



# *Global Intellectual Property*

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## **Intellectual Property Holding Companies: Tax Panacea or IP Mistake?**

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Typical reasons for establishing IP holding company's include (i) tax planning, (ii) protection in the event of insolvency and (iii) administrative synergies, such as consolidation of legal costs. In reality the process of establishing and operating an IP holding company is far from trivial. By its very nature it brings together three complex legal fields, namely intellectual property, tax and insolvency. Moreover, the considerations which apply are usually multi-jurisdictional and therefore inherently complex. Often times, IP holding strategies turn out to be optimized with one or more of the above legal fields more in mind than the others. Failure to assess properly competing economic and legal considerations in these complex international scenarios can lead to failure to meet objectives and runaway costs.

In many cases, the holding company is a subsidiary within an international corporate group. Sometimes, although less often, the holding company is the parent company of the overall corporate group. Adoption of a suitable structure depends to a large extent on the headquarter jurisdiction, the mechanism by which the various synergies are anticipated to operate, and on the circumstances of the particular scenario.

Issues to consider in detail include which group companies have standing to enforce the intellectual property and how damages are calculated in that event. For example, solutions which perhaps work best from the tax or insolvency point of view can compromise standing to sue and entitlement to claim certain categories of damages. Think about it, if your holding company does not make any sales or, why should it have any claim to lost profits damages. In practice, considerations tend to be more subtle as the discussion below explains by reference to a number of recent examples.

What different types of intellectual property will be held? Does the holding strategy and particularly the various agreements and documentation which implement it take into account all of the nuances which apply in

respect of the different types of intellectual property held by the commercial entities? For example, in many jurisdictions the authors of copyright works retain moral rights which cannot be assigned but may need to be waived according to best practice in the particular jurisdiction. Other jurisdictions still have trade mark use requirements applying where a trade mark is registered and so there has to be in place a mechanism which protects the trade mark from cancellation for non use by the proprietor. All relevant considerations obviously need to be accounted for in the agreements and related documentation.

Other issues to consider include what happens in future to the intellectual property of the operating companies. For example, most businesses want to develop continually their intellectual property portfolios. Selecting an IP holding jurisdiction purely on the basis of tax or corporate considerations can leave the holding company in a position where it does not have access to the international intellectual property treaties required to develop efficiently and manage an intellectual property portfolio. Depending on the scale of the portfolio this can have huge cost and time ramifications.

Depending upon where the intellectual property is generated there may also be issues with technology exportation to get it into the holding company. For example, while South Africa does not generally require inventors to obtain a license when first filing an invention overseas, it does have relatively onerous exchange control legislation. This means export of capital by South African residents (including intellectual capital) is traditionally prevented in the absence of South African Reserve Bank Approval. Failure to observe properly such legislation, and to account for it in the documentation can lead to the relevant technology transfer transactions being considered void.

If a business wants the freedom to undertake structured financing or securitization processes other considerations arise. What happens when business unit



is to be divested (this may be required as part of the investors exit strategy)? Does the structure afford the necessary freedoms and will the transfer give rise to stamp duty type considerations which still apply in a number of European jurisdictions. While answering all these questions is beyond the scope of this article, it is hoped that some of the observations provide food for thought and the examples which follow seek to illuminate a number of interesting recent developments.

## The Taxman Cometh

The potential tax advantages of IP holding company structures are significant and well-known. The objective, from a tax planning perspective, is to transfer the enterprise's proprietary intangibles to an owner in a tax-advantaged jurisdiction, and to minimize exposure to tax in other jurisdiction by carefully controlling how the new owner exploits the intangibles.

By way of illustration, suppose that you are the VP tax of a major widget maker – the famous U.S. multinational enterprise, Acme Widget Co., which has operations on five continents. In addition to the parent company, which owns all the U.S. intangible property (including patents) used in the U.S. widget business, and all of the foreign patents, several Acme Widget subsidiaries around the world also own valuable intangibles used in their local-country or regional business activities, and the income each earns from those activities is taxed by tax authorities in which the subsidiary is organized or created.

The U.S. parent company itself is organized in relatively high-tax state, and, even worse from a tax perspective, makes and sells its widgets in all fifty states. Tax authorities being what they are, each state wants to tax its share of Acme Widget's income, and tax authorities being what they are, the sum of the amounts each state believes it is entitled to tax is, unfortunately, significantly greater than all of Acme Widget's income.

This is not a career-advancing scenario for as bright, hard-working and ambitious a VP tax as you. So you look for a solution. You incorporate a new subsidiary in a tax-friendly state, and arrange to have parent's valuable intangible property, including patents, transferred to the NewCo. Since the actual business activities—manufacturing, marketing and selling widgets, conducting R&D to produce new and improved widgets, and so forth—will continue to be conducted by the parent, you also expect to put in place an exclusive, royalty-bearing license from the new owner (NewCo) to the parent, giving parent all the intellectual property rights it needs to keep carrying on its business activities.

To exercise these rights, parent will have to pay the

new owner arm's length royalties. The royalties reduce parent's taxable income, hence its tax bill, but of course are income to NewCo, hence taxable by the local tax authorities. But since NewCo has been incorporated in a very tax-friendly jurisdiction, its taxes will be much less burdensome. Moreover, since NewCo does not itself actually conduct any business activities outside its home state—truth be told, it doesn't actually make, market or sell anything, and its licensing activities consist of single intercompany agreement filed in your drawer—you expect to argue that NewCo does not have nexus with the other states, and hence is not subject to tax anywhere else.

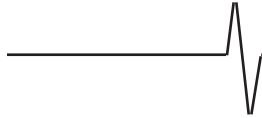
You're felling pretty good about your contribution to Acme Widget's bottom line, not to mention the lower effective tax rate and the boost this will provide to Acme Widget's stock price, until your outside tax counsel weighs in. She points out that immediately before the NewCo structure was implemented, parent has all the rights in the intangible property, and immediately after, it still has all the rights, except for legal title. What's really changed, she asks. The states will likely argue that in substance, nothing has, and on that basis treat the transfer to NewCo and license back to parent as a round trip, meaning that in reality all still is as it was, hence so is your tax bill. If the tax IP holding company structure is to be viable, she argues, parent should have materially fewer rights than it did before the structure was implemented.

With this observation in mind, you revise your plan. Parent will transfer its valuable intangible property to NewCo, but will only receive non-exclusive, non-sublicensable rights under the royalty-bearing license from NewCo. As a result, the transaction in its entirety cannot be treated as a round-trip, the transfer of ownership to NewCo should be respected, and the net result should be an improved state tax position.

In most companies, the tax left hand and the IP right hand make sure to optimize their respective positions but each has not the slightest idea of what the other is up to. But yours is a special situation. Acme Widget's general counsel actually hired you, and wants to stay informed. So to stay on her good side, you write up a memo describing the plan and send it her way.

## The Patent War Starts

So, Ms. General Counsel you review the memo from VP tax that NewCo has now been formed, and all of the Acme Widget's intellectual property (IP) from all over the world has been transferred into it. NewCo is awash in valuable IP but you, having been subject to a three day seminar by Acme's CTO (Chief Technology Officer) about its cutting edge technology, know that Acme treasures its patents above all. You are determined to provide some corporate focus on monetization of this



great IP and are confident that with NewCo.'s choice of a tax advantageous venue, it will receive favorable tax treatment on all that royalty revenue it generates. As you sit there happily contemplating all the royalties that will roll in, you pick up another file marked "URGENT" and learn that Acme is in the midst of a dispute with a major widget competitor (WMD, Inc.) that is saber rattling its patents at Acme, threatening to shut down your best selling model just before the next holiday cycle – a scant nine months away. Fortunately, ACME has a few patents of its own to rattle back with – patents you are confident will cover WMD's products.

What, if any, connection is there between these two apparently separate files on your desk? Read on.

There are two major patent issues to consider in terms of using a holding company structure for management of corporate IP. While the holding company model has recognized benefits in terms of generating revenue streams from IP as a focused corporate mission, and freedom to locate the holding company so as to secure favorable tax treatment, these patent considerations should be fully understood before you gloat over Acme's and NewCo.'s new org chart.

### **Standing to Sue**

Only a patent owner has "legal standing" to prosecute an infringement claim in court. As the Federal Circuit recently reminded us in *Int'l Gamco v. RPost*, an exclusive licensee who has been granted at least one exclusive right of a patent owner may join the patent owner, but only as a coplaintiff. An exclusive licensee may not bring a suit in its own name unless, as evidenced in a written instrument, it holds all of the substantial rights in the patent in a manner that makes the licensee a virtual assignee. A non-exclusive licensee has no right to join a patentee in an infringement suit regardless of the level of economic harm it suffers.

Generally, if a patent owner (such as NewCo) is itself owned by a parent corporation (such as Acme), the parent corporation does not have legal standing to join the patent owner in claiming damages for patent infringement. Even though the parent owns the patent owner, it does not own the patent. Even where the parent may have a claim of equitable ownership of the patent, that will generally not be sufficient for purposes of establishing legal standing. In the wake of the 2006 Supreme Court decision in *eBay v. Merc Exchange* holding that not every successful patent infringement plaintiff is entitled to a permanent injunction, some commentators suggest that a parent company's status as an equitable owner of the patent asserted against one of its direct competitors may be an eBay factor that can help the holding company patent owner obtain a permanent injunction remedy, but most cases hold that a parent lacks standing to seek either injunctive relief or monetary damages.

### **Lost Profits As A Measure of Damages**

Typically, aside from saving on the tax bill, the main corporate mission of a patent holding company is to generate revenue streams from licensing the patents in its portfolio to others. In order to give it the flexibility to do so (and for the reasons explained to VP tax earlier), the patent or manufacturing subsidiary will generally take back only a nonexclusive license. In this scenario, only NewCo has legal standing to enforce the patents for acts of infringement that occur after Acme assigns the patent to NewCo. Acme, retaining only a nonexclusive license, has no legal standing to join NewCo in an infringement suit if the only acts of infringement occur after the assignment to NewCo.

Since Acme, as a nonexclusive licensee, lacks standing to sue (regardless of the economic harm it suffers), NewCo will not be able to seek a recovery of Acme's profits due to the infringement. Instead, as a non-manufacturing licensor, the damage recovery will be limited to a reasonable royalty. In many instances, a reasonable royalty calculation will yield damages that are only a relatively small percentage (20% – 25%) of a lost profits calculation.

In *Poly-America, L.P. v. GSE Lining Tech., Inc.*, the Federal Circuit applied this rule, denying a non-manufacturing corporation patent owner (akin to a patent-holding company) recovery of the lost profits of its sister manufacturing corporation where the sister corporation held only a nonexclusive license to the infringed patent. The Federal Circuit explained that the two corporations "must take the benefits with the burdens . . . [and] may not enjoy the advantages of their separate corporate structure and, at the same time, avoid the consequential limitations of that structure - in this case, the inability of the patent holder to claim the lost profits of its non-exclusive licensee.

Of course where the manufacturer has some form of exclusive rights in the patent, it may have standing to join with the patent-holding company as a coplaintiff and seek lost profits to the extent that the specific acts of infringement were of its exclusive right and caused it to suffer such loss.

### **Reassignment to Manufacturer**

A patent owner may assign its right to sue for the past infringements when it assigns a patent. Hence, a manufacturing company that, before filing suit, obtains a reassignment from its sibling patent-holding company of the patent (together with the right to sue for past infringements) will have standing to prosecute the suit solely in its name - but can only seek lost profits as of the date of the reassignment (assuming the manufacturing company only held a nonexclusive license prior to the reassignment).



## Reorganization (Bankruptcy)

While it is never a pleasant thought, some consideration should also go into the care of IP assets in the event of a bankruptcy reorganization (of the original patent owner or a holding company) to ensure that some entity has standing to enforce the IP. In the recent (2007) case of *Morrow v. Microsoft*, where a bankruptcy court separated ownership of patents from the right to enforce, the Federal Circuit held that interests generated under trust or bankruptcy law do not govern standing issues under patent law and that even in the bankruptcy or trustee context only a patent owner or its “successors in title” is entitled to bring a “civil action for infringement of his patent.” The Court concluded that although the plaintiff (trustee) had been given the naked right to sue infringers under the reorganization plan, a different trustee was the patent title holder, holder of the right to sell the patent, to grant exclusive and nonexclusive licenses or transfer any of the rights that it holds to another party. The Federal Circuit noted that, unfortunately for the plaintiff (trustee), the “liquidation plan contractually separated the right to sue from the underlying legally protected interests created by the patent statutes – the right to exclude.”

## Conclusion

So Ms. General Counsel – what will you do? Will you keep NewCo and take the benefits of the tax haven? Or will you transfer some or all of the patents back to Acme, for use as counterclaim material that will help keep WMD at bay, or, if push comes to shove, at least be used to claim

lost profit as the measure of damages and a permanent injunction as a form of relief.

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