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Securities surprise: Debt with equity could bring unintended interest-related consequences for issuers and holders

by Roger F. Clark
Grant Thornton, Seattle

In a climate in which venture capital is difficult to come by, entrepreneurial companies may be inclined to issue debt rather than common or preferred stock to attract financing. To further sweeten a deal, debt may be accompanied by warrants or options, or issued as convertible debt repayable in the borrowing corporation's stock.

Under Section 1273(c)(2) of the Internal Revenue Code (IRC), a debt instrument that has an equity component (such as an option, warrant, or conversion feature) is considered an "investment unit" and an amount paid for it must be allocated between the debt component and the equity component. The amount allocated to the equity component is allocated away from the debt component, thereby potentially creating original issue discount (OID).

OID, then, generally represents the difference between the amount allocated to the debt instrument portion of the investment unit at the time of issue and the amount of debt that will ultimately be repaid at maturity.

Example: A company issues for \$1 million a debt with a face amount to be

paid at maturity of \$1 million that bears 6 percent interest. The debt has an option or warrant attached and the relative fair market values of the debt and equity components are \$800,000 and \$200,000, respectively. The difference between the \$800,000 allocated to the debt component at the date of issue and the \$1 million to

paid at maturity represents OID, which should be amortized over the life of the debt. For tax purposes, the value of the warrants, and therefore the amount of OID, may be determined using any well-established and reliable method for determining the value of warrants. The Black-Scholes method, a defined calculation frequently used for financial statement purposes, is sometimes used for tax purposes. However, it frequently results in a larger allocation of value to warrants than some other methods resulting in higher OID.

Alternatively, valuation experts may be used to calculate the value of warrants by reference to the present value of future cash flows from the warrants.

Documenting the intentions of the parties and the support for the values used is important. In one recent court case, *Custom Chrome, Inc. and Subsidiaries vs. Commr*, CA-9, 2000-2 USTC ¶50,566, aff'g, rev'g and rem'g Dec.

52,858(M), the court determined that there was no OID because the parties had not negotiated a specific discount attributable to the warrants, and the strike price of the warrants was equal to the fair market value of the related stock at the date of issuance of the warrants. Both borrowers and lenders considering these instruments should be aware of the possible consequences of OID arising from such bifurcated transactions.

BORROWER CONCERNS

"Obtaining adequate financing continues to be the number one problem cited by many companies," observes Roger Clark, a tax partner with Grant

Thornton's Seattle office. "For these companies, the OID issue is less important than getting financing to survive and grow. However, companies selecting from financial alternatives should evaluate OID and its tax and financial statement impact, as appropriate, in selecting the financial source and instrument."

Although early-stage companies generally are more concerned with getting financing and achieving profitability than they are with tax deductible interest, later-stage companies might anticipate writing off a certain amount as interest expense.

"No deduction is allowed for interest that's paid on a disqualified debt instrument," cautions Paul Beecy, a tax senior manager with Grant Thornton's Boston office. In this context, debt is determined to be disqualified if it meets certain tests under IRC Section 163(f): Generally, a debt instrument is disqualified if (i) it is issued by a corporation; (ii) it is payable in equity ("equity-linked" debt); (iii) the equity is equity of the borrower or a related-party company; and (iv) it is issued after June 8, 1997.

A debt is considered "equity-linked," indicates the IRC, only if a "substantial amount" of the principal or interest on the debt obligation is either (a) required to be paid in, or convertible into, equity; (b) payable in, or convertible into, equity at the option of the borrower or a related party (regardless of the likelihood the option will be exercised); or (c) payable in, or convertible into, equity at the option of the lender or a related party but only if there is "substantial certainty" the option will be exercised.

"The biggest problem," suggests Beecy, "is the lack of def-

initions of terms. What is a 'substantial amount' of principal and interest? Is it 33 percent? Twenty percent? Five percent? No definitive guidance currently exists."

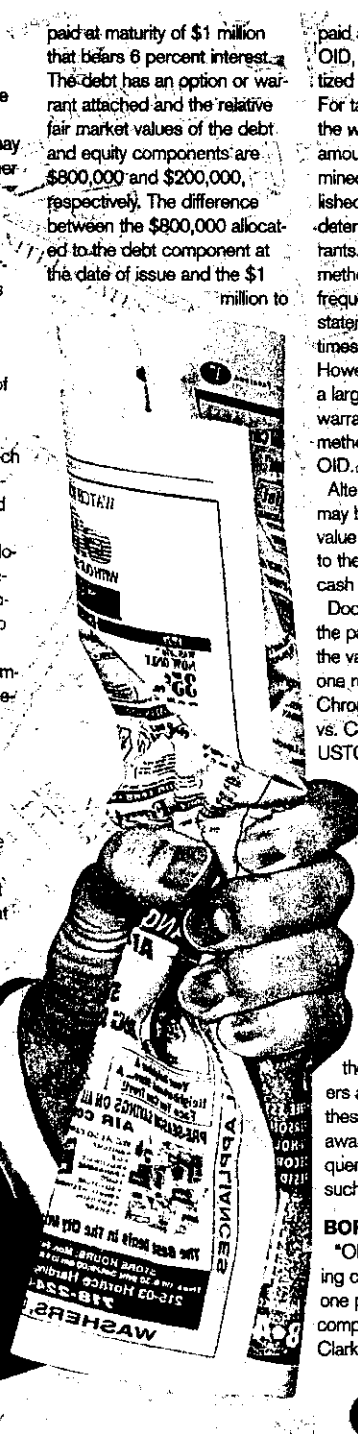
Beecy continues, "And what constitutes 'substantial certainty'? The legislative reports on this rule indicate that in-the-money warrants would have 'substantial certainty' of exercise. So, penny warrants most likely meet this test. There's also no indication of when or how often the 'substantial certainty' test is applied."

Beecy also notes that the Internal Revenue Service has issued little guidance on how to treat these arrangements.

"Basically, it's a facts and circumstances test."

Additionally, he explains, "If

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#	State	\$Mil
93	California	1,248
24	Massachusetts	256
10	North Carolina	116
8	Washington	77
2	Illinois	76
12	Texas	75
6	Florida	62
5	Georgia	38
4	Maryland	38
7	New Jersey	37

Source: VentureReporter.net
October 15, 2002

#	Industry	\$Mil
57	Software	492
28	Services	325
30	Wireless	272
11	Pharma	252
23	Biotech	231
14	Semiconductors	213
24	Security	212
19	Infrastructure	207
9	Optical	151
4	Healthcare	125
12	Content	116
11	Medical Devices	109
9	Telecom	105
8	Hardware	93
5	Broadband	86

Source: VentureReporter.net
October 15, 2002

Grant Thornton

LIFESCIENCE VENTURES

Venture Funds with Biotechnology Focus

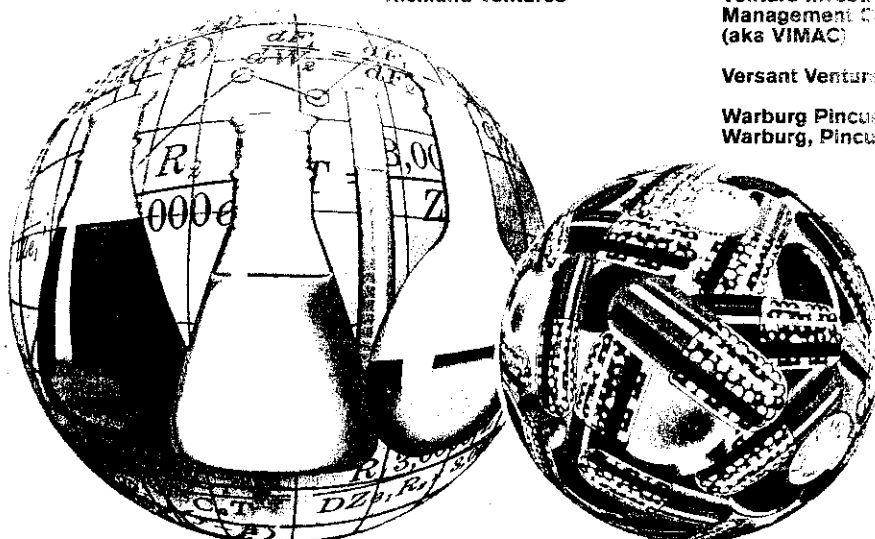
A.M. Pappas & Associates, LLC	CID Equity Partners	(OneLiberty, AGTC, NewcoGen)	Morgenthaler Ventures	TL Ventures (fka Radnor Venture Partners)
ARCH Venture Partners	CMEA Ventures (fka Chemicals & Materials Enterprise Associa)	Forward Ventures	NeuroVentures Capital	Technology Funding
Aberdare Ventures	Cardinal Partners (fka Cardinal Health Partners)	Frazier & Company	New Enterprise Associates	Three Arch Partners
Accel Partners	Charlotte Angel Partners	Healthcare Ventures, LLC (fka Healthcare Investments)	Oxford Bioscience Partners	TriState Investment Group
Advanced Technology Ventures (aka ATV)	Cogene Biotech Ventures	Institutional Venture Partners	Perennial Ventures (fka Tredegar Investments)	Tullis Dickerson & Co., Inc.
Advent International Corporation	Collinson, Howe & Lennox, LLC (aka CHL Medical Partners)	Integra Ventures	Perseus LLC	U.S. Bancorp Piper Jaffray
Afta Partners (fka Burr, Egan, Deleage & Co.)	De Novo Ventures	InterWest Partners	Polaris Venture Partners	UV Partners (aka Union Ventures) (aka Utah Ventures)
Atlas Venture	Delphi Ventures	Invencor, Inc.	Prism Venture Partners	Venrock Associates
Aurora Funds, Inc.	Domain Associates, L.L.C.	JAFCO America Ventures, Inc.	ProQuest Investments	Versant Ventures
Avalon Ventures	Emerging Technology Partners, LLC	Kleiner Perkins Caufield & Byers	Prolog Ventures, LLC	vSpring Capital
BCM Technologies, Inc.	Emerging Technology Partners, LLC	Lilly BioVentures	Prospect Venture Partners (fka Prospect Management, LLC)	Walden International
Bear Stearns Health Innoventures	Essex Woodlands Health Ventures (fka Woodlands Venture)	MPM Capital (fka MPM Asset Management LLC)	Research Triangle Ventures (RTV)	
BioVentures Investors	Flagship Ventures	Maryland DBED (aka Dept. of Business & Economic Development Mitsui & Co. Venture Partners (MCVP))	Rho Ventures (aka RHO Management) STARTech	
Blue Chip Venture Company		Mohr Davidow Ventures	Sprout Group	
Boston Millennia Partners			St. Paul Venture Capital, Inc.	
Burrill & Company				

Venture Funds with Healthcare Focus

Accel Partners	Crosspoint Venture Partners	Kaiser Permanente (aka National Venture Development)	Riggs Capital Partners
Blue Chip Venture Company	Dauphin Capital Partners	Lambda Funds, The	SSM Ventures
C&B Capital Investors, L.P. (aka Croft & Bender)	Diamond State Ventures, L.P.	Mission Ventures	Salix Ventures
Charter Venture Capital (aka Charter Ventures)	First Analysis Corp.	New Enterprise Associates	South Atlantic Venture Funds, L.P.
Conning Capital Partners	Focus Ventures (aka Charter Growth Capital)	Oxford Bioscience Partners	Sprout Group
CrossBow Ventures	HLM Management Company	Pacific Venture Group	Three Arch Partners
	Insight Venture Partners (aka Insight Capital Partners)	Partisan Management Group	Tullis Dickerson & Co., Inc.
		Richland Ventures	Venture Investment Management Company, LLC (aka VIMAC)
			Versant Ventures
			Warburg Pincus, LLC (aka E.M. Warburg, Pincus & Co)

90 DAY TOP INVESTMENTS	
Company	\$MM
National Surgical Care	75.0
AcSera	61.8
RuDOS Pharmaceuticals	46.0
Alecia MDC	45.0
CombinatoRx	40.0
Ista Pharmaceuticals	40.0
Anadys Pharmaceuticals	38.3
Nobex	35.0
Zyomyx	27.0
CHF Solutions	26.2
Codexis	25.0
Mobile Medical Industries	24.0
MicroMed Technology	23.0
Insulet	22.0
Peninsula Pharmaceuticals	22.0
Sucampo Pharmaceuticals	20.5
National Imaging Associates	20.0
IntraLuminal	20.0
Neuro3d	19.5
Microvention	19.0

Source: VentureReporter.net
October 15, 2002



Are you, or do you know a practitioner who's a thought leader in the Life-Sciences industry in Hawaii? If so, let us know! E-mail us at hvj@pacificforums.com

VENTUREVIEW



The Real Role of Management Consulting in the Information Age

by James D. Warren Jr.
CMC
JD Warren Associates LLC

Hawaii's burgeoning information technology sector has the advantage of gleaning valuable insights by looking to one of its closest neighbors. San Francisco, like Hawaii, is regularly influenced by developments in Silicon Valley, although business executives remain skeptical about the ability of information technologies to deliver on the promise of competitive advantage.

Though these business leaders believe that information technology is essential to operate, they doubt that IT can truly yield either tactical or strategic advantage for their firms. In fact, they believe this so strongly that they resist using management consultants in their information technology projects.

IT can and should be a key enabler of competitive advantage. Too often, it isn't, probably because:

- Most IT projects focus on product content (software specifics, vendor knowledge, and "experience in our industry") rather than on creative methodologies and cross-industry experience.
- Most companies continue to use technical consultants and hope that they will somehow get good management advice.

Simply stated, technical consultants deliver content and management consultants deliver the strategic framework.

Content work is task oriented, which is the essence of software systems implementa-

tion. Of course, no consulting organization can ignore the content elements.

Technology projects without content will ultimately fail. However, truly sustainable business value – tactical and strategic advantage – can be achieved only by "outside the (black) box" study and exploration. One principal job of management consultants is help corporate executives look at this bigger picture.

Together, executive-consultant teams can develop a vision for the future, one supported by sound business thinking. They can draw upon broad business models, often across diverse industries and technologies. As a result they can craft ways for that vision to be implemented – be realized – through information technology.

This is very much a "put the horse in front of the cart" scenario, because the real role of management consulting in the information age is to:

- Ensure that proven software properly executes the required business processes
- Ensure that industry-specific, vendor-provided software does not keep management from true strategic innovation and competitive uniqueness.
- Ensure that the business is not limited by the constraints software companies design for their own commercial interests.

Avoiding "Me Too" Solutions

Management must recognize that an IT project is just one of many strategic alternatives for the firm. Other

options usually abound. Corporate management should therefore demand that technology products be evaluated in exactly the same way as any other investment opportunity. Stated somewhat differently, management must not evaluate technical solutions too early on in the process – and certainly not before the purpose is defined.

Too often, decision makers rush to catalog "what's out there" already: What software is available? How have others in this industry used technology? What solutions have our leading competitors acquired? Product vendors actively encourage this discussion, because it is key to their sales programs.

With all their might, organization leaders must resist the tendency to buy into this "product paradigm". And, by using IT-savvy management consultants, they can ensure their planning is not overly influenced by product-specific discussions. When they dwell on what others have done, management is ensuring a "me too" strategy, one where all the players in an industry compete by fine-tuning their competitors' execution. Ultimately, this results in everyone – all industry members – executing the software vendor's vision. This is not sustainable competitive advantage.

Fear seems to be an important motivator (or demotivator) for management teams. They may feel they need a quick answer. Their experience has been that IT projects are late, over budget,

and don't deliver as promised. These are self-limiting doubts.

Management ought to be examining – and fixing – the root causes of implementation failure, so that high success rates of properly visioned technology projects can be achieved.

Why Ask "Why?"

A sound way to design these projects – and to achieve successful implementations – is to begin with "Why?" questions, rather than "How?" questions.

Content-driven approaches almost always begin with the "How?" questions, but these always drive the thinking down into the details prematurely:

"How should this process begin?"

"How can we make this system work?"

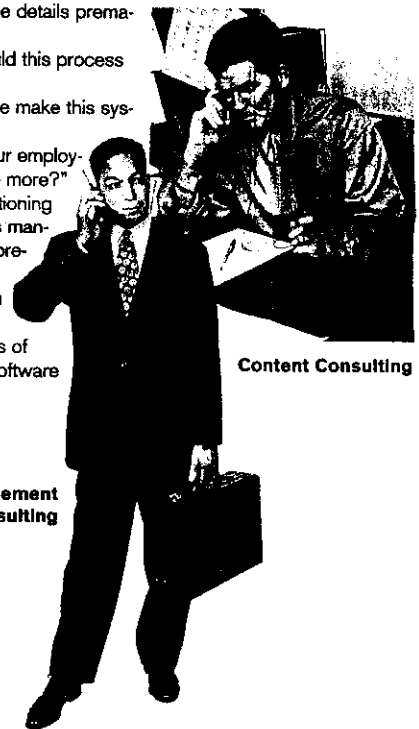
"How can our employees produce more?"

Such questioning quickly leads management to premature concentration on the features and functions of competing software

packages. It rushes to the detail without considering the overarching reasons for undertaking the project in the first place. And it wastes time by forcing the team to examine huge amounts of feature/function detail that will never be used. After all, only one solution will be accepted.

The most important questions to ask first are the "Why?" questions. This line of inquiry opens the vision and broadens the scope of client/management thinking: "Why are we undertaking this initiative?" "Why are we in trouble?" "Why aren't we getting

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Content Consulting

Management Consulting

STRAIGHTSCOOP

Continued from cover

the debt is a disqualified debt, the borrower runs the risk that all of the interest expense associated with this debt could be permanently disallowed as a tax deduction."

"Companies willing to issue debt with equity components in order to sweeten the attractiveness of the debt obligations need to be careful," he says.

LENDER CONCERNS

Conversely, venture capitalists, angel investors, or others

who lend money to entrepreneurial companies through such arrangements should be aware of the risk potential associated with OID. Holders of an instrument subject to the investment unit allocation rules of IRC Section 1273(c)(2) described above should be aware of unexpected OID interest income inclusions; non-cash, phantom income inclusion events.

"When corporations have inter-

est expense, the lenders generally have interest income," Clark notes. A debt-holder who eventually receives stock rather than cash as payment for accrued interest may incur taxable OID interest income for the amount paid in stock, in what, he says, could be "a surprise that comes out later."

And generally, even if the corporate borrower's interest expense deduction is disallowed, the lender may continue

to have taxable OID interest income.

AVOIDING SURPRISES

Entrepreneurs considering such debt arrangements are advised to be aware of any potential consequences associated with OID. "Up front it's important to find an appropriate valuation approach with respect to what is allocated to the equity component, and to make sure that no one is surprised by the fact that OID exists," sug-

gests Clark. "More than anything," he says, "you want to raise money and avoid surprises."

This piece is not intended to answer specific questions or suggest suitability of action in a particular case. For more information, contact Roger F. Clark at (206) 398-2464 or Bob Doering in the Honolulu office at (808) 536-0066.

FILM VENTURES

Strategies for Successful Producers

by John J. Lee Jr.
Pacific Business Forums
Sept. 2002 Featured Expert

There are seven key principles and practices consistently employed by a small core of the most powerful independent motion picture producers. It is assumed that you have solid story sense, deep producing craft and a nose for the audience. The seven are in addition to these, they are all business related and are substantially easier to implement as a part of your life and your production empire than the creative talent you have already hard won. Engaging these seven principles and practices will dramatically increase your creative freedom, packaging power, and profit share.

We here list the seven principles. They can be found in more complete form in *The Producer's Business*

Handbook, available at major bookstores and libraries. You will also receive a thorough introduction in them by participating in a two day Producer's Business Seminar, scheduled monthly. Or if you would like personalized help organizing or more importantly engaging them into your production organization, you are invited to schedule a preliminary meeting with us.

The Seven Major Principles and Practices Common Among the Film Industry's Most Successful Producers

1. Each uses an Internal Greenlight System

Understanding a studio's greenlighting criteria allows production organizations to replicate this process in their

own shops. The internal greenlight system allows the producer to evaluate the strength of the picture before a studio meeting and even points producers to which studio distribution team will most predictably extract the greatest earnings for each picture.

The discoveries from this absolutely critical process become the center of each picture's financial future.

2. Each operates with Fully Funded Development

Without question, most production companies fail because of under capitalization. Development is sophisticated, time-consuming and expensive. It should be approached with similar planning and funding as production. Producers must have their own development funding independent of a studio, sufficient to develop a slate of pictures.

This is the foundational practice, allowing each picture to predictably, unshakably move through the development process.

3. Each primarily or exclusively uses Bank Production Financing

The primary importance of this practice is not the obvious advantages of low bank interest and copyright ownership of each picture. These are both valuable, but even more beneficial is that bank production financing pushes the producer into global distribution relationships for each picture. These relationships are critical to engage essential pre-sale collateral and virtually insures that every picture produced has solid, global distribution, including at least the US and six major foreign territories with collaborative maturity from commencement of earnest development, months preceding production.

This is the catalyst that solidifies each picture's integrity.

4. Each Engages US and Foreign Territory Distribution Relationships for Each Picture During its Development

Internal greenlights are confirmed first with a US studio and then with a major distributor in each of the six major foreign territories. These confirmations are the second step in each picture's earliest development evolution and the beginning of essential creative and marketing collaboration.

With an average of sixty percent (60%) of all global income being earned outside the US for US pictures, the foreign markets are essential in this process and contribute a broad array of essential elements, including cover-shot clarification and major media market preparation.

This process defines and clears The Pathway to each picture's global audiences and income.

5. Each Plans the Rights Liquidation and either Sells Some Rights directly or participates in these sales

This is beginning with the end in mind. Understanding the vast array of highly profitable ancillary sales areas, planning these rights sales with the producer negotiating and closing some of these sales, substantially increasing the producer's profitability and advancing each picture's distribution power.

This is the key to protecting each picture and maximizing its profitability.

6. Each Participates in the Campaign Management of their pictures in the US and the major foreign markets

Campaign creative, media planning and media buying exists in a highly sophisticated world of its own. Few producers even understand the semantics. However, knowing your target audiences must have a minimum reach and frequency media buy to deliver minimally acceptable box office gross, allows producers to anticipate each picture's opening week-end with more understanding than trepidation. Studio distribution departments are rarely surprised. They know fairly closely what box office results the

campaign will drive.

This is the ultimate topspin for each picture's profits.

7. Each is a Balanced Producer, giving equal weight to creative, audience and profits

Production of the vision only seems like the producer's primary objective. When the picture is completed, especially if it fulfills the producer's creative objective, is when it is inescapably clear that the picture's capacity to play to its audiences, and return a profit to the producer are equally important with its creation. Balanced producers sustain an EQUAL check and balance between these three. Producers must: understand their creative craft, and remember that audiences experiencing their creations become the picture's income.

This balance assures the stability of each picture as it passes through the processes of development, production and distribution.

John Lee has been immersed in every business aspect of feature motion picture development, production, and distribution for over twenty-five years. He has bought and sold motion pictures and their various rights within the major markets and at MIFED, Cannes, and AFM, acquired screenplays and motion picture rights to novels, and negotiated, managed and/or performed every other business function of motion picture development, production, US and foreign theatrical and ancillary distribution, including auditing distributors in the perfection of producers' profits participations. His relationships are extensive and intimate with major production talent, motion picture studios, agents, entertainment banks, attorneys and ancillary licensees.

John is the CEO of Entertainment Business Group. He is also the author of *The Producer's Business Handbook* published by Focal Press and the primary seminar presenter for Entertainment Business Group Seminars. contact: john@ebgroup.net

Venture Funds with Entertainment/Media Focus

ABS Capital Partners
Advanced Technology Ventures (aka ATV)
Advantage Capital Pictures
Alta Communications
Ascend Venture Group, L.L.C.
BCI Partners
Boston Capital Ventures
Charter Venture Capital (aka Charter Ventures)
Collinson, Howe & Lennox LLC
(aka CHL Medical Partners)
Diamond State Ventures, L.P.
Draper Fisher Jurvetson (fka Draper Associates)
Focus Ventures (fka Charter Growth Capital)
GRP Partners (aka Global Retail Partners)
Genesis Park Ventures
Granite Ventures, LLC (fka H&Q Venture Associates)
Grotech Capital Group
HLM Management Company
Highland Capital Partners
Insight Venture Partners (fka Insight Capital Partners)
InterWest Partners
Jefferson Capital Partners, Ltd.
Morgan Stanley Venture Partners (aka MSDW)
New Venture Partners LLC
(fka Lucent New Ventures Group)
Northwest Venture Associates, Inc.
(fka Spokane Capital Mgmt.)
Northwood Ventures
Oxford Bioscience Partners
Pequot Capital Management, Inc.
Primus Venture Partners, Inc.
Riggs Capital Partners
Sprout Group
Sutter Hill Ventures
TechnoCap Inc.
Three Arch Partners
Trident Capital
Warburg Pincus, LLC (fka E.M. Warburg, Pincus & Co)

Are you, or do you know a practitioner who's a thought leader in the Film/Entertainment Industry in Hawaii?
If so, let us know! E-mail us at hvj@pacificforums.com

INTERNETLAWUPDATE

This is a periodic update of key technology and Internet law recent developments brought to you by Brown Raysman Millstein Felder & Steiner LLP. For more information on technology and intellectual property-related legal developments, visit <http://www.brownraysman.com>.

Visible Notice of License Terms or Unambiguous Manifestation of Assent Required for Enforceable License of Downloaded Software

Web users who downloaded and installed a free software "plugin" are not bound by the arbitration clause in the end user license agreement when an "immediately visible notice of the existence of license terms" was not displayed prior to downloading or during the software installation process. *Specht v. Netscape Communications Corporation, Inc.*, No. 01-7860(L) (2d Cir. Oct. 1, 2002). The Court of Appeals for the Second Circuit upheld the District Court conclusion that the license agreement was unenforceable under California common law, finding that "where consumers are urged to download free software at the immediate click of a button, a reference to the existence of license terms on a submerged screen is not sufficient to place consumers on inquiry or constructive notice of those terms." The court concluded that without such notice, the downloading of the software could not constitute acceptance of the license terms.

The opinion is available at <http://csmall.law.peace.edu/lawlib/legal/us-legal/judiciary/second-circuit/tst3/01-7860.opn.html>

Editor's Note: *Specht v. Netscape* is important because the decision recognizes the enforceability of online contracts, but makes clear that the enforceability of such contracts depends upon an unambiguous manifestation of assent by the accepting party - a requirement that is not met if a reference to the terms of the contract is not made visible to the accepting party. Companies should consider the court's statement that "[r]easonably conspicuous notice of the existence of contract terms and unambiguous manifestation of assent to those terms are essential if electronic bargaining is to have integrity and credibility" in utilizing online agreements.

Arbitration Clause in Online Payment Service Contract Unconscionable Under California Law

The arbitration clause in the user agreement for the PayPal online payment service is both procedurally and substantively unconscionable under California law and is therefore unenforceable. *Comb v. PayPal, Inc.*, No. C-02-1227 JF (N.D. Cal. Aug. 30, 2002). The District Court, noting the small value of the average transaction involving the service, the lack of sophistication of the service's customers, and the likelihood that no alternative payment services are available that do not require arbitration clauses, found the agreement to be procedurally unconscionable. In finding substantive unconscionability, the court focused on elements of the agreement that, among other things, permitted PayPal to change the agreement without prior notice by posting the revised agreements on its Web site, permitted PayPal to

take unilateral action to freeze customer accounts and retain control of disputed funds in its sole discretion, and limited venue for arbitration proceedings to a specific county in California.

The decision is available at <http://www.cand.uscourts.gov/cand/tentrule.nsf/4f9d4c4a03b0c170882567980073b2e4/f2025ae0bc17e30488256c480061e7077?OpenDocument>

Editor's Note: Unlike the *Specht* case, described above, this case does not question whether there was assent to the term of an end user license. Rather, in this case, the court found that the terms of the license were unconscionable. This case is of particular concern because many of the elements referenced by the court to support a finding of unconscionability are commonly included in today's typical "click wrap" agreement. Companies

retrieve the e-mails from backup tapes, in continuing to rely on the vendor "throughout months of apparently fruitless attempts to retrieve the critical e-mails," and in refusing to provide technical information regarding the e-mails to the adverse party's expert, among other things.

The decision is available at <http://www.tourlaw.edu/2ndCircuit/September02/01-92260.html>

Trademark Licensee's Domain Name Registration and Use Justified Under Broad Grant in Trademark License

A trademark owner's grant to a film company of "all rights" which the company "may require" in order to produce and promote a film encompasses the right to register and use domain names incorporating certain licensed trademarks. *Twentieth Century Fox Film Corp. v.*

Interstellar Starship Services, Inc. v. Epix, Inc., No. 01-35155 (9th Cir. Sept. 20, 2002). The Court of Appeals concluded that the only decisions in which courts ordered transfer of a domain name were those in which the plaintiff had proved "the rigorous elements of cybersquatting."

The appeals court upheld the lower court's conclusion that the defendant did not act in bad faith in registering the domain name, and that an injunction against future infringing uses of the domain name was a sufficient remedy for past infringement.

The decision is available at <http://www.ca9.uscourts.gov/ca9/>

owner's goods, but instead used the domain to redirect users to a Web site offering the products of the trademark owner's competitors.

The decision is available at <http://pacer.mad.uscourts.gov/dc/cgbin/recentops.pl?filename=collings/pd/minarkelectric.pdf>

Third Parties' Infringing Use of Trademarks on the Internet Supports Finding of Civil Contempt

The defendant Alfredo Versace's inability to substantiate his claims that he could not control the marketing of items containing his infringing trademark on Internet Web sites, as previously ordered by the District Court, support a finding of civil contempt. *A.V. v. Versace, Inc. v. Versace*, No. 96 Civ. 9721 (S.D.N.Y. Sept. 3, 2002). The defendant had previously been enjoined from using his name as a trademark without prominently disclaiming affiliation with the plaintiff Gianni Versace, and a subsequent contempt order made clear that the injunction applied to Internet marketing. The court found that the defendant had offered no credible evidence that the Web sites were beyond his control, or that he had taken steps to purge the infringing sites. The District Court also modified the previous injunction to prohibit the defendant from any use of his name as a trademark.

The decision is available at <http://www.brownraysman.com/InternetLawUpdate/A.V.Versace.PDF>

Split WIPO Panel Refuses Transfer of "Justdoit.com" Despite Respondent's "Suspicious" Use to Redirect Traffic

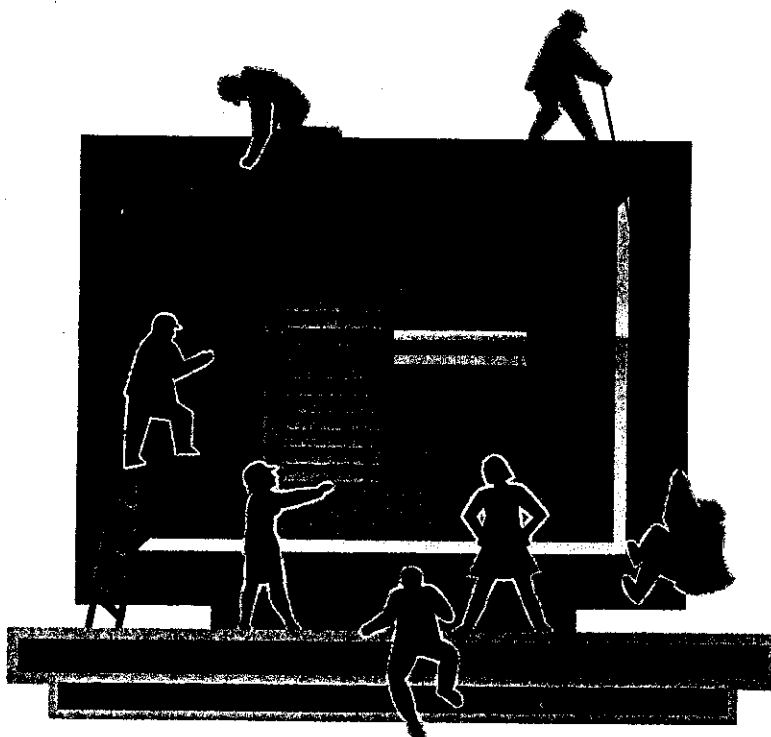
A party's use of a domain incorporating another's trademark solely to redirect traffic to its own Web site does not justify transfer, where the evidence does not prove bad faith registration. *Nike, Inc. v. Circle Group Internet, Inc.*, No. D2002-0544 (WIPO, Sept. 10, 2002). Characterizing this as "a very close case," a split Panel first noted its suspicions about Respondent's use of the "justdoit.com" domain merely as a redirect to its Web site that "add[ed] nothing to the bona fides" of the site. However, the Panel found that Complainant failed to establish the element of bad faith registration, and noted that by waiting a full two years after the UDRP procedure became available to take action against Respondent, Complainant complicated its task of proving this element.

The decision is available at <http://arbitr.wipo.int/domains/decisions/html/2002/d2002-0544.html>

UK Domain Appeals Panel Finds "Abusive Registration" in "Scooby Doo" Fan Site with Domain Name Identical to Complainant's Mark

A fan site that uses the precise name of the person or character to whom it pays tribute is an "Abusive Registration" under the Dispute Resolution Service (DRS) Policy of Nominet, the registry for ".uk" domain names. *Hanna-Barbera Productions, Inc. v. Hay, DRS 00389* (Nominet, Aug. 23, 2002). A Panel of Appeal convened under the DRS Policy agreed that the "scoobydoo.co.uk" domain was a tribute site to cartoon

Continued on page eight



should be aware that this case could provide fodder for challenges to the enforceability of such agreements under California law. In some cases, companies may want to consider amending the terms of their online agreements accordingly.

Failure to Provide Timely Discovery of E-Mail May Be Sanctionable

A party that fails to provide discovery of e-mails in a timely manner may be subject to sanctions, including an adverse inference instruction to the jury, even if such failure was not due to gross negligence or bad faith.

Residential Funding Corp. v. DeGeorge Financial Corp., No. 01-9282 (2d Cir. Sept. 26, 2002). Vacating the District Court's denial of sanctions against the non-producing party, the Second Circuit remanded with instructions to allow discovery on whether the non-producing party acted with a culpable state of mind in delaying its decision to retain an outside vendor to

Marvel Enterprises, Inc., No. 01 Civ. 3016 (AGS) (S.D.N.Y. Sept. 24, 2002). The District Court dismissed the trademark owner's breach of contract and infringement claims against the film company, finding that the trademark owner could not establish that the promotion of the film did or did not require any specific marketing technique, because such inherently subjective judgments were within the discretion of the film company.

The decision is available at <http://www.brownraysman.com/InternetLawUpdate/TwentiethCenturyVMarvel.PDF>

Editor's Note: This case suggests that many of the forms of license commonly in use today may be construed to allow a licensee broad flexibility with respect to domain name registrations.

Injunction Transferring Domain Name Not Required Upon Finding of Trademark Infringement

A court that finds trademark

newopinions.nsf/56AC05798CBB473688256C39007AD37B/\$file/0135155.pdf?openelement

Changed Circumstances in Domain Name Dispute Eliminate Res Judicata Bar

A trademark owner is not barred by the doctrine of res judicata from bringing a new infringement action against a domain name holder where the holder's use of the disputed domain name has changed since the trademark owner's first unsuccessful action. *Minarik Electric Co. v. Electro Sales Co., Inc.*, Civ. No. 2001-12352-RBC (D. Mass. Sept. 26, 2002). The District Court noted two key changes that differentiated the claims from the prior suit for purposes of res judicata analysis: 1) The trademark owner had terminated the distribution agreement that required the defendant to actively market the trademark owner's products, and 2) the defendant was no longer using the disputed domain to assist in the sale of the trademark

the results we need?"

The Japanese school of manufacturing management says that if you ask "Why?" five times, you will get to the root cause of anything.

"Why is this not working?"

"Because the numbers are not consistent."

"Why are the numbers not consistent?"

"Because the cost variances are not correct."

"Why are the variances not correct?"

"Because we cannot manufacture consistently."

"Why can't we manufacture consistently?"

"Because ..."

...and, at this stage, you will now know where to focus your efforts. However, if you had begun the process by asking "How should we undertake this initiative?" you will be trapped in the details far too soon.

Mrs. Fields' Changes the Recipe

When project teams take the time to broaden the scope of their inquiry, they tend to create new ways of looking at old, intractable problems. Major projects in history often achieve breakthrough benefits by applying cross-disciplinary thinking, applying proven wisdom from one arena and mapping it into a different application or industry.

Several years ago I led a team of consultants in the Mrs. Fields' Cookies Corporation. The company had been comfortable for many years - 40 stores and a plan to expand. As they looked at a traditional chain-store retail management

model, it became clear they could never achieve scale economies by doing "more of the same". In fact, with more stores (and thus more corporate overhead) their overall profitability would probably decline.

The first ground rule of the executive-consultant team was to outlaw all the "How?" questions. Everyone agreed some type of technology could be successfully implemented. But before launching into any technical discussions, we began the classic management consulting model of IT investigation:

- Strategic discussion,
- Examination of alternative visions,
- Analysis of implementation risks, and
- A survey of other successful models from other industries and disciplines.

We looked at retail, distribution, and the information technology industry itself. Finally, we considered manufacturing. Why couldn't the retail chain view itself as a manufacturer? In fact, a manufacturer with a very short distribution pipe!

This simple change in perception immediately led us to the solution. We saw, that the Mrs. Fields' organization could best succeed by not implementing the traditional chain-store expansion model. Instead, we took an example from another industry - manufacturing. By pushing inventory replenishment decisions down to the store level and automating the "re-order point" (baking another batch) process, we achieved the business objective of revenue

explosion without cost expansion. Moreover, it was technically feasible and inexpensive to implement.

Everyone came to regard the stores as a widely dispersed system of little factories. For each store, we developed local-level baking schedules based on proven statistical algorithms from manufacturing systems. We enabled the retail clerks to calculate their own bake time and batch quantity decisions, right at their own in-store computers. Furthermore, this enabled corporate headquarters to achieve control and efficiency without superimposing layers and layers of management. In fact, our solution allowed the company to eliminate some store level management functions altogether as the computers did much of the command and control work.

Our model enabled the Fields organization to press on past the product paradigm. We started with the bigger picture: instead of limiting ourselves to retail solutions at the outset, we drew upon proven outside technologies. These decisions were key to the company's success. We combined strategic thinking, visioning, and viability, which enabled implementation excellence. This "win-win" was made possible through the use of simple and proven management consulting techniques.

The New Marching Orders

To generalize, then, what can organizations do to ensure that their information projects achieve truly strategic

results? Four lessons emerged from the Fields endeavor. Breakthrough solutions occur when management:

1. Remains focused on the overall target (and thus takes a "solution-neutral" approach to the work).
 2. Ensures that creative, visionary ideas receive a fair and open hearing.
 3. Insists that any analysis of options include serious study of implementability.
 4. Demands that all intellectual content, ideas and approaches be considered.
- This forces the analysis to yield breakthrough possibilities, through cross-disciplinary approaches.

All of which sounds like a very challenging set of marching orders! These are

• They can suggest the application of other ideas because of their breadth of ideas and experiences. The outsiders' sense of what is possible - with "possible" considered from a broader perspective - can spur inside people to broader visions for the enterprise.

• They can guide the client to an articulated vision of the goal and to an implementation roadmap that will get them there. Remember, both are necessary for success; one without the other is insufficient.

• Finally, having "been there and done that" before, the outside consultants become the catalysts for success. They help management determine the right mixture of the new and the old, the pos-



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broad and demanding exhortations for busy people holding full time jobs. How can they possibly do it all?

Not surprisingly, this is where a team of outside advisors - the management consultants - can literally come to the rescue. Such people are not so much "doers" (although the good firms have people who have implemented many times before and are therefore technically well-grounded consultants) as they are inciters. Here are three key areas where management consultants can incite the inside team to success:

abilities and the risks, and they provide a "reality check" that the vision and the plan make sense.

Thus, the real role of the management consultant is what it has always been: to add value greater than the fees, to add knowledge greater than the existing intellectual capital, and to be the catalyst for wonderful new things to develop - all for the client's benefit.

Properly done, the results are amazing.



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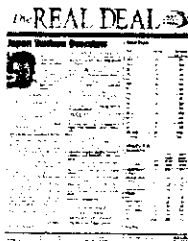
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Contact us at 536-8911 for more information or e-mail us your company info (as required below) to info@pacificforums.com.

You may also fax to us at 566-0300. Please DO NOT send an executive summary or business plan at this time!

- 1 Legal Company Name
- 2 Year Established
- 3 Type of Entity
- 4 State(s) Incorporated/Registered
- 5 Qualified Hawaii High Tech Business?
- 6 Funds received to date and sources
- 7 Amt. Raised as QHTB under Act 221?
- 8 CEO/President
- 9 Add'l Contact
- 10 # of Employees
- 11 # Startup Partners
- 12 Est. # Customers
- 13 Est. # Vendors
- 14 Business Address
- 15 Phone
- 16 Fax
- 17 Cell
- 18 eMail
- 19 Business Description
- 20 2000 Revenue
- 21 2001 Revenue
- 22 Funds sought
- 23 Comments
- 24 Please sign below and fax to: 566-0300

I hereby authorize the release of this information to potential investors/lenders. I understand that

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Signature _____ Date _____

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character Scooby-Doo, commenting that "a genuine tribute site cannot ordinarily constitute an Abusive Registration." However, the Panel found the registration to be abusive in that the domain was identical to Complainant's mark, and suggested "lovescoobydoo.co.uk" as a better choice for a fan site. It ordered transfer to the Complainant.

The decision is available at <http://www.nic.uk/dns/appeals/han.nabarbera-v-hay.html>

District Court Issues Preliminary Injunction Against File-Sharing Service Madster

Finding what appeared to be "facilitation of and contribution to copyright infringement on a massive scale," a District Court granted a preliminary injunction against Madster, the file-sharing service previously known as Aimster. In re Aimster Copyright Litigation, No. 01 c 8933 (N.D. Ill. Sept. 4, 2002). Madster allows its members to identify large numbers of users with whom they can transfer files in encrypted form and send instant messages. The court ordered the plaintiffs, record companies and music publishers, to submit proposed language for a narrowly-tailored injunction that would prevent continuing contributory infringement while allowing any non-infringing uses of Madster.

The decision is available at <http://www.nysd.uscourts.gov/court/web/pdf/D071LNC/02-08101.PDF>

Display of Video Clip on Internet Is "Within the State" Under New York Right of Publicity Law

A video clip of the plaintiff displayed on the defendant's Web site constitutes usage "within the state of New York" for purposes of pleading a violation of the plaintiff's right of publicity under New York's Civil Rights Law §§ 50 and 51. *Molina v. Phoenix Sound Inc.*, No. 231 (N.Y. App. Div. Sept. 26, 2002). The court held that plaintiff's allegations that the clip was available on a "world wide basis" via the Internet satisfied the pleading requirements

for this element. The court reversed a grant of summary judgment in favor of the plaintiff, however, noting that triable issues of fact remained as to, inter alia, whether the Web site was actually accessed within the state.

The decision is available at <http://www.brownragsman.com/IntemetLawUpdate/MolinaVPhoenix.htm>

Public School Student Can Be Disciplined for Off-Campus Web Site Accessed from School

A student-created Web site aimed at a specific school and/or its personnel, that is "brought" into the school environment or accessed at school by its originator, is "on-campus speech" for purposes of the First Amendment. *J.S. v. Bethlehem Area School District*, No. 33 MAP 2001 (Pa. Sept. 25, 2002). The Pennsylvania Supreme Court held that the student's Web site containing derogatory and threatening statements about a teacher did not constitute a "true threat" under the First Amendment, in part because the site discouraged school personnel from entering. Nonetheless, the court found that because the student accessed the site at school, showed it to another student and informed other students of its existence, there was a sufficient nexus between the Web site and the school to consider it on-campus speech for First Amendment purposes, and affirmed the school district's disciplinary action against the student.

The decision is available at <http://www.aopc.org/OpPosting/Supreme/out/J-111-2001mo.pdf>

Personal Jurisdiction Upheld Based on Company's Marketing of Course on the Internet

A company's Internet advertising and sale of seats for a course scheduled to be held in the forum state was sufficient to justify the court's exercise of personal jurisdiction over the company. *Mulcahy v. Cheetah Learning LLC*, et al, Civ. No. 02-791 (D. Minn. Sept. 4, 2002). The course was to feature

allegedly infringing course materials that gave rise to a copyright dispute. Even though the course was cancelled and the infringing materials were never distributed within the forum state, the court held that the company purposefully established meaningful contacts and relations with the forum state when it used the Internet to actively solicit and sell seats.

The decision is available at <http://www.nysd.uscourts.gov/court/web/pdf/D08MNX/02-08453.PDF>

Opening E-Mailed Links to Pornography Sites Not Sufficient to Deny Unemployment Benefits

Under Minnesota law, the denial of unemployment benefits to an employee on grounds of misconduct cannot be based on a record that demonstrates only that the employee opened links to three adult Web sites that appeared on his e-mail account. *Moench v. Red River Basin Board*, No. C5-02-312 (Minn. Ct. App. Sept. 24, 2002) (unpublished opinion). The Court of Appeals noted that there was no evidence as to how often the employee visited the adult Web sites and for how long, whether the sites were accessed during work hours, and whether the employee went beyond the opening pages of the sites.

The decision is available at <http://www.brownragsman.com/IntemetLawUpdate/Moench.PDF>

New California Law Requires Notification of Security Breaches Involving Unencrypted Personal Information

As of July 1, 2003, State agencies and individuals and businesses conducting business in California, that own or license computerized data that includes personal information, will be required to disclose breaches in the security of the data. Senate Bill 1386 (signed Sept. 25, 2002) amends the California Civil Code to provide for notice of security breaches involving information that combines an individual's name

with social security, driver's license, account, debit or credit card numbers, if the information is unencrypted. Notice is required to be given "in the most expedient time possible and without unreasonable delay." The law provides for written or electronic notice, or a form of substitute notice by e-mail, Web site posting, or media notification where the number of persons to be notified exceeds 500,000.

The text of the chapter law is available at http://www.leginfo.ca.gov/pub/bill/sen/sb_1351-1400/sb_1386_bill_20020926_chaptered.html

WorldCom Blocks Access to Alleged Child Porn Sites in Response to Attorney General's Enforcement of New Pennsylvania Law Aimed at ISPs

<http://www.com.com/2100-1023-959045.html>

California Governor Signs Bill Prohibiting Unsolicited Commercial Text Messages to Cell Phones

http://www.leginfo.ca.gov/pub/bill/asm/ab_1751-1800/ab_1769_bill_20020919_chaptered.html

Michigan Attorney General Takes Action Against Internet Billing Companies for Facilitating Child Porn

http://www.ag.state.mi.us/press_release/pr10347.htm

Virginia Tax Commissioner Rules that Online Provision of Digital ID Services is Nontaxable Service Transaction

<http://policylibrary.tax.state.va.us/OT/Policy.nsf/cod0d2ea93db9ba485256968006a39ed/4fc004c608de4b6a85256c160049b99970?OpenDocuement>

Missouri Director of Revenue Rules that Online Financial Services Purchased in Conjunction with Tangible Personal Property is Subject to

State Sales Tax
<http://dor.state.mo.us/tax/rulings/LR1104.htm>

With European VAT Law Change Looming, British Court Moves Forward Friesland's Case Challenging AOL's VAT-Free Status in UK
<http://www.vninet.com/Print/1135404>

Australia Federal Court Shuts Down Holocaust Denial Site Under Racial Discrimination Law
http://www.hreoc.gov.au/media_releases/2002/61_02.html

Department of Justice Reaffirms Position that Internet Casino Gambling is Illegal Under Existing Federal Law
[http://www.rgtonline.com/news-page2/detail.psp.q.All.e.\(10001b522\).a.htm](http://www.rgtonline.com/news-page2/detail.psp.q.All.e.(10001b522).a.htm)

Department of Commerce Extends Contract With Internet Corporation for Assigned Names and Numbers for One Year
<http://www.icann.org/general/ame-n5-jpamou-19sep02.htm>

California Attorney General Launches Consumer Protection Suit Targeting Spammers
<http://caag.state.ca.us/newsalerts/2002/02-111.htm>

Canada Privacy Commissioner Finds Violation in Courier Company's Collection of Electronic Signatures and Posting on Parcel Tracking Site
http://www.privcom.gc.ca/cf-dc/cf-dc_020905_e.asp

Emergency Order Against Anti-Abortion Cybersquatter Clarified to Encompass Registration as Well as Use of Domain Names
The decision is available at <http://www.nysd.uscourts.gov/court/web/pdf/D08MNX/02-08168.PDF>



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