McDermott Will & Emery

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McDermott International Legal Highlights

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Welcome to the next edition of McDermott International Legal Highlights. This publication includes a collection of articles written by McDermott lawyers in the US and Europe focusing on recent and future legal challenges that Japanese companies may face while expanding abroad. We are reporting on topics relevant for Japanese companies where McDermott has special skills and deep experience.

We hope that you enjoy these legal news updates. Please feel free to contact your McDermott attorney or me if you have further questions or require clarifications.

Jacques Buhart
Partner
Paris, Brussels
McDermott Will & Emery

The New World of Global Tax Planning: a Checklist for Success

Cym H. Lowell (Dallas)

As all multinationals (MNEs) are discovering, domestic implementation of the recommendations set out in the base erosion and profit shifting (BEPS) final reports from 2015 has the potential to significantly impact their effective tax rate planning.

The immediate issue flows from the country-by-country (CbC) transfer pricing (TP) documentation process. Many countries (including China, Japan, Italy and the United Kingdom) have implemented domestic legislation effective for 2016, and the United States has finalized regulations that will come into effect in 2017. A multilateral instrument relating to CbC is well underway, and is expected to impose the CbC requirements on all 3,000+ existing treaties.

The critical consequence of the CbC process, as well as many of the other BEPS issues, will be an inevitably heightened focus by tax authorities on testing locally reported TP results on a profit split basis. This is not necessarily a cause for concern as it is possible to develop a means of reporting TP results on this basis, e.g., as elements of advance pricing agreements or Competent Authority processes, though typically these are not included in local documentation.

In the case of companies that have not developed profit split models, it may be a challenge to develop pertinent TP data owing to systems limitations, accounting differences, faulty assumptions, country-specific issues, etc. There are inevitably surprises when a robust profit analysis is undertaken.

The following is a checklist for formulating an effective CbC strategy.

Form a Working Group

Companies addressing their CbC issues should develop a working group composed of internal colleagues and external advisors who can develop an efficient and effective policy for adapting to the new world.

The working group could be composed of internal experts in

- Tax (domestic and international)
- Transfer pricing (if separate)
- Information technology
- The supply chain
- Relevant laws

As well as the CFO (financial accounting) and external international technical tax advisors, transfer pricing advisors, lawyers and financial auditors as appropriate in terms of independence and related matters relating to the auditor. Consider the role of attorney-client privilege in the process.

Note also, that there are a variety of providers offering software solutions for CbC; these can be useful in the creation of a working group.

Look at Current Global Effective Tax Rate (ETR) Planning

Once the working group is in place, it can

- Refresh the building blocks of the existing ETR plan or confirm them as fit-for-purpose.
- Decide exactly how the plan will be implemented.
- Determine the structural aspects (non-TP aspects) of the ETR plan.
- Consider the TP building blocks
    - Undertake a functional analysis.
    - Is TP performed on a one-sided basis, e.g., CPM transactional net margin method?
    - How will the TP structure integrate with non-TP building blocks?
- Allocate taxable income by country.
- Formulate global results on a system profit, or profit split, basis (a two-sided TP basis). If the MNE has utilized profit split methodologies for TP documentation, examination, dispute resolution or otherwise, this experience will be invaluable in adapting to the CbC world. For example, groups with Japanese experience from the post-1986 period will likely have developed such approaches.

Formulate CbC for Global Documentation

The group's next steps are to

- Complete a draft of the local, master, and CbC documentation. A template is available at C.Lowell, M.Martin & M.Levey, U.S. International Taxation: Agreements, Checklists & Commentary Form 2.11 (Thomson Reuters 2016).
- Evaluate reports from the standpoint of each local tax authority and the standpoint of the home or other pertinent country tax authority.
- Prepare a risk assessment for each building block of the global ETR strategy.
- Prepare simulated potential tax authority evaluations, which will be instructive in the process of re-evaluating the ETR strategy, restructuring as appropriate and preparing for controversy.

If the group is not experienced with profit split TP methodologies, this will be an interesting experience; be patient.

Re-Evaluate the Global ETR Plan

The group should then:

- Revisit the building blocks of the ETR plan, evaluating it in light of the CbC analysis above
- Consider if it is necessary to change the building blocks
- Determine whether or not to update the ETR plan
- Consider potential restructuring options
- Identify other conclusions.

Consider the Impact of Potential Restructuring

If a restructuring is determined to be necessary, the following should be taken into account

- Income tax
- TP
- Exit or restructuring taxes
- Existing examinations or pending disputes
- Other as appropriate
- Consumption taxes
- Financial accounting
- Financial reporting.

Prepare for Controversy

Even the best-laid plans sometimes go awry, so the group should

- Categorize the building blocks of the existing global ETR plan.
- Consider
    - The risk of a tax authority challenge, e.g. where some of the building blocks are specifically mentioned in the BEPS final reports.
    - The potential impact of a successful challenge on global ETR.
    - The likelihood of successfully being able to defend a challenge.
- Prepare a cost-benefit analysis of defending tax authority challenges.
- Decide which of the building blocks of the existing global ETR plan will be proactively amended.

In relation to those building blocks that the group decides will not be amended, the group should

- Proactively prepare responses to possible tax authority enquiries.
- Gather and organize existing data and other materials supporting group's position.

In relation to those building blocks that the group will be amending, are currently under audit, or are being challenged, the group should

- Articulate controversy positions for each block.
- Consider the impact of restructuring on tax authorities' perceptions of existing building blocks.

Set the Agenda for Proceeding

Once the working group has completed these steps, it should create a timeline for implementation and for informing the relevant tax authorities.

Using Licenses and Settlement Agreements to Determine Patent Damages in the United States

Dan Foster (Orange County)

Under US patent law, if there is a finding of infringement of a valid patent, the patent owner is entitled to damages adequate to compensate for the infringement and no less than a reasonable royalty for the use made of the invention by the infringer.

Since 1970, the analysis of a "reasonable royalty" in connection with licenses has relied, at least in part, on the factors set forth *in Georgia-Pacific v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970):

- The royalties received by the patentee for patent-in-suit that prove, or tend to prove, an established royalty.
- The rates paid by the licensee for use of similar patents.

- The type of rights that the licensor would have granted to the licensee, including the level of exclusivity and/or restrictions on territories or customers.
- The licensor's policies and marketing to maintain the patent monopoly by not licensing, or by only licensing under special conditions.

Generally, licenses may be presented to help the jury decide an appropriate royalty award. Patent owners and product manufacturers may both have strategic reasons to refer to prior licenses, including settlement agreements. Parties customarily may want to establish a particular rate, or even the structure of payment.

The Federal Circuit has recently acknowledged that "past licensing practices of the parties and licenses for similar technology in the industry may be useful evidence" *Carnegie Mellon Univ. v. Marvell Tech. Group, Ltd.*, 807 F.3d 1283, 1304 (Fed. Cir. 2015). "But such evidentiary use must take careful account of any 'economically relevant differences between the circumstances of those licenses and the circumstances of the matter in litigation'". The courts therefore require consideration of the similarities and differences between prior license agreements and the damages sought in the case at hand.

Litigation settlement agreements are a special kind of license agreement that receive more scrutiny and less credibility. As the Federal Circuit stated in a 2012 decision, "the propriety of using prior settlement agreements to prove the amount of a reasonable royalty is questionable" *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 77 (Fed. Cir. 2012). That same court did, however, concede that there may be cases where a settlement agreement could be considered if it is the "most reliable" license in the record.

For such a settlement agreement to be considered, a damages expert first "must provide some analysis on the litigation underlying the agreement" (emphasis in original) *Baltimore Aircoil Co., Inc v. SPX Cooling Techs. Inc.*, Case No. 13-2053, Dkt. No. 211 (D. Md. August 22, 2016). In Baltimore Aircoil, the district court excluded an expert's opinion that relied on a settlement agreement where the expert "offer[ed] no details as to the litigation posture of [the parties] at the time of settlement . . . including the parties' positions in regards to claim construction, validity, or infringement."

Even for a case involving the same patent, the experts will have to overcome the concern that the settlement agreement was made in the context of settling litigation and thus did not reflect the royalty the parties would have reached just before infringement began. The expert opinions must be "tied to the relevant facts and circumstances of the particular case at issue and the hypothetical negotiations that would have taken place in light of those facts and circumstances at the relevant time" *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1318 (Fed. Cir. 2011).

Although many courts have excluded settlement agreements, in limited cases they have allowed a settlement agreement to be admitted following a complete expert analysis. In a 2015 decision (*AstraZeneca AB v. Apotex Corp.*, 782 F.3d 1324, 1335 (Fed. Cir. 2015), the Federal Circuit upheld the use of a settlement agreement that involved the same product and the district court analyzed the pertinent settlement and licensing negotiations in detail and with close attention to the similarities and differences between those negotiations and the hypothetical negotiation in this case

The potential use of these licenses in court should also be considered by parties entering into licensing or settlement agreements. Patent owners should be aware that future juries may be asked to consider all licenses relating to the patent at issue, or similar patents. This is especially true for licenses that are entered outside litigation. Companies that make products, and which may be sued for patent infringement, should consider that their own licenses could be relevant, particularly if they cover the same products that are later accused of infringement.

Full-Function Joint Ventures in the European Union

Jacques Buhart (Paris/Brussels) and Louise Aberg (Paris)

At the inception of a joint venture (JV) in the European Union, parent companies must determine whether or not the newly created structure is full-function. The answer to this question, which depends on the JV's degree of autonomy, will determine the relevant legal framework.

If the JV is full-function it will fall within the scope of the EU Merger Regulation (Council Regulation (EC) No 139/2004 of 20 January 2004), assuming that the turnover thresholds set out in the Regulation are also met. Under these circumstances, the JV will need to be notified to the European Commission that will assess the impact of the JV on competition on an ex ante (based on forecasts rather than actual results) basis.

If the JV is not full-function, parties will not need to notify it to the Commission but the Commission may operate a control ex post (based on actual results rather than forecasts) under Article 101(1) of the Treaty on the Functioning of the EU, which prohibits anti-competitive agreements between undertakings.

The ex post control has the advantage of avoiding the notification process that could potentially delay the implementation of the JV. There is a risk, however, that the parent companies will not obtain a clearance decision and the fate of their JV will be subject to legal uncertainty. It is therefore generally preferable for companies to make sure their JV is full-function and within the scope of the Merger Regulation, as a clearance decision is irrevocable and unlimited.

Uncertainty Over What Constitutes Full-Function

In order to be considered full-function, a JV must operate on a market performing those functions typically carried out by other autonomous undertakings operating on the same market.

In its Consolidated Jurisdictional Notice under the Merger Regulation (OJ C 95/1 (2008), the Commission sets out four criteria to ensure that a JV has sufficient autonomy from its parent companies:

- The JV must have sufficient resources to operate independently on its market.
- The JV must carry out activities beyond one specific function for the parents.
- The JV must have limited sale/purchase relationships with the parents.
- The JV must operate on a lasting basis.

These criteria appear clear, but in practice the Commission takes a pragmatic approach and case-by-case analysis in order to allow companies to benefit from a merger decision in situations where a JV would, in principle, not be considered as full-function. The analytical framework provided by the Commission in the Notice is therefore not always a definitive guide, but useful guidance can be found in the case law.

Guidance From the Case Law

DOCUMENTATION ESTABLISHING THE JV

When notifying a JV to the Commission, the parents must provide supporting evidence that the JV is full-function.

In IV/M.904 (2 April 1997), the Commission considered that the shareholders' agreement clearly showed a lack of full-function character insofar as it was written that the main purpose of the JV would be to provide services to one of the parents.

In COMP/M.5740 (16 June 2010), the Commission advised the parties to adopt a business plan showing the future diversification of the JV's sale and purchase relations.

Carefully prepared documentation is therefore key.

ECONOMIC CONTEXT IN WHICH THE JV OPERATES

The EU courts have ruled that it is appropriate to take into account the characteristics of the market on which a JV operates in order to assess the degree of autonomy it enjoys in relation to its parent companies (judgement of the Court of first Instance of the European Communities (now the General Court of the EU), T-87/96 (4 March 1999)). In IV/M.222 (12 November 1992), the Commission considered that a JV that was dependent on its parent companies for the supply of steel could still be considered as full-function because vertical integration in the steel industry is normal and, to a certain extent, necessary.

Market conditions may also come into play. In IV/M560 (11 May 1995), the fact that the JV would rely on its parent companies during an initial startup period did not mean the JV was not full-function, because the market on which the JV would operate was expanding.

In COMP/JV.57 (30 April 2002), the Commission referred to the current situation of the pay-TV market to justify that a JV should be considered full-function.

ACCESS THE JV HAS TO RESOURCES

The Commission has made it clear that it is not necessary for a full-function JV to actually own the resources necessary to its operation as long as they are "accessible"

(COMP/JV.19 (11 August 1999)). This accessibility may, for example, take the form of exclusive access to the parent companies' production units (COMP/M.3506 (11 June 11 2003)).

The Commission has adopted a pragmatic approach in relation to intellectual property rights; it is sufficient for parent companies to grant a license to a JV (COMP/JV.44 (3 May 2000)). Indeed, regard must be given to the need for parent companies to retain intellectual property rights in order to carry out their own, separate activities (IV/M.1332, 21 December 1998).

EXTENT OF TRADE RELATIONS BETWEEN PARENT COMPANIES AND JVS

According to the Notice, in principle a full-function JV must achieve more than half its sales with third parties. In practice, however, the JV's sales can be mostly to its parent companies, as long as it can be shown that sales to third parties are intended to increase. For example, the Commission considered that a JV was full-function when only 15 per cent of its sales were directed to third parties in the first year of its creation, on the basis that this was expected to rise to 65 per cent by the third year (IV/M.1005 (15 January 1998)).

Given that the Commission's official guidance must be read in conjunction with the case law, it is vital for companies seeking to form a full-function JV to obtain advice.

Brexit: Competition Law Implications for Japanese Companies

Mai Muto (Brussels)

Until the United Kingdom leaves the European Union, or the terms of an exit agreement with the European Union are set, Japanese companies with interests in the United Kingdom or the European Union should conduct their business as usual, unless they intend to file an antitrust damages claim in the United Kingdom.

There is currently considerable speculation as to the effect of various levels of Brexit on UK laws. Assuming the most extreme option, a "full Brexit", a number of potential changes can be identified.

Antitrust

Since EU competition law has long been integrated in UK competition law, the only major changes to UK competition law that are likely under a full Brexit, are to Sections 60 and 10 of the Competition Act 1998.

Section 60 requires the UK competition authorities and the UK courts to maintain consistency with the general principles of EU law and the case-law of the EU courts, and to have regard to the decisions of the European Commission. Post-Brexit, it is likely that Section 60 will be repealed and the UK courts may start developing jurisprudence that departs from EU case law. Section 10, which grants "parallel exemptions" to agreements that meet the criteria of an EU block exemption regulation, is also likely to be repealed.

Major changes are, however, expected in procedure and enforcement. Regulation 1/2003[1], which provides for a number of duties for national competition authorities, would cease to apply in the United Kingdom. As a result, the UK Competition and Markets Authority (CMA) could open its own investigation concurrently with one being conducted by the European Commission. This would increase costs and uncertainty for businesses, and there would also be a risk of double fines.

In a similar vein, the EU leniency regime would no longer apply in the United Kingdom and companies will have to dual-file immunity/leniency applications.

Merger Control

Unless a new arrangement is put in place following a full Brexit, the United Kingdom would depart from the one-stop merger control under the EU Merger Regulation, which grants the Commission exclusive jurisdiction to review transactions that meet certain turnover thresholds[2]. Unless the Commission amends the turnover thresholds, this could result in fewer notifications to the Commission because UK turnover is often significant.

For mergers that satisfy both the EU turnover thresholds and the UK turnover thresholds, merging parties would need to make two, parallel filings with concomitant increase

[1] Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.
[2] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

in time and costs. In such cases, there would be a risk of inconsistent conclusions, generating uncertainty for the parties involved.

State Aid

The EU State aid rules would no longer apply to the United Kingdom after a full Brexit. The UK Government would therefore be able to provide UK businesses with funding, including preferential tax treatment, as it sees fit, within the confines of World Trade Organization anti-subsidization rules.

Funding recipients would no longer face the risk of having to pay back State aid.

Private Enforcement

In the event of a full Brexit, Commission prohibition decisions would have no binding effect on the UK courts. This will increase the evidential burden on claimants, who will have to prove the infringement in the UK court proceedings from scratch.

UK courts will no longer have the facility of referring questions of interpretation or validity of EU law to the Court of Justice of the European Union for a preliminary ruling.

The Recast Brussels Regulation[3], which provides guidance on which courts have jurisdiction, would also cease to apply in the United Kingdom, which will create ambiguity as to jurisdiction.

The Directive on Antitrust Damages Actions[4], which EU Member States need to implement in their legal systems by 27 December 2016, may not now be implemented by the United Kingdom. In the absence of the protection given by this Directive to leniency corporate statements, there would be a risk that the UK courts may order their disclosure.

These factors could discourage claimants from bringing actions in UK courts. In the event of a full Brexit, it may become inadvisable to pursue claims in a UK court against defendant companies not based in the United Kingdom.

Comment

Although Brexit is causing a great deal of legal uncertainty in many areas, in the sphere of competition law there is little impact on companies, at least in the short term. The only immediate impact would be that damages claimants will need to consider the potential consequences of Brexit on the UK legal system when choosing the court of jurisdiction.

More long term, without an arrangement for coordination between the European Commission and the CMA, the duplication of antitrust investigation and merger control could increase administrative work and costs for companies and potentially entail a risk of conflicting results.

Apart from those procedural effects, there may be a gradual policy shift, but no seismic substantive changes are expected.

MCDERMOTT INTERNATIONAL HIGHLIGHTS

Case in Which Disclosure of Technical Level of Person of Ordinary Skill in the Art Affected Determination of Whether Prior Art Is Enabling

Takashi Saito wrote this bylined article on In re Steve Morsa, in which the Federal Circuit affirmed a Patent & Trademark Office finding that admissions made by a patent applicant in his submission to the PTO were sufficient to enable prior art for the patent. The Federal Circuit previously ruled the PTO had applied the incorrect prior-art-enablement procedure and remanded.

McDermott International Seminar in Tokyo

The annual McDermott International Seminar in 2017 will be held in Marunouchi, Tokyo in conjunction with an IP Seminar on January 25 and 26, 2017.

[3] Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

[4] Directive 2014/104/EU of the European Parliament and of the Council of 26 November 2014 on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union Text with EEA relevance.

AUTHORS

For more information, please contact your regular McDermott lawyer, or:

Jacques Buhart
Paris/Brussels
+33 1 81 69 15 01
+32 2 282 35 01
jbuhart@mwe.com

Cym H. Lowell
Dallas
+1 214 295 8063
clowell@mwe.com

Daniel R. Foster
Orange County
+1 949 757 7103
dfoster@mwe.com

Louise Aberg
Paris
+33 1 81 69 15 25
aberg@mwe.com

Mai Muto
Brussels
+32 2 282 35 24
mmuto@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com