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MEMORANDUM

TRADEMARK HOLDING COMPANIES

The Need for Quality Control And Other Issues¹

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INTRODUCTION

Delaware offers a 100% tax exemption for royalty income such as license fees received from the license of trademarks. In order to take advantage of this benefit, an operating concern generally assigns all ownership rights in trademarks to a wholly-owned (and often newly formed) Delaware subsidiary corporation. The Delaware subsidiary then would enter into a license agreement with its parent (and perhaps other affiliates and/or third parties) and collect a fair market royalty on the trademarks, typically based on sales. Under Delaware law, the subsidiary generally qualifies as a "Delaware investment holding company" ("DIHC"), which is exempt from income tax on the royalties as well as on all other passive income such as interest, dividends and capital gains.

¹ Note: As this article was written in 1993, some sections may need updating.

THE NEED FOR QUALITY CONTROL

Trademarks are a unique form of property that can be bought, sold, assigned and licensed. Trademarks are unique, because unlike other forms of property, they have no independent significance apart from the goodwill they symbolize. A clear example of “goodwill” is the quality of products or services which a consumer associates with a particular trademark. When a trademark suggests a high quality product or service, the consumer will pay more for the product or service simply because of the expectation of higher quality associated with the trademark. The trademark thus is a symbol of goodwill and nothing else.

Under both federal and state laws, trademarks are entitled to protection as they are used in commerce. For example, when a trademark has greatly increased in value as a result of its owner providing quality products or services over a number of years, such owner’s protection under the law may exclude any third party from using the same trademark for the same line of products or services. The trademark laws thus protect the value of goodwill that a business develops over years of producing quality products and services.

The assignment, sale or licensing of a trademark without the associated goodwill, i.e., without regard for quality control, could be deemed, in legal terms, a “naked” assignment under which the trademark is deemed “abandoned”. As a result, protection formerly provided for the owner under trademark law could be lost should a third party wish to claim rights to the trademark.² For example, if the owner sells a trademark to another business, the purchasing business may not have the same trademark law protection if the previous owner’s concern for quality control is not maintained. Similarly, if the owner of the

² The theory underlying the “doctrine of naked assignment” is based on notions of consumer deception. A trademark can become unenforceable against others when it no longer is associated with a particular owner and origin of goods, such as when the owner has entered into an unrestricted license of the trademark with a third party. Thus, for example, if a trademark is licensed exclusively to an unrelated third party without any restrictions such as quality control, and such third party then uses the trademark to identify similar, but much lower quality products, consumers could mistakenly believe that the original business stands behind the new products. A potential infringer thus may be able to successfully convince a court that the rights associated with the trademark and the protection normally accorded to the owner were abandoned at the time of license. For representative cases, see: Defiance Button Mach. Co. v. C & C Metal Products, 759 F.2d 1053 (2nd Cir. 1985); Cartier, Inc. v. Three Sheaves Co., Inc., 455 F. Supp. 123 (1979).

trademark enters into an exclusive license with a third party without any concern for quality control of the licensee's use, the owner and licensee both may lose all trademark law protection.

Since trademarks are often the most valuable assets of a business, extreme care should be taken to minimize the risk of naked assignment. An assignment of a trademark to a DIHC should be carefully drafted to provide for assignment of all goodwill associated with the trademark. Similarly, the license agreement for the trademark should provide for adequate control over the quality of the goods or services. In all cases, trademark counsel should review the matter to ensure that the proper course is followed.

One important function for a trademark holding company is to oversee the quality control procedures in effect for the operating affiliates and other licensees of the trademarks. This function serves several important objectives. First, such operation should enhance the value of the trademarks over time. This objective alone evidences an important business purpose for establishing a trademark holding company. This business purpose has the added benefit of further enhancing the substance of the holding company operation for state tax purposes. Third, the function is critical to minimize the risk of "naked assignment" as discussed.

There are a number of alternatives to be considered when determining how the trademark holding company will implement quality control procedures for its licensees. One alternative is to require licensees to report periodically (say, quarterly) to the DIHC on matters of quality control. Trademark counsel can prepare a list of questions to be answered relating to (a) consumer complaints, (b) quality control maintenance procedures, and (c) compliance with specific license agreement requirements, among others. The DIHC Board at its meeting in Delaware would review a compiled report from licensees and take appropriate action as warranted. The minutes of the DIHC Board meeting would reflect a discussion of quality control issues and evidence

a fulfillment of business objectives relating to preserving and enhancing the quality associated with the licensed trademarks.

Another approach, in conjunction with the first alternative, is to engage the services of independent quality control experts. This could range from the use of independent testing labs to an independent quality control auditor of the DIHC, or a combination of both. The independent testing lab would determine, as engaged and instructed by the DIHC, the minimum quality standards, the relative position in the market of the quality of the product (such as, “meets average quality standards”), and/or the results of specific tests designed to test certain aspects of the product (e.g., color fading, breakage, etc.).

An independent quality control auditor could be engaged by the DIHC to implement whatever quality control program is designed by the DIHC and its counsel. This “service provider” could compile the periodic reports from licensees, perform on-site visits at the licensees’ plants or offices, coordinate independent testing services and any number of related and ancillary tasks. The service provider would prepare a report of quality control procedures for review of the Board of directors at their meetings. The independent nature of the service may provide a level of protection and enhancement of trademarks which would not exist if the DIHC had not been formed. This could demonstrate an essential business purpose and justification for forming the trademark holding company.

OTHER ISSUES

A. Change of Ownership as a Matter of Record

In order to reflect the DIHC as the new owner of the trademarks, it generally is necessary to change the registered owner into the name of the DIHC in the appropriate public registration offices. These would include the offices where registrations had been recorded prior to the assignment of property rights to the DIHC. In the United

States, the central federal filing office is the U.S. Patent and Trademark Office, Washington, D.C.

Outside of the United States, the DIHC generally would need to change registrations in the proper recording offices of the applicable foreign countries. The laws of foreign countries differ on the requirements to change registrations, and counsel experienced in such matters (and in particular the special requirements of certain countries) should be consulted. Many assignments must go through a “legalization” process. The assignment document to be recorded in a foreign country, for example, might need an accompanying power of attorney, with the assignor/assignee signatures notarized. The notary’s signature may need to be attested by the applicable state’s Secretary of State, and that Secretary of State’s signature similarly may need to be verified by the U.S. Secretary of State. Finally, the U.S. Secretary of State’s signature may need to be verified by the foreign consulate’s office of the foreign country involved.

B. Arms-Length Royalty Rate

When the DIHC enters into license agreements for the use of trademarks, absent other reliable indicators of value, it is very important to have an independent arms-length appraisal of the trademarks and the proper royalty rate. It is recommended that an independent expert appraisal firm perform the necessary analysis and provide a written report of its conclusions for the DIHC’s reliance in determining the fair market royalty rate. Such rate should reflect considerations relevant to arms-length negotiations. The license agreement then should incorporate such fair market royalty rate. Further, all terms of the license agreement should reflect arms-length considerations and be followed carefully.

C. Delaware Law Concerns

In order to qualify and maintain exempt status in Delaware, a DIHC generally must confine its activities in Delaware to the

maintenance and management of “intangible investments” and the collection and distribution of income from such investments. Delaware law provides that trade names and trademarks are included in the definition of “intangible investments”. The DIHC must be careful, however, never to provide services to its affiliates or others. Care thus should be exercised in formulating trademark license agreements with affiliates to ensure that the DIHC is not performing services for such licensees which might jeopardize the tax-exempt status of the DIHC. For example, a DIHC cannot undertake a plan to continuously police all operational and product quality standards of its licensees. Such activities are common in a franchiser/franchisee relationship and may go beyond “maintenance and management” activities.

Importantly, however, the Delaware Division of Revenue has taken the position generally that protecting and maintaining rights in intellectual property are permitted “maintenance and management” activities. Accordingly, for example, a DIHC owning and licensing trademarks all over the world could have on staff in Delaware all necessary personnel to maintain registrations and renewals thereof, to litigate trademark infringement actions and to ensure quality control procedures are being followed. Alternatively, the DIHC could engage an independent service provider to coordinate such needed services, including the implementation of a quality control audit system.

CONCLUSION

Significant benefits could be derived from the valuable substance offered by a trademark holding company which has implemented a quality control program. Not only is royalty income receivable on a tax-exempt basis in Delaware, but the added benefit of enhanced quality control, whether or not with the assistance of an independent service provider, may be of great value to the operating parent and affiliates. As with any DIHC having the potential for significant benefits, special Delaware counsel or other qualified advisors should be consulted with respect to permitted Delaware activities, and

qualified trademark counsel should be consulted on the proper method of assigning and licensing trademarks and with respect to the necessary quality control program.

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