TWO WORLDS COLLIDING?

TRANSFER PRICING AND DAMAGES IN INTELLECTUAL PROPERTY LITIGATION

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I. INTRODUCTION

The profitable management of intellectual property (IP) in today's world requires that firms balance sometimes conflicting incentives. Tax rules in the U.S. and in many other countries require that businesses charge "arm's-length" transfer prices when licensing their IP to affiliated entities across jurisdictional boundaries. All else equal, a firm has the incentive to set a transfer price to shift as much profit to lower-tax jurisdictions as can be economically justified under the applicable transfer pricing rules. However, this strategy can present a possible conflict with the firm's efforts to enforce its IP rights. For example, what if the firm believes that a rival in the U.S. is infringing a patent it owns? To recover monetary damages resulting from the infringement, the patent owner may file litigation against the alleged infringer. According to U.S. patent law, the patent owner is entitled to a damage award that is no less than a reasonable royalty for a hypothetical license of its patent to the infringer. Of course, within this framework, the patent owner wants to demonstrate that its damages are as large as possible. That is where the potential conflict arises: the patent owner must be aware that its own "agreed-upon" transfer price(s) could potentially be "discovered" during the litigation. The alleged infringer's damages expert may point to the transfer price(s) (and supporting contemporaneous documentation) as a benchmark for the value of the patent that puts a ceiling on a damages award.

The possibility of a conflict arises because properly done transfer pricing studies and patent infringement damages analyses rely, in principle, on the same valuation premise: the

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value of a patent derives from its incremental contribution to the firm's profits. In our view, to avoid possible conflicts, there should be increased coordination among a firm's tax and IP litigation professionals. Indeed, firms should coordinate their IP licensing, litigation, and transfer pricing strategies before they find themselves in litigation, either as defendant or plaintiff.

Here, we provide a general framework for comparing and reconciling possible differences between transfer prices and IP infringement damages. While the principles we discuss hold for any type of IP for which transfer prices may be set, for ease of exposition we limit our discussion to patents. In addition, with respect to transfer pricing rules, we focus specifically on the requirements of U.S. Internal Revenue Code §482. Even so, our conclusions are not affected by this focus since many state tax rules and the tax codes of other countries are broadly similar to §482. In the end, we conclude that different valuations of the same IP can typically be reconciled with careful consideration of the economic circumstances that underlie each valuation.

II. A PRIMER ON VALUATION ACCORDING TO §482

A. Background

§482 requires that a transfer price be determined for certain defined intangible assets exchanged between a U.S. corporate entity and a foreign affiliate. While there are several accepted methodologies for determining a transfer price, a general principal of these methods is that the transfer price should reflect the outcome that would be realized in an uncontrolled arm's-length transaction. Therefore, valuations used to support a firm's transfer price must be based on the assumption that the U.S. company and its foreign affiliate behave as if they were unrelated parties negotiating at arm's-length. All other aspects of their existing (or proposed) commercial relationship and the terms of the asset exchange (*e.g.*, the terms of exclusivity, geographic constraints, *etc.*) are not constrained by law or IRS rules.

B. A Market-Based Valuation Approach to Transfer Pricing

Because it relies on the "arm's-length" standard, §482 requires a market-based valuation analysis. In this vein, the applicable regulations explicitly identify three valuation methodologies that are acceptable for determining arm's-length transfer prices of intangibles: (1) the comparable uncontrolled transaction method, (2) the comparable profits method, and (3) the profit split method. While there are differences among these methods, in the end each attempts to extrapolate a transfer price based on a benchmark. As we understand it, the IRS has a preference for market-based benchmarks, *i.e.*, *actual* arm's-length transactions. However, given the many factors that affect the pricing of an arm's-length transaction (some of which we discuss below), finding a truly comparable benchmark transaction to any given patent (or patent portfolio) may not be possible. As such, §482 also allows for so-called "unspecified methods" for determining a transfer price. Even under these alternative methods, the transfer price must still ultimately reflect the so-called arm's-length "fair market value" of the patent.

One possible alternative method involves explicitly simulating an arm's-length negotiation for the exchange of the asset. More precisely, the valuation analyst explicitly models both the least amount that the putative seller would be willing to accept to sell (or license) the patent, and the most that the buyer would be willing to pay to buy (or license) the patent. The seller's floor is based on the incremental cost of selling or licensing the patent, *e.g.*, measured as the profits it expects to lose to its licensee. The buyer's ceiling is based on its expected incremental gain from doing so, *e.g.*, measured as the profits it expects to gain from having access to the patented technology relative to the next-best alternative technology. These amounts form the boundaries of the negotiation, between which the fair market value of the patent lies, depending on the parties' relative bargaining power. In the end, the outcome of that negotiation yields a market-based transfer price.

In modeling this negotiation, the analyst must remember that the fair market value for any particular patent depends on the specific nature of the patent, and on the parties' competitive relationship and expected use of the patent. For example, if the licensee is a competitor to the licensor, then, all other things equal, the cost of licensing for the latter rises and the fair market value will rise. Only a transfer price that fully reflects the market circumstances that affect each party's reservation price will appropriately measure the patent's fair market value and, therefore, be defensible. The corollary is: to be defensible, valuation for transfer pricing purposes should not be based on a simplistic application of certain formulae or rules-of-thumb that can be applied to all industries and circumstances.

III. A Primer on Valuation in connection with IP Litigation

Economic damages in litigation in which one party is alleged to have infringed the patent rights of another are intended to return the patent owner to the financial position that it would have held absent the infringement. This is known as the "make-whole" standard. If reasonable royalty damages are awarded, they should the "price" to which the patent owner and infringer would have agreed for the infringer's use of the patented invention. Thus, the reasonable royalty construct is, in effect, an exercise in determining the fair market value of the patent at issue. In this context, the parties to the transaction—the patent owner and the accused infringer—are, most likely, unwilling participants to a hypothetical negotiation. As a result, as with transfer price valuations, the calculation of economic damages in patent infringement litigation also requires careful consideration of the specific nature of the patent and the parties' competitive relationship and expected use(s) of the patent.

IV. Similarities and Differences Between Transfer Price Setting and Economic Damage Calculation: Practical Considerations

Fundamentally, the fair market value of any patent derives from how much the patent is worth to both the buyer and the seller, taking into consideration the economic alternatives available to each and each party's relative position within the marketplace. This principle holds in both the transfer pricing and litigation contexts. Given this similarity, should one expect that the fair market value for a certain patent will be the same when measured for a transfer price analysis as when determined for an economic damage calculation? The short answer is "no." The specific negotiating framework and market circumstances that surround these two assignments are, in most instances, likely to be different. For example, one prominent difference between transfer price setting and the determination of infringement damages is that transfer prices are often simultaneously set for a bundle of different IP assets, whereas the calculation of infringement damages typically involves at most only a few different patents. As we discuss below, this holistic approach to transfer price setting can affect the valuation of the IP.

To minimize potential conflicts that might arise in pursuing a company's transfer pricing and IP litigation strategies, it is important to understand why differences between a transfer price and an infringement damages calculation may arise and how to reconcile those differences. At a minimum, the valuation experts hired in both contexts should be, to the extent possible, aware of and consider the work prepared by the other.

In evaluating the comparability of the typical transfer pricing and damages analysis, at least the following factors should be considered:

- **Complementarity** — Patents (indeed, IP generally) may be transferred as a single, separable asset or within a portfolio that contains several IP assets. How the IP is packaged surely can affect its value. Internal licenses often cover a bundle of patents. Since certain patents may complement others, they may generate more incremental profit in combination than each specific patent asset would generate on its own. In this situation, the fair market value of one infringed patent alone may be less than the fair market value of the patents combined. Alternatively, a licensee that commits to licensing a bundle of IP may, because of its commitment to license the entire bundle, be able to negotiate a more favorable price for the bundle than the sum of the prices it would face if it licensed each asset individually.
- **Exclusivity —** The rights to use IP assets typically can be protected only through the use of the legal system and/or through secrecy. A patent that is owned or licensed exclusively entitles the owner / licensee to be the only party with the legal right to use the patent. All other things equal, a transaction in which the buyer / licensee obtains exclusive rights to a patent will likely fetch a higher price than one in which the transferred rights are non-exclusive. That is,

all other things equal, exclusive rights will reduce the degree of competition faced by the licensee.

- **Duration —** The term of a patent's remaining life and the term of a license to that patent can affect a royalty. All other things equal, a seller / licensor may demand a higher price for a patent with a long remaining life because it knows that it can prevent the buyer / licensee from using the patent for a long period of time. Conversely, knowing that royalties would be payable for many years, the licensee would seek to minimize the running royalty *rate* (*e.g.*, the royalty on each unit of a product sold) on a long-term license. In a similar vein, all else equal, if a licensor can lock-in a licensee for a long period it might be willing to accept a lower running royalty *rate* for a license.
- **Scope** — A license or sale of a patent may, in certain circumstances, restrict the geographic area or field of use in which the patent can be used. Because of different geographic or field of use market conditions (*e.g.*, the demand in the specified region for the product(s) embodying the patent, or the availability of economic alternatives to the products embodying the patent within the specified region or field of use), such restrictions can have an important effect on a patent's value. Moreover, the seller / licensor may face certain costs or other barriers to exploiting its patents in certain areas or fields of use. All else equal, it may have an incentive to license its property to an entity that is better able to exploit its value. In that situation, all other things equal, the fair market value may be lower.
- **Commercial Relationship** — The commercial relationship between the seller and the buyer (or the licensor and the licensee) plays a critical role in the valuation analysis. Indeed, the grant of a license to a competitor may cause (1) the licensor to lose sales to that rival and/or (2) a decrease in the selling price(s) of its product(s) that embody the patent. In this situation, the fair market value must compensate the seller / licensor for these expected losses. Conversely, a firm might choose to license its property only to an entity that will exploit the

patent in an area within which the parties will not compete. This is often the situation in a transfer pricing setting. All other things equal, this will tend to reduce the fair market value.

- **Reservation Price** — The buyer's / licensee's and the seller's / licensor's reservation prices establish the bargaining framework within which the fair market value of the patent at issue is negotiated. These reservation prices incorporate all relevant market and transaction-specific information that affect the parties' expectations about the incremental volume of sales and/or profitability likely to be generated by the patent at issue.

Each of these factors affects the fair market value of the patent. Before a transfer pricing study can be used to provide an "established royalty" for patent litigation (or before a damages study can be used to inform a transfer pricing analysis), the role that each of these factors plays in each valuation analysis must be understood, compared, and contrasted. For example, an exclusive patent license allowing an affiliated company to be the sole user of a patent in a foreign country is a fundamentally different transaction than a non-exclusive license to a competitor that will be using the patent at issue to be a more effective competitor. Thus, in the litigation context, the fact that there is a transfer pricing study yielding a royalty estimate that is at odds with the one prepared for infringement litigation may not be troubling, by itself. But, in-house tax and litigation counsel, the company's outside lawyers, and their valuation experts should recognize that the different studies need to be reconciled and any differences researched and explained. In sum, the optimal management of a firm's IP portfolio requires that valuations be accurate, defensible, and appropriate to the *specific* assignment.