Pitfalls In Indemnification Provisions In Intellectual Property Related Agreements

BY DAVID A. LOEWENSTEIN AND KRISTEN J. MATHEWS*

Probably the least analyzed but perhaps most important contractual provision from the perspective of the purchaser or licensor is the indemnity agreement. Typically, these terms are not actively negotiated, may be on the back of a printed form in the "small print," and will generally not receive much attention. Usually, parties assume the provision exists and is valid and meaningful. The reality, however, is that they may be included but provide little protection. Many companies have a false sense of security that if they buy or license a product, they are immune from an infringement suit on that product. This complacency, however, is extremely dangerous as we explain below.

In this age of increased specialization, it is virtually guaranteed that a final product will include another party's component. This raises the possibility that the purchased or licensed component may infringe a third party's intellectual property rights and potentially expose the component purchaser to unanticipated liability.

With this as a backdrop, we analyze some commonly overlooked problems with indemnity agreements.

I. Introduction

Frequently, indemnification problems arise in a patent infringement context, and much of our analysis focuses on these situations. Many general practice lawyers are under the misconception that if a vendor provides a license under its own patents, all patent infringement problems are over. However, it is a well-known principle of patent law that even if a vendor gives a purchaser a license under its patents, the purchaser might nevertheless infringe a third party's rights. This is because patents give a right to *exclude*-not a right to practice.

Similarly, another misconception is that purchasing a product gives some assurance that a vendor can and will stand behind its product in the event the purchaser is sued. As we explain in more detail below, this belief can be a dangerous oversimplification.

Because many of these provisions are drafted by vendors, they are most likely drafted in the vendor's favor, and unless negotiated carefully, may leave a purchaser exposed to liability far more than either party anticipated.

As with most contract-based disputes, it is always far simpler to work out agreeable language during the negotiation phase than it is afterwards when a suit is filed.

II. UCC – Default Provisions

Assuming the sold or licensed product is a good, and in some jurisdictions software is considered a good[1], the Uniform Commercial Code[2] provides a default warranty that a seller's product does not infringe any patents. This default provision, however, excludes situations where the product is made according to the buyer's specifications.[3] Therefore, if the purchaser designs the product or provides a manufacturer with specifications to build it, in all likelihood the vendor will not be required to indemnify.

The UCC default provision may be sufficient in many circumstances, but it may not cover all situations (for example if the product is not a good or if the seller is not a merchant), and in several situations discussed below it may not provide enough protection for purchasers.

III. Losses That Far Exceed Purchase Price

A potentially significant problem may exist with inartfully drafted indemnity provisions concerning the amount of indemnity. For example, if a company buys a component from a vendor for two dollars and incorporates that component into a device that later sells for $100, there could be a dispute concerning the amount the vendor is required to pay for indemnity. If the purchaser were sued for patent infringement because the component infringed, the patentee would claim the infringement was caused by the component, but the component was an indispensable part of the final product. The patentee would seek damages based on the value of the entire product and could conceivably seek damages based on the

1. *Micro Data Base Sys. v. Dharma Sys.*, 148 F.2d 649, 654 (7th Cir. 1998) (holding software is a good, and citing cases from other jurisdictions reaching the same result).

2. UCC Section 2-312 provides: "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."

3. *Jack Frost Lab v. Physicians & Nurses Mfg. Corp.*, 1995 Lexis 6413 (S.D.N.Y. 1995).

*David A. Loewenstein is a partner at Brown Raysman Millstein Felder & Steiner, LLP and Kristen J. Mathews is an associate at the firm. *I am grateful for the contributions of Peter Scher. The views expressed here should not be attributed to the firm or to any client.*

"entire market value rule," which permits patentees to recover damages for lost profits on products that naturally are sold together with the infringing product. *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538 (Fed.Cir. 1995).

Suppose further, the component purchaser lost, and had a judgment awarded against it for $100 per unit. In this situation, it seems unlikely the vendor would voluntarily pay 50 times more than the sales price of the component. To avoid this problem (either as a vendor or a purchaser), the parties could draft language in the original indemnity agreement establishing maximum liability, or at least provide some guidance on how to calculate the amount. A vendor probably would want to limit its obligation to indemnify at the amount it received from the buyer. A purchaser would want a larger cap. The resolution of this fact-intensive impasse will depend on the parties' relative bargaining positions, including the component's importance, the relative values of the product and component, and the purchaser's ability to buy elsewhere.

In any event, the observation above, that disputes are easier to avoid in the negotiation stage than they are to resolve after litigation has commenced, is apropos.

A similar problem arises with products in which damages are measured by throughput. Suppose an infringing device that costs $100,000 produces products or services that are valued at $10,000,000 per year. If the purchaser were sued for infringement, the patent owner might seek lost profits damages on the order of the value of the throughput. Again, both the purchaser and patentee, each for its own reason, would argue the infringing (but low cost) device caused the infringement. Yet, the large scale of these damages may not have been foreseen by the vendor, and unless an indemnity provision were negotiated with this in mind, the vendor may not be required to compensate the purchaser fully.

A third related problem concerns injunction relief. As in the example above, suppose the throughput value exceeded the device's cost by several orders of magnitude. If the purchaser were enjoined, its damages in lost business would far exceed the cost of the device. Indemnification provisions could be drafted to take into account this eventuality, or to exclude them expressly if the vendor wants to avoid open-ended liability. Alternatively, if the vendor is unwilling or unable to compensate the purchaser fully, the purchaser could buy business interruption insurance.

In any case, it is a mistake to assume a standard indemnity provision would necessarily cover all these possibilities.

IV. Insolvency and Foreign Vendors

A related problem exists when damages exceed the vendor's capability to pay.

When dealing with smaller vendors, the possibility of insolvency should be considered. If this is a likely outcome, the purchaser should consider requiring the vendor to post a bond to cover its indemnification obligations, or to have adequate insurance policies naming the purchaser as an insured.

Similarly, when dealing with smaller, foreign vendors operating in jurisdictions whose laws enable them to avoid liability by closing shop and reopening as a new company, it might be advisable to bind the officers and directors of the vendor to the indemnification provision as well as the vendor itself. To effectuate this, the officers and directors would be required to sign the vendor agreement in the individual's capacities. It might also be possible to bind future companies that have common ownership with the vendor. Insurance or some form of financial guarantee is another option. All these suggestions may help, but if the vendor is outside United States Courts' jurisdiction, these provisions may not be a complete solution.

Finally, when dealing with foreign vendors, choice of law, choice of venue provisions, and consent to personal jurisdiction provisions become especially important. The high cost to pursue a vendor and enforce an indemnity provision in a foreign jurisdiction may be "more trouble than it's worth."

V. Full Indemnity

To avoid some of these problems, purchasers should require vendors to fulfill several obligations: (1) compensate the company for any monetary judgments awarded to a third-party claimant; (2) defend the company (i.e., legal fees and costs); and (3) hold the company harmless for losses, liabilities, costs and expenses arising from the types of claims that are covered by the indemnification provision (i.e., generally make sure that the company does not suffer any direct or consequential losses arising from the claim).

The "hold harmless" language may encompass an obligation by the vendor to "cover" the purchaser's costs of being enjoined from using the component, to obtain a license from the patent owner for the purchaser's continued use of the component, to replace or modify the component so that it is no longer subject to an injunction, or to refund to the purchaser any fees paid for the component.

Additionally, the provision should require the vendor to "defend", "indemnify" and "hold harmless." Omitting any of these terms may lead to uncovered liability.

VI. Scope of Indemnification

Another weakness in typical vendor-oriented indemnification provisions is the scope of the third-party claims they cover. A standard indemnification provision may be limited to certain jurisdictions or the dates on which the claimant's property rights were created. For example, a standard indemnification provision may only apply to claims that the component infringes third-party patent rights issued in a certain country as of the effective date of the agreement. It is important that the scope of coverage expressly address all the types of intellectual property (patents, copyrights, trade secrets, etc.) and at least consider proprietary rights created after the

agreement was signed.

On a similar note, an indemnification provision may fail to protect the company due to pure semantics. For example, consider a provision under which the vendor is required to protect the purchaser from claims that the component infringes a third-party's intellectual property right. What if the component itself does not infringe any rights, but the use of the component infringes (a method patent claim for example)? To avoid this potential problem, the indemnification provision should cover the component and its use.

The purchaser may also be able to negotiate the allocation of responsibility for claims that arise from the combination of the component with the rest of the company's product. In other words, the component alone might not infringe or misappropriate any third-party rights, and the rest of the purchaser's product alone might also not infringe but the combination of the component with the rest of the product might infringe. Which entity should be responsible in this instance? This is a problem that can be settled in either direction depending on the nature of the relationship between the parties. If the component is an "off-the-shelf" product and the vendor has no part in the component's integration with the larger product, then the vendor will be less likely to agree to indemnify. Conversely, if the component is custom-made by the vendor to use with the larger product, or the vendor has acted as a consultant to the purchaser, it is more likely that the vendor will agree to indemnification.

VII. Geographical Limitations

To protect purchasers, the indemnity agreement must cover distribution and any resulting adverse claim in any jurisdiction in which the purchaser does business.

For example (and this is based on a recently litigated case I was involved in), a U.S. purchaser of Asian products must make sure the Asian vendor has the right to sell the product to a company that intends to resell the product in the U.S. Take as an example, a Japanese patent owner that granted an Asian vendor a license under its Japanese patents. The vendor sells its component to a manufacturer that incorporates the component and ships the final product to the U.S. The manufacturer (or a retailer) is then sued in the U.S. under the patent owner's U.S. patents.

Unless the underlying agreement between the Japanese patent owner and the Asian vendor expressly granted a worldwide license, U.S. Courts may find the license was limited to sales in Japan, and sales in the U.S. infringed U.S. patents that were not included in the license. *Mid-West Conveyor Co. v. Jervis B. Webb*, 92 F.3d 992 (10th Cir. 1996); *Kabushik Kaisha Hattori Seiko v. Refac Tech. Dev. Corp.*, 690 F.Supp. 1339 (S.D.N.Y. 1988); see also *Ortho Pharmaceuticals Corp. v. Genetics Inst.*, 52 F.3d 1026 (Fed.Cir. 1995).

A similar issue has arisen where an Asian supplier claims it is licensed under a third party's patents, and therefore can sell its products free of any infringement claim.

Several problems can occur:

1. How do you prove the vendor's representation is correct?
2. What jurisdiction's laws apply to the underlying agreement?
3. What is the geographic scope of the underlying patent license?

Proof that the vendor is licensed:

The easiest way to satisfy oneself that the vendor is licensed, as it claims, is to look at the license. The license however might be confidential, and the vendor cannot disclose it. Even reviewing what appears to be an unambiguous license grant may not be as simple as it seems. Some questions to consider: Are all relevant patents (U.S. and foreign) listed in any appendices? Are current and future patents included? Does the licensee (vendor) have the right to sell, or just the right to make and use?

Another situation that has come up is where the vendor said it had invested in and owned part of the patent owner, and because of its ownership claimed to have the right to sell products free from any infringement claim. The trouble here is that partial ownership of a corporation may not give a person a right to license the corporation's patents. (Consider whether a General Motors stockholder has the right to grant patent licenses under GM's patent portfolio).

To add to the complexity, some of these questions may turn on foreign law, and may be difficult to resolve without obtaining advice on foreign law.

VIII. Parties Indemnified

Another basic term of an indemnification provision identifies the entities that are to be protected by the vendor from third-party claims. The vendor will be required to protect the purchaser, but the language in a standard clause may not cover the purchaser's successors, assigns, directors, officers, shareholders, employees or agents. Any of these persons conceivably could be sued for some form of infringement.

Additionally, suppose a purchaser sells to a downstream retailer, and the retailer is sued for a claim that arises from the component? In all likelihood, the retailer will expect its supplier to indemnify. The retailer's supplier (the purchaser) will turn to its vendor. Even though there is no direct relationship between the retailer and the component vendor, the vendor may be required to indemnify.

IX. Indemnification for Claims Between Indemnifying Party and Indemnified Party

For the most part, indemnification provisions are usually intended to protect the indemnified party from exposure vis-à-vis third-party claims. In situations in which a vendor has declined to fulfill its indemnification obligations with respect to a third-party claim, the indemnitee may be forced to litigate the validity of an indemnification provision against the vendor, and may incur legal costs. It may be appropriate for the vendor "to indemnify" the purchaser for costs of enforcing the indemnification provision. These costs and expenses are sometimes re-

ferred to as "fees-on-fees."

Under New York law, unless the indemnification provision expressly refers to indemnification for interparty claims, the indemnifying party may not be required to indemnify for those costs.[4] To avoid this result, the indemnification provision should expressly require that fees for which the vendor is responsible to pay include, without limitation, fees arising from any claim to enforce the indemnification agreement.

A company may also address attorneys' fees arising from interparty claims on a more general bases in a provision separate from the indemnification provision. For example, when parties desire to allocate the responsibility for attorneys' fees resulting from contract disputes, they can do so in a separate provision of the agreement (applicable to claims generally, not only to claims to enforce the indemnification provision) in which the parties agree that the prevailing party shall be entitled to recover its actual costs and reasonable attorneys' fees and expenses as part of damages.

X. Exclusions

Many vendor-oriented indemnification provisions contain a list of situations in which the vendor has no indemnification obligations. For example, the vendor may not be required to indemnify to the extent that the third-party claim arises due to the company's modification of or addition to the component, the company's combination of the component with other systems, or the company's use of the component in an environment other than that specified in the agreement. Although these "exclusions" from the vendor's indemnification obligations may be reasonable, they should not apply if the company's modification, addition, combination or alternative environment was approved or authorized by the vendor.

4. *Hooper Assocs., Ltd. v. AGS Computers, Inc.*, 74 N.Y.2d 487, 548 N.E.2d 903, 549 N.Y.S.2d 365 (1989)

XI. Obligation to Remediate

From a purchaser's (indemnitee's) perspective, an indemnification provision should keep it in business with as little interruption as possible. If the purchaser is enjoined from using the product, the vendor (indemnitor) should be obligated to either obtain a license from the patent owner to permit continued use, or to replace or modify the product to avoid infringement. Remediation should be done at the vendor's cost and within a specified time. Unless the infringing product is promptly replaced, it does an enjoined defendant little good. Also, the parties should consider who decides on the remedy. One option is to have the purchaser decide whether the non-infringing replacement is an acceptable remedy. At some point, especially after a bad experience like an injunction, a purchaser simply may want to deal with another supplier, and may not want a replacement. In this case, the purchaser may rather have an indemnity payment instead of a replacement product.

Finally, if none of these options is reasonably available, the vendor should be required at a minimum to refund the price paid for the component. This last resort probably would not fully compensate the indemnitee for its actual damages resulting from being unable to use the component. Further, none of these remedies should be deemed the sole remedy. To the extent one of these remedies does not fully compensate the defendant for its damages that result from an injunction, the vendor also could be required to indemnify for those additional expenses.

XII. Obligation to Notify

Another potential pitfall in indemnification provisions is the seemingly benign requirement that the indemnified party promptly notify the vendor of a third-party claim. Standing alone, this requirement might not be problematic. However, in many vendor-oriented standard provisions, this requirement is phrased as a condition on the vendor's obligations. If the purchaser does not promptly notify the vendor that a claim has arisen, the vendor is relieved of its obligations. This result can be avoided by establishing that the vendor's obligations are only relieved to the extent that the vendor is prejudiced by the delay in notifying the vendor of the claim.

XIII. Personal Injury and Property Damage Claims

In addition to third-party claims that are based on an infringement or misappropriation of intellectual property rights, there are other third-party claims that may arise from the third-party component. For example, the component may cause physical injury, death or property damage, or it may contain harmful software viruses. Third-party claims might also arise from the vendor's failure to comply with applicable laws or its breach of its confidentiality obligations or other warranties, representations or obligations. Each of these types of third-party claims should be covered by the indemnification provision.

XIV. Defending Claims

Finally, some indemnification provisions give the indemnifying party (the vendor) sole control over the defense and settlement of any claims. An alternative construction permits the indemnitee to participate in the defense or settlement of the claim, at its own expense, with the counsel of its choice. To the extent that a settlement involves no more than a monetary payment (which would be the indemnitor's responsibility), it may not be necessary for the indemnitee to have input into the settlement decision. However, the indemnification provision should provide the indemnitee with some control over the vendor's settlement of the third-party claim if it includes an admission or makes a promise that somehow prejudices the indemnitee's rights.

Another typical vendor-oriented term in an indemnification provision pertains to the timing of the vendor's obligation to pay an award for damages. For example, the provision might state that the vendor shall indemnify the company for damages "finally awarded" by a

court. Under this language, the vendor may not be required to pay an award that is being appealed. Yet, the purchaser may be required to pay the award, or to post a bond for the award, pending the appeal. One solution is to require the indemnitor make these payments when they are due, regardless of whether there is an appeal pending.

XV. Who Chooses Counsel?

Some indemnity agreements permit the indemnitor to choose counsel, others do not. An adjunct to the golden rule (the person with the gold makes the rules) would mean the party paying attorneys' fees should be permitted to choose.

If selection of counsel is important, it should be spelled out ahead of time.

Timing could be a problem. For example, some provisions permit the indemnitor to select counsel, but give it time to decide *if* it will indemnify. Suppose the indemnitor wants to save money by hiring an inexpensive lawyer and that lawyer loses (a lot). The indemnitor then decides it is not required to indemnify. To avoid this problem, an indemnified party should insist that selection of counsel requires the indemnitor to "live with" the consequences of its selection.

XVI. Conclusion

Standard indemnification clauses may provide the illusion of protection from third-party claims, but frequently they do not provide any real protection. For this reason, it is important to draft skillfully and to negotiate indemnification clauses to avoid large and unanticipated liability.