

LEGAL UPDATE

CLIENT NEWSLETTER OF
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APRIL - MAY 2004

TRADEMARK APPEALS COURT OVERTURNS RULING IN "KEY WORD" ADVERTISING DISPUTE

In a recent edition of *Legal Update*, we discussed the trial-court decision in *Playboy Enterprises, Inc. v. Netscape Communications & Excite, Inc.* involving trademark implications of so-called "key word" advertising sold by internet search engines. To briefly review, the controversial advertising practice involves the search engine's display of banner advertisements for products and services related to the search term(s) in the user's query. For example a user may enter a trademarked brand like "Jim Beam® Bourbon" as a search query. The search engine then renders a web page containing search results that contains a banner advertisement for competing alcoholic products. For search engines searching for shrinking advertising revenue, this technique is an effective way to sell very targeted advertising in a mass medium. To consumer trademark owners, the practice is gross misappropriation of their valuable marks.

Although courts in Europe have found trademark infringement in "key word" advertising campaigns, the California District Court in *Playboy Enterprises, Inc. v. Netscape Communications & Excite, Inc.* was the first U.S. court to consider the

continued on page 3

IN THIS ISSUE

TRADEMARK: Court Rules in "Key Word" Dispute	1
PUBLIC DUTY: D.C. Court Reviews Police Mistake	1
BUSINESS TAXATION: R & D Credit in Software Development Industry	2
COMMERCIAL: Mechanic's Liens	3
STAFF NOTES	4

PUBLIC DUTY DOCTRINE D.C. COURT APPLIES DOCTRINE TO CLAIM OF POLICE MISTAKE

The District of Columbia Court of Appeals recently ruled that a trial court was correct in granting a motion to dismiss an action against the District of Columbia under the *public duty* doctrine where the Plaintiff relied to her detriment on a negligent misrepresentation of fact by a police officer at the scene of a fatal housefire.

Two of the Plaintiff's, Ms. Miller's, children died in a fire in her house when she and her husband exited the house after they were told by a policeman that the two children were safe on the other side of the house. When Ms. Miller was led around the house, she discovered that the two were not the children she had been trying to save, but a niece and cousin who had been staying at the house that night. The two children Ms. Miller was trying to save were still in the house and, tragically, perished in the fire. Ms. Miller brought suit against the District of Columbia under the survival and wrongful death statutes and alleged negligent infliction of emotional distress.

The law of the District of Columbia—as in most jurisdictions—is that the government has no duty to provide a public service to any particular citizen, that its duty is to the public at large absent a *special relationship*. Mrs. Miller alleged that the police in this instance owed her and her children a special duty of care, so the so-called *public duty* doctrine did not apply. The District of Columbia moved to dismiss the lawsuit. The trial court granted the motion, concluding that even if all of the allegations by Ms. Miller were true, the *public duty* doctrine still applied and the District owed the children and Ms. Miller no greater a duty than is owed the general public. Ms. Miller appealed the trial court's ruling.

In *Miller v. District of Columbia*, D.C. App. No. 02-CV-1312 (Feb. 5, 2004), the D.C. Court of Appeals first explained that the trial court had been correct that *Allison Gas Turbine v. District of Columbia*, 642

A.2d 841 (D.C. 1994) was the controlling precedent. In *Allison*, a helicopter crashed into the Potomac River with a pilot and three passengers. Civilian divers helped save the pilot but were then ordered by the Harbor Patrol to stay out of the water, even though the divers had offered to try to rescue the passengers. The Harbor Patrol waited until their equipment arrived to begin the rescue operation, which was, unfortunately, too late to save the three passengers. The *Allison* court explained that "under the public duty doctrine, the District has no duty to provide public services to any particular citizen." The Court further noted that "the duty to provide public services is owed to the public at large," and unless there has been direct or continuing contact between the victim and the police or government agency and the victim justifiably relied on that contact, then no specific legal duty exists. The Court in *Allison* held the District of Columbia immune from liability, concluding that the conduct of the Harbor Patrol officers was directly related to their on-scene responsibility during the rescue, which was an integral part of the officer's general duty to the public, therefore, not creating a special relationship.

The Court of Appeals in *Miller* determined that there was a potential difference between *Allison* and *Miller*. In *Allison*, the order to the civilian divers had been a judgment call by officer on the scene, which in turn made the passengers' condition worse as a result. In *Miller*, there was an alleged misunderstanding and misstatement of fact, which reduced the chance of rescue for the two children. To reconcile this, the Court looked to *Warren v. District of Columbia*, 444 A2d 1 (D.C. 1981) (en banc). In this case, the victims had called emergency services twice after they heard intruders in their home. The 9-1-1 operator told them that police were being sent to the house. The facts came out that an officer was dispatched to the house after the first call but, when no one answered the door, he left the scene; and, no one was sent after the second call. The

continued on page 4

BUSINESS TAXATION

THE R & D TAX CREDIT IN THE SOFTWARE DEVELOPMENT INDUSTRY

Section 41 of the Internal Revenue Code grants a tax credit for “qualified research” expenditures. The five requirements for qualified research are: first, the research must qualify as a research deduction under Section 174 of the Code; second, the research must be “undertaken for the purpose of discovering information”; third, the information discovered must be “technological in nature”; fourth, the application of the information discovered must be “intended to be useful in the development of a new or improved business component of the taxpayer”; and, fifth, “substantially all” the research must “constitute elements of a process of experimentation” for a valid purpose under the tax credit. A tax *credit* is a subsidy since it offsets dollar-for-dollar the taxpayer’s tax liability, whereas a *deduction* is only worth the deduction multiplied by the taxpayer’s marginal tax rate.

The legislative history of the research and development (R & D) tax credit reveals a Congressional intent to give incentives for companies to invest in research that might not otherwise be undertaken because of its high risks. Thus, the very uncertainty of the results of the research was the rationale for the tax credit in the first place. Congress considered that allowing experimentation to qualify for the tax credit where the feasibility of the final result was certain would undermine the rationale and might encourage companies to be conservative in their resource allocation, inducing them to concentrate on problems with a solution that was evident from the outset. Accordingly, for example, research spent on drugs to cure cancer, which has proven to be an almost impossible task, would clearly qualify for the credit.

The Court of Appeals for the Tenth Circuit recently clarified applicability of the R & D tax credit to commercial software development companies in *Tax and Accounting Software Corporation v. United States*, 301 F. 3d 1254 (10th Cir. 2002), *certiorari denied*, 123 S. Ct. 2246 (2003). Tax and Accounting Software Corporation (TAASC) develops and sells software for use by tax and accounting professionals. In 1993 and 1994, TAASC developed four computer software products for sale by customers. There was no question that some of the software was unique in

the functions provided. TAASC claimed a portion of its software R & D expenditures as tax credits under Section 41. The Internal Revenue Service (IRS) disallowed the credits and assessed deficiencies totaling \$317,000, a substantial sum for a small company. The U.S. district court granted summary judgment for the company and the government appealed. The Court of Appeals reversed.

The Court’s opinion is long and complicated, given the history of the case and the proceedings at the district court level. For purposes of this article, however, there were only two open issues with respect to the five requirements for “qualified research”: first, whether the research was “undertaken for the purpose of discovering information” and, second, whether substantially all the research constituted “elements of a process of experimentation.”

With respect to the first issue, the government argued that the “discovering information” requirement was only met if the taxpayer expanded or refined principles of the physical or biological sciences, engineering, or computer science. TAASC argued, on the other hand, that the requirement was met since it developed new and more efficient combinations of software that were not available to the public. The Court of Appeals disagreed with both the IRS and the taxpayer. With respect to TAASC’s argument, the Court reasoned that developing a new and useful product is by itself not enough. More is needed. On the other hand, the Service’s position was too stringent since it seemed to require basic discoveries in science. The Court’s position is an intermediate one. It held that new information must be discovered, separate and apart from the product being developed, but the discovery need not be one that advances the basic principles of computer science or rise to the level of expanding or refining the common knowledge of skilled professionals in a particular field of science or engineering.

With respect to the second issue on the meaning of “process of experimentation,” the Court concluded that this requirement had two aspects: first, whether the process of experimentation allows a taxpayer to use methods that are generally known, and, second, whether the test requires the taxpayer initially to believe that there is uncertainty as to whether the final result is feasible. As to the first sub-issue the Court concluded that the term “process of experimentation” can include research in which the taxpayer tries

alternative methods to achieve a result and all of the methods are already commonly known, but the taxpayer is uncertain which method will achieve the desired result. This, of course, is a completely logical conclusion since “virtually all research utilizes existing scientific principles and technology.”

As to the second sub-issue the IRS argued that the legislative history of Section 41 strongly suggested that qualifying research must from its outset involve some technical uncertainty about the possibility of developing the product. For example, debugging programs alone would not qualify because of lack of uncertainty as to the final result. TAASC, on the other hand, argued for a contrary reading of the legislative history based on a post-enactment conference committee report. The Court disregarded the subsequent Congressional comments as inapplicable to the original legislation. The taxpayer had conceded in its briefs and pleadings before the district court that it believed that its goal was technically feasible. Given that admission the Court of Appeals had no trouble finding that the taxpayer as a matter of law could not meet the “experimentation” requirement and, therefore, was not entitled to the credit.

The Court of Appeals’ outcome in this case is in accord with other circuits’ decisions. Moreover, the Court’s interpretation of Section 41 is reasonable given the original purpose of the R & D credit. This case and similar ones, however, are unlikely to be the last word on Section 41 for two reasons. First, it is probable that the information technology (IT) industry will use its political clout to attempt to amend Section 41. Second, and more importantly, such amendment would serve the needs of the country as much as the interests of the IT industry. There are truckloads of economic research studies conducted by the regional Federal Reserve banks demonstrating that the extraordinary productivity increases in the U.S. during the second half of the 1990’s were due in no small part to the wide application of IT in a variety of business settings. A moment’s reflection on how IT has increased the productivity of the readers of this article will no doubt confirm the scholarly work.

Please call Roy Morris or the author if you have any questions on business taxation in general or the R & D credit in particular.

NÉSTOR CRUZ

COMMERCIAL MECHANIC'S LIEN LAWS IN DC, MARYLAND & VIRGINIA

All states permit persons who performed work or provided materials for a construction project (whether that person is a contractor, subcontractor, builder, supplier or laborer) to claim a *lien* against the improved property. A mechanic's lien gives the subcontractor a security interest in the property. At its most extreme, the mechanic's lien can be foreclosed and the worker will be paid with the proceeds of the foreclosure sale. All state laws differ, however, and specific compliance with lien laws is crucial. If you provide work in multiple states, it is important to remember that familiarity with one state's lien laws does not protect you in another state. Below is a brief discussion of some of the important deadlines and key differences between commercial Mechanic's Lien laws in Virginia, Maryland and the District of Columbia.

Virginia

Claimants may file a "Memorandum of Mechanic's Lien" at anytime after the work is commenced or materials furnished but not later than 90 days from the last day of the month in which the claimant last performs work or provides materials (but not later than 90 days from completion of the entire project). Va. Code Ann. §43-4. Virginia further narrows the time period during which a claimant must act by prohibiting the filing of any lien seeking payment for work/materials provided more than 150 days prior to the date of last work. The memorandum is filed in the clerk's office in the county or city in which the building is located. The claimant must also provide notice to the property owner and general contractor as well. An owner in Virginia may assert as an affirmative defense that he has paid the general contractor for all work. Upon filing the memorandum, the lien is perfected. However, a lawsuit to enforce the lien must be filed within 6 months from the date the memorandum is recorded or 60 days from the time the building was completed – whichever is the last to occur. Va. Code Ann. §43-17. In Virginia a mechanic's lien relates back to the time the labor began even if the lien was not recorded in the land records at that time.

Maryland

A lien does not exist in Maryland until a lawsuit has been filed and a judge enters an order. Every building erected or repaired to the extent of 15% of its value is subject to a lien. A claimant must file a Petition to

Establish a Lien in the Circuit Court where the property lies within 180 days after the work has been finished or materials furnished. Md. Code Ann. Real Property § 9-105. A claimant must also provide notice within 120 days after doing the work or furnishing materials to the owner of the property. In Maryland the owner is responsible for paying the subcontractors even if he paid the general contractor in full. Thus, if the general contractor does not pay its workers, the owner may have to pay twice. This is an important difference between the lien laws in Virginia and Maryland. After the petition has been filed the court will set a show cause hearing and, assuming claimant is entitled to a lien, enter an order establishing a lien.

District of Columbia

The District of Columbia allows a party who has supplied labor or materials for the erection, improvement, repair of, or addition to, a building to file a Notice of Intention to Lien with the Office of the Recorder of Deeds within 90 days after the completion of work. DC § 40-301.01. The claimant must give notice to the owner as well. The lien shall be for the amount of the contract price or, in the absence of a contract, for the value of the labor or materials provided. An action to enforce a lien must be filed within 180 days after the filing of a notice of intention to lien or from the date of completion of the building.

The above-discussed deadlines are a very general overview of the lien laws in Virginia, Maryland and D.C. The deadlines and other requirements often vary depending on the type of work being performed, the type of building or structure being erected and the status of the worker performing the services. Among other issues, the state codes provide very specific instructions regarding filing requirements, notice, priorities, formats, waivers, defenses and status of *bona fide* purchasers. In general, the codes also provide sample forms for use when drafting petitions and other filings.

DANA THERIOT

TRADEMARK

continued from page 1

issue. The case arose when the defendant search engines sold a Playboy competitor banner advertising triggered by certain keyword search terms including the words "playboy" and "playmate"—trademarked terms of plaintiff, Playboy Enterprises. As a result, when users entered those keywords

into defendants' search engines, the resulting pages included banner advertisements for adult entertainment websites not sponsored or affiliated with Playboy but rather by its competitor.

Playboy sued the search engines for trademark infringement. The district court granted summary judgment in favor of the defendant search engines because "playboy" and "playmate" are common English words, there was no evidence presented that users typing these words into the search engine were seeking information about Playboy's goods and services and therefore there was little likelihood of confusion.

Playboy appealed the decision to the Court of Appeals for the Ninth Circuit. The Court of Appeals reversed the lower court's ruling and found that there were disputed issues of fact under which a jury could find significant likelihood of confusion. Specifically, the Court found that Playboy's strongest theory of likelihood of confusion is under a certain type of confusion—*initial interest* confusion. "Initial interest confusion" is customer confusion that creates initial interest in a competitor's mark. Although often dispelled before an actual sale, initial interest confusion impermissibly capitalizes on the goodwill associated with a mark and thus is actionable trademark infringement.

Applied to the *Playboy* case, there was potential initial interest confusion created when a user—looking for a Playboy product or service—typed the words "playboy" or "playmate" into defendant's search engine and received search results that included unlabeled banner ads for Playboy competitors. The user, confused as to whether Playboy sponsored the advertising, could then "click through" the advertiser's link to its site where it sells non-Playboy goods and services. Even if the user recognizes the competitor's site as entirely unrelated to Playboy, the damage has been done. The use of advertising generated by Playboy's marks initially confused the customer into believing that a competitor's site was sponsored by Playboy, and that competitor gained a potential customer through misappropriation of Playboy's trademarks. Accordingly, the Court of Appeals remanded the case to the lower court for a trial on the issue of trademark infringement under the initial interest confusion doctrine.

Shortly after the Court of Appeals decision, the parties settled the case. Nonetheless, as a result of the decision, the use of trademarks in "key word" advertising has become significantly less appealing to anyone except the registered owner of the marks.

TIMOTHY FEELY

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

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The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

STAFF NOTES

Ray Jones was the unlikely winner of the CMG Final Four Prognosticating Pool. All participants are thankful they don't try to do this for a living. *In a remarkable, contrarian move, Ray picked two finalists from the same side of the bracket...that's impossible, of course, but neither team made it anyway and Ray won on the strength of his early-round picks.*

* * *

Margarita and Néstor Cruz spent spring vacation in Belgium and The Netherlands. While in Amsterdam they were invited to dinner at the home of a firm's client, thus having the opportunity to experience some non-tourist sights.

* * *

Very graceful. Larry Carr, plodding but committed pre-dawn runner, broke a bone in his foot on St. Patrick's Day when he stepped on a rock. *Picking up the slack, Ray Jones and Scott Cummings have both started training for the upcoming Baltimore Marathon.*

* * *

Here's a wild and crazy idea: give blood. After 9-11, the enthusiasm for giving blood was unprecedented. While the need persists, donations have fallen back to pre-9-11 levels. The American Red Cross will be more than happy to take your call: (800) GIVE LIFE.

* * *

CMG recently completed a total changeover of its computer system. Painless...seamless...transparent...proactive...Bingo! *Now, how do I screen all these e-mails from deposited royalty looking to deposit \$400 million in my bank account?*

PUBLIC DUTY DOCTRINE

continued from page 1

victims, relying on the information from the 9-1-1 operator, went downstairs to help a friend, were caught and victimized by the intruders. The Court sustained a dismissal of the action relying upon the *public duty* doctrine, even though the public officer had misstated a fact, and the victims had relied on that misstatement.

Considering both *Allison* and *Warren*, the Court in *Miller* concluded that "actions of the police during a rescue operation are

protected by the public duty doctrine and are not subject to retrospective dissection at trial." The Court of Appeals explained that even when a plaintiff relies on a negligent misrepresentation of fact instead of on the discretionary assessment of a rescue scene, the *public duty* doctrine still protects decisions of emergency personnel. Consequently, the trial court was correct in dismissing the case with prejudice.

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