Liability Issues Change With Economy Shift

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L E S

Shift from manufacturing to service economy opens possibility for enormous financial risks; contract precautions advised

INTRODUCTION

Consider the following scenario:

For $10,000, a computer company sells a standard computer to a stockbroker. The stockbroker installs his own portfolio management program on the computer and offers each of his clients modem access to the portfolio management program. The broker is very successful. His computer handles 100,000 portfolio transactions per day.

Big Brokerage Inc. has a patent on the method of providing portfolio management services to customers over a computer modem. Big sues the stock broker, alleging the latter's program performs the patented method. Big asks for damages of $1 per transaction handled by the broker's computer. The jury awards Big $10 million.

Should the computer company reimburse the broker for the $10 million? No, you say. But the computer company, in an effort to get the sale before a competitor, included in the sales contract, at the request of the broker, an infringement indemnity provision. A rather expensive sales promotion effort.

When asked why the computer company assumed such a liability, the former company president said: "We thought we were indemnifying for infringement by the computer, not for infringement by use of the computer."

Is the hypothetical exaggerated? Could the owner of a *method* patent get damages based on each use of the method? Would the computer company have been liable for infringement damages even without the indemnity provision? Would a real company insure its customers against infringement liability by agreeing to an infringement indemnity provision without limit?

This article explores the realities of liability for infringement of patents claiming methods for performing services, and, using the results of a survey of corporate counsel in the United States and Canada, identifies what real companies are doing regarding infringement indemnity of their customers. In conclusion, the authors suggest an indemnity provision that balances the legitimate interests of the parties.

The Risk of Infringement of Patents on Services Is Real

The hypothetical is exaggerated, but not science fiction. Numerous patents address methods of managing portfolios, methods that may be performed on suitably programmed computers.[1] Indeed, all a computer does is perform methods, many of which may be patented. Consider, for example, patented banking services performed by an ATM, patented voice mail services provided by a computer programmed to function as a telephone answering machine, or, in the biopharmaceutical field, computers programmed to control patented PCR analysis. Of course, computers are not the only manufactured equipment that may be used to perform patented methods. Consider, for example, a high-pressure liquid chromatography (HPLC) machine that performs various drug-screening processes, a number of which may use patented separation methods.

While each of these scenarios may be hypothetical, the risk of infringement damages based on the use of a patented method is real. Recently, AT&T asserted against MCI and others certain AT&T patents claiming the method of providing 1-800 and other intelligent network services.[2] AT&T is seeking damages for each 1-800 call serviced by MCI. Because the volume of such calls could be huge, even a small reasonable royalty would quickly add up to a paralyzing figure.

In an era in which service providers have replaced manufacturers as the primary revenue source in many industries, patents on the methods performed by those service providers could impose significant liability on the service providers and on those who make the service possible.

INFRINGEMENT DAMAGES BASED ON THE NUMBER OF TRANSACTIONS USING A PATENTED METHOD IS A RECENT DEVELOPMENT

The United States patent laws provide for infringement damages equal to at least a reasonable royalty.[3] A reasonable royalty consists of the amount a willing licensor and licensee would have agreed to in a so-called "hypothetical negotiation." Traditionally, such damages have been calculated based on the manufacture or sale of the patented products. This is sensible because the royalty is directly related to the patent rights, the right to exclude others from making, using, selling, offering for sale, or importing the patented product.[4]

Where, however, the patent claims a method, not a product, the basis for a reasonable royalty differs. Although a damage calculation based on the number of uses of the patented method appears

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logical, courts have ordinarily measured damages for each infringement in terms of either throughput, the volume or cost of raw materials used in the method, or output, the number of or sale of products made using the patented method. Because infringement damages based on a reasonable royalty should observe commercial realities,[5] these damage awards have reflected a marketplace where most method patents were directed to methods of manufacture.

These traditional royalty bases measure use of the patented method indirectly, but practically. Not many traditional businesses, and therefore, not many courts, have measured use of a patented method by the number of operations or transactions because such counting operations were not often done in traditional manufacturing businesses. Assessing damage awards for infringement of service patents calls for a basis other than an output or throughput royalty. Such royalties, which measure tangible things, appear inappropriate in a service industry relating to intangibles. The alternative, a per-use calculation, is apparent. But given the traditional reluctance of courts to depart from throughput royalties, when would this technique be appropriate?

One recent opinion, *de Graffenried v. United States*,[6] considered precisely this question. This case involved the calculation of compensation owed by the United States for unauthorized use of a patented device for controlling lathes. The United States had used the device for producing cannon barrels. The patentee sought damages based on each use of the patented device, while the United States urged that sales of the patented device itself should form the basis for compensation.

The United States Claims Court addressed these arguments by examining when per-use damage awards are proper. The court laid out various factors in deciding whether to apply royalties based on use of a patented product or method. First, the court considered whether the practice in the industry at the time of the hypothetical negotiation included a throughput or per-use royalty. Upon finding that a throughput or per-use royalty was not the industry norms in that case, the court looked to whether the parties were inclined to depart from general industry practice. Finally, the court analyzed the nature of the technology and surrounding circumstances.

◄ Court Review ►

In so doing, the court reviewed the potential advantages and disadvantages inherent in these types of royalties and predicted the extent to which these factors would have affected the negotiators' decisions. For instance, the court stated that a potential advantage of a per-use royalty is the ability to represent accurately the value of a patent to each licensee by varying royalties among licensees based on actual frequency of use of the patented invention. Also, a licensor and a licensee share the risk of an initially incorrect estimation of success of a patent. On the other hand, the court observed that a per-use royalty imposes increased transaction costs for administering the license because monitoring compliance by a licensee can be both difficult and costly. The court further noted the unpredictability of the timing and amount of per-use royalty payments. Ultimately, the *de Graffenried* court refused to award a per-use royalty and granted a royalty payment for each infringing device made and used.

In this service-dominated era, counting of transactions is common and often the only way to determine the value of a service to its user. Thus, many courts, following the analysis used in *de Graffenried*, will conclude that a per-use royalty is an industry norm that would have been selected during hypothetical negotiations. This conclusion would be compelled where the owner of the method patent does not sell the product used to perform the method, and, therefore, could not have obtained consideration for the patent any other way.

Application of a per-use royalty as a measure of damage for infringement of a method patent no doubt will become more common.

ABSENT AN EXPRESS INDEMNITY PROVISION, A PRODUCT MANUFACTURER PROBABLY WOULD NOT BE LIABLE

In the hypothetical that started this article, the computer manufacturer sold a computer that could be used by the customer for a variety of applications. Many of the uses of the computer would not infringe the patent on the portfolio management service. Thus, since the computer had practical uses that did not infringe the patent, the computer was a staple article of commerce.[7] Because the computer manufacturer was making and selling a staple article of commerce, it would be liable for infringement only if it sold the computer with knowledge that the purchaser intended to use it to perform the patented method, if it somehow modified the computer to perform the patented method, or if a separate patent covered the computer itself.

Inducing Infringement

If the purchaser of a staple article of commerce uses it to practice a patented method, the manufacturer of the staple article of commerce would be liable for inducing infringement of the method patent only if the manufacturer knowingly urges, encourages, or aids such infringement.[9] The manufacturer would be liable for such indirect infringement even though the product itself does not directly infringe a patent.[10]

In our hypothetical, to be held liable for inducing infringement of Big's method patent, the computer manufacturer must have known about the method patent and sold the computer to the stockbroker with the intent that the latter would use it to perform the patented method.[11] What if the manufacturer knew the broker intended to use the computer to perform a portfolio management program? Assuming the manufacturer also knew about Big's patent, would that be sufficient to establish indirect infringement? Probably something more would be needed, such as evidence that the manufacturer knew Big's patent covered all portfolio management programs. As stated by Professor Chisum, "mere sale of a staple with knowledge of the buyer's intended use does not constitute. . . active inducement."[12]

Thus, for the manufacturer to be liable for inducing infringement of the method patent, he would have had to actively encourage the broker to use the patented method on the computer. What if the manufacturer advertised the computer as capable of performing portfolio management programs? Even then, a charge of inducement might fall short without proof that there were no portfolio management programs available except for the one covered by Big's patent.

Contributory Infringement

One who sells a product that is especially adapted for use in infringement of a patent is liable as a contributory infringer.[13] The patent statute requires a showing that an alleged contributory infringer knew that the combination for which the component was especially designed was both patented and infringing.[14] For instance, a seller of a device whose installation instructions infringe a method patent is liable as a contributory infringer.[15]

In our hypothetical, the computer was a standard product, a staple article of commerce. The manufacturer, therefore, could not be held liable for contributing to the infringement of the patented portfolio management program. But what if the manufacturer sold the computer with a math coprocessor that facilitated financial transactions, a high-speed modem to permit communication with the broker's clients, and the operating software required to load and operate the portfolio management program? Because each of those additions is itself capable of use with other noninfringing programs, the manufacturer still would not be liable for contributory infringement. But suppose the manufacturer installed a software program specifically designed to provide an interface between the modem and the patented portfolio management program. In the latter case, the manufacturer likely would be found a contributory infringer.

INFRINGEMENT INDEMNIFICATION SURVEY

When a manufacturer sells a staple product, such as the standard computer of our hypothetical, the manufacturer would only be liable for infringement if the product itself directly infringed a patent. The manufacturer's liability for indirect infringement requires substantially greater effort and culpability than merely selling a standard product capable of being used in an infringing manner. In that case, why did our computer manufacturer agree to indemnify his customer? To make the sale! Would manufacturers in the real world do the same, particularly in the face of potential liability far beyond the value of the sale?

To learn how industry was addressing this potential problem, the authors went straight to the source and asked patent counsels at major corporations about their companies' actual practice regarding indemnification of their customers. In June 1996, the authors sent a survey to 667 patent counsels in the United States and Canada. The survey consisted of 11 questions, many divided into subquestions, which yielded a total of 25 questions.[16]

Indemnification

Before addressing the survey results, it is useful to discuss indemnity briefly and generally. Indemnity obligations commonly arise from contracts in which an indemnitor agrees to compensate the indemnitee for any loss the indemnitee sustains or for any liability the indemnitee incurs.[17] Indemnification is based on the principle that "everyone is responsible for the consequences of his own negligence, and if another person has been compelled to pay the damages that ought to have been paid by the wrongdoer, they may be recovered from him.[18] Indemnity provisions are intended to impose, by contract, liability on the party who should be liable. Between a manufacturer and a customer, indemnity may run both ways. The manufacturer may indemnify the customer for damages caused by defects in the product. The customer may indemnify the manufacturer for damages caused by the customer's use of the product. While the latter is not as common as the former, this concept allows the party who should be liable to protect the innocent party.

In our hypothetical, the indemnity given the customer had little to do with the culpability of the manufacturer and a lot to do with marketing. The manufacturer assumed a liability that rightly should have been the customer's in order to induce the customer to buy the computer. Where the customer might otherwise have had to buy insurance against infringement liability, the cost of that insurance and the risk were assumed by the manufacturer.

Under general rules of contract law, the parties may limit the scope of their indemnity agreement in several ways. The indemnitor can restrict the scope of liability by covering only certain types of injuries and certain types of actions causing the injuries.[19] The indemnitor can define its liability according to a percentage of negligence assigned to it.[20] And the indemnitor can limit its obligation by placing a maximum ceiling or cap, restricting the liability only up to a specified sum in the contract.[21]

Apparently, our hypothetical computer manufacturer did not employ any method for minimizing the risk or limiting the liability. As the survey results show, many manufacturers, to one degree or another, assume the risk and the liability for their customer's infringement.

# RESPONDING	INDUSTRY
4	automotive
14	chemical
17	computer hardware and components
21	computer software & services
14	consumer products
21	electronics
12	machinery
5	pharmaceutical
10	telecommunications

Table A

The Respondents

As of the close of 1996, 73 counsels responded, many from some of the world's leading corporations. Seven of the companies responding had annual sales of less than $100 million; 17, from $100 to $500 million; 10, from $500 million to $1 billion, and 38, over $1 billion. The industries represented in Table A produce a number exceeding the number of respondents, because many checked multiple industry groupings.

THE RESULTS

The survey uncovered some interesting, but unsettling, information on standard practices in the industry regarding indemnification of customers for patent infringement. Slightly over 90% (66/73) "sometimes" or "always" indemnify customers for patent infringement. Nearly one-half (45%) always include such indemnity in purchase agreements.

As discussed above, the potential for liability based upon uses of a patented method appears to be greatest in the computer/electronics/telecommunications industries ("electronics industries") because of the versatility of computers and computer-based products such as telephone switches. That being the case, the authors expected that indemnity practices in the electronics industries would differ. In fact, 95% (37/39) of respondents who checked one of the electronics industries categories "sometimes" or "always" indemnify customers for patent infringement, and 64% (25/39) "always" indemnify customers for patent infringement.

In all industries, of those who "always" indemnify customers for patent infringement, 68% (25/37) impose limitations on the indemnity. For example, of those who always indemnify customers, 95% "sometimes" or "always" exclude indemnification where the customer modifies the product or uses it in combination with another product.

The survey results demonstrate that the vast majority of companies include some form of patent infringement indemnity in sales contracts. While many of such indemnifications exclude infringements arising from modifying the product or combining the product with another, it is unclear whether such exclusion encompass the use of a general purpose product, such as a computer, in an intended but unanticipated combination, such as with software that performs a patented method.

Many respondents (88%) use indemnification provisions that define the manufacturer's remedies for minimizing the infringement damages, *i.e.* obtaining for the customer a right to continue using the product (83%), modifying or replacing the product to avoid infringement (83%), or refunding the purchase price (75%), or any of the three at the infringer's option (84%). Each of these traditional remedies assumes the infringement arises from the product. Modifying or replacing the product would have little effect on the customer's use of a patented method unless the modified product prevented the customer from doing what he wanted, an unlikely remedy.

These contractual remedies also only limit prospective damages for infringement; damages based on each use of a patented method, such as each 1-800 call, could mount up dramatically before any of the contractual remedies become effective. The manufacturer still would have to indemnify for the damages that accrued before one of the contractual remedies took effect.

Surprisingly, only 26% (18/68) always place a monetary cap on the manufacturer's liability. This was also true in the electronics industries where the risk of per-use liability apparently is highest. Given the potential for per-use infringement damages, many manufacturers are assuming a significant risk. While customers may expect such unlimited indemnity, the manufacturers who give their customers what they expect risk losing much more than the customer. Other than as a response to market pressures, there is no reason for a manufacturer to insure a customer against liability arising from the customer's own wrongful acts.

THE ALLOCATION OF INFRINGEMENT RISK MUST CHANGE AS THE SCOPE OF RISK CHANGES

The survey of corporate patent counsel demonstrates that infringement indemnification provisions are the norm in sales contracts in many industries. In some industries, given the prospect of per-use damages for infringement by a customer of a patent on a method of performing a service, the traditional liability-allocation scheme may shift too much risk from service providers to equipment manufacturers. Although the prospect of liability for infringement of service patents is a new development, manufacturers should reconsider their policy regarding indemnification of their customers in light of the real risk that the customer's actions could result in significant liability on the manufacturer.

In reevaluating their indemnification policy, manufacturers should consider the scope of their potential infringement liability without an indemnity provision, the scope of their potential liability with a full indemnity of their customers, and the reasonableness of allocating the risk of infringement liability in view of the relative benefits to and culpability of the manufacturer and customer.

Liability Without an Indemnity Provision

Direct Infringement — As described above, a manufacturer may be liable for direct infringement if the product as sold is covered by a patent claim. The manufacturer could be sued by the patent owner as a direct infringer without ever involving the customer. The customer, however, generally wants some protection in the event the patent owner sues for the customer's use of the infringing product. The customer also wants protection from damages caused by his use of the product being enjoined as a result of a successful infringement action. Because the customer is the innocent party, it is entitled to indemnity for the manufactuer's infringement. The Uniform Commercial Code recognizes where the risk should lie. In the absence of any express indemnity contract, a buyer may seek indemnification from a seller under an implied warranty of noninfringement.[22] UCC § 2-312(3) warrants that goods delivered by a seller are free of third-party infringement claims.[23]

The warranty provided under the UCC is not unlimited, however. The UCC does not impose liability on the manufacturer where the infringement arises from features in the product specified by the buyer.[24] Also, the UCC indemnity does not extend to infringement arising from use of the product after it is delivered. The court in *Motorola, Inc. v. Varo, Inc.*[25] stated that the UCC provides "no warranty that a buyer's use of the good will be free of all infringement."[26] Similarly, the court in *Chemtron, Inc. v. Aqua Products, Inc.* [27] agreed with the Motorola holding, stating that if the goods themselves do not infringe, they are in fact delivered "free of the rightful claim of any third person by way of infringement" as required by UCC § 2-312(3).[28] In *Chemtron,* a seller supplied components that, when combined with other nonsupplied components, infringed a patent. The court held in favor of the seller, however, reasoning that the UCC does not entitle a buyer to impose liability on the original seller of the noninfringing component parts.[29]

A manufacturer could avoid an indemnity provision by forcing customers to rely on the UCC indemnity. The risk allocation is clear, the manufacturer is liable only if the product itself infringes. Any other liability arising from the customer's use of the product is allocated to the customer. This option, however, carries with it a level of uncertainty as to the amount of damages, assuming the statute applies, as well as exposure to potential litigation brought by the customer to determine who, under the UCC, should be liable. As courts exercise significant discretion in applying the UCC indemnity, parties relying solely on the UCC are not assured of a certain outcome.

Indirect Infringement—A manufacturer may be liable for inducing or contributing to infringement. In each case, the customer has to be a direct infringer for the manufacturer to be an indirect infringer.[30] If, for example, a manufacturer induces his customer to infringe a patented method, both parties may be liable, jointly and severally, for the infringement. The patent owner does not need to sue both parties; the total infringement damages can be recovered from one party at the whim of the patent owner. Because no right of contribution may exist between joint patent infringers,[31] the party sued for infringement may have no way to obtain from the other joint infringer a proportional share of the damages.

Without a contractual indemnity provision, each party assumes a risk of being liable for all damages associated with an infringement. Assumption of the total liability would be inappropriate for the manufacturer who is not solely at fault for the infringement. Because the UCC warranty of noninfringement probably would not apply where the buyer is the direct infringer, a sale without any contractual provision on infringement liability would leave both parties in an uncertain situation. Perhaps, in lieu of an indemnity provision, the sales agreement could include a provision requiring contribution in the event of such joint infringement.

Liability With Full Indemnity of the Customer

Where the manufacturer indemnifies its customer without limitation or qualification, the manufacturer is virtually guaranteed to be liable for any infringement damages awarded against the customer, assuming the infringement arose from use of the product purchased from the manufacturer.[32] Such an indemnity provision is clearly for marketing purposes because it has no relation to the manufacturer's potential liability without the provision and no relation to the value of the transaction. In effect, the manufacturer has included in the price of the product any unlimited infringement insurance policy. With the prospect of method patent infringement damages being based on the number of services provided by using the product, the liability risk to the manufacturer could be orders of magnitude greater than the manufacturer's profit or even the value of the transaction.

The tradition of granting customers such unlimited indemnity arose when the liability for an infringing sale of a product (particularly when measured on what would have been a reasonable royalty) was almost always less than the profit margin on the product. Over the last 15 years, U.S. courts increasingly have recognized the value of patents by awarding significant damages for infringement. Such damages often are based not on a reasonably royalty, but on the patent owner's lost profits. Indeed, the Federal Circuit has enhanced the potential for lost-profit damages by allowing an award of lost profits even where the patent owner does not sell the patented product.[33] Thus, the risk of significant damages for infringement is much greater than in the past, even before considering the potential of per-use damages for infringement of a patented service method. Consider, for example, the AT&T suit for infringement of the 1-800 service patent. Instead of a royalty-per-service transaction performed by MCI, could AT&T seek the profit it lost on each 1-800 call serviced by MCI?

Because the assumption of risk without commensurate benefit is contrary to good business practice, manufacturers should evaluate their policies regarding infringement indemnification of customers. They should negotiate a compromise that properly reflects each party's contribution to the liability and each party's benefit from the transaction.

A Balanced Infringement Indemnity Policy

The survey results suggest that indemnifying customers for infringement is a practice, to varying degrees, in all industries. Thus, customers likely will resist attempts to eliminate indemnity provisions. Moreover, with no indemnity provision, the manufacturer's potential liability will be uncertain because of the varying rules regarding contribution among joint infringers or the unpredictability of enforcement of the implied warranty of noninfringement under the UCC. The goal of any infringement indemnity policy, therefore, should be to negotiate and include in a sales contract an indemnity provision that allocates liability based on respective culpability for infringement, that limits liability to reflect the relative value of the transaction to the parties, and that makes liability reasonably predictable. Of course, in reaching any goal, many compromises are made. Thus, the ideal infringement indemnity policy will always reflect the market so long as such a risk assumption is part of the sale. Such compromises, however, must be balanced to avoid transferring to the manufacturer significant unfunded liability.

As a reflection of an infringement indemnity policy that balances the interests of the parties, consider the following provision:

> 1. In the event of a claim or suit against Buyer alleging (a) the Product as sold by Seller or (b) Buyer's use of the Product as sold by Seller infringes any patent issued or copyright registered by the country in which the Product was sold to Buyer, Seller shall defend Buyer to the extend the claim or suit concerns such infringement, provided Buyer gives Seller prompt notice of such claim or suit and continuous cooperation in such defense.
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> 2. In any claim or suit against Buyer that is defended by Seller pursuant to paragraph 1, Seller shall control the defense, shall pay all litigation costs, including reasonable attorney's fees incurred by Seller in such defense, and shall indemnify Buyer for all damages awarded by a court or settlement payments approved by Seller.
>
> 3. If, in any claim or suit against Buyer that is defended by Seller pursuant to paragraph 1, as a result of a court order not subject to further appeal or a settlement approved by Seller, Buyer is enjoined or otherwise prevented from using the Product as sold by Seller, Seller, at its option, may (a) procure for Buyer the right to continue using the Product, (b) replace or modify the Product to avoid infringement, or (c) repossess the Product in exchange for a refund of the depreciated value of the Product. Seller's option selected under this paragraph shall be Buyer's sole remedy for any prospective effects of any court order or settlement.
>
> 4. Seller's total, cumulative liability under paragraphs 2 and 3 shall be limited to 75% of the price paid to Seller by Buyer for the Product.
>
> 5. Notwithstanding any other provision of this Article, Seller shall not be obligated to defend and shall not be liable for costs or damages awarded in any claim or suit for infringement in which (a) the Product was made by Seller pursuant to specifications supplied by Buyer, or (b) the alleged infringement is based on use by Buyer, without Seller's permission, of the Product as sold by Seller in combination with another item not sold by Seller, where the alleged infringement arises from the combination or from practice of a method made possible by the combination, or (c) the alleged infringement is based on the Product as modified by Buyer without Seller's permission.

Note that the Seller's obligation to defend and indemnify is limited to infringement arising from the Product as *sold by the Seller* or from use by the Buyer of the Product *as sold by the Seller*. This eliminates liability arising from modification of the Product or from combination of the Product with something else. Nonetheless, paragraph 5 explicitly excludes such situations. Paragraph 5 seeks to identify those situations where the manufacturer had no control over the buyer's activity and, therefore, should have no liability for the result.

In terms of the potential for per-use damages for infringement of a method patent, if the Product *as sold by the Seller* can be used in such an infringing way, the risk of infringement should not rest entirely on the Buyer. In that event, the Seller must rely on the cap to liability in paragraph 4 to keep the amount of potential liability within reason. Where, however, the Buyer combines the Product *as sold by the Seller* with another item not sold by the Seller (the broker's portfolio management program in our hypothetical) in order to perform a service, the Buyer should be liable for any infringement by such service absent the Seller's permission for such a combination.

The provision proposed above will not be controversial in those industries where manufacturers traditionally have limited their infringement liability. Customers will resist the proposed provision in those industries where manufacturers traditionally have insured their customers against any infringement. Not surprisingly, the risk of infringement liability for customers' use of manufacturers' products is greatest in the latter industries.

CONCLUSION

Changes in technology have altered the traditional roles fulfilled by equipment manufacturers and their customers. As economies have shifted focus from manufacturing to the provision of services, so too has intellectual property enjoyed a heightened role in ordinary commercial transactions. Evidence suggests, however, that equipment manufacturers have failed to recognize these trends when forging their commercial relationships. If customers have recognized the changing risk allocation, they resist altering the commercial relationships for obvious commercial reasons.

Now is the time to reevaluate industry relationships at the most fundamental level: that of the basic sales contract between manufacturers and end users. Infringement liability founded upon the use of a patented method may create enormous financial risks for manufacturers in service-based industries, particularly those associated with electronics. Sound business judgment would insist on balancing cost and risk with certainty gained through various strategies to address a potential infringement award. The option of offering indemnity with monetary caps is direct, easy to implement and enables manufacturers to predict future liability with certainty in strategic business planning. Monetary caps not only facilitate business planning but also encourage end users to employ the product in a responsible, noninfringing manner.

In addition to a monetary cap, the parties should attempt to allocate liability based on relative culpability. Even with a cap, few reasons suggest that one party indemnify another for activity over which the indemnitor has no control.

Heightened attention to these issues in future contract formation, along with a review of existing commercial relationships, will ensure that manufacturers and end users are prepared for the realities of the new services era.

FOOTNOTES

1. *See* United States Patent No. 4,346,442 ("Securities Brokerage-Cash Management System")(discussed in *Paine, Webber, Jackson & Curtis, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 564 F. Supp. 1358 (D. Del. 1983)).

2. *See, e.g., American Telephone & Telegraph; Firm and Unitel Sue Stentor, Charging It Violated Patents*, Wall St. J., May 7, 1993; Jonathon Chevreau, *Unitel, AT&T Try to Stop Patent Use: Infringement suit launched against MCI, Stentor*, Financial Post, May 7, 1993.

3. 35 U.S.C. §284.

4. 35 U.S.C. §271(a).

5. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116, 1120 (S.D.N.Y. 1970), *modified*, 446 F.2d 295 (2d Cir.), *cert. denied*, 404 U.S. 870 (1971).

6. 24 U.S.P.Q.2d 1594 (Cl. Ct. 1992).

7. *See Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176 (1980).

8.

9. 35 U.S.C. §271(b).

10. *E.g., Cugley v. Bundy Incubator Co.*, 93 F.2d 932 (6th Cir. 1937); *Saes Getters S.P.A. v. Ergenics, Inc.*, 17 U.S.P.Q.2d 1581, 1586 n.9 (D.N.J.), *aff'd*, 914 F.2d 270 (Fed. Cir. 1990).

11. See, e.g., Hewlett-Packard Co. v. Bausch & Lomb Inc., 909 F.2d 1464 (Fed. Cir. 1990).

12. Donald S. Chisum, *Patents* § 17.04[d] (1995)(collecting cases at n.6).

13. 35 U.S.C. §271(c).

14. *Id.*

15. *Hall v. Montgomery Ward & Co.*, 57 F.Supp. 430 (N.D. W. Va. 1944).

16. Following are the questions posed on the survey. For most, the survey elicited answers of "always," "sometimes," and "never":

1. In your company's contracts for the sale of *products*, do you include provisions to indemnify the buyer for damages imposed in patent infringement lawsuits?
2. According to the contract's provision, what does your company agree to do in the event of a patent infringement claim?
   - Indemnify the purchaser for damages
   - Defend the purchaser
3. How does your company condition its obligation to indemnify for patent infringement?
   - The obligation is conditioned upon prompt notice from the purchaser of an infringement claim
   - Liability arises only for patents issuing before a specified date or event
   - Liability arises only for patents issuing in a specified country or countries
4. What types of patent infringement liability are excluded?
   - Where infringement arises from a modification to the product by the purchaser
   - Where infringement arises from the purchaser's use of the product in combination with another product
5. As to excluded patent infringement liability, is the purchaser contractually required to indemnify your company?
6. How does your company limit its patent infringement indemnification liability?
   - Your company's indemnification agreement has no upper monetary limit
   - Your company's indemnification agreement has an upper limit equal to . . .

     . . . the value of the infringing product

     . . . the value of the transaction

     . . . a percentage of the value of the transaction

     . . . an arbitrary limit that is more than the value of the transaction

     Some other limit (briefly describe):
7. In the event of an allegation or claim of infringement, does your company's in-demnification agreement require the purchaser to sell back the product or allow your company to modify it to a noninfringing condition?
8. If the purchaser's use of the product is enjoined, your company's indemnification agreement provides that your liability is limited to . . .

   . . . obtaining for the purchaser the right to continue using the product

   . . . modifying or replacing the product to avoid infringement

   . . . refunding the price or depreciated value of the product

   . . . any of the above at your company's option
9. As to liability exceeding the limit of indemnification, is the purchaser required to indemnify your company?
10. Does your company perform patent infringement clearance evaluations...

    . . . routinely on all new or improved products?

    . . . only on new products involving substantial investment?

    . . . on a case-by-case basis?

    . . . on some other basis.

    Describe:
11. Does your company consider patent infringement indemnification of your customers as a problem?

    Is it a contentious issue in the negotiation of sales contracts?

17. *Williston on Contracts* § 2:19(c), at 158 (4th ed. 1990).

18. 41 Am. Jur. 2d *Indemnity* § 1, at 348 (2d ed.).

19. *See Forman v. Exxon Corp.*, 770 F.2d 490 (5th Cir. 1985)(indemnity contract to tortious but not contractual injuries); *Everhart Indus. Inc. v. Duracell Intern Inc.*, 666 F.Supp. 549 (M.D. Tenn. 1987)(losses incurred under or imposed by law).

20. *Daughdrill v. Ocean Drilling & Exploration Co.*, 702 F.Supp. 1267 (E.D. La. 1988), *reconsid. denied*, 709 F. Supp. 710 (E.D. La. 1989).

21. 41 Am. Jur. 2d, *supra* note 19, §47; 42 C.J.S. § 19, at 106. *American Jurisprudence Legal Forms 2d* as well as other standard legal forms suggest limiting the amount of liability and placing a monetary cap in drafting an indemnity agreement.

22. UCC § 2-312(3) states:

Unless otherwise agreed a seller who is a merchant regularly dealing in goods of the kind warrants that the goods shall be delivered free of the rightful claim of any third person by way of infringement or the like but a buyer who furnishes specifications to the seller must hold the seller harmless against any such claim which arises out of compliance with the specifications.

23. The UCC requires that a seller must be "a merchant regularly dealing in goods of the kind." Official comments to the UCC define a merchant regularly dealing in goods of the kind as one whose "[g]oods are part of seller's normal stock and are sold in his normal course of business." UCC § 2-312, cmt. 3.

24. UCC § 2-312(3).

25. 656 F.Supp. 716 (N.D. Tex. 1986).

26. *Id.* at 718 (emphasis added).

27. 830 F. Supp. 314 (E.D. Va. 1993).

28. *Id.* at 315.

29. *Id.*

30. *E.g., Met-Coil Sys. Corp. v. Korners Unlimited, Inc.*, 803 F.2d 684 (Fed. Cir. 1986).

31. *E.g., Chemtron, Inc. v. Aqua Prods. Inc.*, 830 F.Supp. 314, 316 (E.D. Va. 1993); *Construction Technology, Inc. v. Lockformer Co.*, 781 F.Supp. 195, 201 (S.D.N.Y. 1990); *Motorola, Inc. v. Varo, Inc.*, 656 F. Supp. 716, 717-18 (N.D. Tex. 1986).

32. The manufacturer might avoid liability for the customer's willful infringement since indemnification against willful acts causing injury to the public may be void as contrary to public policy. See 41 Am. Jur. 2d *Indemnity* §9 at 353.

33. *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538 (Fed. Cir.), *cert. denied*, 116 S. Ct. 184 (1995).