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709 - Reorgs, Licenses and Spin-offs: Who's Left Holding the IP?

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Session 709

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T.J. Angioletti is vice president and associate general counsel for Oracle where he leads the patent, trademark and copyright group. He manages Oracle's intellectual property portfolio and counsels the organization on a variety of issues related to intellectual property and marketing.

Mr. Angioletti started his career at Oracle after working for Apple Computer, Inc. and Pillsbury Madison & Sutro (now Pillsbury Winthrop).

He is involved in a number of organizations that focus on intellectual property, and currently serves on the board of directors for the Intellectual Property Owners' Association (IPO) and the Stanford Law School Science & Technology Advisory Board.

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John Pratt

John Pratt is a partner with Kilpatrick Stockton in Atlanta, GA. He founded and led the growth of the firm's Atlanta patent prosecution practice, chairs the firm's intellectual property practice and practices primarily in the patent area, including patent prosecution, litigation and licensing.

Previously, Mr. Pratt served as part-time general counsel to an Internet consulting firm that survived the Internet downturn.

Mr. Pratt has served on the board of directors of Honduras Outreach, Inc., a non-profit, non-denominational Christian non-profit based in Georgia that operates clinics, schools and other activities to improve the lives of Hondurans living in a rural area in Olancho, Honduras. An accomplished woodworker, furniture maker and woodworking tool expert, Mr. Pratt devotes a portion of his practice to tool and furniture patent matters.

Mr. Pratt earned a BS from Clemson University and a JD from Harvard University.

2010 ACC Annual Meeting

Reorgs, Licenses and Spin-offs: Who's Left Holding the IP?

Presented By:
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David Bumsted, ANDRITZ (USA) Inc.
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- Assignment of IP to New Entity
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REORGS, LICENSES AND SPIN-OFFS: WHO'S LEFT HOLDING THE IP?

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1) Licenses/Intellectual Property Not Transferable to New Entity

Many intellectual property licenses will have anti-assignment provisions or be non-transferable as a matter of policy. These can apply even to simply “name change” transfers. For example, in *Cincom* the same computers loaded with the same software in the same place, but owned by the newly formed entity were found to infringe a copyright of a software owner since the old entity was not permitted to transfer its rights. Restriction on transfer usually encompasses transfer by operation of law as well as explicit transfer.

a) Patents, Copyrights and Software

i) Scenario[1]

Licensee licensed software from Licensor. The license included provisions of the following:

- The license was non-exclusive and non-transferable;
- The license did not permit Licensee to transfer its rights or obligations under the license agreement without the prior written approval of Licensor; and
- The license required that software be used only on a specific computer in Licensee’s Oswego, NY facility

Licensee underwent an internal corporate restructure with a series of mergers with other subsidiaries of its parent corporation. The surviving corporation was Corporation A (not Licensee). The software at issue remained on the specific computer in Oswego, NY facility, but was now owned by Corporation A.

ii) Questions:

(1) *Did the merger constitute an impermissible transfer of an intellectual property license absent text in the license agreement to the contrary?*

In the *Cincom* case, yes. The *Cincom* ruling only applies to 6th Circuit federal courts to date. Few judicial opinions have followed dealing directly with the issue. It is worth noting that *Cincom* did not address a related situation whether a transfer occurs when the licensee is the surviving entity in a merger.

(2) *Does state law which generally permits free assignability of contracts (absent the parties’ agreement to contrary) control?*

In the *Cincom* case, no. State law governs IP license agreements to the extent not inconsistent with federal law. The court explained that while state law generally permits free assignability of contracts absent the parties’ agreement to the contrary, federal common law generally presumes that an

[1] Facts underlying dispute in *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 2009)

intellectual property license is not assignable unless expressly set forth in the agreement. The Court reasoned that free assignability of patent or copyright licenses would undermine the reward that encourages invention. Any entity desiring to acquire a license could approach either the original inventor or one of the inventor's licensees.

The Court noted the relationship between copyright and patent law in noting the following: "in copyright cases such as this, we refer to the case law interpreting patent law 'because of the historic kinship between patent law and copyright law'" (citing *Sony Corp of Am. v. Universal City Studios, Inc.* 464 U.S. 417, 436 (1984).

iii) Other Pitfalls

In addition to possibly copyright, trademark or patent liability, there is also a danger that the surviving entity will not have sufficient rights to pass a software audit. Software owners can learn about restructuring, mergers or acquisitions and exercise their audit rights to see if new entities are using existing software without having acquired new licenses.

iv) Possible Solution

Best time to address is when negotiating original deal with licensor. If it is foreseeable that the licensing entity will change or need to assign rights due to restructuring, consider seeking a carve out to anti-assignment provision for limited amount of time or to a limited extent (e.g., where user base remains the same, but corporate structure changes). Consider establishing flat re-assignment fee up front. Note, a simple provision that "such consent shall not be reasonably withheld" is usually *not* that useful.

b) Trademarks

i) Issue - Improper Securitization – Assignment in Gross:

Companies occasionally seek to use trademark registrations as collateral for financing. In seeking to perfect their security interests, many companies conditionally assign rights in the trademarks to the lender.

ii) Pitfalls:

Because of the ban on assigning trademarks apart from their goodwill, an outright assignment of an ITU application (before a statement of use is filed) could invalidate the application and eventually the registration. *See Clorox Co. v. Chem. Bank*, 40 U.S.P.Q.2d 1098 (T.T.A.B. 1996) (assignment of ITU application voided resultant registration under 15 U.S.C. §1060 despite parties intent to create a conditional assignment as a security interest).

iii) Potential Solution:

When drafting security agreements, avoid language that explicitly or implicitly assigns ownership of the trademark(s) to the lender. The lender should file liens in the USPTO to inform others of the security interest.

2) Assignment of IP

a) Patents

Many patent assignment issues are determined under the appropriate state law; however, federal patent law governs whether an assignment is an automatic assignment or only an agreement to later assign rights. In addition to issues related to disputes in ownership between inventor and assignee, inventor assignment clauses can impact standing.

i) Scenario[2]

One of joint inventors, Inventor A, conceives of subject matter of Patent X in 1999 while employed at Company M. In 1996, Inventor A entered into an employee inventions agreement with Company N (predecessor to Company M, merged in 1997). The employee inventions agreement with Company N was assigned to Company M. The agreement included the following language:

- "all inventions…which are related to or useful in the business of the [Company N]…and which were…conceived…during the period of [Inventor A's] employment, whether or not in the course of [Inventor A's] employment;" and
- "[Inventor A] assigns all of his or her right, interest, or title in any Invention to Company N to the extent allowed by law."

Inventor A testified that at the time of conception of the invention, he was still subject to the original 1996 employment agreement. Inventor A separated from Company M in 2000 and joined Company G. In 2001, Inventor A and co-inventor B applied for Patent X which was eventually assigned to Company G.

Evidence was introduced that Company M was aware of the invention of Patent X and failed to assert ownership of the invention at any time.

[2] Facts underlying dispute in *SiRF Technology, Inc. v. International Trade Commission* , 601 F.3d 1319 (Fed. Cir. 2010).

ii) Questions

(1) *What law governs the assignment clause—state or federal? Is Company M a co-owner of Patent X?*

Federal patent law governs whether an assignment is an automatic assignment or only an agreement to later assign rights. In *SiRF* case, court initially concluded that the employment agreement provided for an automatic assignment. The present, automatic language of "Inventor A assigns" expressly grants rights with no further action needed on the part of the Inventor A. "If the contract expressly grants rights in future inventions, 'no further act [is] required once an invention [comes] into being,' and 'the transfer of title [occurs] by operation of law.' " *SiRF Tech.*, 601 F.3d at 1326 (internal citations omitted) (alteration in original).

However, the remaining question is whether the invention is "related to or useful in the business of the Employer" within the meaning of the agreement. State law governs such determination (here California law). Court found that the terms "related to" and "useful in" are inherently ambiguous. Under California law, extrinsic evidence is admissible to prove meaning of such ambiguous terms. The Commission concluded that there was no evidence that the invention of Patent X was related to or useful in Company N's business. Evidence was introduced that provided that Company M was aware of the invention and failed to assert ownership of the invention at any time, which suggested that Company M itself did not consider the invention of Patent X related to or useful in its business within the meaning of the employee agreement. Thus, the Court held that Company M was not a co-owner of the patent.

A side note and from a high level oversimplified perspective—the invention at issue related to GPS technology. Company G is Global Locate, which is in the business of GPS technology. Company M is Magellan, a company perceived to be involved with GPS technology. Yet, the court found that the invention was not related to or useful in Magellan's business.

(2) *What impact does the assignment have on standing?*

Absent the voluntary joinder of all co-owners of a patent, a co-owner acting alone will lack standing. In *SiRF* case, the Defendants[3] challenged standing for plaintiff to bring infringement action based on third party Company M is a co-owner of the patent (and not a party to the lawsuit). The court found that Company M was not a co-owner and thus Company G had proper standing to bring the suit.

[3] Proper term would be "respondents" as the SiRF matter was an ITC matter.

(3) *What effect does the recordation of an assignment have upon burdens of persuasion?*

As a matter of federal patent law, the *SiRF* court held that recordation of an assignment creates a rebuttable presumption that the assignment is valid. Defendants challenged whether plaintiff had meet its burden in establishing it having standing to bring suit in light of the ownership issues raised. Court found that Company G had satisfied this burden by showing that inventors had assigned their rights to Company G. Defendants argued that Company G should also have the burden to establish that an interest in the patent had not been previously assigned to Company M. Court held that that burden rested with the Defendants. While the recording of an assignment with the USPTO is not a determination as to the validity of the assignment, it does however create a presumption of validity as to the assignment and places the burden to rebut such a showing on one challenging the assignment.

b) Trademarks

i) Scenario

Company A acquires or merges with Company B. Company B owns trademark registrations and pending applications. If the newly formed Company AB seeks to register trademarks in the USPTO that are similar to Company B's marks, Company AB's applications will likely be refused on the grounds that they are likely to be confused with Company B's marks.

ii) Possible Solution:

Company B should assign its registrations and applications to Company AB at the time of the merger/acquisition. The assignment should be recorded in the USPTO. If, for some reason this does not happen at the time of the assignment, a retroactive or nuc pro tunc assignment can be executed after the merger/acquisition.

iii) Potential Pitfalls:

(1) Company B's portfolio included intent-to-use applications. Section 10 of the Trademark Act, 15 U.S.C. §1060 prevents the assignment of intent-to-use (ITU) applications before a statement of use or amendment to allege use has been filed. The rationalization is that ITU applications cannot be assigned apart from the goodwill associated with them. The USPTO is attempting to preclude the trafficking of ITU trademarks. Accordingly, ITU applications can be assigned when the portion of the business associated with ITU mark is also transferred to the new owner. However, the business must be "ongoing and existing." 15 U.S.C. §1060(d)(1)(2006).

(2) Company B owns marks under a name not included in the merger/acquisition documents. Company AB will need to establish the chain of title to show the changes in ownership. This can be tedious. When a company restructures numerous times, the documentation regarding the changes may be lost by the time Company AB is formed. If the entire chain of title cannot be established through restructuring documentation, an officer from Company B who is knowledgeable about the deals can submit a declaration or affidavit to the USPTO explaining the gaps in the chain of title.

3) Separate Holding Company and Operating Entities

Often for tax benefits or organizational efficiency, companies have one entity that owns IP that is practiced by a related entity. For example, a holding company or parent may license a patent to an operating entity that makes devices covered by the patent. Such shuffling of IP can have benefits but also holds some potential traps.

a) Patent Example

i) Scenario[4]

Mars—the candy company—owns two patents related to coin changers. Its wholly owned subsidiary—MEI—made and sells vending machine coin changers. Mars does not make vending machine coin changers. MEI had a royalty agreement with Mars based on gross sales value of coin changers using Mars' patented technology. MEI's was obligated to pay the royalty even if MEI did not make a profit. Another Mars subsidiary--MEI-UK--also had a license to the patents "in any country in the world." *Mars, Inc. v. Coin Acceptors, Inc.*, 527 F.3d 1359, 1368 (Fed. Cir.). In 1990, Mars owned both patents and files infringement suit against Coinco. Fifteen years later, Mars obtained infringement judgment against Coinco. During litigation, the patents changed hands a couple of times. First, in 1996, Mars transferred "its entire interest in the Covered Intellectual Property that relates to the business of the Parties" to MEI for tax reasons. *Id.* at 1363. Then, after final judgment, Mars and MEI entered a "Confirmation Agreement" acknowledging that Mars retained the right to sue for past infringement and transferred any rights to past infringement MEI may have had back to Mars.

ii) Questions

(1) *Who had standing to bring the suit when it was filed in 1990?*

Mars, as the owner of the patent up until 1996, had standing in 1990. Because MEI-UK also had rights to practice the patented technology in the

[4] Taken from *Mars, Inc. v. Coin Acceptors, Inc.*, 527 F.3d 1359 (Fed. Cir.), *cert. denied*, 129 S.Ct. 653 (2008).

U.S., MEI was not an exclusive licensee and thus did not have standing in 1990.

(2) *Could Mars seek lost profits?*

Mars could not seek lost profits because it did not make or sell devices and because MEI was not its exclusive licensee. Note, the court left open the possibility that had MEI's profits "inexorably flowed" to Mars, it may have been able to seek lost profits. MEI could not seek lost profits before 1996, because it was not exclusive licensee or owner.

(3) *What impact did the 1996 agreement have (when Mars transferred "its entire interest" to MEI)?*

Mars lost standing for the period after 1996 because it transferred its entire interest to MEI.

(4) *Could Mars cure the lack of standing by reacquiring the patent as in Schreiber Foods*[5]*?*

Perhaps, but the method it used here did not do that. The language it used to try and reacquire the patent was "Mars and [MEI] do hereby acknowledge that Mars owns and retains the right to sue for past infringement of the Litigation Patents. To the extent that MEI may have or claim any rights in or to any past infringement of the Litigation Patents or any recovery therefore, … MEI hereby … irrevocably assign[s] all such rights to Mars." *Id.* at 1371. This was insufficient because 1) Mars' "acknowledgement" did not itself transfer and did not change the fact that it had lost all rights during original transfer and 2) the only rights MEI did actually transfer in the agreement were to past infringement and this is not the same as title.

iii) Take Away

Only a patent owner or exclusive licensee can have constitutional standing to bring an infringement suit, a non-exclusive licensee does not. Owner/licensor cannot seek lost profits for a non-exclusive licensee whose profits do not inexorably flow to parent and whose royalty payments are not tied to profits. It is uncertain whether parent can recover lost profits of non-exclusively licensed entity whose profits do "inexorably flow" to the parent. Offering geographically limited exclusive licenses to operating entities is one way to preserve right for lost profits, but then consider whether those entities would be necessary parties to an infringement suit brought by holding company.

[5] *Schreiber Foods, Inc. v. Beatrice Cheese, Inc.*, 402 F.3d 1198, (Fed. Cir. 2005) (allowing plaintiff to reacquire patent title to correct the jurisdictional defect that arises when the plaintiff loses title to the patent during litigation).

b) Trademark Example

i) Scenario:

A company might convey trademarks to a wholly-owned subsidiary holding company which then licenses back the IP rights to the parent for tax purposes. This arrangement could invalidate the trademark rights if the subsidiary is not able to exercise sufficient control over the nature and quality of the goods and services sold by the parent under the licensed marks. *See Generally* J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 18:51 (4th ed 2010).

ii) Potential Pitfalls:

It appears that this tax diminishing approach can backfire. McCarthy's points to a case where a court ordered a parent corporation to file a combined New York state tax return with its two wholly-owned Delaware subsidiaries "to which it had assigned its trademarks which were licensed back to the parent. The court affirmed the appellate tax tribunal which had held that the 'assignment and license-back transactions with the subsidiaries lacked a business purpose or economic substance apart from tax avoidance …')." *Sherwin-Williams Co. v. Tax Appeals Tribunal of Dep't of Taxation & Fin. of State of N.Y.*, 784 N.Y.S.2d 178, 182 (App. Div. 2004).

4) Damaging Statements

a) Trademark Example

i) Issue:

Mischaracterization of trademarks could hurt a company's ability to enforce its rights in the same. Improper use of a trademark by employees can create a public record that degrades the distinctiveness of a trademark. Public use of a company's mark as a descriptive or generic term could create evidence of the descriptiveness or genericism of a term. Producers of the TiVo DVR, for example, ought to be careful to use the term TiVo as an adjective and not as a noun. This frequently plays out in connection with applications to register marks in the USPTO. Examiners will frequently surf the Internet to identify how the mark is used. If the Examiner comes across multiple descriptive uses of the mark, she or he will use excerpts from websites, blogs and articles to support a descriptiveness refusal. Often enough, these uses come from the applicant itself—either official through improper use on its marketing materials or unofficially, through references made by employees on blogs or quotes given to reporters. Often times, the offending act is one of omission: the company fails to police how third parties reference their marks.

ii) Possible Solution:

Trademark counsel can draft up usage memorandum for the company to distribute to its employees. The company should establish guidelines for how employees and the media refer to its mark, e.g. Kleenex brand tissues, TiVo DVRs and Xerox copiers.

b) Patent Example 1 – Press Release

i) Issue:

Company wants to issue a press release regarding IP acquired during merger or acquisition. Marketing oriented folks want to characterize the patents as "essential" to an industry, "pioneering" in a field, or as "covering" specific types of technology. These types of statements may contradict positions in a future litigation. For example, the company may not want the patents to be deemed standards essential, there may be other patents the company holds in the field, or there may be prior art in the allegedly "covered" area that the company now wants to avoid covering.

ii) Possible Solution:

Have an attorney review any characterization of newly acquired IP. Avoid, or very carefully consider, any characterization of claim scope, status of prior art, applicability to industry standards, etc.

c) Patent Example 2 – Internal Emails

i) Example:

Microsoft employee writes email referencing i4i's products and a corresponding patent, by patent number, and states that the competitors technology would be made "obsolete" by a Microsoft product. Email supports finding that Microsoft knew its accused product would infringe i4i's patent if used by Microsoft's customers.[6]

ii) Possible Solution:

Instruct employees to be cautious about any written reference to patents—including references to competitor patents or characterizations about what their own patents may or may not cover.

5) U.S. vs. Foreign TM Registrations

Unfortunately, trademark protection around the world largely remains a patchwork system of national laws and registries, requiring a country-by-country approach. There have

[6] *i4i, Ltd.P'ship Corp. v. Microsoft Corp.*, 670 F.Supp.2d 568, 578 (E.D. Tex. 2009).

been, however, several key developments that have internationalized and harmonized trademark practice, including: (1) the introduction of the European Community Trademark System in 1997; (2) the adoption of the Trademark Law Treaty in 1994 (and the U.S. accession in 2000) which reduced many of the formalities of trademark registration; and (3) the recent expansion of the Madrid Protocol to include jurisdictions such as the U.S. in 2003 and the European Union in 2004. Nevertheless, acquiring and maintaining a viable international trademark portfolio is not without its pitfalls. While each country presents a unique set of potential obstacles and complications, there are some basic questions to be considered.[7]

a) How Are Trademark Rights Acquired?

- The U.S. grants trademark protection for a mark upon its use in the marketplace; one need not register a mark in order to be afforded trademark protection under the law.
- Most foreign jurisdictions grant priority to the first-to-file.
    - One of the interesting corollaries to this rule is that, again unlike the U.S., most foreign jurisdictions ***do not*** require proof of use in a trademark application. While use in the jurisdiction is a requirement for trademark protection, the application itself does not require a demonstration of actual use.
        - This means that there may be many "place-holder" registrations by parties who are not currently using the mark in the jurisdiction but may, at least initially, present an obstacle to a valid user's application because those parties were the first to file their application.
    - As a result, a successful application to register a mark often involves filing petitions to cancel those marks alleged to be confusingly similar to the applied-for mark based on their non-use.
- Absolute/Relative Grounds for Refusal
    - The USPTO can refuse an application based upon relative grounds, meaning the mark—relative to others currently registered—is not proper for registration.
    - In many foreign jurisdictions, the trademark office considers *only* absolute grounds, meaning if a mark meets the statutory minimums (e.g. it is not descriptive, offensive, etc.).

[7] The information provided herein is drawn from the following source: Edward J. Fennessy, Trademarks Throughout the World (5th ed. 2010). For more information, see Ethan Horowitz, World Trademark Law and Practice (2d ed. 2010); Worldwide Trademark Transfers: Law & Practice (Susan Barbieri Montgomery & Richard J. Taylor eds., 2010).

  - The result of a purely absolute examination is that the resulting field may contain a number of registrations that are, in fact, confusingly similar. These jurisdictions take the position that the mark owners themselves are responsible for protecting their own rights. In such jurisdictions, the primary means of establishing and protecting a trademark is not by registration alone, but by diligently seeking to prevent the registration or use of marks similar to your own.

b) Must All License Agreements be Recorded?

- The U.S. does not require recording licenses with the USPTO, leaving to the owner of the registration to demonstrate a proper license upon a challenge by some third party.
- Some other jurisdictions, however, *require* that a trademark owner record any agreement granting a licensee the right to use the registered trademark.
  - In China, Korea and Taiwan, the government or a third party may petition to cancel a mark based upon its owner's failure to properly record a licensing agreement within the statutory time period.
  - In such countries, use by a third party, unrecognized by the government (because no license agreement has been recorded) does *not* inure to the benefit of the registration owner.
- Additionally, some countries require that such licensing agreements be submitted to governmental authorities for approval.
  - Often times, the application of the relevant law is unpredictable and can result in the refusal of a licensing agreement for reasons unclear to the registration owner.
  - This practice further contributes to the uncertainty of international trademark practice in some countries.

c) What Evidence is Required to Update Chains of Title?

- Another way to ask the same question: What is the evidentiary burden that an owner by transfer of a registration will bear to prove proper ownership of the registration?
- In the U.S. original documents are not required.
- In some international jurisdictions, such as Brazil, the original documents are required.

d) Must an Assignment Include Goodwill?

- In the U.S., trademarks cannot be assigned without the goodwill that they symbolize. The Lanham Act provides that “"[a] registered mark or a mark for which an application to register has been filed shall be assignable with the goodwill of the business in which the mark is used, or with that part of the goodwill of the business connected with the use of and symbolized by the mark." 15. U.S.C. § 1060. While the term "goodwill" sounds necessarily ephemeral and abstract since such goodwill rests primarily in the minds of consumers, the term is used to refer to tangible business assets that, upon transfer, will serve to maintain the quality of the goods or services offered under the mark.
    - The guiding principle here is that U.S. law seeks to protect the consumer against inconsistent and unpredictable quality changes each time a trademark is transferred; the law prefers that the quality of goods offered under the ACME mark for example, be consistent over time, rather than fluctuating unpredictably after a transfer.
- Other countries, like the UK, permit assignments without the goodwill of a business.
    - Some countries place additional restrictions on these types of assignments, requiring that the party acquiring the trademark rights en gross make some representations to the general public in the form of advertising or labeling, that the “quality” of the goods or services offered under the mark has changed.

e) How Might a Registration Owner’s Rights be Terminated?

- Non-renewal: most foreign jurisdictions grant trademark protection for 10 years; registration owner must file renewal application.
    - Some countries, Spain for example, require a declaration of use upon the filing of a renewal.
- Non-use: the primary means by which third parties successfully cancel prior registrations is a cancellation proceeding for non-use.
    - Must use within 5 years of registration, as a general rule.
- While this is certainly not true in all jurisdictions, some foreign jurisdictions soften the severe consequences of a first-to-file rule by permitting a party to petition to cancel the prior registration based on that registration owner’s knowledge of the petitioning party’s own unregistered mark at the time the registration owner filed its application. This line of argument for cancellation is often available for marks with substantial international use and evidence of substantial advertising that would have reached the jurisdiction. Of course, use

prior to the registration owner's application is helpful, but the use must be somewhat significant.

- As mentioned above, use by a party not of record can, in some jurisdictions, be grounds for cancellation, whether by party or *sua sponte* by the trademark office of that country.

6) Tax Implications to Watch Out for with Multinational Intellectual Property Ownership

In multinational corporations, the location of intellectual property within the group can dramatically affect the worldwide effective tax rate. By careful structuring of development, ownership and transfers of intellectual property a multinational corporation can reduce its tax burden. That structuring, however, may be disregarded if the terms of the agreements are inconsistent with their economic substance.

The IRS has authority to make allocations among members of a controlled group if a member does not report its true taxable income. Treas. Reg. § 1.482-1(a)(2). Absent an abuse of discretion, that allocation must be sustained; however, in some cases taxpayers have been successful in convincing courts that an IRS allocation was arbitrary, capricious, or unreasonable.[8]

The IRS and courts use four methods for determining whether an intercompany transaction is consistent with an arms length transaction: (1) comparable uncontrolled transaction method, (2) comparable profits method, (3) profit split method and (4) unspecified methods. Reg. § 1.482-4 (a).

a) Ownership of Intellectual Property for Tax Purposes

i) Ownership Generally:

- Who Owns the IP?
    - If IP is legally protected, the legal owner is the owner for purposes of Treasury Regulation § 1.482-4 (determining taxable income in connection with transfers of intangible property). Treas. Reg. § 1.482-4(f)(3)(A).
    - Legal ownership may arise by operation of law or by contract. *Id.*
    - If no owner can be determined by reference to law or contract terms, the taxpayer who has *control* over the IP is the owner. *Id.*

[8] *Veritas Software Corp. v. Comm'r*, No. 12075-06, 2009 WL 4723602, at *15 (T.C. Dec. 10, 2009); *Eli Lilly & Co. v. Comm'r*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988); *Bausch & Lomb, Inc. v. Comm'r*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991); *Ciba-Geigy Corp. v. Comm'r*, 85 T.C. 172 (1985); *Sundstrand Corp. v. Comm'r*, 96 T.C. 226 (1991).

- Multinational groups may structure ownership of their IP in several ways:
  - Individual owners and developers
  - Centralized ownership in a "Principal"
    - The Principal enters into contract research agreements with others who perform R&D.
    - Potential issues include whether taxpayers assertion of "ownership" is consistent with allocation of risk
  - Cost Sharing Arrangements
    - Potential issues include whether buy-in payments are consistent with arm's length transactions

ii) <u>Scenario</u>[9]: Ownership by a Principal vs. Joint Development

Ciba-Geigy, a Swiss company, developed technology related to herbicides. A U.S. Subsidiary performed certain tasks during the development of the technology, which was eventually patented. There was no agreement between Ciba-Geigy and its U.S. Subsidiary to share costs or benefits of the research. Ciba-Geigy licensed the technology to the U.S. Subsidiary in exchange for a royalty.

- Ciba-Geigy:
  - Planned the synthesis program
  - Selected chemical compounds for screening
  - Determined which would be commercialized
  - Was capable, during the relevant time period, of independently developing the new herbicide.
- U.S. Subsidiary:
  - Performed parallel screening and field testing
  - Assumed responsibility for U.S. registration of patentable compounds
  - Did not have, during the relevant time period, facilities or personnel required for developing the herbicides.

The IRS attempted to impute a joint development agreement between Ciba-Geigy and the U.S. Subsidiary.

[9] Facts underlying dispute in *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 226-30 (1985)

iii) Question

(1) *Who owns the IP?*[10]

Ciba-Geigy exercised complete control over the research and was the sole developer (owner) of the IP. *Id.* at 232-33.

In determining which member of a group is the developer (owner) of intellectual property, the "greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group." *Id.* at 232. Other important factors include the location of development activity, the ability of member of the group to independently carry out the project and the degree of control exercised by each member. *Id.*

iv) Scenario[11]: Buy-in Payments

U.S. Parent assigned to Foreign Subsidiary right to use IP in exchange for royalties and a one-time prepayment. Foreign Subsidiary paid $6.3 million in 1999 and $166 million in 2000, which was later adjusted to $118 million. The IRS concluded that the cost-sharing allocations did not reflect U.S. Parent's income, determined that a $2.5 billion buy-in was appropriate, and allocated $2.5 billion income to U.S. Parent. The $2.5 billion allocation was later reduced to $1.675 billion)

Controlling Law

- Buy-in payments are consideration for an interest in *pre-existing* intangible property that is *transferred* to a participant in a qualified cost-sharing arrangement. § 1.482-7(g)(1)-(2).
  - Any interest in subsequently developed intangible property may be the subject of other consideration, but is not appropriately included in calculating the buy-in payment.
- If the buy-in payment is not arm's length, the IRS may make allocations of income that reflect an arm's-length transaction. § 1.482-7(g)(1)

v) Question

(1) *Was the IRS's allocation of a $2.5 billion buy-in payment arbitrary, capricious, or unreasonable?*

Yes. The IRS:

- Reduced its initial valuation with no explanation;

[10] When this case was decided the Treasure Regulations specified that the "developer" of the IP was the "owner" for tax purposes. Current regulations specify that the legal owner is the owner for tax purposes; however, to the extent that no owner can be determined by reference to IP law or contract, this analysis of who own intellectual property is still valid.
[11] Facts underlying the dispute in *Veritas Software Corp. v. Comm'r*, 133 T.C. No. 14 (Dec. 10, 2009)

- Valued software, a short-lived intangible, as if it had perpetual life;
- Took into account items not transferred or of insignificant value including: weak relationships with distributors, customer lists and customer bases, and access to a research and development team;
- Included subsequently developed intangibles, including rights to future co-developed intangibles; and
- Incorrectly calculated useful life, discount rates, and growth rate.

(2) *Was Foreign Subsidiary's reported buy-in payment consistent with an arm's-length transaction?*

Yes, based on the Compared Uncontrolled Transaction method, which the Tax Court found to be the best method to determine arm's-length standard in this case. The comparable uncontrolled transactions were more than 90 agreements between U.S. Parent and original equipment manufacturers.

vi) Take Away

- The taxpayer's transactional structure should be respected if it is consistent with economic substance, i.e., risk allocation is consistent with conduct over time, financial ability to assume risk and control over activities giving rise to the risk. Treas. Reg. § 1.482-1(d)(3)(iii)(B).
- Global R&D activities should be structured so that ownership of the resulting intellectual property is clear.

b) Allocation of Profits from Marketing Activities

i) Scenario

Foreign Parent enters U.S. market and uses U.S. Subsidiary to market and develop its products in the U.S. under trademark registered to Foreign Parent. Foreign Parent licenses its trademark to U.S. Subsidiary for a royalty based on sales, and both Parent and Subsidiary are obligated by the contract to undertake specified marketing activities. U.S. Subsidiary establishes Foreign Parent's products in the market after several years of marketing activity.

ii) Questions:

(1) *Who owns the trademark?*

Foreign Parent owns the trademark pursuant to intellectual property law. Treas. Reg. § 1.482-4(f)(3)(ii), Example 1. Subsidiary does not own the trademark, but owns the license. *Id.*

(2) *Is Subsidiary entitled to share in the income attributable to the trademark based on its marketing activities?*

No. The consideration for each party's marketing activities is embedded in the contractual terms of the license. *Id.* at Example 3.

(3) *If subsidiary undertakes additional marketing activities above and beyond those required by the agreement is Subsidiary entitled to income attributable to the trademark?*

No, if the license is of sufficient duration that the Subsidiary could reasonably anticipate reaping the benefit of its activities in the form of increased sales or revenues and the subsidiary's actions increase only the value of the Subsidiary's intangible property. *Id.* at Example 4.

Maybe, if the Subsidiary's activities increase the value of the Parent's trademark. In that case Parent may be required to compensate subsidiary. *Id.*

c) Transfer Pricing and Royalties

i) Scenario[12]:

U.S. Parent develops IP and licenses IP to Foreign Subsidiary. Foreign Subsidiary manufactures products and sells products to U.S. Parent for distribution in the United States and sells product in foreign markets. Foreign Subsidiary pays U.S. Parent royalty based on a percentage of sales. In some cases, including *Bausch & Lomb*, the IRS has contended that the Foreign Subsidiary is a contract manufacturer and should only receive routine manufacturing profits. Treating the Foreign Subsidiary as a contract manufacturer allocates more of the profits, and thus more of the tax burden, to the U.S. Parent. The IRS has also questioned whether the royalty rate and the price of the products sold to the U.S. Parent are consistent with arm's-length transactions.

ii) Questions:

(1) *Is the Foreign Subsidiary a contract manufacturer?*

In *Bausch & Lomb*, no. The Tax Court found that the license and sales had independent significance. Subsidiary was intended to serve foreign markets, there was no guarantee that Bausch & Lomb would purchase any of Subsidiary's products, and there was no guarantee that the price would remain the same. Subsidiary bore the risks of variation in volume and price and,

[12] Facts underlying dispute in *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, *aff'd*, 933 F.2d 1084 (2d Cir. 1991)

therefore, was not a contract manufacturer. *Bausch & Lomb*, 92 T.C. at 584. Furthermore, the license royalty and sale price varied independently and should be analyzed separately. *Id.*

In cases where a Foreign Subsidiary bears volume and pricing risks, courts have consistently rejected arguments by the IRS that foreign subsidiaries should be considered contract manufacturers for their U.S. Parents. *See Eli Lilly,* 84 T.C. 996; *Bausch & Lomb,* 92 T.C. 525; *Sundstrand*, 96 T.C. 226.

However, if a license of IP and sale of the product manufactured under the license are interdependent, a separate royalty rate and transfer price do not have significance. *Bausch & Lomb*, 92 T.C. at 584. Moreover, if the Parent company is required to purchase the Subsidiary's production under the license, the Subsidiary is a contract manufacturer. *Id.*

(2) *Was the Foreign Subsidiary entitled to profits in excess of routine manufacturing profits?*

In *Bausch & Lomb*, yes. By bearing the risks of volume and pricing, BL-Sub was entitled to a royalty rate that provided profits substantially in excess of routine manufacturing profits. *Id.* at 611.

(3) *Was the transfer price paid by U.S. Parent consistent with an arm's-length transaction?*

In *Bausch & Lomb*, yes. The Tax Court held that the transfer price was consistent with an arms length transaction based on comparable transactions between unrelated parties. *Id.* at 591-93.

(4) *Was the royalty paid by Foreign Subsidiary consistent with an arm's-length transaction?*

In *Bausch & Lomb*, no. The Tax Court found the royalty rate was too low based on the licensee's profit projections and capital investment. The Tax Court adjusted the 5% royalty rate to 20%. This adjustment was affirmed by the 2nd Circuit. *Id.* at 611.

But in *Ciba-Geigy*, the royalty paid by Ciba-Geigy's U.S. Subsidiary was consistent with an arm's-length transaction. After finding no comparable uncontrolled transactions, the Tax Court considered (1) offers by unrelated parties to pay 10-15% royalty, (2) the potential profit to the U.S. Subsidiary and (3) the U.S. Subsidiary's return on investment. The IRS determined that the 10% royalty was consistent with an arm's-length transaction. *Ciba-Geigy Corp. v. Comm'r*, 85 T.C. 172, 226-30 (1985).

iii) <u>Take Away</u>

U.S. courts have generally respected a taxpayer's transactional structure if the results are consistent with results that would have been realized in an arm's-length transaction.

CASE SUMMARY

1) Licenses/IP Not Transferable to New Entity

Cincom Systems, Inc. v. Novelis Corp., 581 F.3d 431 (6th Cir. 2009)

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Schreiber Foods, Inc. v. Beatrice Cheese, Inc., 402 F.3d 1198 (Fed. Cir. 2005)

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4) Damaging Statements

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6) Tax Implications to Watch Out For with Multinational IP Ownership

Veritas Software Corp. v. Comm'r, No. 12075-06, 2009 WL 4723602, (T.C. Dec. 10, 2009)

Bausch & Lomb, Inc. v. Comm'r, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991)

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