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Freda provides IP litigators with a nice road map

I am about to launch into a foolish endeavor: Writing an article about tax law. I hate tax law. I hate doing my taxes every April. I'm not a tax lawyer and never will be. I admire tax lawyers — their creativity, their ingenuity, their ability to master the plethora of ever-changing tax code provisions and regulations. Though I admire them, I will never be one of them.

Yet, I am drawn like a moth to a flame to write about a recent decision from the 7th U.S. Circuit Court of Appeals, *Freda v. Commissioner of Internal Revenue*. 2011 WL 3802707 (Aug. 26, 2011, 7th Cir. 2011). One could say that this is a case about trade secrets or about settlements in IP litigation. But in its heart, it is a tax case. I write about it because: 1) I've always been curious about the issue presented, and 2) it is a topic that a good IP litigator should know at least something about, so that you don't sound entirely uninformed before telling your client to go talk to a tax lawyer.

The question in *Freda* is whether the monetary compensation received by the plaintiff in settlement of a trade secret misappropriation case can be treated as a long-term capital gain or whether it must be treated as ordinary income. Capital gains, of course, are taxed at a more taxpayer-friendly rate than is ordinary income, so any plaintiff who receives a substantial amount in settlement of litigation wants to know whether there is a way the settlement proceeds can be treated as capital gains.

In *Freda*, the court ruled that although a trade secret settlement could be a capital gain in some circumstances, the taxpayer in this case failed to sustain his burden of proving that the proceeds from the settlement constituted a capital gain.

The settlement that gave rise to the tax question was preceded by years of litigation. C&F Packing, a sausage manufacturer, brought claims of trade secret misappropriation against its customer, Pizza Hut, and also against IBP, a competing meat-packing company. The trade secrets related to a process for making and freezing precooked sausage to make it look and taste like home-cooked sausage. Under a confidentiality agreement, the secret process was entrusted to Pizza Hut.

Things turned rancid when Pizza Hut allegedly shared the process with IBP, which then began undercutting C&F on the price of sausage sold to Pizza Hut. C&F's sales of sausage to Pizza Hut

Inside IP Law

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dwindled and eventually C&F filed a lawsuit.

C&F obtained a $10.9 million jury award against IBP, but for various reasons the case against Pizza Hut lingered on for several more years. Eventually, the parties settled and C&F agreed to drop its trade secret case for a payment of $15.3 million. C&F, a closely held S corporation, treated this payment as a capital gain, as did the shareholders, including Freda.

In the tax court litigation against the IRS, Freda argued that settlement proceeds received as a result of a sole claim for misappropriation of a capital asset, such as a trade secret, should always be taxed as capital gains. The 7th Circuit rejected this broad approach, holding instead that the issue should be determined by applying the "origin of the claim" doctrine. This doctrine provides that the tax classification of money received in a settlement of litigation is to be determined by looking at the nature of the claim settled. " … [A]mounts received in compromise of a claim must be considered as having the same nature as the right compromised." Though a trade secret can be a capital asset, it is not enough to simply look at the label of the claim (such as "trade secret misappropriation" or "patent infringement") to determine the nature of the claim. Instead, it is necessary to look at the remedy sought or agreed to and the actual basis of the recovery.

The court recognized that if the money received by the plaintiff represents a replacement of capital destroyed or diminished, the payment is considered a return of capital. In contrast, a payment for lost profits or royalties is treated as ordinary income.

Unfortunately for the taxpayer in this case, the allegations of the complaint focused on lost profits rather than focusing on damage to or destruction of a capital asset. Freda countered that the claims for lost profits and royalties were just a measuring stick for loss of value to the trade secrets, but the court found that argument unconvincing and upheld the tax court's conclusion that the lost royalties alleged by C&F were "the main attraction." Thus, under the origin of the claim doctrine the proceeds were deemed ordinary income and not a payment for destruction of the capital asset.

Freda also tried another angle, equally unsuccessful, to achieve the beneficial tax treatment. He claimed that the misappropriation and subsequent settlement payment constituted a protracted commercial transaction, in which a capital asset (the trade secret) was exchanged for money. The tax code recognizes that the proceeds from a "sale or exchange" of a capital asset held more than one year are capital gains. The court rebuffed the argument, finding that the misappropriation followed years later by a settlement payment did not constitute a sale or exchange. The court explained that to qualify as a sale the owner of a trade secret must transfer the entire right to exclude others from using the secret. Here the fictional "sale" to Pizza Hut did not include a transfer of the sole right to exclude, since C&F exercised that right itself when it sued and recovered damages from IBP, the other defendant. "C&F could not have transferred all substantial rights in its trade secret while simultaneously keeping a $10.9 million right to exclude IBP in its back pocket." Since C&F had not transferred all substantial rights in the trade secret, there was no "sale or exchange" of a capital asset.

Could C&F and its owners have obtained more favorable tax treatment if they had pleaded and litigated their case differently on a destruction of value theory? Perhaps. But we mustn't let the tail wag the dog. It is not clear whether C&F could have recovered $15.3 million pursuing this approach. It is likely that a lost profits theory of recovery could be calculated and proved with more certainty. There are worse things than paying tax on a $15 million recovery.

Tax law, like sausage-making, is usually a bit messy. The *Freda* case provides IP litigators with a nice road map of how settlements of patent and trade secret cases will be viewed when the tax man comes.