A Voyage to Mars: A Patent Is Licensed to A Subsidiary, And All Is Lost

By Thomas Carey, Partner

A *June 2008 opinion* of the Court of Appeals for the Federal Circuit exemplifies the perils that tax planning maneuvers can pose to a company's ability to enforce its patents. More specifically, a company's standing to sue – which requires having a legally sufficient stake in a dispute – can be lost through overly creative corporate structuring.

Companies sometimes separate ownership of intellectual property from its use for tax planning purposes. For example, Toys'R'Us decided years ago to transfer its trademarks to Geoffrey Inc, a Delaware subsidiary, which then charged royalties to each affiliate that used the marks. This ploy had the effect of transforming operating income – generated in the various states where Toys'R'Us stores were located – into royalty income received in Delaware, where Geoffrey Inc. maintained its office. Named the "Geoffrey Loophole", this strategy has been adapted for use by many patentees, who form intellectual property holding companies and license their patents to affiliates. This strategy may have tax benefits, but it carries the potential to diminish the value of patents, as our new case demonstrates.

Mars Incorporated ("**Mars**"), the candy maker, owned two patents covering technology used in vending machines. Mars chose to exploit this technology through a subsidiary, Mars Electronics International ("**MEI**"), which manufactured and sold vending machines. Rather than assign the patents to MEI, Mars licensed them and charged a royalty. Mars also licensed the patents to a UK subsidiary ("**MEI-UK**") that made and sold vending machines, and which was not restricted from selling them in the US.

The tangled facts of Mars Inc. v. Coin Acceptors, Inc. may be simplified as follows:

- *1988*: Mars notifies Coin Acceptors Inc. ("**Coinco**") that its products infringe the Mars patents.
- *1990*: Mars brings suit against Coinco for infringement.
- *1996*: In the wake of a dispute with the UK tax authorities, Mars transfers its "entire interest" in the patents to MEI, and both parties agree that MEI-UK continues to be licensed to use the patents throughout the world.
- *2003*: The final Mars patent expires.
- *2005*: the trial court enters a final judgment of infringement against Coinco, and begins proceedings on the question of damages.

Mars sought lost profits, a measure of damages that is usually available only to the manufacturer of patented products. This measure generally results in a higher damages award than the "reasonable royalty" available to a patentee who licenses his patents but does not manufacture the products.

Before the damages trial, Coinco argued that lost profits were not available to Mars. The trial court agreed, and ruled further that Mars was not entitled to **any** damages after it had transferred the patents to MEI in 1996.

The trial court suggested two solutions to this problem: Mars could amend its complaint to add MEI as a plaintiff; or it could have MEI transfer the patents back to Mars before final judgment. The court did not, however, permit Mars to add MEI as a plaintiff with respect to infringement that occurred before January 1996, since MEI was then a mere licensee, not the owner, of the patents.

In 2006, in response to this ruling, MEI and Mars entered into an agreement by which MEI acknowledged that Mars retained the right to sue for past infringement of the patents. The district court treated this agreement as one that deprived MEI of standing, but that gave Mars the right to recover damages for the period during which MEI had owned the patents.

The court then awarded damages of $14 million, based upon a royalty rate of 7% running from 1988, when Mars notified Coinco of its infringement, until 2003, when the last patent expired. This included the post-1996 period when MEI owned the patents.

On appeal, Mars argued that it was entitled to damages based upon lost profits. It claimed that because MEI was its wholly-owned subsidiary, all manufacturing profits of MEI flowed inexorably up to it. The Federal Circuit did not disagree with Mars's theory, but said that the record contained no evidence of manufacturing profits having actually been remitted to Mars. On that basis, the trial court's denial of lost profits was upheld.

The Federal Circuit also affirmed the trial court's refusal to permit Mars to add MEI as a plaintiff for pre-1996 infringement. Only an exclusive licensee, said the court, has standing to sue for infringement, and the license rights granted to MEI-UK were sufficient to deprive MEI of standing as an exclusive licensee. In support of this conclusion, the court cited not only the 1996 agreement, but the testimony of the Mars tax director who, when asked if MEI-UK could sell its products in the United States, replied, "That could happen, sure."

Coinco fared better before the appellate judges than did Mars. Agreeing with Coinco, the Federal Circuit rejected the trial court's view that the 2006 agreement, which acknowledged that Mars had retained the right to sue for past infringement despite transferring the patents to MEI, sufficed to give Mars standing to sue for damages from 1996 through 2003. The Federal Circuit agreed with Coinco that, in order to confer standing on Mars, the 2006 agreement would have had to transfer title to the patents back to Mars, not merely the right to sue for past infringement.

The Federal Circuit had no problem with a 7% royalty rate for computing damages. In a huge blow to Mars, however, the Court concluded that Mars lacked standing to sue for infringement for the period 1996-2003 because MEI, not Mars, owned the patents during that time. The trial court had treated the 2006 Agreement as one that deprived MEI of standing for the period 1996-2003, a result that neither party appealed.

On that basis, the Court of Appeals concluded that **no plaintiff had standing to sue** for that eight-year period, and sent the case back to the district court to recalculate damages so as to exclude that period. Thus, over half of the long period of infringement is to be eliminated, likely halving the $14 million damage award.

The record does not indicate what tax benefit, if any, Mars derived from its strategy of licensing the patents rather than transferring them to its subsidiaries. It is clear, however, that Mars erred by entering into non-exclusive licenses when it could have easily granted MEI an exclusive license in the US, and MEI-UK exclusive rights in the UK. This would have conferred standing on MEI, made lost profits available as a remedy, and averted the disastrous loss caused by the company's attempts to cure its standing issue.

That "cure" involved an attempt to separate ownership of the patent from ownership of the right to pursue a claim for infringement. While creative, it caused a double whammy: it deprived MEI of standing because it had abjured its right to sue, and deprived Mars of standing because it did not own the patent. Thus the parties entered a Twilight Zone where a patent surely existed, but no remedy for infringement for an eight-year period was available.

One moral of the story is that maintaining patent ownership in the hands of the company that is actually manufacturing the products offers the soundest basis for standing to recover infringement damages. If that type of ownership structure is not desirable, an exclusive license is always preferable to a non-exclusive license for ensuring standing. Finally, Mars might have done more to make its tax director aware of the implications of the patent law. Had he been sensitive to the issues, he would not have said "That, it could happen, sure" when asked if MEI-UK could sell into the United States.

Death and taxes may be inevitable, but infringement happens from time to time as well. Good planning involves being prepared for the possible as well as the inevitable.