

Drafting and Negotiating Defense and Indemnification Provisions

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Sales agreements and licenses may be the driving force for a significant number of companies generating revenue today, but management of certain liability risk and protection for clients down the road depends on properly drafted intellectual property (IP) defense and indemnification provisions. Whether as outside counsel drafting a license agreement for a client or as an in-house attorney looking to update an employer's standard sales and services agreements, practitioners often overlook IP defense and indemnification clauses until it is too late. Particular industry customs and the concerns of important customers play a large role in shaping IP defense and indemnification provisions in purchase and license agreements. However, proactive private practitioners and in-house counsel should use these provisions to manage their clients' risk of liability by narrowing and carefully drafting and negotiating these often glanced-over provisions.

This article addresses important considerations for reasonably narrowing defense and indemnification provisions alone, as well as in combination with corresponding representations and warranties provisions. In most circumstances, considerations for IP defense and indemnification provisions in purchase agreements for the sale of goods are equally applicable to license agreements for services, technology, and software. Accordingly, throughout this article, the term "seller" denotes a seller of goods or services or a licensor of technology or software. Likewise, the term "buyer" is used for a corresponding buyer of goods or services or the licensee of technology or software.

IP defense and indemnification issues addressed in this article relate to IP generally—patents, trademarks, copyrights, and trade secrets, associated with the sale of goods and services or licenses of technology and software. However, the primary focus is on provisions that limit liability in patent infringement lawsuits. The larger litigation defense costs and complex issues

in play in patent litigations usually dwarf those in other types of IP actions. While liability for copyright infringement or trade secret misappropriation actions is often successfully avoided or managed by corporate policies prohibiting intentional malicious acts, patent infringement actions often arise without the intentional acts of copying or the like by the seller and therefore require greater attention in the drafting of IP defense and indemnification provisions.

While it is not possible or even highly probable that all of a seller's risk can be eliminated in the context of a business transaction, the risk can at least be man-

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aged and minimized. This is particularly true because boilerplate IP defense and indemnification provisions are typically overly broad in favor of protecting the buyer or licensee. The following sections highlight important issues to be considered by a seller for reasonably narrowing these provisions that are applicable in most industries for managing the seller's inherent exposure to liability associated with the sale of goods or the licensing of intellectual property.

Defense and Indemnification—General Terms and Triggers

A well-constructed IP defense and indemnification provision should clearly set forth the terms, scope, and breadth of a seller's defense and indemnification obligations,

and include the events and conditions that trigger such obligations. For example, language for a boilerplate IP defense and indemnification provision may include:

Seller will defend, indemnify, and hold Buyer harmless against a third-party action, suit, or proceeding ("Claim") against Buyer to the extent such Claim is based upon an allegation that a Product, as of its delivery date under this Agreement, infringes a valid United States patent or copyright or misappropriates a third party's trade secret.

This seemingly innocuous provision creates potential liability in the form of an unbounded indemnification and hold harmless statement that may include lost profits or business interruption damages. On the other hand, this same example limits the triggering event that creates the seller's defense and indemnity obligation. It also limits the type and geographic scope of the defense and indemnity, which are addressed in greater detail below.

As evident in the above example, a critical element is the term that creates or triggers a seller's defense and indemnification obligations. A well-drafted provision must clearly state whether a seller's obligation is triggered by the filing of a complaint, the receipt of a letter alleging infringement, or merely offering a patent license. The seller's counsel should advocate that the triggering event be limited to the filing of a claim, lawsuit, or proceeding. The seller can then also determine, case by case, whether to step in and defend or indemnify for mere allegations of infringement or offers to license. Such a decision often depends on the seller's business relationship with the buyer, as well as the perceived stature and merit of the patent and the party alleging infringement.

In contrast, a buyer's goal is to minimize the resources it would have to expend in dealing with a third-party patentee alleging infringement. By requiring the

Combination Exclusions

Products are often used as components integrated into a larger system by the buyer. Simply supplying a single component without knowing how it will be used in a system can create significant liability and hardship for a seller when the buyer seeks defense and indemnification from all its component suppliers in response to a patent infringement lawsuit brought against its system. To manage such risk, component manufacturers often include combination exclusions in their IP defense and indemnification obligations. A combination exclusion may state that the “Seller shall have no defense or indemnity obligation for a Seller-furnished product that has been used with or combined with hardware or software not furnished by Seller.”

Blanket combination exclusions may be problematic for products specifically designed to operate with other products not supplied by the seller, e.g., software designed to operate with a computer or a memory component designed to operate with a microprocessor or microcontroller. Accordingly, the scope and extent of combination exclusions can and should be tailored to the particular products licensed or sold. Factors to consider in drafting combination exclusions include whether the product is a staple good in commerce, the use of the product as a stand-alone item, the licenses held by the seller from other third parties regarding the use of the product, and the ability of the buyer to modify or customize the purchased product for use with its particular product.

seller’s defense and indemnification obligation to trigger early, e.g., upon receipt of a letter or other communication, the buyer effectively diverts a potential problem directly to the seller, with little expenditure of resources. It is typical for a purchase agreement or license agreement to create the seller’s IP defense and indemnification obligation based on the filing of an action, a claim, or a proceeding. However, recently we have seen buyers more aggressively seeking contract language in which a seller’s IP defense and indemnity obligation is triggered by an allegation of infringement, particularly in market segments with patent troll activity.

Defense and Indemnification—Separate but Related Obligations

Historically, for certain industry segments, protection afforded buyers of goods from third-party patent infringement was in the form of IP indemnification only. In the last decade, sales and license agreements have extended the sellers’ obligations to include both defense and indemnification obligations. Of late, it is not unusual for such agreements to create obligations for the seller to defend, indemnify, and hold the buyer harmless. Each of these separate, but related, obligations

increases the seller’s exposure to liability. Although industry custom may dictate this arrangement, deciding whether to tie one’s defense obligation to the obligation to indemnify should be critically evaluated. The two obligations are completely separate, yet they are often combined. Indemnification does not merely create a “pay the way” obligation for the seller. In assuming a level of risk, the seller must be able to determine and contract for the amount of involvement it wishes to undertake in a claim for IP infringement made against a buyer.

A prudent way to provide specific limitations to the seller’s defense and separate indemnity obligations is to substitute the blanket statement to “defend, indemnify, and hold the buyer harmless” with the following:

Seller will defend, at its expense, a third-party action, suit, or proceeding against Buyer (“Claim”) to the extent such Claim is based upon an allegation that a Product, as of its delivery date under this Agreement, infringes a valid United States patent or copyright or misappropriates a third party’s trade secret. Seller will indemnify Buyer for any judgments, settlements and reasonable attorney

fees resulting from a Claim as provided in this Section.

The seller should also consider making its defense and indemnification obligations conditioned on the buyer promptly notifying the seller of the claim in writing once the buyer is aware of the claim; the buyer giving the seller sole authority and control of the defense or settlement of the claim; or the buyer providing all information and assistance requested by the seller to handle the defense or settlement of the claim.

Important Defense and Indemnification Exceptions

Sellers should consider explicit exceptions to their defense and indemnification obligations. Examples of limiting or obviating exceptions to the creation of an obligation include exclusions for a product that has been modified by someone other than the seller, a product that has been modified by the seller in accordance with the buyer’s specifications or instructions, and a claim of infringement based on the buyer’s other products or third-party products. In association with these exceptions, sellers should also consider obtaining a reverse defense and indemnification obligation from buyers. A reverse obligation could include, for example, an agreement to defend the seller against third-party claims, judgments, or settlements and to reimburse attorney fees resulting from a claim against the seller’s product that has been modified by someone other than the seller or a product that has been modified by the seller in accordance with the buyer’s specifications or instructions. The seller should also consider expressly limiting or excluding liability when the alleged infringement results from the negligence or willful misconduct of the buyer.

Hold Harmless and Limitation of Liability Provisions

Because it has become common for defense and indemnification provisions to hold buyers harmless from IP infringement, sellers are now facing large potential damages including the buyer’s lost profits, business interruption expenses, and other consequential damages. Hold harmless provisions should be evaluated to impose reasonable limitations; otherwise, the seller could be responsible for more than it bargained for. The purpose of a seller holding a buyer harmless against IP

infringement allegations is to ensure that the buyer is placed in the same position that it would have been in absent the infringement allegation, not to ensure that its potential profits are protected. To manage this risk, the scope of the IP defense and indemnification hold harmless provision should have well-defined limitations of liability to exclude lost profits and indirect, consequential, incidental, and business interruption expenses.

It is in a seller's interest to include a limitation of liability disclaimer following IP defense and indemnification provisions that states, for example:

No Other Remedies Regarding Infringements—The foregoing states Seller's entire liability and Buyer's sole and exclusive remedy with respect to any infringement or misappropriation of any intellectual property rights of any other party.

Likewise, a seller should make it clear that any indemnification obligations are limited to the amount finally awarded by a court or agreed to in a settlement.

In addition to excluding certain types of damages, it may also be reasonable for sellers to consider a limitation of liability provision that sets a cap on its liability. It is quite common in the licensing of off-the-shelf software products, for example, to cap liability at the price paid by a buyer for use of the software. In other industries, it is common to set a liability cap at a multiple of the sale or transaction price.

Geographic Limitations on Defense and Indemnity Obligations

Another consideration in drafting IP defense and indemnification clauses is specific geographic scope restrictions. For example, if a product is sold to a buyer in the United States for use in the United States, the contractual IP defense and indemnification should reasonably be limited to infringement of United States intellectual property, e.g., U.S. patents in U.S. courts. If a buyer ships the received product overseas for use in its factory in the United Kingdom, the seller should not have to defend or indemnify against third-party infringement allegations arising in the United Kingdom regarding infringement of a U.K. patent.

Geographic limitations may further help eliminate the seller's obligation to

defend against some oddball infringement allegations made by third parties. For example, a third party may attempt to allege that a buyer's use of the product in the United States, in some fashion, infringes the third party's foreign patent. Although there is little chance that a U.S. court would find that it has jurisdiction over infringement of foreign patents, a seller with an unbounded duty to defend and indemnify could still be required to expend resources and incur unnecessary outside counsel expense merely to respond to the meritless allegations in a foreign

on a linear depreciation monthly over a (X) year useful life, in which case Buyer will return to Seller the Product and cease all use of it.

Such provisions, with the possible exception of the refund, are likewise advantageous for the buyer. These provisions allow the buyer to maintain functionality of the purchased good by using the substitute product without the headache of being subject to a full patent infringement action that diverts significant resources from the buyer's business.

To mitigate or terminate the impact of IP infringement claims, a seller should consider provisions that explicitly allow the seller to substitute a modified noninfringing product or service that provides the necessary functionality for the buyer.

court or otherwise. Geographic limitations would provide the seller with a graceful way to decline to defend and indemnify in such instances without disrupting important business relations.

Remedial Measures: Noninfringing Substitutes or Modified Goods

To mitigate or terminate the impact of IP infringement claims, a seller should consider provisions that explicitly allow the seller to substitute a modified noninfringing product or service that provides the necessary functionality for the buyer. For example, the seller may wish to add a provision that includes one or more of the following obligations:

Seller, at its own expense and option may: (1) procure for Buyer the right to continue use of the Product; (2) replace the Product with a noninfringing product; or (3) refund to Buyer a pro-rated portion of the applicable Fees for the Product based

Coordinating Defense and Indemnification with Representations and Warranties

Narrow IP defense and indemnification provisions can easily be undone by the inclusion of broad representations or warranties due to the conflicts the two create. For example, the standard Uniform Commercial Code (UCC) provisions that have been adopted under the laws of virtually all states state that in any contract for the sale of goods, it is inherent that the seller warrant against infringement of a third-party's property rights.¹ Such implicit rights trump the narrow provisions of a carefully drafted IP defense and indemnification provision. Fortunately, most reasonably sophisticated sales agreements appropriately and explicitly disclaim such UCC warranties. However, all too often, in addition to disclaiming such UCC warranties, many carefully and not-so-carefully drafted IP defense and indemnification provisions have little or no value when the contract itself further includes an explicit

warranty against IP infringement.² In such instances, a buyer may seek indemnification from a seller under either or both of these provisions. Accordingly, any restrictions on the seller's potential liability set out in the IP defense and indemnification provisions will be rendered moot in view of the provided blanket representation and warranty against patent infringement with no limitations.

From the seller's perspective, it is therefore prudent to include a representation or warranty against IP infringement if a well-structured IP defense and indemnification section is included in the agreement. During negotiations, to the extent such provisions are discussed, the seller's counsel may argue that the warranty against IP infringement is unnecessary for two reasons: (1) The IP defense and indemnification provisions set forth the extent of the buyer's IP indemnification, and the warranty against patent infringement therefore provides an unnecessary second cause of action under the agreement; and (2) of a more practical nature, it is not possible for the seller to evaluate every third-party patent in force to make such a representation

and warranty, even after an extensive patent clearance study has been performed. Finally, to the extent that a buyer still demands that a representation and warranty against patent infringement be included, it is wise to include such a provision with the explicit statement that the sole remedy for breach of this representation and warranty is provided under the patent indemnification section.

The purpose of a well-drafted arm's length defense and indemnification provision is not to afford the buyer or seller the opportunity to take advantage of the other; rather, it is an opportunity to apportion appropriate risk inherent in any sale or license. This can be accomplished by employing some of the practice tips discussed in this article with the understanding that no matter how many scenarios are considered, there is always a risk of the unknown that cannot be contracted away. ●

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Endnotes

1. Section 2-312 (2) of the UCC states: "Unless otherwise agreed, a seller that 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 that furnishes specifications to the seller must hold the seller harmless against any such claim that arises out of compliance with the specifications."

Section 2-312 (3) of the UCC states: "A warranty under this section may be disclaimed or modified only by specific language or by circumstances that give the buyer reason to know that the seller does not claim title, that the seller is purporting to sell only the right or title as the seller or a third person may have, or that the seller is selling subject to any claims of infringement or the like."

2. It should be noted that because a finding of infringement would constitute a direct breach of the warranties in the agreement between the buyer and seller, a buyer would potentially have a direct claim for breach of contract against the seller, separate and apart from the claim raised by a third party asserting a claim of infringement. A carefully crafted IP defense and indemnification provision should therefore make indemnification the sole and exclusive remedy for the breach of contract, thereby cutting off any additional claims between the buyer and the seller.