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# *Intellectual Property Licensing Agreements and How Definitions of “Affiliates” or “Subsidiaries” Can Make or Break Your Licensing Agreements*

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Licensing agreements that involve intellectual property require intensive negotiations over financial terms, such as the royalty rates, as well as non-financial terms, such as the scope of the parties involved. Defining terms like “Affiliates” or “Subsidiaries” is typically considered boilerplate language, and yet these terms can be the most important.

Whether to include certain terms or definitions in contracts depends on if those terms help reduce risks and misunderstandings and provide legal rights to both parties that might not have otherwise been interpreted correctly without such terms or definitions. “Affiliates” and “subsidiaries” are such terms that parties to a licensing agreement must define, especially in regard to temporal limitations. There can be all

kinds of consequences in failing to properly define these terms.

Generally, “affiliates” and “subsidiaries” are defined as entities that are, become controlled by, or in control of one of the parties in a licensing agreement. The issue lies in whether the terms “affiliates” or “subsidiaries” in the licensing agreement include after-acquired affiliates or subsidiaries—affiliates or subsidiaries that gained control after the Effective Date of the signing of the licensing agreement. Given that licensing agreements tend to span over years, it is likely that new subsidiaries or affiliates may be created or acquired while older ones may have been terminated or expired since the Effective Date. Therefore, it is essential to negotiate and determine, between the parties, whether after-acquired affiliates or subsidiaries are covered within the agreement.

Every substantive term in the license should be defined with as much detail necessary to avoid litigation. By familiarizing oneself with past case law involving licensing agreement disputes, certain foreseeable points of contention can easily be avoided. The following are five cases that delineate how the scope of the definition of “affiliates” or “subsidiaries” greatly affects a court’s legal conclusion of the scope of a licensing agreement. Note that the cases below are from difference jurisdictions and any comparisons between the cases are only to serve as points of consideration when drafting a contract, regardless of jurisdiction.

## ***Paul M. Ellington v. EMI Music, Inc***

For newly drafted agreements, especially involving copyright licensing agreements in New York, clients and drafters need to be mindful of what the term “affiliates” embodies and explicitly define its temporal constraints, or else the agreement may be

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assumptively including only affiliates existing at the time of the Effective Date of the agreement.<sup>1</sup>

Plaintiff Paul Ellington, the grandson and heir of Duke Ellington, sought a claim for a breach of contract against EMI Music (“EMI”) for effectively “double-dipping” into the royalties of the foreign sales of Duke Ellington’s music.<sup>2</sup> In the contract, the royalty provision at issue required EMI to pay Ellington “a sum equal to fifty (50%) percent of the net revenue actually received by [EMI] from foreign publication” of the relevant musical compositions.<sup>3</sup> Under the provision, Ellington was to collect royalties based on income received by a publisher after the deduction of fees charged by foreign sub-publishers.<sup>4</sup> However, at the time of the agreement, foreign sub-publishers were typically not affiliated with domestic music publishers whereas recently, many domestic publishers, including EMI, have become affiliated with foreign sub-publishers.<sup>5</sup>

In an audit report of EMI, Ellington discovered that the affiliated foreign sub-publishers retained 50% of the royalties while the remaining 50% was split between EMI and the Ellingtons.<sup>6</sup> Effectively, because the foreign sub-publishers were not considered affiliates under the calculation, 50% of the income received through the affiliated foreign sub-publishers and 50% of the remaining income, resulting in 75% of the income, were received by EMI and “affiliates” in sum.<sup>7</sup>

However, the Court held that unless there was explicit language demonstrating the parties’ intent to bind future affiliates of the contracting parties, the term “affiliates” only pertained to those affiliates in existence at the time the parties executed the contract.<sup>8</sup> The Court analyzed the parties’ intent and held that the use of present tense language, and not forward-looking language in the agreement, demonstrated the parties’ intent to bind only affiliates in existence at the time of the agreement.<sup>9</sup>

In a later clause, the Court further analyzed that the use of Ellington’s confirmation that “any other affiliate companies of [EMI] not specifically mentioned, *were and are now* possessed of and are entitled to the original copyright of the [relevant] musical compositions” was probative of an intent to limit the agreement to then-current affiliates.<sup>10</sup> Thus, the Court of Appeals of New York held that the contractual term “affiliates” was unambiguously defined as those affiliates that were in existence at the time the agreement was executed, which did not include any future affiliates.<sup>11</sup>

However only four of the seven justices for the New York Court of Appeals supported the holding, with a fifth only concurring with the result while rejecting the majority’s interpretation of “affiliates.”<sup>12</sup> The other two justices dissented, stating that the term “affiliates”

was ambiguous and that Ellington’s interpretation seemed at least as reasonable as EMI’s and should not have been decided by the Court on a motion to dismiss.<sup>13</sup> The dissenting opinion focused on the policy issues of the precedent set by the majority opinion and contended that there was enough ambiguity to have sufficiently pled a cause of action for breach of contract. However, with *Ellington* now as precedent for newly drafted agreements, especially in New York, practitioners need to consider including future-looking language for relevant terms such as “affiliates.”

## ***IP Co., LLC v Cellnet Technology, Inc.***

A District Court of the Northern District of Georgia held that a lack of express imitations to only then-current affiliates shows that there was no intent for any temporal limitation in regards to qualifications for an “affiliate” under an agreement.

After a series of interrelated patent licensing and assignment agreements involving wireless mesh network systems between Plaintiff SIPCO, LLC (“SIPCO”) and Defendant B&L Tech Company (“B&L”), SIPCO and its related company IP CO., LLC (“IP CO.”) filed a lawsuit asserting breach of contract claims against B&L and Hunt Technologies, LLC (“Hunt”) after Hunt purported to obtain B&L’s assets.<sup>14</sup>

In 2003, three former B&L employees formed the separate company SIPCO as a part of a reconstruction of B&L, and later in 2004, SIPCO and B&L executed a Licensing Agreement, wherein B&L licensed and assigned certain patents to SIPCO in return for royalty payments.<sup>15</sup> Part of the agreement was that B&L retained rights to the patents within the utility industry and granted SIPCO rights to the patents outside the utility industry.<sup>16</sup> In a Notification Agreement, additional to the Licensing Agreement, B&L and SIPCO agreed that B&L must give SIPO notification of B&L’s intent to sell or transfer the licensed patents to any third party and give SIPCO the right to purchase the patents on the same terms as offered to the third party.<sup>17</sup> However, one exception in the Notification Agreement was that if the sale was to Landis & Gyr, Inc. (“L&G”), or in certain specified situation to an affiliate of L&G, there was no need to provide notice or a right of first offer to SIPCO.<sup>18</sup>

In 2005, SIPCO and B&L executed a Release Agreement to modify the terms of the Licensing and Notification Agreements in order to (1) reduce the royalty and payment obligations by SIPCO, (2) modify a potential bar to SPICO’s plan to transfer its patent assets to a holding company, and (3) allow

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B&L to assign its assets, “without prior authorization of [SIPCO], to an entity that acquires at least substantially all of the assets of B&L.”<sup>19</sup>

Then in 2006, B&L entered into an Asset Purchase Agreement with Hunt, wherein B&L assigned “substantially all” of B&L’s assets, including the patents that had been licensed to SIPCO under the Licensing Agreement without giving notice to SIPCO or the opportunity to purchase the licensed patents on the same terms as offered to Hunt.<sup>20</sup> Thereafter, SIPCO and IP Co. filed a lawsuit asserting breach of contract against B&L and Hunt.

One of the pertinent issues discussed on motion for summary judgment was whether the Hunt transaction violated the Notification Agreement. One of the arguments that SIPCO made was that Hunt was not an “affiliate” of L&G as termed in the Notification Agreement. The Licensing Agreement defined affiliate of entity as “a person or entity that controls, is controlled by, or is under common control with the entity.”<sup>21</sup>

SIPCO conceded that Hunt and L&G were under the common ownership and control in 2006 however, they argued that when the parties executed the Notification Agreement in 2004, they were not.<sup>22</sup> The court held that because neither the Licensing Agreement nor the Notification Agreement expressly limited the definition to only current affiliates of L&G and that in another clause of the Notification Agreement the sale of B&L’s business was to L&G or “its successors in interest,” there was no intention of any temporal limitation.<sup>23</sup> Thus, the court stated that because the parties could have easily included such a limitation if that had been their intention, but did not, Hunt qualified as an “affiliate” of L&G for the purposes of the Notification Agreement.<sup>24</sup>

Both relying on the temporality alluded in other clauses of their respective licensing agreements, *Ellington* and *IP Co.* reveal how courts may be giving more weight to certain phrases in the agreement than the drafting parties may have intended. However, since contract interpretation tends to focus on what is expressly stated, a temporal limitation in one clause may influence the temporality of another. In *IP Co.*, future affiliates were included in the definition because another part of the contract used the phrase, “its successors in interest,” which was evidence that time was not of the essence. Whereas in *Ellington*, affiliates were limited to only those that existed at the time the contract was executed because another part of the contract used the phrase, “were and are now possessed,” which was evidence that the contract was only addressing the present state of the parties.

Therefore, in light of *Ellington* and *IP Co.*, parties to a licensing agreement must be wary of how the temporal limitations of different clauses affect one another.

## ***nQueue Inc. v. Control System (USC) Inc.***

In a motion for partial summary judgment, the Central District of California held that within a licensing agreement, if terms such as “affiliates” are explicitly defined, the definition controls so long as there is a reasonable explanation for any internal dichotomy with another section of the agreement.<sup>25</sup>

nQueue and Equitrac Corporation develop software for photocopy machines, and in 2011, nQueue sued Equitrac Corporation for patent infringement.<sup>26</sup> The parties settled in 2012 and nQueue granted a license to Equitrac through a Settlement Agreement in Section 2.4 that granted “to Equitrac and its Affiliates, ... [a] license under the Patents-in-Suit for Licensed Products” including the right to use and resell Licensed Products.<sup>27</sup>

Section 1.2 of the Settlement Agreement defined an “Affiliate” as any entity that controls, is controlled by, or is under common control with that Party, directly or indirectly, *as of the Effective Date* of the agreement.<sup>28</sup> Section 1.4 defined “Licensed Products” as products of any entity acquired by a Party or Affiliate that were not materially different from the Licensed Products sold by Equitrac as of the date of its acquisition without any reference to when the products needed to have been acquired.<sup>29</sup>

Soon after the Settlement Agreement was executed, nQueue filed another lawsuit against a different competitor, Control Systems, for infringement of the same patent based on their development of a similar software program, Copitrak.<sup>30</sup> Subsequently, an indirect, wholly owned subsidiary of Equitrac acquired Control Systems’ parent corporation and as result, Control Systems asserted that it became an “entity acquired by a Party” as delineated by the definition of “Licensed Products” set forth in Section 1.4.<sup>31</sup> To that effect, Control Systems filed a motion for partial summary judgment contending there was no infringement because their software program was a Licensed Product under Section 1.4.<sup>32</sup>

In opposition to Control Systems’ motion for partial summary judgment, nQueue contended that (1) Control Systems was not an “Affiliate” as defined in Section 1.2 and (2) Copitrak was not a Licensed Product as defined in Section 1.4.<sup>33</sup> The court applied California contract law and held that although

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Control Systems' products were considered Licensed Products, as defined by the settlement agreement, Control Systems was not considered a licensee under the agreement.<sup>34</sup>

Because Section 1.4 failed to specify any temporal limitations for when "an entity [was] acquired by" Equitrac or its Affiliates, the court rejected nQueue's argument that Control systems is not "an entity acquired by" Equitrac in accordance with Section 1.4.<sup>35</sup> However, because Section 2.4 plainly stated that only an "Affiliate" of Equitrac would receive the benefits of the licensing agreement, and Section 1.2 defined the term "Affiliate" as an entity that controls, is controlled by, or is under common control with that party, directly or indirectly, *as of the Effective Date* of the agreement, Control Systems' was not a licensee.<sup>36</sup> The agreement was signed July 19, 2012 and Equitrac did not acquire Control Systems' parent corporation, Nuance, until December 31, 2012.<sup>37</sup>

The court rejected Control Systems' argument that the scope of Section 2.4 must correspond to the scope of Section 1.4 because Control Systems' products were deemed Licensed Products under Section 1.4, then Control Systems necessarily would qualify as one of entities in Section 2.4.<sup>38</sup> The court held that it was not unreasonable for nQueue and Equitrac to have intended that only Equitrac could sell products made by a company it acquired as a plain interpretation of the settlement agreement.<sup>39</sup> Therefore, because there was a logical explanation for the alleged dichotomy between the two sections of the contract, the court denied Control Systems' motion for partial summary judgment.

In light of *nQueue*, *Ellington*, and *IP Co.*, a court could either hold that there is a logical explanation for a dichotomy between temporal limitations of two separate clauses (*nQueue*), or use another clause of a licensing agreement as a rationale that the definition of "affiliates" should synchronize under the same temporal limitations (*Ellington* and *IP Co.*).

## ***Imation Corp. v. Koninklijke Philips Electronics N.V.***

The U.S. Court of Appeals for the Federal Circuit ruled that a cross-licensing agreement between Koninklijke Philips Electronics N.V. ("Philips") and 3M Co. for patents, which were related to optical and magneto-optical data storage and retrieval technologies, applied to subsidiaries of the parties even though those subsidiaries were not acquired or created until after the contract's expiration date.<sup>40</sup>

While the cross-licensing agreement was still effective, 3M created a subsidiary, Imation Corp., to handle data-storage media production in 1996.<sup>41</sup> Once the cross-licensing agreement expired in 2000, the agreement provided that the cross-license would continue for the lives of the relevant patents and would also apply to the "subsidiaries."<sup>42</sup>

Then in 2003, Imation entered into a joint venture with Moser Baer India Ltd., which established Global Data Media FZ-LLC ("Global Data"), and bought a controlling interest in Memorex International Inc. ("Memorex") in 2006.<sup>43</sup> In 2007, Imation sought a declaratory judgment that Global Data and Memorex qualified as subsidiaries covered by the license in the agreement and Philips moved for judgment on the pleadings.<sup>44</sup>

The Agreement between 3M and Philips stated that Philips "agrees to grant and does hereby grant to [Imation] and its *subsidiaries*" a license that included a set of specific patents.<sup>45</sup> The Agreement defined "subsidiaries" as any "business organization as to which the party now *or hereafter* has more than a fifty percent (50%) ownership interest" and also provided that "any patent license which has been granted... shall continue thereafter... as to each Licensed Patent for its life."<sup>46</sup>

The District Court, applying New York state contract law, ruled that Global Data and Memorex could not benefit from the license because they did not qualify as subsidiaries once the Agreement expired but the Federal Circuit disagreed.<sup>47</sup>

On appeal, the Federal Circuit, applying New York contract law, held that because the Agreement stated Philips "agrees to grant and does hereby grant" a license, Philips granted a single "present" grant to "a class composed of Imation and its Subsidiaries of rights to existing and future patents," so long as those patents "claim priority to a date on or before the expiration date."<sup>48</sup> Therefore, the license vested as soon as the Agreement was signed and included any companies that fit into the definition of "subsidiary" as set forth in the Agreement.<sup>49</sup>

The Federal Circuit also found that the definition of "subsidiary" under the Agreement was not limited by the expiration of the Agreement because the definition explicitly contemplated that a business could qualify as a subsidiary "hereafter."<sup>50</sup> The Agreement also did not include any temporal limitation in the definition of "subsidiary" and the court followed that "principles of parallelism" suggest that the expiration date of the Agreement was not intended to have a broader scope over when the license expired.<sup>51</sup> The court dismissed Philips' reliance on insurance cases that interpreted "hereafter" to be limited by the end

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date of the coverage extended under an insurance contract because licenses do not necessarily run concurrently with agreements, unlike occurrence-based insurance policies.<sup>52</sup>

The *Imation* court observed that license agreements are intentionally expansive in order to “enable[] the parties to operate in a given area of technology, free of the risk that the other party would threaten infringement.”<sup>53</sup> In this particular case, the court believed that the parties wanted the licenses to be synchronous with the fluid scope of future acquisitions because the parties were sophisticated corporations operating through the world, and their corporate structures were going to change inevitably.<sup>54</sup>

In view of both *Ellington* and *Imation*, courts consider fairness on a policy level but as shown by *Ellington*, it is not enough to overcome what a court will deem as unambiguous language. The strong-worded policy arguments in the dissents of *Ellington* seem to correspond with the policy argument that supported the *Imation* court’s decision.

The *Imation* court stated that, as with the changing of corporate structures, a fluid membership should coexist with the acquisition of additional intellectual property rights, which also could apply to the facts in *Ellington*. In the dissent and concurrence of the *Ellington* opinion, Judges Smith, Rivera, and Lippman opined that the ruling on the term “affiliates” could “set[] the stage for the type of abuse...namely corporate reconfigurations that avoid the understanding of parties.”<sup>55</sup> The dissent stated that the judges should not have assumed the terms of agreement were just an unintended result of “the globalization of the music industry[,]” which inherently favors the music publishers over the artists, but rather an unfair interpretation that furthers the inequity.<sup>56</sup>

The takeaway of *Ellington* and *Imation* is that although courts recognize certain interpretations do not fare well with policy considerations, if there is no explicit language in a contract, courts are hesitant to favor certain interpretations even when it is questionable if the holding is fair and completely embodies the intent of the parties when drafting the agreements. Therefore, it is imperative that contract drafters avoid any ambiguities in terms of the definitions for “affiliates” and “subsidiaries,” especially in relation to temporality.

## ***GTE Wireless, Inc. v. Cellexis International Inc.***

The United States Court of Appeals, First Circuit held that under Arizona contract law, when there

is a settlement agreement that defines “affiliates” without any explicit temporal limitations and there also is extrinsic evidence that supports a reasonable interpretation that there was intent to include future affiliates, there is a triable issue of fact.<sup>57</sup>

Cellexis and Freedom Wireless, Inc., covenanted not to sue in a Settlement Agreement with GTE Mobilenet Services and Corporation and GTE Corporation (collectively “GTE”) for trade secrets that GTE allegedly stole from Cellexis involving prepaid cellular telephone service technology.<sup>58</sup> In the Settlement Agreement, Cellexis and its principals covenanted not to sue GTE and its affiliates, partnerships, joint ventures, and/or successors regarding the technology at issue, which later was protected by two patents.<sup>59</sup>

The background history of the case involved an intricate series of corporate transmigrations. The present case was filed by GTE against Cellexis and Freedom Wireless Inc. (“Freedom”), whom Cellexis sold its rights to under the patent applications. GTE claimed that Freedom’s patent suit against Celco, a later affiliate of GTE, was a breach of the Settlement agreement.<sup>60</sup> The issue was whether the definition of GTE in the Settlement Agreement only included affiliates that were in existence at the time the agreement was executed.

The court reviewed the summary judgment *de novo* and under Arizona law. The court held that the district court was wrong to have denied admission of extrinsic evidence while only relying on findings of “other provisions of the Settlement Agreement that contain language in the future tense, indicating that the drafters of the contract would have use a future tense if they intended to include future affiliates.”<sup>61</sup>

At the district court, GTE attempted to introduce the GTE general counsel’s deposition into evidence, where he stated that he and Cellexis’ attorney had decided not to include a list of GTE entities because the names of the entities were always changing since GTE was aiming to become a national cellular carrier.<sup>62</sup> The court stated that when extrinsic evidence supports a reasonable interpretation of a contract, it compels a broader interpretation that cannot be resolved by a court on summary judgment.<sup>63</sup> Under Arizona contract law, to ascertain intent, the Corbin approach is used to admit extrinsic evidence that would illuminate and/or demonstrate the parties’ intent.<sup>64</sup> Further, independent of the district court’s error about the extrinsic evidence, the court considered that the most natural reading of the terms relating to “affiliates” did not contain any temporal limitation, which would incorporate any entities of which GTE consists, or is affiliated, with through partnership or other agreements at any given time.<sup>65</sup>

Therefore, based on procedural history and extrinsic evidence, the court held that there were conflicting reasonable interpretations of the contract language and therefore created a triable issue of that that required the fact-finder to determine whether the parties intended to include future affiliates within the definition of GTE.<sup>66</sup>

The discrepancy between how courts deal with absence of explicit temporal limitations for affiliates is shown between *GTE Wireless* and *Ellington*. In *Ellington*, the court held that because the provision was clear and unambiguous—meaning that “there [was] no reasonable basis for a difference of opinion”—the intent of the parties must originate within the four corners of the contract, which meant no extrinsic evidence.<sup>67</sup> However, in light of *GTW Wireless*, it is possible that the *Ellington* court may have missed the inherent conflicting reasonable interpretations of the contract language within the plain language of the contract, such that the absence of explicit forward-looking language inherently may present conflicting reasonable interpretations, which was the contention of the dissent in *Ellington*. Even if the difference in state contract law was what played a significant role in the courts’ analysis, such issues could be easily avoided if parties to a contract discuss and explicitly state whether future affiliates

are included in the definition of “Affiliates” and “Subsidiaries.”

## Conclusion

The foregoing cases should caution contract drafters towards defining, in detail, the temporal limitations regarding affiliates and subsidiaries. The cases may also imply that there could be contracts other than licensing agreements that also need better definitions of “affiliates” and “subsidiaries.” For example, in non-compete agreements, practitioners should be considering the including of forward-looking language in order to bind future affiliates and subsidiaries to the terms of the non-compete agreement. However, as exemplified in the foregoing cases, the context of the full agreement or relationship between the parties may also play a role in the ultimate interpretation.

The dichotomy on how courts handle contractual interpretations, especially involving the temporality of whether an affiliate or subsidiary falls under the definition in a contract, should alert parties to a licensing deal that discussing the temporal scope of the definition of “affiliates” and “subsidiaries” may mean avoiding an undesirable lawsuit.

1. *Paul M. Ellington v. EMI Music, Inc.*, 24 N.Y.3d 239 (2014).
2. *Id.* at 243.
3. *Id.* at 245.
4. *Id.* at 241.
5. *Id.* at 243.
6. *Id.*
7. *Id.*
8. *Id.* at 246 (citing *VKK Corp. v. National Football League*, 244 F.3d 114, 130-31 [2nd Cir. 2001]).
9. *Id.* at 246.
10. *Id.* at 242 (emphasis added).
11. *Id.* at 243.
12. *Id.* at 248.
13. *Id.* at 249.
14. *IP Co., LLC v. Cellnet Technology, Inc.*, 660 F.Supp.2d 1351 (2009).
15. *Id.* at 1353.
16. *Id.*
17. *Id.* at 1353-54.
18. *Id.* at 1354.
19. *Id.*
20. *Id.*
21. *Id.* at 1359.
22. *Id.*
23. *Id.* (citing *Peachstate Developers, LLC v. Greyfield Res., Inc.*, 644 S.E.2d 324 (2007)).
24. *Id.*
25. *nQueue Inc. v. Control System (USC) Inc.* [No. 12-cv-01365, C.D. Ca. Nov. 27, 2013].
26. *Id.* at 2.
27. *Id.* at 3.
28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.* at 4.
33. *Id.* at 5.

34. *Id.* at 6.
35. *Id.* at 7.
36. *Id.* at 13.
37. *Id.* at 14.
38. *Id.* at 13.
39. *Id.* at 15.
40. *Imation Corp. v. Koninklijke Philips Electronics N.V.*, 586 F.3d 980 (Fed. Cir. 2009).
41. *Id.* at 982.
42. *Id.* at 983.
43. *Id.*
44. *Id.* at 984.
45. *Id.* at 986.
46. *Id.* at 983.
47. *Id.* at 988.
48. *Id.* at 986.
49. *Id.*
50. *Id.* at 988.
51. *Id.* at 989.
52. *Id.* at 991.
53. *Id.*
54. *Id.*
55. *Ellington v. EMI Music*, 24 N.Y.3d at 253.
56. *Id.*
57. *GTE Wireless, Inc. v. Cellexis International Inc. et al.*, 341 F.3d 1 (1st Cir. Mass. 2003).
58. *Id.* at 2.
59. *Id.* at 3-4.
60. *Id.* at 3.
61. *Id.* at 5.
62. *Id.* at 4-5.
63. *Id.* at 5.
64. *Id.*
65. *Id.* at 6.
66. *Id.*
67. *Ellington v. EMI Music*, 24 N.Y.3d at 244.

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