

IP Agreements: Structuring Indemnification and Limitation of Liability Provisions to Allocate Infringement Risk

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Today's faculty features:

Kenneth A. Sprang, Partner, **Washington International Business Counsel**,
Washington, D.C.

Daniel Winston, Partner, **Choate Hall & Stewart**, Boston

Jeremy Younkin, Partner, **Foley Hoag**, Boston

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IP Agreements: Structuring Indemnification and Limitation of Liability Provisions to Allocate Infringement Risk

Kenneth Sprang

PURPOSE OF INDEMNIFICATION

- ❑ **Theoretical:** Allocate risk in an economically appropriate manner.
- ❑ **Practical Purpose:** To give Indemnitee clear, well-defined contractual remedy if Indemnitee suffers damage after the closing due to:
 - Misrepresentation by the Indemnitor
 - Breach by Indemnitor
 - Damage resulting from act or omission of Indemnitor
 - Malfeasance of Indemnitor

REPRESENTATIONS AND WARRANTIES

- ❑ Some agreements will have representations and warranties made by one party or the other.
- ❑ These are statements of fact about a party's business, assets and financial condition.
- ❑ Reps and warranties seek to allocate economic risk between the parties – therefore indemnification provisions must provide a remedy if reps and warranties are breached

INDEMNIFICATION: REMEDY FOR THE UNKNOWN

- ❑ Indemnification seeks to protect Indemnitee from the unknown.
- ❑ Cannot control the actions or omissions of Indemnitor
- ❑ In sale must rely on representations and warranties of seller
- ❑ Indemnification clause provides remedy for
 - Errors and omissions of indemnitor
 - Criminal conduct of indemnitor
 - Breach of warranties and representations of indemnitor
 - Failure of indemnitor to exercise due diligence
- ❑ One means of addressing issues not resolved in due diligence

ADDITIONAL BENEFITS OF EXPRESS INDEMNIFICATION

- Expansion of class of protected parties
- Expansion of recoverable losses
- Mechanics
- Completeness
- Customized protection
- Motivation
- Leverage

SUBSTANTIVE MATTERS – SPECIFIC LOSSES

- Losses suffered by reason of misrepresentation.
- Losses suffered by reason of breach of covenant.
- Losses and expenses caused by acts or omissions of indemnitor.
- Losses and expenses caused by criminal acts of indemnitor
- Future claims against Indemnatee from former business
- Protection of corporate directors
- Recovering consequential damages
- Recovering all fees and expenses incurred by the indemnitee, including attorneys' fees

CONSIDERATIONS

- ❑ Relationship to representations and warranties.
 - Indemnification provisions may be less or more extensive than the related representations.
 - Helpful resources if indemnitor is reluctant to provide specific representation or warranty
 - Do not overlook the psychological dynamic and fact that indemnitor is seeking to minimize risk as well.

WHO IS INDEMNIFIED?

- Buyer only.
- Buyer plus directors, officers, employees, stockholders and affiliates (parent, subsidiary, etc.).
- Buyer plus directors, officers, employees, stockholders and affiliates plus funding sources or other assignees.
- Seller.
- Look carefully at state legislation with regard to directors and officers.
- Avoid piercing of the veil.

STRATEGY RE: CONSEQUENTIAL DAMAGES

- ❑ Be explicit particularly with regard to any damages that may not be reasonably foreseeable.
- ❑ Define with care those consequential damages you can identify
- ❑ Care should be taken to differentiate consequential damages suffered by the other party from consequential damages paid by the indemnified party to third parties.

CEILING ON INDEMNIFICATION

- ❑ Agreement may contain upper limit on the maximum indemnification payments that the indemnitor can be required to make.
- ❑ Like the "basket" and survival, negotiations must balance Indemnitor's need for peace of mind and Indemnitee's need for protection.
- ❑ Ceiling can be limited to certain categories of claims, and exclude others.
- ❑ Indemnitee may seek to exclude third party clauses from the ceiling.
- ❑ Where the Indemnitee agrees to ceiling, likely to seek to set the ceiling at a high level, e.g., purchase price.

Thank You

Kenneth Sprang
Washington International Business Counsel
202-683-4090
ksprang@wibclaw.com



Indemnification In IP Agreements:

U.C.C. § 2-312(3)

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U.C.C. § 2-312(3)

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

- Do you want to “otherwise agree”?

- What constitutes a “rightful claim” may vary from jurisdiction to jurisdiction.
 - *Pac. Sunwear of Calif. v. Olaes Enters.* 167 Cal. App. 4th 466 (2008)
 - *EZ Tag Corp. v Casio Am., Inc.*, 861 F.Supp.2d 181 (S.D.N.Y. 2012)

- Consider who should pay for the defense of baseless infringement claims.

- Damages for breach may also vary from jurisdiction to jurisdiction.
 - *EZ Tag Corp. v. Casio Am., Inc.*, 861 F. Supp.2d 181 (E.D.N.Y. 2012)
 - *Insituform Techs., Inc. v. AMerik Supplies, Inc.*, 850 F. Supp. 2d 1336 (N.D. Ga. 2012).

- The “hold harmless” clause of § 2-312(3) protects sellers in some situations.
 - “[S]hifts all costs, including attorneys’ fees to the buyer who furnishes a seller with specifications that lead to a claim of patent infringement.” *RFR Indus. v. Rex-Hide Indus.*, 2005 U.S. Dist LEXIS 44809, at *3 (N.D. Tx. 2005).

- The seller may also be protected if the infringement claim arises from the buyer's combination of the seller's product with some other products. See *Chemtron, Inc. v. Aqua Prods.*, 830 F. Supp. 314, 316 (E.D. Va. 1993).

- Consider who should pay when infringement claim is based on:
 - a party's alteration of the product
 - a party's combination of the product with third-party products

- U.C.C. specifies procedures for invoking rights.
- A seller that recognizes its duty to indemnify and defend will often be entitled to control the defense and settlement
 - The U.C.C. allows the seller to demand that the buyer turn over control of the litigation to the seller. U.C.C. § 2-607(5)(b).
 - Consider the parties' rights in litigation, including rights to select counsel and experts, make (or approve) strategic decisions, and control settlement.

Jeremy Younkin
Foley Hoag LLP
155 Seaport Blvd.
Boston, MA 02210
jyounkin@foleyhoag.com
(617) 832-3077

Indemnity Clauses: Focus on the Meaningful Terms

Dan Winston

September 1, 2015

by any measure

CHOATE HALL & STEWART LLP

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Indemnification Language: Why It Is Important

- Indemnity Clauses are often overlooked
- Disparity between potential damages and indemnifying party
- Interplay with maintaining good customer relationships
- Very little published law

Indemnification Clauses: Key Provisions

- When does the indemnity obligation accrue?
 - Subtle language differences matter: Is indemnity for:
 - “an allegation of infringement”
 - “a claim of infringement”
 - “a judgment of infringement”
 - “infringement”
 - What specific “product” is the indemnity for?
 - A claim against indemnitor’s “XYZ product”
 - A claim against the customer’s product/system?

Indemnification Clauses: Key Provisions

- What types of infringement and damages are covered?
 - Carveout Clauses
 - Combination with other products or services
 - Modifications
 - Unauthorized use
 - What is the specific carve-out language?
 - “any” combination/modification
 - claims “based on” the combination/modification
 - claims that would not exist “but for” ...
 - Indemnity for liability and defense or also “damages”?

Indemnification Clauses: Key Provisions

- Who controls the defense?
 - Settlement, negotiations and approval rights
 - Sole control of defense clause
 - Relative sizes of parties
 - Multiple indemnitor cases
- What are the liability limitations?
 - Standard versus indemnity limits
 - Limits to specific amounts
 - Limits on types of damages: “lost profits,” “consequential damages”
 - Parallel warranty claims

Questions?

Dan Winston
Choate, Hall & Stewart LLP
Two International Place
Boston, MA 02110
dwinston@choate.com
(617) 248-4049