TORT AND INSURANCE PRACTICE

Committee News

Spring 2002

Intellectual Property Law Committee

UNDERSTANDING CERTAIN BANKRUPTCY HURDLES FOR TECHNOLOGY COMPANIES

by Risa Lynn Wolf-Smith and Erin Connor

Technology companies typically own or license essential intellectual property. Through various contracts such as license agreements, cross-license agreements, website design and development agreements, software development agreements, web page linking agreements, technology sharing agreements, joint ventures for sharing intellectual property rights, and other agreements, technology companies operate their businesses using valuable patents, copyrights, and trademarks. These contracts are generally deemed "executory contracts" in bankruptcy and are often the most valuable "assets" an e-commerce or dotcom debtor possesses. However, a bankruptcy filing may strip the value of such executory contracts and cripple a company's efforts to reorganize. This article will explore certain bankruptcy rules that pertain to executory contracts of intellectual property and suggest practical methods for maintaining their value in bankruptcy.

Section 365 of the Bankruptcy Code offers special treatment for executory contracts involving intellectual property. Under the "Countryman definition," contracts under which performance remains due on both sides are

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Is Your Company Committing Software Piracy?

by Daniel J. Glivar

Before you answer "of course not," chances are approximately 25% that the business-related software applications and programs your company installed during 2000 and uses in its day-to-day operations ***are pirated and subject your company to copyright infringement claims.*** According to the International Planning and Research Corporation's 2000 Global Software Piracy Report, one in four business software applications installed in North America (the United States and Canada) in 2000 has been illegally installed and/or used.

What Is Software Piracy? Stated simply, software "piracy" is the ***unauthorized copying (and/or use) of a software product.*** In legal terms, software piracy constitutes copyright infringement. Perhaps the

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... bringing together plaintiffs' attorneys, defense attorneys and insurance and corporate counsel for the exchange of information and ideas.

Chair

Kari Jo Wangensteen
Dell Computer Corporation
Legal Department
PO Box 149280
Round Rock, TX
(512) 728-1304
Fax: (512) 728-1881
kari_wangensteen@dell.com

Chair-Elect

Charles J Morton, Jr
Venable Baetjer & Howard
2 Hopkins Plz, Ste 1800
Baltimore, MD
(410) 244-7716
Fax: (910) 659-1350
cjmorton@venable.com

Council Representative

G Glennon Troublefield
Carella Byrne et al
6 Becker Farm Rd, Ste 3
Roseland, NJ
(973) 994-1700
Fax: (973) 994-1744
gtroublefield@carellabyrne.com

Last Retiring Chair

Jeffrey M Thompson
4200 Multifoods Twr
33 S 6th St
Minneapolis, MN
(612) 371-1306
Fax: (612) 338-8384
jthompson@meagher.com

Newsletter Editor

Kristine Mary Miller
Holland & Hart LLP
1050 Walnut St, Ste 500
Boulder, CO
(303) 473-2726
Fax: (303) 473-2720
kmiller@hollandhart.com

Web Site Coordinator

Jonathan E Lass
National Instrument Corp
6207 Turtle Point Dr
Austin, TX
(512) 683-6915
Fax: (512) 683-6913
jonathan.lass@ni.com

Vice-Chairs

Debra A Chong
Virtual Boardwalk
5059 Geary Blvd
San Francisco, CA
(415) 876-0800
Fax: (415) 876-0850
debbie@lenos.com

Eric S Henshaw
239 Water St
Boyertown, PA
ehenshaw@fplc.edu
Law Student Vice-Chair

Michael J Polelle
John Marshall Law School
315 S Plymouth Ct, Ste 426
Chicago, IL
(312) 987-1440
Fax: (312) 427-9974
fpolelle@jmls.edu

Carolyn M Sandberg
Schwegman Lundberg et al
TCF Tower
121 S Eighth St, Ste 1600
Minneapolis, MN
(612) 373-6900
Fax: (612) 339-3061
csandberg@slwk.com

Christopher John Schulte
Meagher & Geer PLLP
4200 Multifoods Twr
33 S 6th St
Minneapolis, MN
(612) 371-1314
Fax: (612) 338-8384
cschulte@meagher.com

William Carl Steffin
Squire Sanders & Dempsey LLP
801 S Figueroa, Fl 14
Los Angeles, CA
(213) 689-5130
Fax: (213) 623-4581
nsteffin@ssd.com

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Letter from the Chair

To many practitioners, Intellectual Property is esoteric and academic. Such practitioners mistakenly believe that there is limited application to their "real world" practices. The articles in this edition of the Committee News for the Intellectual Property Committee illustrates how shortsighted such thinking can be.

The collapse of Enron is certainly the biggest bankruptcy news in recent memory, but it is hardly the only one. There were over 39 bankruptcies of billion dollar companies in the last year. Bankruptcy filings are on the rise and technology companies are participants--some as debtors and others as creditors. IP rights can be a key asset that the debtor should be protecting and the creditors should not unknowingly disregard. The article by Risa Lynn Wolf-Smith and Erin Connor highlights how to protect licenses in a bankruptcy filing no matter which side one is on. In these current economic times, such guidance is practical for any practitioner.

Enron's collapse has lead to a new awareness of the ethical responsibilities professionals must maintain even when dealing with a large and influential client. One ethic obligation is not to assist or counsel a client to engage in conduct that the lawyer knows is criminal or fraudulent. Daniel Glivar's article on software piracy reminds us all of the need to help prevent our clients from committing copyright infringement in their software dependent work environments.

IP does not stand for an "intellectual pursuit." Intellectual Property is relevant to virtually every commercial lawyers practice and the everyday world. It is important for this Committee to help demystify the IP practice.

Kari Jo Wangensteen, *Dell Computer Corporation,* Legal Department, PO Box 149280, Round Rock, TX 78714-9280, Business: (512) 728-1304, Fax: 512-728-1881, Kari_wangensteen@del.com

-WANTED-

Project Out-Reach, the ABA Section Officers Meritorious Award recipient, is a co-sponsored high school peer mediation project of the ABA Tort and Insurance Practice Section, the ABA Dispute Resolution and the ABA Young Lawyers Division.

Project Out-Reach is looking to expand its program to include six new high schools. Criteria - School officials will need to commit their schools and volunteers for individual high school peer mediation programs.

Teams of three attorneys trained in mediation techniques will assist school administrators with implementation decisions, conduct training and follow-up meetings; working with new or existing school-based mediation programs. For more information, please contact Sonia Schroeder, ABA Tort and Insurance Practice Section, 312/988-6229 or schroeders@staff.abanet.org.

Software Piracy?...

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most important (and misunderstood) element of copyright infringement is that ***it occurs upon copying (which includes installation), and NOT upon actual use.*** For example, if a computer program is installed (copied) onto a personal computer workstation or a network server, copyright infringement may have occurred regardless of whether such program actually is ever used.

Who Owns The Software? The media containing a software program (usually a disk) is sold to the user, but the actual software program contained on the media generally is provided under a limited use license. The user is deemed to have agreed to such license upon opening, installing and/or using the software program. The most common forms of license agreements between the software provider and user are (1) a "shrink-wrap" license (a written license packaged with the disk inside a plastic shrink-wrap, which usually becomes effective upon opening), (2) a "click" license (which becomes effective after the user accepts by clicking at various prompts during installation), or (3) a formal written license agreement executed by the provider and user (generally for network-installed software). Failure to comply with the terms and conditions of the applicable license may constitute a breach of contract and subject the user to civil and/or criminal penalties.

How Does Software Piracy Happen? Software piracy happens every day in various forms, including copying workplace software for use on a home computer, failing to obtain (and maintain) the proper number of user licenses, or simply "sharing" a floppy disk with a friend or co-worker. In the case of a company or organization, however, ***software piracy generally is the unintended result of one or more of the following circumstances:*** (1) software previously purchased by a company for one workstation routinely was copied onto new computers and servers purchased by the company without purchasing new licenses or additional "seats" for such software; (2) the person or department responsible for software purchases and/or installation did not retain the license agreements, purchase orders, invoices, or receipts proving that the company purchased such software; and/or (3) software or computer purchase receipts do not specify the type of software purchased or the number of permitted users of such software. Any one of the foregoing scenarios results in a company being unable to prove that it has purchased--and has the legal right to use--the software that it currently has installed. ***Software piracy is especially prone to occur during rapid business expansion, management changes or employee turnover--primarily due to poor record-keeping and the absence of a standard software use and control policy.*** Even though unauthorized installations and copying may occur without company management's knowledge, no intent is required, vicarious liability applies, and ignorance of the law is no excuse.

Who's Looking? The Business Software Alliance (BSA) and the Software and Information Industry Association (SIIA) are the two major enforcement groups that have been created primarily to eliminate (or at least minimize) software piracy on behalf of a software industry that lost approximately $11.75 billion to software piracy in 2000 alone. These associations represent the interests of software developers such as Adobe Systems Incorporated, Apple Computer, Inc., Autodesk, Inc., Bentley Systems, Inc., Lotus Development Corporation, Macromedia, Inc., Microsoft Corporation, and Symantec Corporation, and view the unauthorized copying or use of software products as if the software had been shoplifted directly from the shelves of the local computer store. There is little sympathy for infractions, as minor as they may be.

How Do They Know? Each of the BSA and SIIA have set up toll-free anti-piracy reporting hotlines as well as Internet websites with e-mail reporting links (see www.bsa.org and www.spa.org). These hotlines and e-mail links enable any person with knowledge of a company's computer systems or software use to report violations. By guaranteeing that all

reported violations will be held in the strictest confidence, will not be disclosed without the prior authorization of the reporter, and that no telephone calls are recorded or traced, the BSA and SIIA encourage a company's former employees, current unhappy employees, and competition to report such company's unauthorized use of software. ***These confidentiality assurances make it simple for even the non-confrontational "whistle-blower" to reveal a company's violations.***

What Are The Penalties? Section 504 of the federal Copyright Act provides for two measures of damages for copyright infringement in civil actions: (1) actual damages based on the number of copies misappropriated or (2) statutory damages, which range from ***$750 to $30,000 per work infringed.*** The court may increase statutory damages up to $150,000 per work infringed where it determines that the infringement was willful. The court also may award costs and reasonable attorneys' fees to the prevailing party. For ***felony*** violations, federal law carries a maximum five-year prison term for first-time offenders and up to 10 years for repeat offenders, with fines of up to $250,000 for individuals and $500,000 for organizations. For ***misdemeanor*** violations, there is a maximum fine of $5,000 for individuals and $10,000 for organizations. The BSA reports that it has collected more than $68 million over the past nine years from United States companies using unlicensed software.

How Your Company Might Find Out. The BSA and SIIA will send a letter to any company for which they have received information regarding the possible illegal duplication of commercial software products. Generally, the letter will state that unauthorized duplication of software constitutes copyright infringement and that the software companies representatives are fully prepared to pursue all available legal remedies, but will offer the company an opportunity to conduct an internal, company-wide software audit and investigation to determine the circumstances that led to such copyright infringement. The letter also will prohibit the deletion or de-installation of any software currently installed that is published by the software companies represented by the association (for evidentiary purposes) and will prohibit the company from negotiating with any sales representatives or vendors to purchase additional software licenses in order to remedy existing shortfalls. If your company chooses not to respond to the letter, and the reported violation appears to be factually based and reasonably reliable, then there is a risk of a lawsuit being filed and your company becoming subject to an unannounced audit (with the assistance of the United States Marshal's Office).

What To Do If Your Company Gets "The Letter." If your company receives a letter from the BSA or the SIIA, you should consider contacting an attorney. If your company decides to cooperate with the BSA or SIIA to settle an infringement claim, then your company will be required to (1) delete all unauthorized copies of software currently installed, (2) pay a penalty with respect to such deleted software (usually calculated by multiplying the MSRP of the software by a multiplier (as high as 1.5)), (3) buy appropriate licenses for any newly installed software, and (4) pay all attorneys' fees and other costs relating to the investigation and resolution of the copyright infringement claim. Any party entering into a settlement should consider obtaining a confidentiality and non-disclosure agreement so that the terms of such settlement do not end up as first-page news (on a published website or otherwise).

An Ounce of Prevention. The best way to ensure that your company does not commit software copyright infringement is to (1) adopt, employ and enforce a comprehensive internal software management policy, (2) perform periodic audits of company computers and networks, (3) maintain current, accurate and complete records with respect to all software purchases (*e.g.,* keep copies of all software invoices and license agreements for proof of purchase), (4) understand the company's license agreements, and (5) educate management and employees

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regarding compliance with copyright laws (*e.g.*, have each employee execute a standard form of Employee Software Use Policy). The BSA and SIIA also provide auditing software, guidebooks, workplace courses, videos, posters and other employee awareness materials.

A Pound of Cure. Once software has been illegally installed or used, copyright infringement has occurred, and the destruction, deletion or removal of such software will not remedy the infringement. Upon discovery that unauthorized software programs have been installed or are being used at your company, management immediately needs to take appropriate remedial action. Such remedial action may include contacting the applicable software vendor and purchasing the requisite number of additional licenses. Generally, the vendor appreciates the company's honesty and is willing to sell the additional licenses without further action. ⚖

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considered executory for bankruptcy purposes. Although the Bankruptcy Code itself contains no definition of the term "executory contract," bankruptcy courts apply the Countryman definition to analyze the unperformed duties of each party and thus determine "executoriness."

Once a contract is deemed to be "executory," Section 365(a) governs its assumption and rejection. In general, a debtor may exercise "business judgment" to decide whether to assume or reject an executory contract, assessing the benefits and burdens to its business which flow from the contract. If a debtor decides that the benefits of a particular contract outweigh its burdens, it will file a motion with the bankruptcy court requesting that assumption be allowed. In order to assume an executory contract, however, a debtor must cure all defaults under the contract, or provide "adequate assurance" that it will promptly cure, and provide adequate assurance of future performance. If a debtor rejects an executory contract, the contract is deemed breached as of the date of the debtor's bankruptcy petition, and the nondebtor party may file a general unsecured claim for damages.

If the debtor is a licensee of patents or copyrights, the filing of a bankruptcy petition may trigger a number of unexpected hurdles to continuing essential license rights. An executory contract may not be assigned if "applicable nonbankruptcy law" excuses the nondebtor party from accepting performance from or rendering performance to an entity other than the debtor. Because the courts have concluded that patent and copyright law constitutes applicable nonbankruptcy law that excuses performance from another, the Bankruptcy Code prohibits assignment of intellectual property licenses without the consent of the nondebtor party, even if the license in question is silent on any consent requirement. Trademark law, however, is distinguishable and permits unauthorized assignment unless the use of the trademark by the assignee is likely to confuse, cause mistakes by, or deceive customers.

In addition, many courts have held that a literal reading of Bankruptcy Code 365(c)(1) (dealing with assumption and assignment of executory contracts) prohibits **even the assumption** of an intellectual property license under a so-called "hypothetical test." At the Circuit Court level, a majority of courts have endorsed the "hypothetical test." These courts reason that a debtor-in-possession may not **assume** an executory contract over the nondebtor's objection if applicable nonbankruptcy law would bar **assignment** to a hypothetical third party, even where the debtor-in-possession has no intention of assigning the contract in question to any such third party.

Obviously, a bankruptcy decision preventing a debtor with critical IP license agreements from assuming those agreements would not only cripple the debtor and its business,

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COMMITTEE UPDATES

by Kari Wangensteen, Committee Chair

The Committee is always looking for ways to increase the value of your membership. Here are some of the things we have been doing:

The Annual CLE Program

In addition to our Committee News, the Committee is co-sponsoring at this year's ABA Annual Meeting an exciting program entitled, "Applied E-Risk Management: Real Problems. Real Solutions." This practical "how-to" program will be held on Saturday, August 10, 2002, from 9 a.m. to noon. Topics will include discussion about an E-Activity Matrix, Basic E-Risk Profiles, An Ounce of E-Prevention and An Ounce of E-Cure. See Chuck Morton's article in this Newsletter for information on how to sign up for this program.

Committee Meetings

Monthly. On the fourth Thursday of each month, the Committee holds a business meeting by telephone. The hourly conference call, which starts at 2:00 pm Central Time, is an opportunity for us to discuss Committee business as well as participate in round-table discussions.

Annual. The Committee will hold its Annual Business meeting on Saturday, August 10, 2002, from 7:30 am to 9:00 am, Eastern Time, at the ABA Annual Meeting in Washington, D.C.

Committee Resources

Newsletters. The Committee publishes written materials that are useful to the intellectual property lawyer. Currently, we publish a periodic newsletter. If you wish to contribute an article to future editions, please contact the Newsletter Editor, Kris Miller, at kmiller@holland-hart.com. A goal for this coming year is to publish E-Alerts to provide our members with up-to-date information on hot new topics.

Web site. Visit our Web site to access daily intellectual property updated news; intellectual property cases; Committee program materials and presentations. Also check out our new Intellectual Property Information eXchange (IPIX) service where you can access intellectual property practitioners who have volunteered to share their expertise with you. You can also participate in a bulletin board service to exchange ideas.

Membership

The Committee is always interested in new ideas and new members. If you are interested in intellectual property law, then this is the place for you. Please feel free to contact me [kari_wangensteen@dell.com] or the Committee's Chair-Elect or any of the Vice-Chairs for more information.

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but stymie any potential reorganization. Moreover, if the debtor intends to rely on the assignment of valuable license agreements to reorganize its business, a prohibition on assignment would defeat that intent.

There are several means by which a licensee/debtor can maintain licenses in bankruptcy.

Once in bankruptcy, involve the licensor parties as early as possible, and lobby for their support. There are benefits to the licensor in permitting a debtor to assume and assign its license. For example, the prospect of additional license fees or the retention of cross-licenses may be incentives for consent. If the licensor consents to assignment, the debtor should be permitted to both assume and/or assign the license.

Also, a licensee debtor can allow the license to "pass through" the bankruptcy without assumption or rejection. At the conclusion of the case, all property of the estate revests in the debtor. Although a licensor may seek to compel the debtor's assumption or rejection, or request relief from the automatic stay in order to terminate the license, the bankruptcy court should permit the debtor to continue to use the license throughout the case as long as the debtor is current on its royalty obligations.

It is better, however, to consider these issues up front, when negotiating the license agreement in the first place. Consider adding a bankruptcy clause which affirmatively states that in the event the licensee files for bankruptcy, the debtor/licensee or trustee has the explicit right to assume the license and to continue to use the technology. To bolster the enforceability of such language, the agreement should state that patent, copyright or other applicable intellectual property law does not control assignment for purposes of the assumption by the debtor of the license agreement. This language may only be appropriate in certain situations, for instance, in the case of a cross-license between parties with relatively equal bargaining leverage.

Additionally, consider making the license an exclusive license. The characterization of a license as "exclusive" or "nonexclusive" may affect the determination of whether a contractual arrangement is an executory contract in the first place. Under a nonexclusive license, the licensee has a mere right to use the intellectual property, but the licensor retains the rights of ownership. Under an exclusive license, the licensor may be deemed to have transferred title to the licensee in a "nonexecutory sale." A nonexecutory sale would not be subject to assumption or rejection. Note, however, that the label given to a contractual arrangement is not dispositive, and the courts will look to the true nature and economic reality of the contractual relationship.

Finally, if a joint venture between unrelated parties is contemplated, consider contributing the technology to the venture so that the venture can continue to operate in the event of the bankruptcy of either joint venturer.

Until the enactment of Section 365(n) of the Bankruptcy Code in 1988, licensees were also at risk when their licensors declared bankruptcy. If the debtor/licensor rejected the license agreement in question for its own business reasons, the licensee would be left with a terminated license and forced to forfeit its license rights. This statute now provides special protections for licensees to avoid these harsh results.

Under this provision, the nondebtor licensee may elect to either (a) treat the license as terminated, breached and retain a general unsecured claim, or (b) continue to use the intellectual property (trademarks and tradenames are omitted from the definition of intellectual property). If the nondebtor licensee elects to retain its rights, the debtor licensor is only required to: (a) provide access to the intellectual property; (b) not interfere with the exercise of the licensee's rights under the license; and (c) comply with any exclusivity provision in the license agreement.

The licensee must continue to pay royalties and must waive any rights it may have to setoff or administrative claims for unperformed affirmative obligations of the licensor. In addition to retaining the rights under the license

agreement, the licensee may also retain rights under "any agreement supplementary to such contract." A source code escrow agreement would likely be considered an agreement supplementary to a license agreement.

A source code escrow agreement is a contract among the technology licensor, the licensee and a third party who serves as an escrow agent. The escrow agent provides a repository for the human readable program statements, called the source code. A source code escrow agreement establishes the conditions under which the escrow agent may release the source code to the licensee, such as the filing of bankruptcy by the licensor.

Source code escrow agreements have traditionally been used by licensees attempting to avoid the negative impact of a bankruptcy filing by their licensors. In such circumstances, the existence of a source code escrow agreement may protect the licensee's use of technology despite rejection of a license agreement by the licensor in its bankruptcy. An agreement "supplementary" to the license agreement, such as a source code escrow agreement, should be protected and enforceable when a licensee elects to retain its rights under Section 365(n).

No cases have been published that test the enforceability of a source code escrow agreement in bankruptcy. One court has suggested that source code escrow agreements should be enforceable, and several bankruptcy cases consider the enforceability of other types of escrow agreements. Those cases hold that escrow agreements are enforceable so long as certain formalities are followed. Below is a list of items which should be included in any source code escrow agreement.

The escrow agent should be a neutral third party and ideally, a party that specializes in administering technology escrow accounts. Because a source code escrow agreement is a form of express trust, the escrow agent must serve as a trustee for the benefit of the escrow beneficiary, the licensee. The escrow agent should not be affiliated with either the licensor or licensee other than in its capacity as agent for the escrow.

The source code escrow agreement should be a written contract that covers the following subject matter. The source code escrow agreement must clearly identify the property that is to be placed in escrow. The source code escrow agreement must also clearly establish the conditions under which the source code is to be released. In the event that the source code is released, the source code agreement should define the permissible uses for the released source code.

The source code should be delivered to the escrow agent and be fully documented and commented. The Bankruptcy Court must be able to identify the escrowed property and distinguish it from other assets of the debtor. Often licensees and licensors develop new technologies based on existing technology. A fully commented and documented copy of the source code will aid the court in distinguishing the property that is in escrow from the property of the estate.

An experienced technology escrow agent can help with the administration of the escrow account and can recommend procedures for ensuring that the source code is maintained by the licensor and that documentation and comments are up to date. The source code escrow agreement should address issues such as updates to and maintenance of the source code, an audit process and termination procedure. An experienced technology escrow agent will likely have a form of escrow agreement that will cover these issues.

In summary, under the Bankruptcy Code, license agreements used by technology companies are generally held to be "executory contracts." As such, whether you or your clients are a licensee in bankruptcy or a victim of a licensor's bankruptcy, a bankruptcy filing may strip the value of a license agreement and cripple a company's efforts to reorganize. There are, however, practical devices that can be used to maintain the value of technology licenses in bankruptcy. As a licensee, take steps to ensure that you will be in a position to assume and assign the license in the event you become bankrupt. In the event that the licensor becomes bankrupt, Section 365(n) offers some protection for licensees. This protection can be bolstered by the use of a source code escrow agreement.

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ALERT: APPLIED E-RISK MANAGEMENT PROGRAM

by Chuck Morton, Chair-Elect

The IP Committee, along with the E-Commerce, Insurance Coverage and the Self-Insured and Risk Managers Committees of TIPS, and the Cyberlaw Committee of the Business Law Section, is pleased to sponsor "Applied E-Risk Management: Real Problems, Real Solutions" at this year's Annual Meeting. The program will take place in Washington, D.C. on August 10, from 9:00am-12:00pm. National speakers will address insurance and non-insurance ways to limit the inherent risk of conducting business in the new economy.

The Program Chair is our own Kari Wangensteen, Chair of our Committee. Chair-Elect Chuck Morton, and Chair-Elect Designee Chris Schulte, have also played an active role in developing the curriculum. This program marks the continuation in a long series of such programs sponsored by our Committee. Past programs have been well received. We look forward to seeing you in August.

Immediately following the program, an informal lunch for Committee members will be held at an, as of yet, undetermined location. If you are interested in attending the lunch, please contact Chair-Elect and luncheon coordinator, Chuck Morton, at cjmorton@venable.com.

TIPS LAW IN PUBLIC SERVICE COMMITTEE UPDATE

DOMESTIC VIOLENCE PROJECT

TIPS joined forces with the ABA Commission on Domestic Violence to develop and distribute a brochure that provides safety tips for victims of domestic violence. The focus of the program is to make this potentially life-saving information available in work places around the country.

In addition to the physical and psychological damage suffered by victims of domestic violence and their families, there is a direct impact in the work place. Generally, 70% of domestic violence victims are employed and over 70% of them report that the abusers harassed them at work, either over the telephone or in person. Perpetrators cause over 60% of the victims to be either late to and/or absent from work. Domestic violence in the work place costs an estimated 4 billion dollars a year in absenteeism, employee turnover and lower productivity. The answer is not to fire the employee/victim, although sadly that often has been the corporate response. The safety brochure is a simple, but effective tool that provides critical information for victims of domestic violence in a short, direct and easy-to-use form. By distributing the brochure, the employer not only assists the victim in keeping safe, but also preserves the corporate investment in the employee's training and work.

To date, we have received an excess of requests for brochures from employers and other service providers around the country. Major corporations, such as Liz Claiborne and AFC Enterprises, Inc., the parent company of Church's Chicken, are participating in this program. The State of Florida has distributed the brochures to all state employees. Numerous law firms are distributing the brochures to their clients and employees.

You can help this cause by introducing this program to your law firms and clients, and urging them to participate. Preprinted brochures are available and the brochures can also be customized to provide individual company and local information. The brochures are currently available in English and Spanish (hard copies or a 3.5 diskette) and is available in several other languages.

You may also order the Domestic Violence Safety Plan Implementation Kit for Employers.

If you or your clients need additional information on how to order materials, please contact the ABA Service Center at 1/800-285-2221.

2002 TIPS CALENDAR

June 5-7	JCEB ERISA Basics	New York, NY
August 9-13	ABA Annual Meeting	Washington, DC
10	JCEB Executive Compensation	Washington, DC
11	JCEB Breaking Up is Hard to Do: Benefit Implications of Business Failures & Restructuring	Washington, DC
October (TBD)	JCEB Health & Welfare Benefit Plans	Washington, DC
17-18	Aviation Litigation	Washington, DC
November (TBD)	JCEB ERISA Litigation	Chicago, IL
(TBD)	Back to the Fundamentals: Insurance Regulation, Broker-Dealer Regulation, Investment Advisor Regulation	Washington, DC
7-8	JCEB Compensation for Executive & Directors	New York, NY
December 14-16	U.S. Supreme Court Ceremony	Washington, DC