When Lost Profits Are Lost:
Damages in Patent Assertion Litigation with an IP Holding Company

By
Bruce D. Sunstein[1]
Bromberg & Sunstein LLP

I. Two models for the IP holding company

When it comes to obtaining patent damages, intellectual property (IP) holding companies face a unique set of problems. Almost by definition, an IP holding company keeps its IP separate from any business operations, and this separation puts the IP holding company in a class by itself.

In reality, there are two kinds of IP holding companies. One kind is little more than a patent portfolio that has been incorporated or otherwise folded into a legal entity. This kind of IP holding company typically exists for one main purpose—to make money from its intellectual property, either by licensing or litigation. An IP holding company in this category may hold the portfolio of a single inventor, such as the Lemelson Medical, Education and Research Foundation, Limited Partnership, which holds approximately 185 patent properties of the late Jerome Lemelson.[2] Alternatively, an IP holding company in this category may be formed to acquire and hold a portfolio of patents from a variety of sources.[3]

Another kind of IP holding company has affiliates engaged in an ongoing business. An IP holding company in this category will typically be formed and used to provide tax savings and centralized management of intellectual property associated with the business. Tax savings is achieved, or at least attempted to be achieved, by basing the IP holding company in a state (such as Delaware or Nevada) that does not tax royalty income of an IP holding company. The sister companies, located in other states, make royalty payments to the IP holding company, and deduct the royalty payments on their state income tax returns. In this way the sister companies pay less income tax, while the IP holding company does not pay any corresponding state income tax on the royalty payments it receives. As a further trick, the IP holding company can lend money to its sister companies, which deduct interest on their state income tax returns, while the IP holding company gets the interest free of state taxes. Meanwhile, the IP holding company and its sister companies are typically subsidiaries of a parent corporation which will have

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 The author is chair of the Patent Practice Group of Bromberg & Sunstein LLP, Boston. His e-mail address is bsunstein@bromsun.com. Additional contact information is at his firm's web site, www.bromsun.com. The author gratefully acknowledges the work of many colleagues at Bromberg & Sunstein LLP (including Lee Bromberg, Tom Carey, Judith Stern, and Sarah Peck) on which this paper based.

[2] See *Symbol Technologies, Inc. v. Lemelson Medical, Education and Research Foundation, Limited Partnership*, ____Fed. Supp. 2d____ , 69 U.S.P.Q.2d 1738, 2004 WL 161331 (D. Nev. 1/23/04). Litigation of this entity is tracked at www.lemelsoninfo.com.

[3] See, for example, the Acacia Technologies Group of Acacia Research Corporation, discussed at www.acaciaresearch.com and Geoffrey James, "Acacia's Media Patents: The Size And Shape Of The Threat And What You Can Do About It," at http://www.avnonline.com/issues/200311/features/feat_1103_002.shtml.

consolidated financial statements that do not reflect these details, except to show less income tax at the state level.

That is the theory, in any event. In many instances, the tax benefits have been challenged or eliminated.[4]

What both kinds of IP holding company have in common is a special set of considerations potentially limiting recovery of damages in litigation brought to assert infringement of one or more patents in the portfolio of the holding company. Below, we touch briefly on general considerations underlying damages in patent infringement litigation, and explore their special ramifications in the context when the patent owner is an IP holding company. Finally, we discuss an alternative to the IP holding company that avoids its limitations on recovering patent infringement damages.

II. When an IP holding company may experience limits on recovery of a reasonable royalty

The statutory standard for patent damages, in 35 U.S.C. § 284 provides:

> Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.

Determining an appropriate "reasonable royalty" is left for the trier of fact. In determining what is a reasonable royalty, a wide range of factors may be taken into account. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), modified and aff'd, 446 F.2d 295 (2nd Cir. 1971), cert. denied, 404 U.S. 870 (1971), sets forth a non-exhaustive list of fifteen factors to be evaluated in determining a reasonable royalty. (1) royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty; (2) rates paid by the licensee for the use of other patents comparable to the patent in suit; (3) nature and scope of the license; (4) the licensor's licensing policy; (5) commercial relationship between licensor and licensee; (6) convoyed sales; (7) duration of the patent and term of the patent; (8) profitability of the product under license and its commercial success; (9) utility and advantages of the patent over prior art; (10) the nature of patented invention and benefits thereof; (11) the extent of the infringer's use and value thereof; (12) the portion of profit or selling price to allow for use of the invention; (13) the portion of realizable profit credited to the invention; (14) expert testimony; and (15) a hypothetical arms-length negotiation.

If there is an established royalty—the first of the fifteen *Georgia-Pacific* factors—it will typically trump the other factors in determining what royalty is reasonable.[5]

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[4] *See*, for example, Mass. Gen. L Ch. 63, § 31I (2003)(limiting tax benefits from an IP holding company); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993)(Toys'R'Us denied tax benefit) Mazerov, Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue For Many States (Center on Budget and Policy Priorities, May 23, 2003) (available at http://www.cbpp.org/4-9-02sfp.pdf).

In the case where an IP holding company is a plaintiff in patent infringement litigation, it is to be expected that license agreements with the IP holding company may be evidence of an established royalty. If the IP holding company is in the first category we discussed—simply an incorporated patent portfolio—and it has been successful in licensing its technology, then its past licensing practices may be helpful and not harmful to its case for damages.[6]

On the other hand, where the IP holding company is in the second category we discussed—and it has sister companies that are paying it royalties—then the royalty arrangement that has been established for purposes internal to the corporate structure may pose serious problems to recovery in patent infringement litigation. Because the internal royalty is established to address tax concerns, the motivation for determining the royalty rate differs dramatically from the royalty rate one may rightfully demand from a competitor in a patent case.

Even though these considerations differ, however, a court may very well allow the intra-company royalty rate to be entered into evidence in a patent infringement action. It could be argued by the defendant that the intra-company royalty, although established for tax purposes, would still reflect an arm's length negotiation (just like factor 15 of the *Georgia-Pacific* factors) between licensor and licensee, and is therefore an appropriate measure of what a reasonable royalty is.

The IP holding company would seek to downplay the relevance of the intra-company royalty rate or treat it as a floor when considering a reasonable royalty for a competitor. Yet the IP holding company would be faced with the prospect of having the parent company admit that it did not use a higher intra-company rate because the parent company did not want an undue risk of being found to have committed tax fraud. In other words, the defendant can argue that the IP holding company pegged the intra-company royalty as high as it could reasonably be set without being challenged as artificially high by the taxing authorities. These circumstances might well put downward pressure on a determination of what royalty is reasonable in a patent infringement action by the IP holding company.

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[5] *Seal-Flex, Inc. v. W.R. Dougherty & Assocs., Inc.*, 254 F.Supp.2d 647, 656 (E. D. Mich. 2003)(In order for a court to find that a royalty is "established," it must be paid or secured before the infringement began; must be paid by a sufficient number of persons to indicate the reasonableness of the rate; must be uniform in amount; must not have been paid under threat of suit or in settlement of litigation; and must be for comparable rights or activity under the patent); *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075, 1078-79 (Fed. Cir. 1983).

[6] Note that patent licenses negotiated in settlement of pending or threatened litigation have been found to be of little or no weight in determining a reasonable royalty, or are inadmissible under Rule 403 or Rule 408 of the Federal Rules of Evidence. *Deere & Co. v. Int'l Harvester Co.*, 710 F.2d 1551 (Fed. Cir. 1983) (licenses admissible but of little probative value); Hanson v. Alpine Valley Ski Area, Inc., 718 F.2d 1075, 1078, 1082 (Fed. Cir. 1983) (even if exclusion of license offers was error, it was harmless because offers were of little relevance); *Pharmastem Therapeutics, Inc. v. Viacell Inc.*, 2003 WL 22387038 (D. Del. October 7, 2003) (license agreements negotiated when "litigation was threatened or at least probable" inadmissible under Rule 408); *Donnelly Corp. v. Gentex Corp.*, 918 F. Supp. 1126 (W.D. Mich. 1996) (licenses inadmissible under Rule 403 because prejudicial effect outweighed slight probative value); *Century Wrecker Corp. v. E.R. Buske Manuf. Co.*, 898 F. Supp. 1334 (N.D. Iowa 1995) (finding licenses admissible only to the extent relied upon by plaintiff's expert).

III. When an IP holding company may lose out on lost profits damages

The patent statute provides that a reasonable royalty is not the only measure of damages, but rather is a floor on recovery.[7] A patentee who shows a reasonable probability that, but for the infringement, it would have made the sales that were made by the infringer, is entitled to an award of lost profits.[8] However, as a matter of proof, the seminal case in this area, *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, permits an award of lost profits on the establishment of four elements: "(1) demand for the patented product, (2) absence of acceptable noninfringing substitutes, (3) manufacturing and marketing capability to exploit the demand, and (4) the amount of the profit he would have made."[9]

Although it is often difficult for any patent holder to establish the existence of these factors, the IP holding company as a plaintiff is especially vulnerable because it has no manufacturing capability and probably no marketing capability. Sometimes the requirement of manufacturing capability has been interpreted liberally in favor of the patent holder. A patent holder with some manufacturing capability has been found to have the requisite manufacturing capability in part by virtue of the prospect of subcontracting manufacturing.[10] Manufacturing cabability may also be found sufficient if it can be shown that the patent holder could have expanded its facilities to meet demand.[11] On the other hand, the case law does not provide the patent holder with a basis for obtaining lost profits when the patent holder has no manufacturing capacity, since the patent holder cannot show that, but for the infringement, the patent holder would have been able to sell to the infringer's customers.[12]

Given the nature of the requirement for manufacturing capability, in the case of the first kind of IP holding company that we have described— an incorporated patent portfolio—it is difficult to imagine a basis for awarding lost profits, since there is simply no manufacturing capability. However, in the second kind of IP holding company we have described— one that has sister companies that are paying it royalties—there are some arguments, albeit potentially weak, to be made for the availability of a lost profits

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[7] A "reasonable royalty … is … the floor below which damages shall not fall." *Stickle v. Heublein, Inc.*, 716 F.2d 1550, 1561 (Fed. Cir. 1983) (quoting *Bandag, Inc. v. General Tire Co.*, 704 F.2d 1578, 1583 (Fed. Cir. 1983)).
[8] *Del Mar Avionics, Inc. v. Quinton Instrument Co.*, 836 F.2d 1320, 1326 (Fed. Cir. 1987).
[9] *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152, 1156 (6th Cir.), *cert. denied*, 439 U.S. 856 (1978) (Markey, C.J., sitting by designation); *accord*, *Radio Steel & Mfg. Co. v. MTD Products*, 788 F.2d 1554, 1555, 1556 (Fed. Cir. 1986), *Tate Access Floors, Inc. v. Maxcess Technologies, Inc.*, 222 F.3d 958, 971 (Fed. Cir. 2000).
[10] *Gyromat Corp. v. Champion Spark Plug Co.*, 735 F.2d 549, 554 (Fed. Cir. 1984).
[11] *Bio-Rad Lab. Inc. v. Nicolet Instrument Corp.*, 739 F.2d 604, 616 (Fed. Cir. 1984)(testimony that facilities were adequate or could have been made adequate).
[12] *See*, for example, *Water Technologies Corp. v. Calco, Ltd.*, 850 F.2d 660, 671-2 (Fed. Cir. 1988). In *King Instruments Corp v. Perego*, 65 F.3d 941, 947 (Fed. Cir. 1995), lost profits were awarded to a patent holder that did not make or sell devices that were covered by patents in suit, but the patent holder nevertheless was actually manufacturing devices in competition with devices of the defendant. "Thus, as apparent in this case, the patentee may acquire better returns on its innovation investment by attempting to exclude infringers from competing with the patent holder's nonpatented substitute." 65 F.3d at 950. Moreover, it was found that the plaintiff indeed established a basis for lost profits it would have had but for the infringement. 65 F.3d at 952 et seq.

award. In *Kalman v. Berlyn Corp.*, [13] the plaintiff inventor and patentee owned 50% of a company that was the sole manufacturer of the product. The district court denied a motion of the plaintiff to join the company as co-plaintiff in order to recover lost profits. The Federal Circuit reversed, explaining: "When the sole licensee has been shown to be directly damaged by the infringer in a two supplier market, and when the nexus between the sole licensee and the patentee is so clearly defined as here, the sole licensee must be recognized as the real party in interest."

The authority of the *Kalman* case suggests that an IP holding company and its sister corporation that holds a license to the patent in suit and performs manufacturing for the parent company may join as plaintiffs and establish a basis for a lost profits award. However, this position is based only on theory, not on practice. In *Schreiber Foods, Inc. v. Beatrice Cheese, Inc.*,[14] an IP holding company was formed as a subsidiary of the parent operating company. The patent in suit was assigned by the parent to the IP holding company, and the parent received in return a non-exclusive license to the patent in suit. The parent company was the plaintiff. Through trial, the IP holding company was not made a party to the action, and the plaintiff did not disclose the fact that title to the patent had been transferred to the IP holding company. Plaintiff's counsel stated that it was unaware of the transaction until well into the trial, and that it responded to the problem by having title to the patent transferred back to the parent company and the license agreement terminated. The trial court held that the plaintiff had no standing to sue, because it held only a non-exclusive license to the patent, and that the problems created by the absence of the patent holder as plaintiff could not be cured without prejudice to the defendant, since the case had already been tried. The court held, among other things, that "a corporate plaintiff in a patent-infringement case cannot have it both ways by arguing in the infringement case that it holds title to the patent, while in the meantime, assigning the patent to another corporation for tax purposes."[15]

The *Schreiber Foods* case makes clear that it is critical for the patent owner, not merely a non-exclusive licensee, to institute the litigation and to do so under circumstances where the facts of patent ownership and licensing are not disguised. On the other hand, it is not inconsistent, under *Kalman*, for the operating company to join with the IP holding company as plaintiff in the action. It is an open question, however, whether this tactic will permit the combination of IP holding company and operating company to recover lost profits. The *Schreiber Foods* rationale could well be extended to justify a finding that a company, having utilized distinct corporate forms to provide tax advantages, cannot choose to ignore those same forms as a way of claiming entitlement to lost profits in patent infringement litigation.

IV. Advantages of holding property in the parent corporation

While it has become popular for tax and other reasons to hold property in an intellectual property holding company, some of the largest U.S. companies opt for a simpler approach. IBM, Microsoft Corp., Eli Lilly & Company, and 3M (Minnesota

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[13] *Kalman v. Berlyn Corp.*, 914 F.2d 1473, 1482 (Fed. Cir. 1991).

[14] *Schreiber Foods, Inc. v. Beatrice Cheese, Inc.*, ___F. Supp. 2d ___, 2004 WL 371822 (E.D.Wis. 2/20/2004).

[15] 2004 WL 371822 at *9.

Mining & Manufacturing Co.) hold the vast majority of their intellectual property in the name of the parent corporations. Microsoft Corporation, for example, a company that in 1990 held only 5 patents, now owns more than 3,000 U.S. patents in the name of the parent corporation, according to the United States Patent and Trademark website. Eli Lilly (with more than 3,300), 3M (more than 7,600) and IBM (more than 35,000) also have vast numbers of U.S. patents held in the name of the parent corporation. Similarly, these companies have the majority of their European patents held by the parent corporations.

Although case law concerning standing to recover lost profits is unclear, unsettled, and evolving, it appears that a parent company holding a patent has standing to recover lost profits based on the manufacturing activities of its subsidiary.[16] Certainly, there is a better prospect for a parent IP owner to recover lost profits when a subsidiary does its manufacturing than there is for an IP holding company to recover lost profits when a sibling company does the manufacturing, at least in the cases where there are no written license agreements. What makes life difficult for the IP holding company is that, at bottom, the business context is the same for both tax purposes and patent purposes. This context imposes limits on reasonable royalty damages and on lost profits recovery.

Given that patent litigation involving lost profits will likely involve "experts of national repute … presented by both sides to render their opinions of what would have happened in a world that never existed,"[17] a plaintiff's odds of getting into that world are far better when the plaintiff is not an IP holding company.

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[16] *See*, for example*, Minnesota Mining & Manufacturing Co. v. Johnson & Johnson Orthopaedics, Inc.*, 976 F.2d 1559 (Fed. Cir. 1992)(wherein 3M recovered lost profits, without joining its manufacturing subsidiary and without scrutiny as to its corporate form or licenses by the court); *WMS Gaming, Inc. v. International Game Technology*, 184 F.3d 1339, 1361 (Fed. Cir. 1999)(parent patent owner sued in its own name; motion to withdraw stipulation as to parent's manufacturing capability properly denied since manufacturing subsidiary would have had standing to join as a co-plaintiff to recover lost profits, even though subsidiary had a license that was, apparently, non-exclusive).

[17] *Polaroid Corp. v. Eastman Kodak Co.*, 1990 WL 324105, *2, 16 U.S.P.Q.2d 1481, 1483 (D.Mass. 1990)(Mazzone, J.).