Products, Inc. With respect to post-sale restrictions, the dissent expressed concern that practicing patentees may effectively have less control than nonpracticing patentees because a licensee operating outside of the terms of its license would be engaging in an infringing act. However, as the dissent expressed, the same cannot be said of a general purchaser ignoring a restriction tied to a sale. The dissent stated the belief that post-sale restrictions should be enforceable only as a matter of state contract law, even when the sale is conveyed through a nonexclusive license, as contract law would still provide adequate remedy for the patentee. Despite mostly siding with the dissent, the Supreme Court did not appear to share the more extreme position of further extending the doctrine of patent exhaustion and left General Talking Pictures intact.

In an attempt to distinguish the facts of Impression Products from those of General Talking Pictures, the Supreme Court stated that a licensee breaching the contract governing a license to make and sell a patented device was a “fundamentally different situation” from the case immediately before it. However, the fundamentality of those differences may have been the least convincing aspect of the decision. The opinion emphasized that the facts in General Talking Pictures were different because the “licensee ‘knowingly made…sales…outside the scope of its license.’” However, it seems that Impression Products knowingly obtained the restricted product outside the scope of the agreement including the single-use restrictions. Accordingly, if a company producing a patented product were to place a single-use restriction in a license agreement, and if that company were to treat an individual customer as a licensee, the act of allowing the patented product to be the subject of a “sale” to another would apparently be a violation occurring “outside the scope of” that license.

The opinion further noted that the court in General Talking Pictures “treated the sale ‘as if no license whatsoever had been granted’ by the patentee, which meant that the patentee could sue both the licensee and the purchaser—who knew about the breach—for infringement.” However, this is effectively what Lexmark was trying to accomplish: denial of any authorization to Impression Products to benefit from what would be an agreement-invalidating acquiring of the patented product. If Lexmark had been able to prove that the terms of its buyback program were part of a limited, nonexclusive license and had been able to prove that Impression Products was aware of those terms, then Lexmark would have recourse under patent law without having to sue its customers for their failure to follow their agreement with Lexmark.

The opinion declared that General Talking Pictures does not establish “that patentees can use licenses to impose post-sale restraints on purchasers” but failed to explain why that is necessarily true. Would the Supreme Court have reached a different conclusion with respect to Lexmark had they couched the terms of their agreement with their customers as a license? The opinion emphasized that General Talking Pictures involved a licensee that “infringed the patentee’s rights because it did not comply with the terms of its license.” However, with respect to Lexmark, whether the consumers failed to comply with the terms of their agreement with Lexmark was not apparently contested, if brought up at all. That is, Lexmark would have argued that both their customers and Impression Products failed to comply with the terms of the purchase agreement, thereby infringing Lexmark’s patent rights.

The opinion also stated that the patentee in General Talking Pictures “could bring a patent suit against the purchaser only because the purchaser participated in the licensees’ infringement.” Does this mean that the court did not accept as fact that Impression Products was aware of the terms of Lexmark’s buyback program? The Supreme Court declared that “General Talking Pictures, then, stands for the modest principle that, if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee’s rights.” However, Lexmark had never given authority for their customers to dispose of the cartridges in a manner causing them to be in the possession of a competitor.

Nothing in the holding of Impression Products indicates that there is a legal distinction between a licensee-user and a licensee-manufacturer. It seems the only significant distinction causing the Supreme Court to uphold the patentee’s rights in General Talking Pictures, and to find that no such rights existed for Lexmark, is that the terms of the single-use restriction were not part of license agreements, and Lexmark’s customers were therefore not licensees. Despite recognizing that Lexmark’s contractual rights should not be enforced under the patent laws, it seems that the Supreme Court is comfortable with the notion of a patent-related cause of action (i.e., infringement) arising from a contract-related cause of action (i.e., breach of the terms of the license). This position does, in fact, indicate that a practicing patentee has fewer rights than a nonpracticing patentee, just as the Federal Circuit’s dissent had indicated.

**Perspective on the Future**

Lexmark’s desire to control a larger share of the printer ink market is, from a business standpoint, and without regard to the progress of the useful arts, understandable. In light of the Supreme Court’s holding, it seems that companies now have only a few routes for maintaining a legal way to enforce single-use restrictions on a patented product—either contract with their customers to restrict resale of a patented product, and thereafter sue the customers under a contract theory, or structure the terms of restrictions in accordance with a “license to use” agreement to provide a patent infringement cause of action against a company obtaining the patented product despite being aware of such restrictions. The theoretical license agreement could either be a limited, nonexclusive license with the consuming customers or a manufacturing license with some third party, who would ultimately sell the manufactured product to the customers.

It should be apparent that a business strategy based on numerous lawsuits with individual customers is untenable. But why wouldn’t a company like Lexmark attempt to identify future buyback agreements with their customers as license agreements that form a licensor-licensee relationship? The cost of the proposed license would be the market price for the patented cartridges with some discount or benefit provided to the licensee-customer as compared to a customer that buys the patented product...
free of restrictions. It doesn’t seem that such companies would experience any significant added cost, and these companies would maintain a valid patent infringement suit against a competitor reselling the patented product (assuming that it could be proven that the competitor was aware of the terms of the license agreement associated with the initial sale).

Had Lexmark decided to enforce its single-use restrictions by granting a license to a third party allowing them to manufacture only cartridges that were to be filled by Lexmark or its subsidiaries, given that Impression Products was aware of such a restriction, the facts would mirror those of General Talking Pictures. The patentee (Lexmark) contracted with a licensee (third-party manufacturer) dictating that the patented product (cartridge) be used in a specific field-of-use (single-use). Had the third party licensee made a sale outside the scope of the license to a purchaser (Impression Products), and the purchaser was aware of the restrictions, Lexmark’s post-sale restriction should have been upheld under the Supreme Court’s analysis.

Just as software companies have implemented end-user agreements as an end run around copyright’s codified first sale doctrine, we may see patent holders taking affirmative measures to maintain patent rights with respect to sold items. Such patent holders may contract with a licensee-manufacturer whose sales are subject to use-related restrictions or may attempt to structure each individual sale of the subject patented articles as an extremely narrow, nonexclusive license binding each end user to the same use-related restrictions. What legal theory may be used by the patent holders to successfully enforce these restrictions remains less than perfectly clear.

Accordingly, it seems that businesses that identify a licensor-licensee relationship with their customers will maintain an avenue of recourse in a patent infringement action, even though such recourse would potentially include action against their customer-licensees. This would, therefore, provide a level of downstream control of the patented products, something that seems to be at odds with the base notion of patent exhaustion. Should another company ever come into possession of such restricted patented products, they may be shielded from liability if it cannot be shown that they were aware of the terms of such restrictions contained in the subject license agreement.

But should the patent laws be allowed to be used in such a way? As indicated by the Supreme Court, selling a patented product ends the patentee’s rights to how that product is legally used. If the results of the patent exhaustion doctrine provide a public good, and if that public good is valued over that of the interests of companies like Lexmark, it may be necessary for the Supreme Court to eventually overrule General Talking Pictures, just as it overruled A.B. Dick. Alternatively, Congress may need to take action to clarify the patent exhaustion doctrine.

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1 Impression Prods., Inc. v. Lexmark Int’l, Inc., 137 S. Ct. 1523 (U.S. 2017).
2 U.S. Const. art. I, §8, cl. 8.
4 Id. at 12.
5 Id. at 53.
7 Id. at 516.
9 Id. at 182.
10 Id.
11 Impression Prods., Inc. v. Lexmark Int’l, Inc., 137 S. Ct. 1523, 1535 (U.S. 2017).
12 Id. at 1535, citing General Talking Pictures, 304 U.S. 175 at 181-82 (emphasis in original).
13 Impression Prods., 137 S. Ct. at 1535.
14 Id. at 1534-35.
15 Id. at 1535 (emphasis in original).
16 Id.
17 Id.
Championing the Cause of Civic Learning in Public Schools

SADLY, MOST AMERICANS CANNOT name the three branches of government. Many local officials and community leaders admit not knowing the difference between the state and federal court system. Closer to our judicial branch home, members of the jury pool often do not understand basic concepts of the legal system.

It is comforting and inspiring to learn that Chief Justice Tani G. Cantil-Sakauye shares the concerns of many in the legal profession about the low level of civics understanding in our communities. Shortly after assuming office, the chief justice found that civics was marginalized in California public schools to make way for greater emphasis on English and math. The state largely depended on a one-semester American Government class in the senior year that included little, if any, instruction on state courts.

The chief justice teamed with State Superintendent of Public Instruction Tom Torlakson to establish the Civic Learning Award, which recognizes public elementary, middle, and high schools for civic education efforts and identifies models that can be replicated.1 To further show her commitment, Chief Justice Cantil-Sakauye visits the three top award-winning schools.

The chief justice joined with Superintendent Torlakson to create the California Task Force on K-12 Civic Learning. Months of research and stakeholder and public input shaped the task force’s recommendations for elevating the status of civic learning in our K-12 public schools. After six public hearings across the state and more than 600 comments, the final report—Revitalizing K-12 Civic Learning in California: A Blueprint for Action—was released in 2014.2 The report has informed state leaders’ decisions to build more civic learning into state-level education policy and led to the creation of civic learning partnerships throughout the state.3 Typically led by a judicial officer, an education leader, and a business leader, the partnerships convene other community leaders to promote civic learning in their counties.

Los Angeles County is proud to host a civic learning partnership.4 Its activities include civic learning summits, civic learning fairs (which are like science fairs), and promoting the Civic Learning Awards program.

As the doors to civic learning open in the 82 school districts in Los Angeles County and in the Los Angeles Unified School District, it is gratifying to be able to report that the Los Angeles County Bar Association (LACBA) and the Los Angeles County Superior Court (LASC) have already been hard at work furthering civic education. Both organizations already have a rich array of programs, including the Judge David S. Wesley Teen Court program; SHADES (Stop Hate and Delinquency by Empowering Students); Courthouse to Classroom; mock trials; Teachers Courthouse Seminars; LACBA’s Dialogues on Freedom; and LACBA’s Appellate Court Experience.

The Constitutional Rights Foundation is a critical partner in many of these programs, and you can get involved, too. One way is to follow up with schools that have won the Civic Learning Award. These schools have already demonstrated a commitment to civic education and may be especially interested in law-related education and interactive lessons. The California Courts public website has a list of previous award-winning schools. The website also has outreach resources for judges, attorneys, and court staff. Other opportunities for you to get involved include American Bar Association’s Law Day (May 1).5 This year’s theme is Separation of Powers: Framework for Freedom.6

Civic learning is a large umbrella that ranges from voter education to writing letters to legislators. Schools still devote limited time to civics and will need to choose what to include in their lesson plans. Now is the time for judges and attorneys to reach out and bring education about the judicial branch into the schools.

As you plan to fit outreach into your busy schedule, keep the following in mind: 1) our democracy is at risk—your outreach is a remedy; 2) doors are opening to civic education, but there is no guarantee that law-related education will be a part of it unless judges and attorneys make it happen; 3) this is a priority of Chief Justice Cantil-Sakauye, so let’s help her succeed—she cannot do this alone; 4) when legislators don’t understand the courts, they don’t fund the courts, which leads to delays in case resolution; 5) when the public doesn’t understand the courts, they are hesitant to participate as jurors, witnesses, and litigants; 6) making people aware of their rights and how the legal system works promotes access to justice; 7) judges and the rule of law are under attack; this is a way to arm our citizens with the tools they need to fight back; 8) there are many ways to get involved; 9) it provides hope and understanding to the next generation of decision makers; and 10) working with students is fun!

To learn more about the chief justice’s Civic Learning Initiative and access resources, visit: www.courts.ca.gov/20902.htm. Also, to become more involved, contact either author at hdhanidina@lacourt.org or krosenberg@lacourt.org.

4 The authors are honored to be members of its steering committee.

The Honorable Kevin S. Rosenberg and the Honorable Halim Dhanidina are judges of the Los Angeles County Superior Court. Judge Rosenberg has been involved in civics education for over 15 years, including participation in LASC’s Judge Wesley Teen Court Program, Project LEAD, mock trials, and various civics-oriented organizations. Throughout his career, Judge Dhanidina has supported civics education, including involvement in the development of an antigang program for a San Gabriel youth center, participation in Project LEAD, presiding over mock trials, and coordinating elementary school visits to the Deukmejian Courthouse in Long Beach. Both serve as representatives for the Los Angeles County Power of Democracy initiative.
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