10

Representations, Warranties and Indemnification

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In the preceding chapters we discussed a number of affirmative obligations and restrictions imposed on the parties under an intellectual property (IP) agreement. In this chapter we shift to consideration of representations and warranties – statements made by one party as of the time the agreement is executed that are intended to depict the state of the world (or at least the relevant IP) at such time. In many cases, representations and warranties are intended to induce the other party to enter into the agreement, and as such may be relied upon.[1] We next address a series of typical disclaimers of warranty and limitations on liability that are intended to allocate liability among the parties to an agreement. Further allocation of liability, usually for IP infringement, is addressed by the indemnification clauses of agreements, viewed by nonspecialists as particularly dense and impenetrable legal text that is best glossed over quickly – often to their later chagrin. This chapter concludes with a discussion of insurance requirements in license agreements, which further refine the liability exposure of the parties.

10.1 REPRESENTATIONS AND WARRANTIES

Consider the following case as you think about the types of warranties that a licensee of IP may wish to obtain from its licensor.

[1] But see Roger Milgrim, Milgrim on Licensing § 23.01 (differentiating between representations and warranties as follows: "A representation is a statement as to the existence or nonexistence of a fact of state of affairs, or state of mind which acts as an inducement to contract … A warranty is a guaranty, an assurance of the existence or future existence of a fact upon which the other party may rely").

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10.1.1 *Warranty of Title*

Loew's Inc. v. Wolff

101 F. Supp. 981 (S.D. Cal. 1951)

CARTER, DISTRICT JUDGE

This case raises novel questions concerning literary property and warranties, express and implied, in the sale thereof. On March 21, 1949, defendants, Victoria Wolf and Erich Wolff, sold to the plaintiff, Loew's Inc., a story in manuscript form entitled, "Case History." On that date, a regular form contract used by plaintiff was executed by the defendants. The present action is based upon alleged violations of certain provisions of this contract.

Erich Wolff, a doctor, specializing in cardiology, had met his former wife, Cathy, during chemistry lectures where she was a laboratory assistant at the institute at which he studied. Following their marriage, she later became subject to spells of extreme melancholia and attempted suicide. He investigated shock treatment and radium treatment for ovarian glands. Following her second suicide attempt, she submitted to radium treatment. A third suicide attempt followed and she died on May 22, 1942. A year and a half later, Doctor Wolff read articles in medical journals describing a pre-frontal lobotomy operation for melancholia and the marked change it produced in a patient's personality. [All of these events], as testified to by Dr. Wolff, were factual matters and in the public domain.

Victoria Wolf, a short story writer and novelist met Erich Wolff in 1943. Late that year, he first discussed with her the operation on the brain, known as a prefrontal lobotomy, as the basis of a story. She knew, and Erich Wolff told her of the tragic experiences of Wolff and his former wife. Wolff told her of the lobotomy operation; its cure of melancholia, and its transformation of the character of the patient. Due to other commitments, [however,] Victoria Wolf was unable to write the story for Erich Wolff at that time.

After his discussion with Victoria Wolf, he then contacted Elsie Foulstone, also a writer, and discussed the possibility of her aiding him in preparing a draft of the story for motion picture purposes. He told her of the facts above and she wrote a synopsis of a story entitled, "Swear Not by the Moon," based on those facts, plus additional fictional matter. The end product did not please Erich Wolff and he relieved her of any further duties.

Nothing further was done about the story until some time in 1945, when Erich Wolff again contacted Victoria Wolf and prevailed upon her to work on the story. In that year Victoria Wolf wrote a synopsis of a story entitled, "Through Narrow Streets," which was based upon the doctor's former wife's experiences, the doctor's description of a lobotomy operation and her own research concerning it, and additional fictional matter. Dissatisfied, she next wrote a revision entitled, "Brain Storm" and late in 1948 or early 1949, wrote a second revision entitled, "Case History," the story in suit. It was a combination of fact and fiction. As stated above, this story was sold to the plaintiff in March 1949 for $15,000.

The document executed by the parties was entitled "Assignment of All Rights." By its language, (Sec. 1) defendants Erich Wolff and Victoria Wolf transferred and sold to plaintiff all rights of every kind in and to the story and "the complete, unconditional and unencumbered title" thereto. Section 4 of the assignment provided that defendants represented and warranted that each was the "sole author and owner of said work, together with the title thereof"; and "the sole owner of all rights of any and all kinds whatsoever in and to said work, throughout the world"; that each had "the sole and exclusive right to dispose of each

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and every right herein granted"; that "neither said work nor any part thereof is in the public domain"; that "said work is original with me in all respects"; that "no incident therein contained and no part thereof is taken from or based upon any other literary or dramatic work or any photoplay, or in any way infringes upon the copyright or any other right of any individual, firm, person or corporation." …

By Section 6, the defendants guarantee and warrant that they will "indemnify, make good, and hold harmless the purchaser of, from and against any and all loss, damage, costs, charges, legal fees, recoveries, judgments, penalties, and expenses which may be obtained against, imposed upon or suffered by the purchaser by reason of any infringement or violation or alleged violation of any copyright or any other right of any person, firm or corporation, or by reason of or from any use which may be made of said work by the purchaser, or by reason of any term, covenant, representation, or warranty herein contained, or by reason of anything whatsoever which might prejudice the securing to the purchaser of the full benefit of the rights herein granted and/or purported to be granted."

Section 7 provides that the sellers "agree duly to execute, acknowledge and deliver, and/or to procure the due execution, acknowledgment and delivery to the purchaser of any and all further assignments and/or other instruments which in the sole judgment and discretion of the purchaser may be deemed necessary or expedient to carry out or effectuate the purposes or intent of these present instruments."

About three months after the execution of this instrument and the sale, Elsie Foulstone discovered that Erich Wolff had sold his story, and on July 1, 1949, plaintiff was notified that she claimed a portion of the proceeds of the sale because of the work she had done in 1944. On July 30, 1949, plaintiff made a demand on defendants that they obtain a quitclaim and release from Foulstone within a reasonable time or they would be compelled to rescind their agreement of March 21st. On September 21, 1949, Elsie Foulstone filed action in the Superior Court of the State of California, County of Los Angeles, naming Erich Wolff, Victoria Wolf and Metro-Goldwyn-Mayer Pictures as defendants.

[On] February 28, 1950, the Superior Court rendered a judgment in favor of defendants finding that Elsie Foulstone had no valid claim or interest in or to the story, "Case History" which was sold to the plaintiff. The present action was filed on November 2, 1949, prior to the above mentioned judgment.

At the conclusion of the trial, the court found:

1. That "Case History" was a different story from "Swear Not By the Moon," and that the only points of similarity were factual matters from the public domain.
2. That Erich Wolff collaborated with Elsie Foulstone on the story, "Swear Not By the Moon."
3. That there had been proved no fraud or fraudulent representations on the part of the defendants, Erich Wolff and Victoria Wolf.

The second cause of action, in addition to setting forth express warranties which we have found were not breached rests on plaintiff's claim to a "marketable and perfect" title, free from reasonable doubt. This raises the question of the existence and validity of what will hereafter be referred to as "implied warranties."

The plaintiff argues that an express warranty of "marketable and perfect" title, free from reasonable doubt, arose by the use of the words, "complete, unconditional and unencumbered title"; "sole author and owner of said work"; "sole owner of all rights of any and all kinds whatsoever in and to said work, throughout the world"; and "I have the sole and

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exclusive right to dispose of each and every right herein granted." Nowhere in this most comprehensive instrument can be found the words "marketable, perfect or free from reasonable doubt." Thus, in order to find such an express warranty it must be found that the words actually used in the "Assignment of Rights" were or are synonymous with "marketable and perfect" title.

No case has been cited by counsel nor can any be found by this court which holds that the phrase "complete, unconditional and unencumbered title" is synonymous with "marketable and perfect" title. The common meaning of the word "complete" is "Filled up, with no part, item, or element lacking." It means that the "whole" title has been given and that no part or portion of it has been kept by the seller or sold to any other person. In two cases involving the sale of real estate, the words "complete title" were found to mean the instruments which constitute the evidence of title, and not to mean the estate or interest conveyed.

The warranty of "marketability of title" is a warranty found almost exclusively in connection with the sale of real property. Such words as "merchantable title," "clear title," "good title" and "perfect title" have been held in cases involving the sale of land to mean the same as "marketable title." None of these words can be found in the present instrument. As used in this assignment the word "complete" was not meant to be synonymous with the word "marketable or perfect." It was used to mean just what the word indicated, i.e. "whole title," that is, that no other person owned any interest in the property nor was any kept by the sellers. In this respect, the plaintiffs got what they bargained for. It seems evident that the remaining words used in the assignment are not synonymous with "marketable or perfect" title.

Plaintiff argues that the law implies the warranty of marketable title in the sale of literary property. There are more than mere historical reasons for concluding that the doctrine of "marketable title" should be limited to cases involving the sale of real property. This doctrine has a basis in the traditional concepts of judicial fair play. Briefly, the doctrine developed because the courts at common law believed, and rightly so, that since the law required there be a recorded title in the sale of real estate, then that record title should be clear and free from reasonable doubt. A buyer, desiring to purchase the seller's land, would request that the seller deliver to him a "marketable" record of title to the property. If by searching the record, the title was free from reasonable doubt, it was proclaimed that the buyer had a "marketable" title and could not avoid the enforcement of the contract. If on the other hand, a defect appeared in the record title, then the common law courts felt that justice demanded that the seller either clear the record title or they would allow the buyer to avoid the contract. But the doctrine was not applied to the sale of personal property. At common law and with few exceptions the law as it exists today, there was no requirement that the sale of personal property be recorded. The doctrine of caveat emptor therefore prevailed. Without the application of this latter doctrine, it is highly doubtful that any sale of personal property would ever become final. There are no records to search. There is no way to ascertain that a cloud exists on the title. It is not a requirement that a record title be produced before a purchaser will buy the article in question. Thus, because of these differences between the sale of real and personal property, the courts neither then nor now could imply by law into a contract of sale of personal property the doctrine of "marketable" title. If they did so, then there would be no case in which the seller could rest in ease, for if any third person asserted a claim to the property the courts would be compelled to avoid

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the contract between the parties. To do this would be to place upon the seller an unsurmountable burden, and would leave the door open to allow a discontented purchaser to avoid any contract involving the sale of personal property.

For these reasons, in adopting the Uniform Sales Act the warranty of "marketable" title was conspicuously excluded. [It] is obvious that sales involving literary property are different in some respects from the sale of ordinary goods. The sale of literary property is more analogous to the sale of patents and patent rights. Both literary properties and patents are products of the mind, plus skill. Both utilize matters in the public domain. A review of patent cases confirms the position taken by this court.

The rule has been well put in the case of *Computing Scales Co. v. Long*, 66 S.C. 379. There the court said: "If, however, the vendor at the time of the sale knew of a valid outstanding title or encumbrance, and failed to give notice to the vendee, the element of fraud is introduced, and the vendee may rescind without waiting for actual loss to come to him. But mere dispute about the title, or the contingency of future loss, does not warrant a rescission, and, where the buyer returns the goods, and refuses to pay the purchase money, it is incumbent on him to show that there is a valid adverse claim, from which loss to him would inevitably occur. The application of the rule may sometimes result in hardship, but to adopt any other would make it possible for a purchaser to escape from his contract upon any claim coming to his notice, however, baseless or absurd it might be."

The above rules should be even more strictly applied in the sale of literary property. [In] *Golding v. R.K.O. Pictures, Inc.*, 1950, 221 P.2d 95, Justice Schauer of the Supreme Court of California refers to the fact that there are approximately thirty-six basic plots in all writing. Consequently, assertions of similarity and of plagiarism are practically a concomitant of all story writing. To establish then, a rule permitting the purchaser of literary property to return the property and demand back the purchase price upon a mere assertion of similarity or plagiarism is to create a right without the support of reason or principle, the exercise of which would result in untold hardship. There can be no other conclusion but that the law will not imply a warranty of "marketable" title in the sale of literary property.

Notes and Questions

1. *Recourse when defense is successful*. Under *Wolff*, are there any circumstances in which a licensee would have a claim under the licensor's warranty even though the licensee successfully defended against a third party? What injury would the licensee suffer under these circumstances?
2. *Comparison to leases*. Article 2A of the UCC, which relates to leases of personal property, contains the following warranty: "(a) There is in a lease contract a warranty that for the lease term no person holds a claim to or interest in the goods that arose from an act or omission of the lessor other than a claim by way of infringement or the like, which will interfere with the lessee's enjoyment of its leasehold interest" (UCC § 2A-211(a)). Is this warranty consistent with the result in *Wolff*? Should such a warranty be implied in license agreements, or is it peculiar to leases?
3. *Sole ownership*. Suppose that a license contains an express warranty that the licensor is the "sole owner" of a patent. A court then finds that another individual contributed to the invention and is a co-owner of the patent. Does this revelation constitute a breach of the warranty? What harm does the licensee suffer? Does it matter whether the license is excusive or

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nonexclusive? See *Prudential Insurance Co. of America v. Premit Group*, 704 N.Y.S.2d 253 (N.Y.S.Ct. A.D. 2000) (discovery of the second co-owner was "an incurable material breach of defendants' warranty of sole ownership … and properly released plaintiff from any obligation to make further royalty payments thereunder").

4. *Likelihood of invalidity*. What if the licensor is aware of facts that would likely make a licensed right invalid if challenged, such as prior art pertaining to a patent? In *Schlaifer Nance & Company v. Estate of Andy Warhol*, 119 F.3d 91 (2d Cir. 1997), the estate of Andy Warhol granted SNC a license to reproduce and market certain Warhol artworks, as well as his name and likeness, in the fashion, home decorating, gift, toy and entertainment industries. The license contained the following representations and warranties:
   (ii) the Artist is the sole creator and the Estate is the sole owner of the copyrights … although certain elements of the Existing Artworks may involve or incorporate concepts in the public domain;
   (iv) except as noted on the Exhibit, the Estate has and will continue to have the sole and exclusive right to transfer to [SNC] all rights to the … Works …;
   (v) the … Works [do not] infringe the rights of any third parties;
   (vi) neither the Artist nor the Estate has granted and the Estate will not grant any right, license or privilege for Licensed Products with respect to the … Works or any portion thereof to any person or entity other than [SNC].

   The exhibit contained no exceptions (see Section 10.1.2, Note 6). Shortly after the license was granted, issues emerged regarding the estate's title and control over many of the works. Accordingly, SNC claimed that the estate's license of the works to SNC was fraudulent. The court rejected SNC's claim of fraud, holding that the circumstances of the transaction, including the disclaimers in the agreement, would have convinced any reasonable person that title in the works was uncertain. Do you agree? Are the considerations different for artistic works and technologies?

5. *Quitclaim*. In real estate transactions a transferor can transfer property without any warranty at all – a quitclaim transfer. Do such quitclaims exist with respect to IP transfers or licenses? Is this the effect of a license that lacks a warranty of validity and noninfringement?

FIGURE 10.1 After the Warhol estate granted rights in many of Andy Warhol's works to SNC, other deals began to emerge, including an exclusive license of Warhol's prints to a watchmaker.

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6. *Industry-specific considerations*. In *Wolff*, the court concludes that "[t]he above rule [rejecting an implied warranty of "marketable" title] should be even more strictly applied in the sale of literary property," citing *Golding v. R.K.O. Pictures, Inc*., 221 P.2d 95 (Cal. 1950). Do you agree? Are there other industries in which such a rule should be stringently applied? Are there any industries in which this rule should *not* be applied?

10.1.2 *Corporate Warranties*

The sample representations and warranties below are typical of a large IP licensing transaction between two sophisticated parties.

EXAMPLE: REPRESENTATIONS AND WARRANTIES

Each Party hereby represents and warrants to the other that [except as expressly set forth in the Disclosure Schedule attached hereto]:

A. *Due Organization*. It is a corporation duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation.
B. *Due Authority*. It has all necessary power and authority to execute and deliver this Agreement, and to perform its obligations hereunder.
C. *No Conflict*. The execution, delivery and performance of this Agreement and its compliance with the terms and provisions hereof does not and will not conflict with or result in a breach of any of the terms and provisions of, or constitute a default under or a violation of (i) any agreement where such conflict, breach or default would impair in any material respect the ability of such Party to perform its obligations hereunder; (ii) the provisions of its charter document or bylaws; or (iii) any Applicable Law, but, with respect to this clause (iii), only where such violation could reasonably be expected to have a material adverse effect on the ability of such Party to perform its obligations hereunder.
D. *Binding Obligation*. This Agreement has been duly authorized, executed and delivered by it and constitutes its legal, valid and binding obligation enforceable against it in accordance with its terms subject, as to enforcement, to bankruptcy, insolvency, reorganization and other laws of general applicability relating to or affecting creditors' rights and to the availability of particular remedies under general equitable principles.
E. *No Actions*. There are no actions, suits or proceedings pending or, to its knowledge, threatened against it or its Affiliates, which affect its ability to carry out its obligations under this Agreement or which challenge the validity or enforceability of the Licensed Rights.
F. *Ownership*. It is the record owner or registrant of the Licensed Rights in all relevant patent and trademark offices around the world, and there is no action currently pending or threatened challenging its ownership of such Licensed Rights.
G. *No Infringement*. [To its knowledge], as of the Effective Date, the practice of the Licensed Technology as contemplated by this Agreement will not constitute infringement or an unauthorized use of any patent, copyright, trade secret, proprietary information, license or right therein belonging to or enforceable by any Third Party.
H. *No Known Infringers*. It is not aware of any third parties that are practicing or infringing any of the Licensed Rights [other than parties to those licensing agreements listed in Exhibit H].

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I. *No Other Licensees*. [used only if license is exclusive] As of the Effective Date, Licensor has not expressly or implicitly granted any right, title or interest in or to the Licensed Rights to any third party, nor permitted any third party to practice any of the Licensed Rights, whether with or without compensation.

Notes and Questions

1. *Corporate warranties*. Clauses A–E in the above example generally relate to the corporate good standing and authorization of a party to enter into the contemplated transaction. Most of these warranties should be expected of any reputable company doing business. Why are they expressly stated in an agreement?
2. *Material adverse effect*. In Clause C there is a qualification at the end to the effect that a failure of a party's performance to comply with applicable law will constitute a violation of the warranty only if it "could reasonably be expected to have a material adverse effect on the ability of such Party to perform its obligations." Why would the parties agree to excuse some forms of legal noncompliance in this manner? What is "material"? What kind of legal noncompliance might not have a material adverse effect (often referred to as an "MAE") on a party's performance?
3. *Intellectual property*. Clauses F and G pertain to IP. Not all agreements relating to IP have an express warranty concerning IP. Rather, many of them address IP issues through the indemnification clause discussed in Section 10.3. What are pros and cons of addressing IP issues in representations and warranties versus indemnity?
4. *Knowledge*. Clause G begins with the qualifier "To its knowledge." This is a common qualifier in representations and warranties and limits the scope of the representation to things known to the party. Just as in a contract for the sale of residential real estate, the seller is required to disclose all *known* defects in the property; an IP licensor will often argue that it cannot make any representation regarding potential IP infringements of which it is not aware. However, knowledge qualifiers in representations and warranties in IP licenses are generally more contentious and complex than they are in real estate purchase agreements. For example, whose knowledge is being assessed? That of the members of a party's engineering department? Its legal department? The executive who signed the agreement? Is knowledge "actual" or "constructive" (i.e., is there some duty of due inquiry or investigation)? What argument might a licensee make to eliminate the knowledge qualifier from the representation in Clause G? When would such an argument be successful?
5. *No other licensees*. The representation in Clause I is appropriate when an exclusive license has been granted. It assures the licensee that no other licenses, express or implicit, have previously been granted by the licensor. In considering why such a representation is not applicable to a nonexclusive license, see *Western Electric Co. v. Pacent Reproducer Corporation*, 42 F.2d 116, 116 (2d Cir. 1930), *cert. denied*, 282 U.S. 873 (1930), in which the court commented: "the patent owner may freely license others, or may tolerate infringers, and in either case no right of the [nonexclusive] patent licensee is violated. Practice of the invention by others may indeed cause him pecuniary losses, but it does him no legal injury … Infringement of the patent can no more be a legal injury to a bare licensee than a trespass upon Blackacre could be an injury to one having a nonexclusive right of way across Blackacre." Do you see any value in a nonexclusive licensee's learning about prior licensees of the licensed rights?
6. *The disclosure schedule*. In some cases a licensor cannot honestly make the statement that is set forth in a representation or warranty. The licensed IP may, in fact, be infringed by others,

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an allegation of infringement may have been made against the licensor, or a third party may have a previously granted right thereto. If this is the case, and the licensor cannot give a "clean" representation or warranty, the agreement often permits the licensor to disclose these facts in a separate disclosure schedule that is delivered prior to executing the agreement and which becomes integrated into the agreement. If the licensor discloses a "breach" of a representation or warranty in the disclosure schedule, then the licensor is not liable for that breach on the theory that the licensee entered into the agreement with full knowledge. If the licensee does not wish to relieve the licensor of that particular liability, or to enter into the agreement knowing of the risk disclosed in the schedule, then the licensee may decline to execute the agreement, complete the transaction without penalizing the licensor for the disclosed matter, negotiate a reduction in the consideration, or include a specific indemnification by the licensor pertaining to the disclosed matter.

10.1.3 *Performance Warranties*

When the licensor provides the license with software, equipment, chemical reagents or other materials in addition to intangible IP rights, then the licensor will sometimes provide warranties regarding the operation or performance of those materials.

10.1.3.1 Compliance with Specifications

The most common formulation for such performance warranties is that these materials will operate "[substantially] in accordance with their Specifications and Documentation." "Specifications" are written technical documents that are agreed by the parties and appended to the agreement as an exhibit or appendix. They generally detail the technical features, dimensions and capabilities of the licensed product or materials. Documentation, on the other hand, generally refers to the standard descriptive documentation produced by the licensor and describing the licensed product or materials. It is typically less detailed than specifications. The licensee should try to ensure that such documents are as detailed and complete as possible, and that they describe every element of the licensed materials that are important to it. If a licensed product received regulatory approval, then reference may also be made to the licensor's disclosures to the relevant regulatory agency.

Licensees should also take careful note of "wiggle words" like "substantially" in performance warranties. What does it mean to operate "substantially" in accordance with specifications? Are insubstantial malfunctions acceptable? And how bad does an error need to be before it is substantial? Unfortunately, there are no clear legal rules that answer these questions, which are matters of fact unique to each specific case. If the licensee is concerned about such debates, then it should seek to eliminate from the performance warranty qualifiers such as "substantially," "materially" and the like.

10.1.3.2 Reliable Performance

In addition to compliance with specifications and documentation, a licensee may wish to ensure that a product will operate in a reliable and uninterrupted manner. Most specifications that describe the operation of a product do not include general reliability parameters, so these must often be added by attorneys to the warranties.[2] Licensors will argue against the inclusion of such general and open-ended warranties, which suggests that licensees should ensure that specifications contain as much detail as possible regarding the expected performance of licensed products.

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10.1.3.3 Malicious Code

Recent reports of computer viruses and ransomware abound. Thus, when computer software will be delivered or provided, the licensee should consider requesting a warranty from the licensor that the code does not contain any computer viruses or other harmful code. This warranty is necessary in addition to typical warranties regarding software performance because harmful code need not impair the performance of the licensed software itself, but may instead give malicious parties access to the licensee's data or systems, or disrupt the operation of other software or systems.

EXAMPLE: MALICIOUS CODE

[To the knowledge of Licensor,][**1**] the Licensed Software, at the time of delivery [**2**], does not contain any disabling device, virus, worm, back door, Trojan horse, time bomb, ransomware, malware or other disruptive or malicious code that may or is intended to impair, disrupt or block their intended performance or otherwise permit unauthorized access to, hamper, delete, hijack or damage any computer system, software, network or data.

DRAFTING NOTES

[1] *Knowledge* – the licensor will usually request a "knowledge qualifier" in the warranty regarding malicious code, arguing that it should not be held liable for harmful code introduced without its knowledge by third parties (e.g., over the Internet). The licensee will respond that, as between the two parties, the licensor is in a better position to scan for and detect harmful code in its software, and to impose strict security controls on its employees who have access to it. The licensor may counter that it is nearly impossible to determine when, precisely, a virus has infected a software program, and the licensee should implement adequate scanning and security measures in all of its systems as a matter of routine. An even more licensor-protective version of the knowledge qualifier is a statement to the effect that licensor has not intentionally included any such malicious code in the licensed software.

[2] *Timing* – the licensor will likely insist that this warranty be limited to the time at which software was delivered to the licensee, as infection is more likely to occur once software is in general use than at licensor's production facility. With such a qualification, the licensee will have to prove that an infection occurred prior to installation of the software on licensee's system, which could be a difficult task.

[2] One exception occurs in the area of computer and telecommunications networks, in which reliability is a key parameter. An important reliability metric in this area is availability or "uptime" – the amount of time that a product or service is available for use without interruption or unscheduled outage. This metric is often measured in "9s." Thus, if a service is required to have 99.9 percent availability, this is referred to as "three 9s" – the system can be "down" only 1.44 minutes during any twenty-four-hour period. By the same token, "five 9s" (99.999%) reliability permits only 0.864 seconds of downtime during any twenty-four-hour period, a very high standard indeed.

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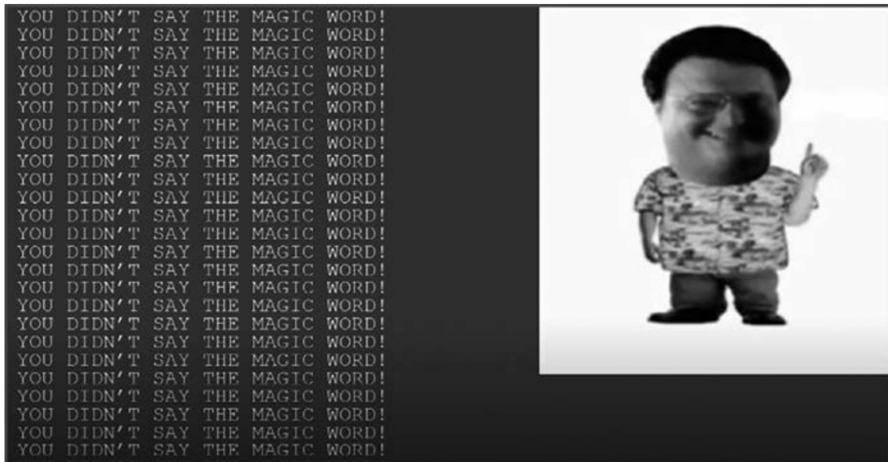

FIGURE 10.2 The 1993 film *Jurassic Park* introduced many viewers to the dangers of malicious computer code. In this classic scene, rogue computer programmer Dennis Nedry sabotages the theme park's computer system to draw attention away from his theft of dinosaur DNA.

10.1.3.4 Exclusions

As with many consumer products, a licensee's alteration of, tampering with or damage to a licensed product may void the relevant warranties. If the product is chemical or biological in nature, the licensor should also ensure that warranties are void if the product is not stored or handled in accordance with its written instructions. Examples of typical warranty exclusions are illustrated below.

> EXAMPLE: WARRANTY EXCLUSIONS
>
> Licensor shall have no obligation to correct or provide services in connection with any Errors that arise in connection with (i) any modification to the Software not made by Licensor, (ii) use of the Software in a manner, or in conjunction with software or equipment, not described in the Materials, or in any way not permitted under this Agreement, (iii) use of a superseded or obsolete version of the Software, (iv) the negligence or intentional misconduct of any user of the Software, (v) errors or defects in Third Party Software, Accessory Software, Hardware, communications equipment, peripherals or other equipment or software not provided by Licensor, or the failure by Customer to provide for regular maintenance of such Hardware and/or Software or (vi) input errors or errors associated with Customer's data. Licensor, at its option, may offer to perform troubleshooting, error correction, diagnostic or other programming services relating to the matters listed in Sections (i) to (vi) above for Customer at the Professional Services Rate.

10.1.3.5 Service Warranties

If a party provides services under an agreement, it will often warrant that those services will be provided "in a professional and workmanlike manner, in accordance with prevailing industry

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standards." While this recitation is fairly common, it is also notoriously imprecise. As one commentator noted nearly thirty years ago,

> Despite virtual universal adoption of the warranty of workmanlike performance by English and American jurisprudence, it remains an amorphous concept avoiding precise conceptualization. The absence of a precise formulation has created uncertainty as to the warranty's doctrinal dimensions. This in turn has produced unpredictable and uneven judicial application of the doctrine.[3]

The warranty of "professional" conduct suffers from the same lack of clarity, and "prevailing industry standards" are little better. Yet, taken together these three terms do offer the recipient of services some comfort, and a hope that truly substandard performance will convince a jury that a breach has occurred.

10.1.3.6 Duration

Many consumer products come with a warranty of thirty days, and the best will last for one year. Time periods of this duration may not be appropriate for sophisticated software systems or industrial equipment. In these cases, warranty terms may last for many years.

10.1.3.7 Remedies

Closely tied to the duration of performance warranties is the licensee's remedy if they are breached. Specifically, what happens if the licensee's multi-million-dollar inventory management system suddenly stops working, bringing its entire production line to a screeching halt? Even if the licensee has a potential monetary remedy for breach of contract and possibly a right to terminate the agreement (after a thirty-day cure period), these remedies are hardly what the licensee most wants, which is the prompt repair or replacement of the defective system. Thus, unlike "legal" warranty clauses, performance warranty clauses generally describe the specific actions that the licensor must take if the licensed products fail to comply with their warranty. These actions often include intake of the issue, problem diagnosis, initial response (sometimes a workaround) and permanent solution. As shown in the following example, many agreements classify problems as "low," "medium" or "high" priority, then assign different time requirements for each stage of response based on the severity level of the problem.

EXAMPLE: RESPONSE AND REPAIR

For purposes of Licensor's obligations under this Section, Errors in the Licensed Products shall be classified as follows:

Severity 1 – Critical problem. Application or significant module unavailable or the results produced by application are erroneous as result of error in the application. No acceptable workaround available.

[3] Timothy Davis, *The Illusive Warranty of Workmanlike Performance: Constructing a Conceptual Framework*, 72 Neb. L. Rev. 981 (1993).

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Severity 2 – High Impact. Function limited or workaround difficult to implement.
Severity 3 – Low Impact. Cosmetic change such as screen wording or a typographical error.

	Severity		
Response	1	2	3
Problem logged	Immediate	Immediate	Immediate
Initial response from Licensor Customer Support	10 min.	60 min.	24 hours
Progress updates	Every hour	Every 6 hours	None
Temporary fix, patch or workaround	12 hours	48 hours	Next minor release
Permanent solution	3 business days	7 business days	Next major release

In addition to specifying specific remedial actions that the licensor must take upon the occurrence of an error in the licensed software, many software licensing agreements also limit the licensor's liability to the performance of such remedial actions or, if the software is not, or cannot be, repaired, to replacement of the software or, barring that, a refund of the purchase price. Such limitations, which have generally been upheld by courts, prevent the licensee from recovering damages for the harm caused by the malfunctioning software, and even from declaring a contractual breach.

EXAMPLE: ERROR REMEDIATION PROCESS AND REMEDY

In the event that Licensee identifies an Error in the Licensed Software, Licensee shall report such Error to Licensor's Level 1 Support Desk in accordance with the reporting procedures set forth in Appendix __.

Following receipt of an Error report, Licensor shall classify the Error as Severity 1, 2 or 3 in accordance with the guidelines set forth in Appendix __ and shall [use its reasonable or best efforts to] respond to such Error within the timeframes set forth in Appendix __ commensurate with the Severity of the Error.

In the event that Licensor is unable to remedy the Error within such time frames, then at Licensee's option, Licensor shall have the option either to (a) replace the Licensed Software with a new product that does not contain the Error, or (b) terminate this Agreement and Licensee's right to use the Licensed Software and refund to Licensee the license fee paid therefor [depreciated on a 5-year straight-line basis.]

This Section sets forth Licensor's sole and exclusive liability, and Licensee's sole and exclusive remedy, for any Error in the Licensed Software.

10.1.3.8 Maintenance in Lieu of Warranty

In some cases, a licensor will refuse to offer any performance warranty on products or services that it provides. Instead, it will offer a paid maintenance program under which it agrees to provide correction and repair services, as well as regular product updates and upgrades. Maintenance programs for software are discussed in more detail in Section 18.2.4.

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Notes and Questions

1. *Performance warranties*. Performance warranties are typically given in software and similar licensing agreements, but not patent licenses. Why? Would you recommend that performance warranties be given more or less frequently? What purpose do they serve?
2. *Remedy*. The software remediation process described in Section 10.1.3.7 is often specified as the licensee's "sole and exclusive" remedy for failures of licensed software, with an ultimate remedy being refund of the purchase price (often on a pro-rated or depreciated basis). Is this fair? What if faulty software causes the licensee significant injury, as it did in *Mortenson v. Timberline* (reproduced in Section 17.1).
3. *Who's drafting*? Performance warranties include many components that really must be drafted (or at least outlined) by the parties' business and technical personnel. The specifications for a software program are critical to allocating the risk and responsibility for malfunctions (and *no* software works perfectly all the time), and severity levels and response times can mean the difference between a licensor's prioritizing one licensee's issues over another's. As an attorney, how would you seek to persuade business and technical personnel to engage with these contractual provisions? How much would you feel comfortable drafting and negotiating yourself?

Problem 10.1

Your client, Microware, plans to obtain an exclusive license to a software system created by DevelopIT. Microware asks you to draft a reasonable set of warranties (including remedies) to be included in the software licensing agreement, assuming the following scenarios:

a. Microware intends to distribute the software via the Apple App Store for consumer download and use.
b. Microware intends to use the software to run its own inventory-planning operation and expects to achieve significant competitive benefits using the software.

10.2 DISCLAIMERS, EXCLUSIONS AND LIMITATIONS OF LIABILITY

The court in *Loew's v. Wolff* considered whether an assignment agreement created an implied warranty of marketable title. To avoid questions like these, most IP agreements today expressly seek to disclaim and exclude all implied warranties of every kind.

DISCLAIMER

EXCEPT AS EXPRESSLY STATED ABOVE, THE LICENSED RIGHTS ARE PROVIDED "AS IS" WITH NO WARRANTY WHATSOEVER, WHETHER EXPRESS OR IMPLIED, WRITTEN OR ORAL (INCLUDING ANY WARRANTY OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, TITLE OR NON-INFRINGEMENT, OR ARISING FROM A COURSE OF DEALING).

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You may recognize many of these implied warranties as deriving from Article 2 of the Uniform Commercial Code (UCC), which pertains to sales of goods. But while the UCC does not apply to licensing transactions (see Section 2.1), attorneys drafting IP agreements have become accustomed to excluding any warranties that might arise by analogy to sales of goods.

10.2.1 *Implied Warranty of Merchantability*

An implied warranty of merchantability is created under UCC § 2-314(1). To be "merchantable," goods must (a) pass without objection in the trade under the contract description; (b) in the case of fungible goods, be of fair average quality within the description; (c) be fit for the ordinary purposes for which such goods are used; (d) run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; (e) be adequately contained, packaged and labeled as the agreement may require; and (f) conform to the promise or affirmations of fact made on the container or label if any.

10.2.2 *Implied Warranty of Fitness for a Particular Purpose*

An implied warranty of fitness for a particular purpose is created under UCC § 2-315. It provides that "Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified under the next section an implied warranty that the goods shall be fit for such purpose."

10.2.3 *Implied Warranty of Title and Noninfringement*

An implied warranty of title and noninfringement is created under UCC § 2-312. The implied warranty of title provides that the title conveyed in purchased goods shall be good, and its transfer rightful; and that the goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge. The implied warranty of noninfringement provides that "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" (UCC § 2-312(3)).

10.2.4 *Course of Dealing*

Under UCC § 2-314(3), "other implied warranties may arise from course of dealing or usage of trade." Accordingly, many disclaimer clauses seek to exclude these implied warranties.

10.2.5 *Disclaiming Implied Warranties under the UCC*

Under UCC § 2-316 there are three general methods by which implied warranties may be disclaimed: (a) specific disclaimers; (b) use of general exclusionary language such as "AS IS," "with all faults" or other language which in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty; and (c) a course of dealing or course of performance or usage of trade.

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ALL CAPS?

Non-lawyers (and many lawyers) sometimes wonder why so many "boilerplate" contractual provisions are written in ALL CAPS. Part of the reason stems from the UCC. Section 2-316(2) states that in order to exclude or modify the implied warranty of merchantability, the text must be **conspicuous**. Likewise, to exclude or modify the implied warranty of fitness, the exclusion must be in writing and **conspicuous**.

Helpfully, the UCC also defines conspicuous for these purposes (§ 1-201(10)):

> "**Conspicuous**," with reference to a term, means so written, displayed, or presented that a reasonable person against which it is to operate ought to have noticed it. Whether a term is "conspicuous" or not is a decision for the court. Conspicuous terms include the following: (A) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and (B) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the same size by symbols or other marks that call attention to the language.

From these humble origins, we get contracts that are laden with ALL CAPS or, better still, **BOLD ALL CAPS**.

In a recent law review article, Professor Yonathan Arbel and Andrew Toler conducted an empirical study of consumer comprehension of material written in ALL CAPS. They found that "[c]onsumers could identify their obligations no better under all-caps than under normal print—and older readers did much worse. In light of this, it is not surprising to find a consumer dislike of all-caps. Our evaluation of subjective sense of difficulty, shows that individuals rank reading as much harder when presented with text in all-caps." Accordingly, Arbel and Toler argue that "Courts should abandon their reliance on all-caps as a proxy for quality consumer consent and consider other, perhaps more contextual factors."[4]

Do you agree?

In addition to disclaimers of implied warranties, many IP agreements contain limitations on the types of monetary damages that may be available following a breach of the agreement (also frequently in ALL CAPS).

EXCLUSION OF CERTAIN DAMAGES

EXCEPT WITH RESPECT TO (i) PERSONAL INJURY, DEATH OR PROPERTY DAMAGE, (ii) A PARTY'S THIRD PARTY INDEMNIFICATION OBLIGATIONS UNDER SECTION __, OR (iii) A PARTY'S BREACH OF ITS CONFIDENTIALITY OBLIGATIONS, IN NO EVENT SHALL EITHER PARTY BE LIABLE TO THE

[4] Yonathan A. Arbel & Andrew Toler, *ALL-CAPS*, 17 J. Empirical L. Stud. 862 (2020).

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OTHER FOR SPECIAL, INCIDENTAL, CONSEQUENTIAL, EXEMPLARY, PUNITIVE, MULTIPLE OR OTHER INDIRECT DAMAGES, OR FOR LOSS OF PROFITS, LOSS OF DATA OR LOSS OF USE DAMAGES, ARISING OUT OF ANY ACTION OR OMISSION HEREUNDER, WHETHER BASED UPON WARRANTY, CONTRACT, TORT, STATUTE, STRICT LIABILITY OR OTHERWISE, EVEN IF REASONABLY FORESEEABLE OR IF SUCH PARTY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR LOSSES.

10.2.6 *Special Damages*

The types of damages that are typically excluded in clauses like this fall into the general category of "special" damages – those beyond the nonbreaching party's direct damages under the agreement (e.g., the price paid for goods or services). "Incidental" damages, defined in UCC §§ 2-710 and 2-715, include additional costs incurred by the nonbreaching party as a result of a breach, such as storage, inspection and transport charges arising in connection with effecting cover and otherwise incident to the breach. "Consequential" damages, in contrast, are losses and injuries suffered by the nonbreaching party of which the breaching party had reason to know (UCC § 2-715(2)). Despite these seemingly clear distinctions under the UCC, the common law is not so clear regarding the distinction between incidental and consequential damages. As noted by the Restatement (Second) of Contracts, "The damages recoverable for loss that results other than in the ordinary course of events are sometimes called 'special' or 'consequential' damages" (§ 351, comment b). In fact, as recently reported by Professor Victor Goldberg, numerous judicial decisions treat these terms as synonymous.[5]

Whatever they are, incidental and consequential damages can typically be excluded both under the UCC and common law unless the exclusion is deemed unconscionable. Under UCC § 2-719(3), the "limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable."

As shown in the example above, some parties also seek to limit exemplary, punitive and multiple damages. These types of damages are typically imposed by a court at its discretion. Examples include treble damages for "willful" patent infringement under 35 U.S.C. § 284 and certain antitrust claims under 15 U.S.C. § 15(a). It is less clear that contractual waivers of these types of damages will be enforceable.[6]

10.2.7 *Exceptions to Exclusions*

It may seem odd to begin a section that seeks to exclude certain types of monetary damages with exceptions to that exclusion. Nevertheless, well-drafted damages exclusions typically include at least some exceptions. In the example above, exception (i) relates to damages arising from

[5] Victor P. Goldberg, *Consequential Damages and Exclusion Clauses*, Columbia L. & Econ. Working Paper No. 582 at 1–2, n. 7 (2018).

[6] See, e.g., *Kristian, et al. v. Comcast Corporation*, 446 F.3d 25 (1st Cir. 2006) (the award of treble damages under federal antitrust statutes cannot be waived by contract, though such a waiver may be effective with respect to treble damages under state antitrust statutes that are more discretionary than the federal statute), Calif. Civil Code §1668: "All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud or willful injury to the person or property of another or violation of law, whether willful or negligent are against the policy of the law."

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personal injury, death or physical property damage. In many cases, waivers of such damages, at least with respect to individual persons, will be deemed unconscionable or otherwise contrary to law, so this exclusion is not particularly aggressive.

Exception (ii) clarifies that a party's indemnification obligation (see Section 10.3) extends to indirect damages that may be claimed against the other party by a third-party plaintiff. In general, this exception is fair, as the indemnified party has no control over the types of damages that an aggrieved third party will seek against it, and the indemnifiability of a claim should not depend on the pleading strategy of the third-party plaintiff. This being said, are there reasons that a party might have for seeking to exclude this exception from the exclusion of indirect damages?

Exception (iii) relates to breaches of the confidentiality provisions of an agreement. The common rationale for the exclusion is that injuries arising from the disclosure of confidential information are, by their nature, speculative and in the nature of consequential and similar damages. Without the exception, the injured party would have no practical way to be compensated for its injuries.

CAP ON DAMAGES

Except with respect to (i) personal injury, death or property damage, or (ii) a party's indemnification obligations under Section __, in no event shall either Party's aggregate liability under this Agreement or for any matter or cause of action arising in connection herewith exceed [$_____] or [__ times the highest/lowest amount paid or payable by one Party to the other during [any [12-month] period during] the term hereof].

In addition to limiting the types of damages to which a party may be subject under an agreement, parties may also wish to limit their absolute financial exposure under the agreement.

10.2.8 *How Much is Enough?*

The amount of a contractual damages cap is subject to negotiation of the parties, and is sometimes one of the most contentious issues in a transaction. The cap can be an absolute dollar amount or based on the amounts due or payable under the contract, either in the aggregate or over a specified period. For large, complex transactions, different caps can be applied to different categories of potential liability under the agreement.

10.2.9 *Exceptions to the Cap*

As with the exclusions from liability, this section begins with some exceptions to the cap on liability. For reasons similar to those discussed above, the limitation of damages for personal injury and death is likely to be unenforceable (though less so for physical property damage). The exception for indemnification liability is sometimes more controversial. In most cases, a licensor that agrees to indemnify its licensee will also agree that its obligation to cover damages payable to a third party should not be subject to the contractual liability cap. In rare cases, however, a licensor may insist that its indemnity obligation be subject to a damages cap (which could be lower than the overall contractual damages cap). See Section 10.3 for a discussion.

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Notes and Questions

1. *UCITA redux*? As discussed in Section 2.1 (Note 1), Article 2 of the UCC (Sales of Goods) does not apply to IP licenses. Yet, as demonstrated by the many references to the UCC above, it seems that a general set of rules relating to license agreements would be useful. This, of course, was behind the effort to create UCC Article 2B, which eventually failed and resulted in the Uniform Computer Information Transactions Act (UCITA). Yet, as noted in Chapter 2, UCITA was adopted in only two states. Does the material in this chapter make you more or less inclined to support a national code relating to IP licensing? With this in mind, would you recommend that your state adopt (or repeal) UCITA?
2. *Enforcement*. As Professor Nimmer has observed, the disclaimers, exclusions and limitations described in this chapter "are routinely enforced."[7] Should they be? Are there reasons to rethink allowing parties to limit their liability via contractual mechanisms like these? Are IP agreements different than other types of agreements in this respect?
3. *Classifying damages*. Exclusions of damages are generally viewed as contractual boilerplate, seldom warranting serious consideration or negotiation. As the Delaware Chancery Court has wryly noted with respect to one such clause, "the laundry list of precluded damages might have been put in the … Agreement by lawyers who themselves were unclear on what those terms actually mean."[8] Nevertheless, the fine distinctions among direct, indirect, consequential, special and other forms of monetary damages can become important once a contract is breached. Consider this hypothetical posed by Professor Goldberg:

   Suppose … that a licensee were to breach a patent license. If the license called for annual payments, the damages would be direct—the present value of the future stream of payments offset by any mitigation. No one questions that. What if the payments were a royalty based on sales? If the licensee were to breach, the future stream of payments would be the royalty on the future sales—losses on collateral business. Would the change in the form of compensation convert the damages from direct to consequential?[9]

4. *Lost profits*. Why do parties often try to exclude lost profits as allowable damages under their agreements?[10] Consider the characterization of lost profits by the court in *Imaging Systems Intern., Inc. v. Magnetic Resonance Plus, Inc.*, 227 Ga.App. 641, 642 (1997):

   there are two types of lost profits: (1) lost profits which are direct damages and represent the benefit of the bargain (such as a general contractor suing for the remainder of the contract price less his saved expenses), and (2) lost profits which are indirect or consequential damages such as what the user of the MRI would lose if the machine were not working and he was unable to perform diagnostic services for several patients.

   Given this analysis, would a contractual exclusion of lost profits damages exclude lost profits even if they were "direct" damages? The court addressed this question in *Elorac, Inc. v. Sanofi-Aventis Can., Inc.*, 343 F. Supp. 3d 789 (N.D. Ill. 2018). The agreement in that case included the following exclusion:

[7] Raymond T. Nimmer & Jeff C. Dodd, Modern Licensing Law, Vol. 2, § 11.56 (Thomson Reuters, 2016–17).

[8] *Pharmaceutical Product Development, Inc. v. TVM Life Science Ventures VI L.P.*, WL 549163 at 7 (Del. Ch. 2011) (quoted in Goldberg, supra note 5, at 1).

[9] Goldberg, supra note 5, at 4.

[10] For a comprehensive discussion of lost profits damages in patent cases around the world, see Christopher B. Seaman et al., *Lost Profits and Disgorgement* in Patent Remedies and Complex Products: Toward a Global Consensus 50 (C. Bradford Biddle et al., eds., Cambridge Univ. Press, 2019).

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IN NO EVENT SHALL EITHER PARTY BE LIABLE TO THE OTHER PARTY FOR LOSS OF PROFITS, SPECIAL, INDIRECT, INCIDENTAL, PUNITIVE OR CONSEQUENTIAL DAMAGES ARISING OUT OF ANY BREACH OF THIS AGREEMENT

The licensor, Elorac, accused the licensee, Sanofi, of failing to use the required commercially reasonable efforts to commercialize the licensed product. Sanofi responded that even if it had breached this obligation, Elorac's only damages would be lost profits, which were expressly barred by the exclusion clause. The court disagreed. It reasoned that "loss of profits" in the exclusion clause must refer to consequential-type damages rather than "the value of the promised performance." To hold otherwise, it reasoned, would give the damages exclusion clause "unintended breadth." Rather, the court held, "a contract must be read as a whole, with effect and meaning given to every term and a reasonable effort made to harmonize the terms, so as to give effect to—not nullify—its general or primary purpose" (Id. at 805). Accordingly, Elorac's claim for monetary damages arising from Sanofi's alleged failure to commercialize survived Sanofi's motion for summary judgment. Do you concur with the court's reasoning? Are there any circumstances under which a party would rationally agree, as Sanofi argued, to exclude all damages, even for direct breach by the other party?

10.3 INTELLECTUAL PROPERTY INDEMNIFICATION

As discussed in Section 10.1, IP licensees cannot assume that the rights that they license will permit them to practice a particular technology, or that they will not later become subject to infringement claims by third parties. To address this issue, most sophisticated IP transactions include provisions by which the parties seek to allocate the risk of third-party infringement among themselves.

As Jay Dratler explains:

> Once a licensing agreement has been consummated, the licensee would like to have the absolute right to use the licensed intellectual property in accordance with the terms of the agreement. Yet reality may intervene … [A] third party may claim rights in the licensed intellectual property superior to those of licensor or licensee. Based on that claim, the third party may sue the licensee for infringement solely for exercising [its] purported rights under the licensing agreement. [Licensees] try to protect themselves against the risk of claims of this sort by asking licensors for warranties of noninfringement. They may also ask the licensor to agree, at its

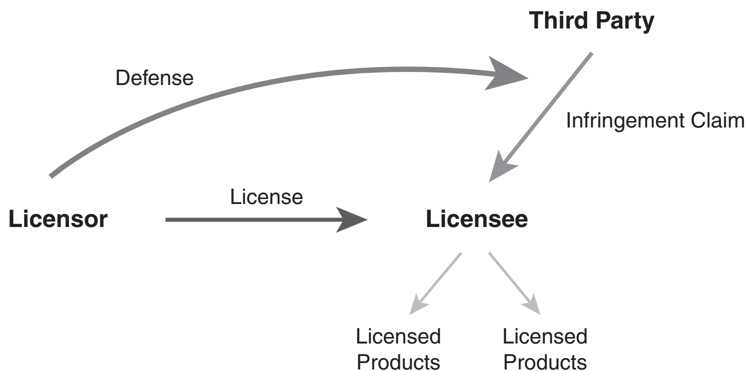

FIGURE 10.3 Illustration of the basic structure for IP indemnification.

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expense, to indemnify or defend the licensee against those claims. This sort of … covenant to indemnify or defend is generally enforceable, subject to certain rules of interpretation.[11]

Professor Michael Meurer describes a common scenario in which IP indemnity is typically required – an agreement between parties in a vertical supply chain:

> [M]uch economic activity is conducted collaboratively by a supply chain of vertically disintegrated firms, in which multiple firms are sometimes implicated in infringing activities, by making, selling, or using patented technology, or by contributing to or inducing another firm's infringement. Often patent owners have the option of suing some or all of the members of a supply chain who contribute to the design, creation, and marketing of a new technology.
>
> To illustrate, a firm named NorthPeak launched a patent enforcement campaign against supply chains active in the market for office building security technology. In 2008, the patent owner "alleged infringement by computers, routers and adapters made by 3Com Corp., Dell Inc. and 25 other manufacturers. Intel intervened in 2009 on behalf of the nine defendants that used its chips." Intel challenged the validity of claims in two patents asserted by NorthPeak in reexamination proceedings at the USPTO. The agency invalidated the relevant claims in one patent but not the other. Following a five year stay of the district court proceedings, litigation resumed and the trial judge used NorthPeak testimony in the reexaminations to construe the remaining claims narrowly, which led NorthPeak to stipulate non-infringement. NorthPeak appealed to the Federal Circuit, which affirmed the claim construction, presumably ending the lawsuit in late 2016.
>
> Because of patent assertions like this, businesses increasingly contemplate the risk of patent infringement when they negotiate contractual relations to form a supply chain. Upstream and downstream firms recognize they may be jointly liable for patent infringement because of their relationship to each other and their connection to the new product. An interesting and difficult question is: how should they manage infringement risk to maximize their joint profit? Which firm should control litigation? Or should they plan for joint control? Should they share responsibility for damages and litigation expenses? If yes, what determines each party's share?
>
> The traditional and simple answer to these questions is that the upstream firm should bear the risk of infringement because it is best able to avoid infringement. Imposing the risk of infringement on the vendor appropriately penalizes a vendor guilty of piracy. More importantly, imposing the risk on the vendor induces non-piratical vendors to make careful design and manufacturing choices, and obtain patent licenses when the risk of infringement is substantial.[12]

Notes and Questions

1. *Litigation risk*. What point does Meurer's example of the NorthPeak proceedings illustrate? Why does Meurer say that the upstream firm typically bears the risk of infringement? Are there reasons that a downstream firm (licensee/customer) should instead bear this risk?
2. *Intervention*. Why do you think that Intel intervened in the various lawsuits brought by NorthPeak against computer and router manufacturers? Was this a wise business strategy for Intel?
3. *Common law indemnity*. Meurer discusses the allocation of liability among sophisticated parties through contractual instruments. But indemnity also exists under the common law, even if no contractual provisions require it. Consider the following explanation by Cynthia Cannady:

[11] Jay Dratler, Licensing of Intellectual Property § 10.02.

[12] Michael J. Meurer, *Allocating Patent Infringement Risk Across the Supply Chain*, 25 Tex. Intell. Prop. L.J. 251 (2018) (citations omitted).

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Indemnity has three forms, common law implied contractual indemnity, equitable indemnity among concurrent tortfeasors, and contractual indemnity. The first occurs if there is a contract between the two parties, but the indemnity is not explicit. The second indemnity arises if there is no contract but there is a relationship between the two parties and a duty to a third party that makes it equitable to share the indemnity obligation. The third type of indemnity is based on the terms set forth in the contract. Whatever the type of indemnity, state contract and tort law (not IP law) govern indemnity, and federal courts will apply state law.

If no indemnity terms are set forth in the licensing or development agreement, one of the common law indemnities will apply. The common law of joint and several liability in the context of equitable indemnity is "fairly expansive." Implied contractual indemnity is unpredictable in result. For the reasons, from the licensor's point of view, it is essential to include a contractual indemnity that explicitly defines and hopefully limits the indemnity. From the licensee's perspective, a good contractual indemnity may make it easier to litigate if necessary because of attorney's fees provisions and statutes of limitations.[13]

* * *

Contractual indemnification provisions are among the most complex provisions in IP agreements. They appear in all forms of IP transactions, whether involving patents, copyrights, trademarks, trade secrets or some combination of the above. Though often allocating significant financial responsibilities among the parties, business negotiators' eyes often glaze over when it comes time to discuss the indemnification clauses. They are viewed as "lawyers" language, but don't let the complexity and seeming uniformity of these clauses fool you. Indemnification provisions are sometimes the most heavily negotiated provisions of an IP agreement, and woe be unto the junior associate who fails to address some clause that could open his or her client up to significant liability.

Read the following example of an IP indemnification clause and then consider the questions that follow.

INDEMNIFICATION BY LICENSOR

(a) *Indemnity Obligation*. Licensor shall indemnify, defend and hold harmless [1] Licensee and its Affiliates and their respective officers, directors, employees, and agents (the "Indemnified Parties") from and against any and all third party [2] claims, demands, costs, damages, settlements and liabilities (including all reasonable attorneys' fees and court costs) of any kind whatsoever, directly and to the extent arising out of claims that Licensee's manufacture, use or sale of the Licensed Product in accordance with this Agreement infringes the U.S. patent, copyright, or trademark rights of a third party or constitutes a misappropriation of the trade secrets of a third party; provided, however, that this indemnification is conditioned [3] upon: (i) Licensee providing Licensor with prompt written notice of any such claim; (ii) Licensor having sole control and authority with respect to the defense and settlement of any such claim; and (iii) Licensee cooperating fully with Licensor, at Licensor's sole cost and expense, in the defense of any such claim. Licensor shall not, without the prior written consent of Licensee, agree to any settlement of any such claim that does not include a complete release of Licensee

[13] Cynthia Cannady, Technology Licensing and Development Agreements 169 (Oxford Univ. Press, 2013).

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from all liability with respect thereto or that imposes any liability, obligation or restriction on Licensee. Licensee may participate in the defense of any claim through its own counsel, at its own expense.

(b) *Abatement of Infringement*. In the event that any Licensed Product is held in a suit or proceeding to infringe any patent, copyright, or trademark rights of a third party (or constitute the misappropriation of a trade secret of a third party) and the use of such Product is enjoined, or Licensor reasonably believes that it is likely to be found to infringe or constitute a misappropriation, or is likely to be enjoined, then Licensor shall, at its sole cost and expense, and at its option, either (i) procure for Licensee the right to continue manufacturing, using and selling such Licensed Product, (ii) modify such Licensed Product so that it becomes non-infringing or no longer constitutes a misappropriation, without affecting the basic functionality of such Licensed Product; provided, however, that if (i) and (ii) are not reasonably practicable, Licensor shall have the right, in its sole discretion, to terminate this Agreement with respect to such Licensed Product by giving Licensee 30 days prior written notice, upon which termination Licensor shall refund to Licensee the License Fee paid by Licensee in accordance with Section x above, depreciated on a straight-line basis over the 5-year period commencing on the Effective Date.

(c) *Exclusions*. Licensor shall have no obligation for any claim of infringement arising from: (i) any combination of the Licensed Product with products not supplied by Licensor, where such infringement would not have occurred but for such combination; (ii) the adaptation or modification of the Licensed Product, where such infringement would not have occurred but for such adaptation or modification; (iii) the use of the Licensed Product in an application for which it was not designed or intended, where such infringement would not have occurred but for such use; (iv) Licensee's continued use of a version of the Product other than the most recently released version, where such infringement would not have occurred if such most recently released version had been used; or (v) a claim based on intellectual property rights owned by Licensee or any of its Affiliates. In the event that Licensor is not required to indemnify Licensee for a claim pursuant to subsections (i), (ii), (iii) or (iv) above, Licensee agrees to indemnify, defend and hold harmless Licensor and its officers, directors, employees, and agents from and against claims, demands, costs and liabilities (including all reasonable attorneys' fees and court costs) of any kind whatsoever, arising directly or indirectly out of such claims.

(d) *Apportionment*. In the event a claim is based partially on an indemnified claim described in Section (a) above and partially on a non-indemnified claim, any payments and reasonable attorney fees incurred in connection with such claims are to be apportioned between the parties in accordance with the degree of cause attributable to each party.

(e) *Sole Remedy*. This Section X states Licensee's sole remedy and Licensor's exclusive liability in the event that the Licensed Product infringes on or misappropriates the intellectual property rights of any third party.

(f) *Cap on Liability*. Notwithstanding anything to the contrary in the foregoing, Licensor's maximum total liability under this Section X shall be [the total amount paid by Licensee under this Agreement during the immediately preceding three contract years].

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DRAFTING NOTES

[1] *Hold harmless* – the term "hold harmless" is often used in conjunction with the obligation to indemnify. But what does it mean? As one court has noted,

> The terms "indemnify" and "hold harmless" have a long history of joint use throughout the lexicon of Anglo-American legal practice. The phrase "indemnify and hold harmless" appears in countless types of contracts in varying contexts. The plain fact is that lawyers have become so accustomed to using the phrase "indemnify and hold harmless" that it is often almost second nature for the drafter of a contract to include both phrases in referring to a single indemnification right … As a result of its traditional usage, the phrase "indemnify and hold harmless" just naturally rolls off the tongue (and out of the word processors) of American commercial lawyers. The two terms almost always go together. Indeed, modern authorities confirm that "hold harmless" has little, if any, different meaning than the word "indemnify."[14]

As a result, one may probably omit this term without significantly affecting the parties' rights and obligations.

[2] *Third-party claims* – see Note 3, below.
[3] *Condition versus covenant* – see Note 5, below.

Notes and Questions

1. *Indemnity versus warranty*. In the discussion of representations and warranties in Section 10.1 we mentioned that some parties forego IP representations and warranties in lieu of indemnification. Now that you have studied an IP indemnity clause, why do you think parties might prefer indemnification over warranties in this area? Think about the results that flow from a third-party infringement in either case. What happens when an unqualified warranty is breached? Does the triggering of an indemnification represent a breach of contract?
2. *Indemnification by licensor*. The above example describes the indemnification obligations of an IP licensor. IP licensees also often have indemnification obligations of their own. Considering the licensor's indemnification obligations in clause (a), against what sort of risks might the licensee be required to indemnify the licensor? Why might the licensee resist indemnifying the licensor for IP-related liabilities?
3. *Third-party claims*. Most IP indemnity clauses offer the licensee protection against third-party claims – that is, claims that the licensee, when using the licensed IP in the manner intended, infringes a third party's IP. In some indemnity clauses, however (particularly in the biopharma industry), the licensee may also seek indemnification from the licensor against its *own* internal losses and costs, in addition to damages that may be due to a third party. Why is this form of indemnification desirable for the licensee? On what grounds might the licensor object?
4. *Scope of IP covered*. In clause (a) the licensor only indemnifies against infringement of US IP rights. Is this reasonable? What if a worldwide license has been granted? Parties will often debate heavily the scope of coverage of an indemnity, sometimes listing specific countries (e.g., the United States, Canada, EU countries, Japan, Korea and China), or identifying countries where the licensed products are anticipated to be manufactured, sold or used. A

[14] *Majkowski v. American Imaging Management, LLC*, 913 A.2d 572, 588–89 (Del. Ch. 2006).

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licensee would, of course, prefer a worldwide indemnity with no qualifications whatsoever. What reasonable objections could a licensor make to such a request?

5. *Conditions versus covenants*. Most indemnity clauses contain a set of actions that the indemnitee must take once it is notified of a claim for which it intends to seek indemnity. Thus, just as the holder of an automobile insurance policy must notify the insurer within a certain number of days if an accident occurs, the indemnitee must notify the licensor and turn over control of the claim. In clause (a) the language states that "indemnification is conditioned upon" the indemnitee taking these actions. Why are these conditions to the indemnification, rather than simple obligations of the indemnitee? What could be the different result if these actions were simply stated as obligations of the indemnitee?
6. *Control of litigation*. One of the key elements of indemnification is the licensor's (indemnitor's) ability to control the defense of any third-party claim for which indemnification is sought. In return, the indemnitor pays all costs of this defense. Why is it important for the indemnitor to control the defense? Are there situations in which an indemnitee might wish to control, or participate in, the defense of such a claim? Why does the last sentence of clause (a) give it the right to do so, but only at its expense?
7. *Abatement of infringement*. Clause (b) is what is often referred to as an "abatement" clause. Contrary to the first impression that many readers have, the abatement clause is intended to protect the *licensor*, not the licensee. It allows the licensor, if an injunction preventing the licensee's use of the licensed product is issued or likely, to terminate the applicable license. This termination avoids the licensor's potential breach of the license agreement by failing to enable the licensee to use the licensed IP and by curtailing any potential claim of inducement to infringe that may be brought against the licensor by the third-party claimant. Usually, however, the licensor is not permitted to terminate the license without compensating the licensee in some manner. The compensation structure set forth in clause (b) contemplates that the licensed product is a system that the licensee would likely have used for a five-year period. Thus, in order to terminate the license and abate the infringement, the licensor is obligated to refund to the licensee a portion of the initial license fee, pro-rated over a five-year term. Needless to say, the details of this compensatory scheme will vary dramatically based on the kind of IP being licensed and the payment structure for the original license. What complications can you see arising if (a) the injunction affects only one of several licensed technologies, and (b) the license authorized the licensee to manufacture and sell products in exchange for a running royalty?
8. *Exclusions*. Clause (c) enumerates situations in which actions of the licensee may relieve the licensor of its obligation to indemnify. This clause lists the typical exclusions that one encounters: the licensee has combined the licensed product with other, unlicensed, products; the licensee has altered or modified the licensed products or used them in a manner not intended.[15] Why is it appropriate to relieve the licensor of its indemnification obligation in these cases? Note the last part of clause (c), which requires the licensee to indemnify the licensor if an infringement arises from any of these situations. Is this always appropriate?
9. *Sole remedy*. Clause (e) provides that the indemnification provisions set out above are the licensor's sole liability, and the licensee's sole remedy, in the event that the licensed products infringe a third party's IP. What other kinds of liability is the licensor seeking to avoid here?

[15] In some industries, additional exclusions from indemnification are encountered. For example, firms that sell chips implementing popular wireless telecommunications and networking standards (e.g., UMTS, LTE, Wi-Fi) will typically exclude any indemnification for their customer's infringement of other patents covering those standards. For insight into why this might be the case, see Chapter 20.

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10. *Apportionment*. Clause (d) provides an apportionment rule similar to that which exists for joint tortfeasors. How easy do you think it is to determine which portions of a claim are, and are not, subject to an indemnification obligation? Read the following case, which tackles this issue in greater detail.
11. *Limitations on indemnification liability*. Refer to the discussion of liability caps in Note 6 of Section 10.2. As noted there, a licensor that agrees to indemnify its licensee will often agree that its obligation to cover damages payable to a third party should not be subject to the contractual liability cap. In rare cases, however, a licensor may insist that its indemnity obligation be subject to a cap (which could be lower than the overall contractual damages cap). Why? Consider a chip designer that licenses IP relating to a particular circuit to the manufacturer of a much larger product, such as a television. In this transaction, the chip designer may receive a small amount, say $0.50, per $500 television sold. Yet if that television, by virtue of including the circuit, infringes a patent held by a competing television manufacturer, the court in awarding "reasonable royalty" damages[16] may base those damages on the price of the $500 television. Even at a relatively modest royalty rate of 0.5 percent, the damages would be $2.50 per infringing television, five times more than the chip designer received per television. In this circumstance, the chip designer may wish to limit its indemnification exposure to the $0.50 that it received, with the balance to be covered by the licensee. But what arguments would the television vendor make in response to the licensor to avoid imposing such a cap on its liability?

PRODUCT LIABILITY AND GENERAL LIABILITY INDEMNIFICATION

This book focuses on IP transactions, and this section covers IP indemnification clauses. This being said, there are many other types of liability for which parties seek indemnification, and many contracts include indemnification for liability involving taxes, environmental contamination, underfunded pension plans and the like, not to mention general acts of negligence and willful misconduct by employees and agents working on the other party's premises.

But beyond these general liabilities, one type of liability, and indemnification, that is very common in biopharma licensing agreements relates to product liability. Specifically, a licensee that has the right to develop and market a drug, vaccine or medical device covered by a licensor's patents will often be required to indemnify the licensor against any third-party claims arising from death or injury caused by the licensed product. The theory is that, while the licensor may have discovered the biochemical agent comprising the active ingredient of a drug, the licensee is responsible for the development, manufacture, testing and regulatory approval of the drug – all of which are usually beyond the control of the licensor. Thus, if a drug causes adverse reactions in patients or a manufacturing lot is contaminated, the licensor will wish to avoid any associated liability and be indemnified by its licensee.

By the same token, trademark licensors typically wish to limit their liability, and receive indemnification from licensees, for injury caused by products bearing licensed marks, whether they are action figures, backpacks, athletic shoes or candy bars.

[16] 35 U.S.C. § 284.

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Southern California Gas Co. v. Syntellect, Inc.

Case No. 08-CV-941-BEN (MDD) (S.D. Cal. 2014)

BENITEZ, DISTRICT JUDGE

This case arises out of [...] SoCal Gas's purchase of an automated interactive system for handling incoming telephone calls made by Syntellect, Inc. (Syntellect). The Syntellect System is one component in SoCal Gas's system for handling customer phone calls. Among other functions, the System allowed SoCal Gas to tie an incoming call to customer information from SoCal Gas's computers. For instance, the System could obtain account records from a computer database based on the incoming phone number. Syntellect's custom application programs provided decision trees for handling calls based on the caller's inputs, enabling call flows that would allow the customer to either complete their task in the automated system, or speak to a live operator.

The purchase agreement for the Syntellect System contained a broad indemnity provision:

> [Syntellect] shall indemnify, defend and hold [SoCal Gas] ... harmless from and against any and all claims, actions, suits, proceedings, losses, liabilities, penalties, damages, costs or expenses (including attorney's fees and disbursements) of any kind whatsoever arising from (1) actual or alleged infringement or misappropriation by Syntellect or any subcontractor of any patent, copyright, trade secret, trademark, service mark, trade name or other intellectual property right in connection with the System, including without limitation, any deliverable (2) [Syntellect's] violation of any third party license to use intellectual property in connection with the System, including, without limitation, any deliverable.

The "System" includes the Vista Interactive Voice Response System, custom application programs developed by Syntellect specifically to SoCal Gas's application specifications, and all specifications and requirements included in the Request for Proposal.

SoCal Gas was sued by a third party, Ronald A. Katz Technology Licensing, L.P. (Katz), which alleged that SoCal Gas's system violated patents held by Katz. SoCal Gas asked Syntellect to defend the suit, but Syntellect refused to defend or indemnify SoCal Gas. SoCal Gas reached a settlement with Katz by entering a licensing agreement granting SoCal Gas a license to use the patents, and releasing them from liability for past use. SoCal Gas agreed to pay a licensing fee to Katz based upon past calls that had used the automated system. There were two categories of calls for which Katz demanded payment and which had actually occurred in the SoCal Gas system: 1) calls which were resolved entirely in the automated system, and 2) calls that were in the automated system, then transferred to a live customer service representative. For each minute of the entire duration of both categories of calls, SoCal Gas agreed to pay $0.011.

On March 28, 2011, this Court granted SoCal Gas's motion for partial summary adjudication on the question of whether Syntellect breached the indemnity provision by failing to defend and indemnify SoCal Gas in the Katz infringement case. Syntellect appealed to the Ninth Circuit. In a memorandum disposition, the Ninth Circuit affirmed this Court's grant of summary adjudication on the question of liability. The Ninth Circuit noted the broad language of the indemnity provision, and that California law interpreted language such as "arising from" to mean that liability will attach if the indemnitor's performance under the contract is "causally related in some manner to the injury for which indemnity

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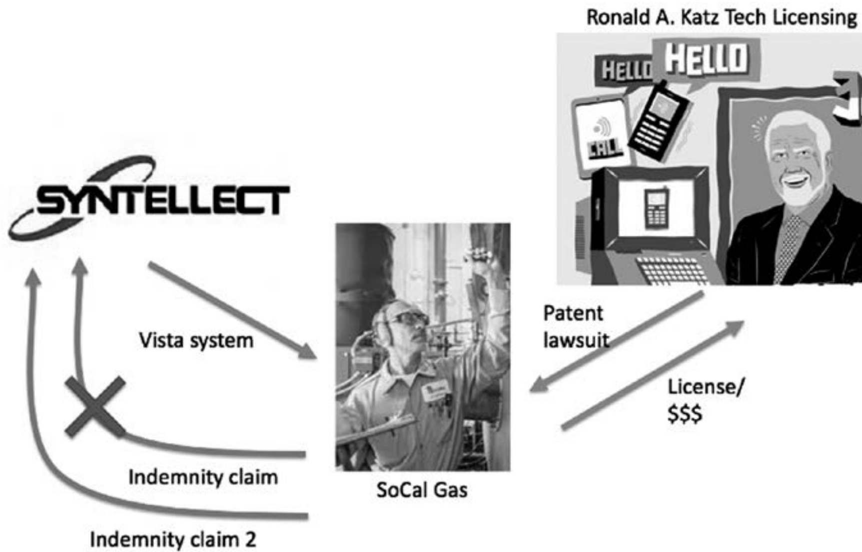

FIGURE 10.4 The parties and dispute in *SoCal Gas v. Syntellect.*

is claimed." The Court found that each of the "accused services" in the Katz complaint was "enabled by Syntellect's performance of its contractual duties." It concluded that the allegations of patent infringement were causally related to Syntellect's provision of the System, and that Syntellect was therefore liable for "damages stemming from utilization of the System."

The Ninth Circuit also found that SoCal Gas's own liability was reflected in the "presumptively reasonable amount of the settlement." However, the Ninth Circuit found that SoCal Gas must still demonstrate that the entire liability should be allocated to Syntellect. When there is a dispute over allocation, the plaintiff is required to prove the reasonableness of the proposed allocation by ordinary means, and a district court may not exclude all evidence relevant to the allocation of damages. As this Court excluded such evidence, the case was remanded for this Court to undertake this inquiry "in the first instance."

The Ninth Circuit clearly stated that it was not holding that apportionment was required, or that Syntellect could not be held responsible for the entire amount. Rather, this Court must consider evidence to determine if apportionment is necessary. To determine if apportionment is required, this Court is directed to consider the "nature of the Katz claims as they apply to the indemnity provision and to other potentially liable parties." The Ninth Circuit stated that when an indemnity obligation is "limited under the contract, an allocation of liability between culpable parties is appropriate." Apportionment is appropriate where "some portion of the liability for the alleged infringement is not embraced by Syntellect's indemnity obligation."

Discussion

As directed by the Ninth Circuit, apportionment is appropriate when the indemnity obligation is limited and "some portion of the liability for the alleged infringement is not embraced by Syntellect's indemnity obligation." The critical question is thus whether the scope of the liability provision, as determined by this Court and the Ninth Circuit, covers

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the entire amount of the settlement, or whether some portion of the settlement amount is not covered by the indemnity obligation and allocation is required. The parties agree that Syntellect is liable for "damages stemming from utilization of the system." SoCal Gas contends that the undisputed facts and legal conclusions demonstrate that no apportionment of liability is required. It argues that the entire amount stems from the utilization of the System, and is covered by the indemnity obligation as interpreted by the Court. Syntellect contends that part of the settlement amount exceeds the scope of the indemnity obligation. Specifically, it claims that 1) the indemnity obligation does not cover damages paid for portions of calls not conducted within the System, and 2) the indemnity obligation does not cover damages to the extent that other components of the automated call system are necessary to provide the allegedly infringing services. It argues that these categories of damages do not "[stem] from the utilization of the System."

The arguments between the parties are essentially based on the interpretation of the Ninth Circuit's language stating Syntellect is liable for damages "stemming from the utilization of the Syntellect system." It is therefore necessary for this Court to examine the indemnity provision to determine what kind of relationship the damages must have to the utilization of the System, and how the obligation is affected by the presence of other parties.

A. The Necessary Relationship Exists Between the Use of the Syntellect System and Damages Paid for Minutes Spent Waiting for an Operator or Speaking to an Operator

Syntellect argues that it should not be required to pay the portion of the licensing fee attributable to the 63% of minutes where a caller was either waiting for a live operator, or speaking to a live operator. It argues that apportionment is appropriate because such damages do not stem from the utilization of Syntellect's System. SoCal Gas contends that such minutes do stem from the utilization of the System. The factual relationship between the use of the System and the minutes spent waiting for an operator or talking to an operator is sufficient for damages for those minutes to fall within the indemnity obligation.

Syntellect essentially admitted that each of the accused services from the Katz complaint was enabled by its performance of its contractual duties. Examination of the Katz complaint confirms that all claims against SoCal Gas were based on services enabled by Syntellect's system, including the partially automated calls. It stated that Katz's inventions were "directed to the integration of telephonic systems with computer databases and live operator call centers to provide interactive call processing services." SoCal Gas was accused of using infringing call processing systems to offer automated customer services, "in some instances in connection with operators." Katz listed accused services, some of which required live operators. Katz clearly alleged that SoCal Gas violated its patents not only when a caller exclusively operated in the automated system, but when SoCal Gas provided services using the System and live operators.

It is also undisputed that the payment of the licensing fee was for the "sole purpose" of settling the patent infringement lawsuit. As SoCal Gas paid the licensing fee to settle the claims, and all claims were based on services enabled by Syntellect's System, then the entire amount of damages was paid to settle claims enabled by the System.

The contract requires Syntellect to indemnify SoCal Gas against "any and all" damages "of any kind whatsoever" arising from actual or alleged infringement of intellectual property rights, including patents, "in connection with the System." Significantly, this language is not requiring Syntellect to pay for damages "arising from" the use of the System, it

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requires the payment of damages "arising from" allegations of infringement in connection with the System. It is apparent that Katz's claim that the partially automated calls infringed the patent is an allegation of infringement of property rights in connection with the System. The licensing fee arose from that infringement claim. The clear terms of the contract therefore require Syntellect to pay for "any and all" damages arising from that allegation. Nothing in the contract requires a particular unit of damages to itself be traceable to the System.

Even if one were to read the Ninth Circuit's opinion to impose an additional requirement that a particular unit of damages must stem from the utilization of the system, the minutes in question meet this requirement. The licensing agreement required SoCal Gas to pay for every minute spent waiting for an operator or speaking to a live operator, if the call spent time in the automated system. If the call did not pass through the system, then no damages would be paid for those minutes. SoCal Gas argues that the damages thus stem from use of the System. SoCal Gas also asserts that it benefits from the use of the Syntellect System even after the customer is no longer actively engaging with the System. For instance, the call is tagged with relevant information, and the System could be used to help properly route a call or give information to a live operator about the call to use during the live portion of the call.

Each minute for which a licensing fee was paid was part of an allegedly infringing service enabled by the System. Syntellect's effort to isolate the minutes spent outside the system is artificial. The damages for minutes spent talking to a live operator or waiting for a live operator during a partly automated call were paid only because the minutes in question were part of an infringing service. The Syntellect System was not merely an incidental presence during those minutes. Its role was not limited to something that the callers passed through, and it was not simply present in the call system while entirely independent acts of alleged infringement took place. The System played an important role in the alleged infringement of patents by providing automation during the call and by allowing SoCal Gas to benefit from the System's ability to tag calls and help access information, even after the customer had left the system. Syntellect cannot avoid liability because the customer was not actively engaging with the System for part of the service. Apportionment of the waiting time and live operator minutes is appropriate if they are "not embraced by Syntellect's indemnity provision." As these minutes clearly are embraced by the provision, no apportionment is required on that basis.

B. Syntellect Cannot Allocate Liability to Other Components

Syntellect argues that liability must be apportioned between it and other components of the call system. It argues that because other components were required, not all of the damages stem from the use of the System. The Ninth Circuit expressly directed this Court to apportion damages if liability was not embraced by the indemnity provision. The text of the provision requires Syntellect to pay "any and all claims, actions, suits, proceedings, losses, liabilities, penalties, damages, costs or expenses of any kind whatsoever" arising from patent infringement allegations in connection with the System. This language is expansive. It makes no provision for allocation and does not purport to limit Syntellect to damages for which Syntellect is at fault. Instead, it clearly envisions that damages paid for patent allegations in connection with the Syntellect system will "all" be paid by Syntellect. Neither the text, nor the Ninth Circuit's opinion requires that the damages stem solely or primarily from the utilization of the system. Syntellect is essentially arguing that the

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multiple components are causally related to the damages, but the contract provides no basis for Syntellect to avoid paying the entire amount. The entire settlement amount was used to settle infringement claims in connection with the System, and Syntellect bound itself to pay "any and all" such damages.

California precedent makes clear that where a party promises to pay the damages "arising from" an activity and the party does not impose other limitations on that liability, the indemnitor must pay the full amount, even if another party's actions are casually related, or even primarily to blame for the injury.

Syntellect argues that the Ninth Circuit directed this court to consider the nature of the Katz claims as they apply to the indemnity provision "and to other potentially liable parties." However, examination of the indemnity provision in the first instance demonstrates that the existence of other potentially liable parties is immaterial in determining Syntellect's obligations. The Ninth Circuit held that "[w]here a party's indemnity obligation is limited under the contract, an allocation of liability between culpable parties is appropriate." Allocation would be necessary if Syntellect's indemnity obligation was limited in such a way that the entire award was not clearly covered. However, this Court has determined that there is no such limitation here. The only relevant limitation found in the contract is that the "claims, actions, suits, proceedings, losses, liabilities, penalties, damages, costs or expenses" arise from actual or alleged infringement or misappropriation "in connection with the System." The entire Katz settlement licensing fee fits within that requirement.

The indemnity obligation at hand makes no effort to allocate damages. Instead Syntellect agreed to indemnify SoCal Gas for "any and all" damages "of any kind whatsoever" arising from infringement claims in connection with the System. As all of the damages paid arose from infringement claims for services enabled by the use of the System, Syntellect must pay them in their entirety. It is therefore irrelevant whether other components or actions by SoCal Gas were necessary for infringement or contributed to infringement. To the extent facts related to the contributions of other parties are in dispute, they are not material, and they will not defeat summary judgment.

Conclusion

Based on the scope of the indemnity provision and the nature of the Katz claims, this Court determines that the entire Katz settlement licensing fee is within the scope of the indemnity provision, and that allocation is not appropriate.

SoCal Gas's Motion for Partial Summary Judgement is GRANTED.

Notes and Questions

1. *Patent troll defense*? The third party that sued SoCal Gas was Ronald A. Katz Technology Licensing, L.P., a well-known patent assertion entity (PAE), sometimes known as a "patent troll." Like the firm NorthPeak, mentioned in the excerpt by Meurer above, Katz's organization has sued hundreds of companies for patent infringement. As one commentator described it several years before the *Syntellect* litigation:

   > Ronald A. Katz once predicted that he would someday become the wealthiest patent holder ever. By most estimates, he has achieved that goal – or will soon.

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A search of federal district court filings shows that just since 2004, his company, Ronald A. Katz Technology Licensing (RAKTL), has filed more than 100 lawsuits against defendants as diverse as New York Life, General Motors and United Airlines. One report said that RAKTL had initiated more than 3,000 claims for patent violations over the last 15 years.

So who is Ronald Katz and how has he come to be such a potent force in the world of patenting?

Now in his early 70's, Katz was a cofounder in 1961 of Telecredit Inc., said to be the first company that enabled merchants to verify consumer checks by phone without the assistance of a live operator. He was awarded a patent as co-inventor of that technology.

In the 1980's, he was awarded a number of patents related to his work involving interactive telephone services. His inventions relate to toll-free numbers, automated attendants, automated call distribution, voice-response units, computer telephone integration and speech recognition …

In the late 1990's, Katz set up RAKTL to license his portfolio to companies using automated call centers. Unlike many patent holders who shy away from litigation due to its high costs and uncertainty, RAKTL has been aggressive in filing lawsuits against companies that refuse to take a license.

With several of his patents already expired and most due to end in 2009, Katz is keeping up the pace. A 2005 Forbes magazine article estimated that he had already earned $750 million in licensing fees at that time and would bring in $2 billion in fees by 2009. That would put him above the man long known as the country's most aggressive patent enforcer, Jerome Lemelson, who earned more than $1 billion in fees before his death in 1997.[17]

Given the notoriety of Katz in the telephone services sector, do you think that Syntellect and/or SoCal Gas should have known that a suit by Katz was likely? Do you think that their indemnification agreement reflected this likelihood?

2. *Refusal to defend*. Syntellect initially refused to defend or indemnify SoCal Gas after it was sued by Katz. Why might Syntellect have done so? What risks does a licensor like Syntellect run if it declines to defend a suit against one of its customers, and the customer defends and settles the suit itself?
3. *Contractual versus legal apportionment*. In *Syntellect*, the indemnification section of the purchase agreement does not contain an express apportionment clause. Rather, Syntellect argues that damages should be apportioned as a matter of law between its system and other components of SoCal Gas's call center operation (phone units, switches, etc.). The court disagrees, noting that the contractual indemnity provision "makes no effort to allocate damages," and instead requires Syntellect to pay "any and all damages of any kind whatsoever" arising from infringement by the system. Should Syntellect have included apportionment language, such as that included in sample clause (d) above, into the purchase agreement? What should such language have said? How easy or difficult would it be to allocate damages to an indemnitor when a settlement is structured in the manner that Katz offered?

10.4 INSURANCE

In order to ensure that one party (the obligor) will be able to fulfill its financial obligations under an agreement, particularly those relating to liability and indemnification, the other party (the obligee) will sometimes insist that the obligor, at its expense, procure and maintain insurance

[17] Robert Ambrogi, *For Ronald Katz, Patent Litigation Pays Billions*, BullsEye Expert Legal News, December 11, 2007, www.ims-expertservices.com/bullseye/december-2007/for-ronald-katz-patent-litigation-pays-billions.

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specifically covering those obligations. In many cases, the obligee will request that it be listed as a "named insured" under the obligor's relevant insurance policy, which will enable the insurance carrier to disburse funds directly to the obligee.

Depending on the nature of the products and services covered by the agreement, as well as the size of any potential financial liability, insurance clauses can range from simple (see the example below) to very complex. In general, an obligee will be more likely to insist upon insurance coverage if the obligor is a small entity or if the potential financial exposure is very large. Thus, when a university licenses patents to a start-up company, the university will often require the start-up company to indemnify it against any and all injury and liability that may arise from the start-up's products, services and operations (particularly if it is in the biomedical field), and that this obligation be secured by a reputable third-party insurance carrier.

EXAMPLE: INSURANCE

Notwithstanding anything to the contrary contained herein, and without limiting or relieving Licensor from its indemnification obligations pursuant to Section __ above, Licensee shall obtain and maintain in full force and effect for the duration of this Agreement general liability insurance underwritten by a national insurance carrier that is reasonably acceptable to Licensor in the minimum amount of $5,000,000 per occurrence, naming Licensor as an intended beneficiary, in order to protect Licensor against any and all damages, losses, obligations and liabilities against which Licensor is indemnified pursuant to Section __ above.

Upon reasonable request by Licensor, Licensee will promptly furnish evidence of the maintenance of such insurance policy, including but not limited to originals of policies and proof of premium payments and other evidence that the policy is current and in force. In case Licensee receives notice of cancellation of the policy, it shall immediately furnish such notice to Licensor along with a written explanation of what measures it will take to reinstate the policy or obtain a replacement policy so that there is no period of lapse in insurance coverage. No insurance hereunder shall be cancelable upon less than 10 days prior written notice to Licensor.

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