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"How to Negotiate and Draft Indemnification Clauses in IP Transactions"

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I. INDEMNIFICATION ARISING OUT OF AN INTELLECTUAL PROPERTY LAWSUIT

A. The Role of Insurance in Indemnification in Intellectual Property Disputes

- Corporations that depend upon manufacturing outside the United States secure extensive insurance coverage to protect their operations against intellectual property claims.
- While exclusion orders in International Trade Court ("ITC") proceedings may bar new shipments from reaching the borders, a retailer who receives product alleged to be infringing may sue a distributor who is in the chain of distribution, linking back to a manufacturer that cannot be pursued.
- Securing an "additional insured" status for such manufacturer can solve many of these problems.

B. Indemnification Is Based, In Part, on Contract Principles

- ***Owens-Illinois, Inc. v. BTR plc***, No. 05 Civ. 2873(LLS), 2010 WL 2607146 (S.D.N.Y. June 29, 2010)
  - Intellectual property representations and warranties in § 3.14(a) of a Sales and Distribution Agreement. Provision's "as currently conducted" language barred indemnity even though the product was "a part of the business spectrum" and "ready to go."
  - As Owens would control the extent of future sales and receive profits from those sales, it was sensible to have Owens take on the risk of future sales under the indemnity agreement.
  - The indemnification provisions of BTR's policy were not triggered where the indemnifiable claims did not exceed the $35 million deductible.

C. The "Contractual Liability" Exclusion May Be Avoided Under an Exception for "Damages

- ***CGS Industries, Inc. v. Charter Oak Fire Insurance Co.***, 777 F. Supp. 2d 454, 2011 WL 1449618 (E.D.N.Y. April 15, 2011)
  - An exception to the contractual liability exclusion for "advertising injury" was implicated, requiring the full amount of the reasonable settlement incurred to be reimbursed pursuant to N.Y. U.C.C. § 2-312(3).
  - The Supplier Agreement was not "another agreement" between CGS (the seller) and Walmart (the buyer) which negates CGS's independent legal duty to indemnify Walmart under section 2-312(3) *(id.* at *7) because that statute (like other analogous state UCC provisions nationwide) conferred upon Walmart an independent legal right to indemnification from CGS.
  - The duty of indemnification exists "in the absence of the [supplier agreement]."
  - It is "a mere decorative counterpane over the blanket protection of the law." Charter Oak was obligated to pay damages for "injury," that arises "out of ... [i]nfringement of copyright, title or slogan," which the court had found arose in an earlier ruling. *Id.* at *8.

- ***Santa's Best Craft, LLC v. St. Paul Fire & Marine Ins. Co.***, 611 F.3d 339, 351-52 (7th Cir. (Ill.) 2010)
    - "Consistent with the Illinois policy that a coverage action should not require the insureds to conclusively establish their own liability in the interest of promoting settlement, we think the proper inquiry is whether the claims were *not even potentially covered* by the insurance policy. See, e.g., *Gypsum,* 205 Ill.Dec. 619, 643 N.E.2d at 1244 (noting the benefits of settlement)."
    - "A competing policy interest is equity-it is inequitable to require an insurer to pay for a settlement that is clearly not within the terms of its policy. Consequently, our prediction is that Illinois courts, in cases in which it is possible that none of the settlement was attributable to the dismissal of claims for damage covered by the insurer's policy, would evaluate whether a 'primary focus' of the claims that were settled was a potentially covered loss (burden on the insured). . . ."
    - "Because, in this case, the parties contest whether the settlement was made in anticipation of covered claims, the burden should be on the insured to prove coverage of the settlement in the first place and then on the insurer to prove the existence of exclusions barring coverage. . . ."
    - "The only remaining coverage dispute, therefore, is whether the allegations and record evidence supporting the trade dress claim suggest that the primary focus of settlement was damages payments for a covered infringement of slogan claim."

D. Defense Reimbursement Under Manufacturer's Policy

- ***State Farm Fire & Casualty Insurance Co. v. Target Corporation***, No. 08-765-FJP-DLD, 2011 WL 1114243, at *7 (M.D. La. March 24, 2011)
  - A suit by a plaintiff injured when a Christmas tree's lights caught fire found the retailer, Target, entitled to a defense from the manufacturer (Inliten's) carrier, Hartford, under Part 2 of the Supplemental Payments provision.
  - Hartford stated that if Hartford defended its insured and an indemnitee was also named as party to the suit, it would defend the indemnitee if conditions (which Target satisfied) were met.
- ***Santa's Best Craft, L.L.C. v. Zurich Am. Ins. Co.***, 408 Ill. App. 3d 173, 190, 941 N.E.2d 291, 307 (Ill. App. Ct. 2010) *appeal denied,* 949 N.E.2d 665 (Ill. 2011)
  - "Zurich's duty to indemnify plaintiffs arises only if the injuries alleged in the underlying lawsuit were actually covered under the policy. See *Binney & Smith,* 393 Ill.App.3d at 290[.]"
  - "We have already determined that the CGL policy does not provide coverage for the injuries alleged in the underlying complaint because they were not 'advertising injuries.' Therefore, Zurich has no duty to indemnify plaintiffs for Monogram's defense expenses under that policy."

- ***Santa's Best Craft, LLC v. St. Paul Fire & Marine Ins. Co.***, 611 F.3d 339, 353-54 (7th Cir. (Ill.) 2010)
  - "The CGL policy required St. Paul to determine that there was no conflict between the insured's interests and those of the indemnitee and required the indemnitee to provide St. Paul with a copy of any demand and give notice of the claim or suit. . . ."
  - "We acknowledge that certain of St. Paul's requirements were impossible for the plaintiffs to satisfy because St. Paul did not immediately defend it in the underlying action. That said, the plaintiffs could have complied with other requirements but chose not to. . . ."
  - "In Illinois, as the plaintiffs acknowledge, a duty to defend encompasses 'defensive' *claims* that serve to reduce liability-but its courts are mum on coverage for uninsured parties. See *Great West Cas. Co. v. Marathon Oil Co.*, 315 F.Supp.2d 879, 882-83 (N.D.Ill.2003). Cf. *Int'l Ins. Co. v. Rollprint Packaging Prods., Inc.*, 312 Ill.App.3d 998 . . . (2000) (holding that the insurer did not have to reimburse defense expenses related to an offensive counterclaim)."
  - "The plaintiffs therefore ask us to extend our limited acceptance of the 'larger settlement rule' for certain D & O policies to require reimbursement for *defense* expenses of related parties unless total defense costs are higher because

of the uninsured party's defense. Cf. *Caterpillar, Inc.*, 62 F.3d at 962 (emphasizing that the proper allocation method is primarily an issue of contract)."

- "None of these cases allows us to predict that the Illinois Supreme Court would require an insurer to reimburse the defense costs of all parties whose defense may have benefitted an insured, given the contract provisions at issue here. The plaintiffs' 'reasonably related' rule would swallow the contract provisions limiting St. Paul's liability to its insureds' contract indemnitees." (footnotes omitted)).

II. RELATIONSHIP OF INDEMNITY AGREEMENT TO INSURANCE COVERAGE

A. Who Provides the Defense?

- Who will control counsel?
  - Will conflicts of interest permit the insured/indemnitee to retain counsel at the insurer's expense?
  - If the standard for reimbursement is reasonableness, will surveys authored by publications such as the AIPLA may set the rates for defending an intellectual property lawsuit?

- If indemnification is owed, does it create a duty to reimburse the defense fees after a specific self-insured retention threshold is exceeded?
- Or is there a duty to both defend and indemnify where selection of counsel may be controlled by the indemnitor?
- Is there a provision requiring that the counsel be subject to the approval of the indemnitee?
- If these issues are not addressed can they be negotiated?
- If an indemnification obligation exists, is it best to await resolution of the underlying litigation so that the existence of the indemnity relationship and factual disputes as to its applicability do not negatively affect that litigation before resolving insurance coverage indemnification disputes?

B. Can Coverage Issues Be Resolved Where the Underlying Action Proceeds?

- Recurring issues include:

- Where the indemnity agreement appears to provide the indemnitor the right to select counsel, but that counsel is not deemed acceptable to the indemnitee, or different rights from those sought to be vindicated by the indemnitor are at issue, who controls counsel?

- Can a cost-sharing arrangement be negotiated, leaving the issue of who will pay what portion of the litigation expense to resolution following the conclusion of the underlying suit?

- Are there any specific reporting or cooperation requirements that must be fulfilled?

- Is a reporting requirement implicated where defense fees exceed 50 percent of the amount of the self-insured retention?

C. Indemnification Exposure and Its Distinct Aspects vis-à-vis Insurance Coverage

- Express indemnity "refers to an obligation that arises by virtue of express contractual language establishing a duty in one party to save another harmless upon the occurrence of specified circumstances."

- A clause that contains the words “indemnify” and “hold harmless” is an indemnity clause.
- It may obligate the indemnitor to reimburse the indemnitee for any damages the indemnitee becomes obligated to pay the third person.
- Another option for the indemnitor is simply to fund the defense going forward. With assumption of the duty to defend comes control over settlement to the extent it requires a monetary payment.
- Such a course may be preferable to allowing the underlying action to be adjudicated for several reasons.
- To the extent any of the claims potentially are covered by insurance, the breadth of the duty to fund a settlement typically is broader than the duty to indemnify a judgment where the basis for relief is definitively spelled out and proof of actual vs. potential coverage is required.
- An indemnitor may have a wider array of challenges to an indemnitee’s claims. Where grounds for denial of indemnification are based on lack of notice or willful infringement, these defenses to indemnification can be

interposed more easily following an adjudication because the facts as proven at trial may preclude use of these theories to bar indemnification.

  - An indemnitor that fails to allow settlement may be exposed to liability in excess of that contemplated by the contract if its failure to settle subjected the indemnitee to greater monetary risks than could have been achieved by a settlement.

- Unlike an insurance policy, in the absence of a specific provision in an indemnity agreement, an indemnitee is not required to notify the indemnitor, defend, or even give notice of a claim as a condition precedent to recovery under the indemnity agreement.
  - The courts will not infer a notice requirement as a condition precedent to a right to recovery on an indemnity contract where there is no provision requiring it, but be wary of those jurisdictions such as Illinois and New York that require timely notice as an implied provision of the contractual agreement to defend.

D. The Effect of Delay in Notice to the Indemnitor by the Indemnitee Litigating a Patent Infringement Action

1. The Prejudice Standard

- Applying a prejudice requirement to an indemnity agreement, a New York federal district court found no indemnity due as a consequence of a delay in notice to the indemnitor of a claim against the indemnitee.

- ***Red Ball Interior Demolition Corp. v. Palmadessa***, 947 F. Supp. 116, 123 (S.D.N.Y. 1996).
    - The indemnity agreement did not include a specific prejudice requirement regarding the effect of late notice to the indemnitor of a claim against the indemnitee with respect to the indemnity agreement, and case law suggested that "[a] contractual duty ordinarily will not be construed as a condition precedent absent clear language showing that the parties intended to make it a condition."
    - While noting that there was a possible analogy to New York insurance law, which makes notice a condition precedent to coverage, the court determined that the actual prejudice standard would apply. Absent a showing of prejudice, which the indemnitor did not attempt to make, there was no bar to coverage for late notice on the facts before the court.

- Applying a prejudice standard to the enforcement of an indemnity agreement, District Judge Randa held that the seller's eight-year delay in giving notice to its insurer that a popcorn popper had allegedly caused a fire in the home and its nearly five-year delay in notifying the insurer that seller's homeowners' insurer had filed a subrogation action against the seller was unreasonable and presumptively prejudicial.

- ***West Bend Co. v. Chiaphua Indus., Inc.***, 112 F. Supp. 2d 816 (E.D. Wis. 2000).

  - The seller breached an implied condition of timely notice in its indemnity agreement with a manufacturer and thus forfeited its right to indemnity. Under Wisconsin law there is a rebuttable presumption of prejudice when more than a year of delay arises, shifting the burden of proof to the insured to show an absence of prejudice.

  - The *West Bend* insured could not meet its burden as undisputed facts evidenced that delay well beyond that date occurred. The absence of an opportunity to evaluate or investigate by the insurer until eight years after a fire was key to the court's decision. By the time this matter came to the attention of Royal's claims representative, the case "was settled, done deal, check was being issued." There was an implied condition to provide notice in an indemnification context, even absent its specific contractual requirement.

- Jurisdictions following the implied duty to notify discussed by the *West Bend* court applying Wisconsin law include *Alabama*, *California*, *Massachusetts*, *Ohio*, and *Washington*.

2. The Strict Contractual Interpretation Standard

- In a case directly addressing indemnification for patent infringement *claims*, the seller of a wood polymer decking business did not suffer actual prejudice.

- ***Trex Co., Inc. v. ExxonMobil Oil Corp.***, 234 F. Supp. 2d 572 (E.D. Va. 2002).

    - A court applying Virginia law found that the buyer waived its contractual right to indemnification for losses sustained in defending a patent infringement claim because the buyer did not timely notify the seller of the initial claim.

    - This despite an allegation that delay in giving notice deprived the seller of an opportunity to negotiate or resolve the matter short of trial and even though the infringement claim was made against the seller prior to the sale of the business and the seller made no effort to settle nor was notice given within two weeks of the commencement of the suit allowing time for settlement discussions.

- Applying Virginia law, a federal district court found that even if an indemnitee's failure to notify the indemnitor of a claim would be subject to a prejudice standard (which the court did not believe accurately reflected Virginia law), the facts evidenced prejudice, which precluded indemnification.
- The indemnitor was deprived of the opportunity to structure license agreements and was subject to greater damage exposure.
- The indemnitor had no chance to avoid this damage exposure for the sale of the products in a marketplace in greater volume than had been originally contemplated. The court also specifically rejected arguments of estoppel or waiver as grounds for precluding the defense of lack of timely notice on the pertinent facts.

- The same result arose in cases following the law of *Florida*, *Michigan*, *Minnesota*, as well as *New York*.

III. INSURANCE APPLICABLE TO INDEMNIFICATION

A. Umbrella Insurance

- Many significant corporations have no "first dollar" insurance available.
  - Their Commercial General Liability policy may serve only as a "fronting policy" with no trigger for coverage available until either its exhaustion by payment of settlements or entry of judgment in an amount exceeding the self-insured retention (often the amount of the primary policy limits).
- Other corporate risk management programs may include umbrella policy provisions with "drop down" policy language.
  - No exhaustion is required to reach and allow "first dollar" defense fee reimbursement where potential coverage under the umbrella is broader than that of the primary policy.
  - ***Federal Ins. Co. v. Stroh Brewing Co.***, 127 F.3d 563, 567 (7th Cir. 1997) [Sept. 19] ("Discrimination 'simply means differential treatment.'")

- ***Westchester Fire Ins. Co. v. G. Heileman Brewing Co., Inc.***, 321 Ill. App. 3d 622, 633 (2001) ("Westchester does not dispute that Rausser [price discrimination] falls within the scope of its coverage for discrimination.").

- Another circumstance can be where the definition in the umbrella policy can benefit parties indemnity relationship – "joint venture."

- Smaller corporations often have broader and more accessible coverage than larger corporations because there is less perceived exposure.

B. Tort Insurance Coverage

1. Canadian Policies

- The policyholder may secure broader insurance rights as an additional named insured under policies issued in Canada with worldwide coverage.

- The 1976 ISO CGL policy which includes express coverage for the offenses of unfair competition and piracy (albeit with an express exclusion for trademark infringement claims) may be available as a "first dollar" primary coverage.

2. International Policies

- Technology companies often procure broader international coverage
  - The key is the “territory” description
  - It may permit coverage for “advertising injury” or “personal injury” anywhere in the world, so long as the offense is committed within policy’s defined territory, typically outside the U.S.

- ***Hewlett-Packard Co. v. CIGNA Property & Cas. Ins. Co.***, No. 99-20207 SW, 1999 U.S. Dist. LEXIS 20655, at 13-14 (N.D. Cal. Aug. 24, 1999)
  - “In short, nothing in the Policy restricts covered Advertising Injury claims to those in which all damages must be suffered outside of the United States, its territories or possessions . . . . The territorial limitation in the CIGNA Policy emphasizes the location of the occurrence, not the location of the resulting damages.”
  - “In the present case, HP disseminated allegedly false advertisements about refilling inkjet printer cartridges internationally. Nu-kote alleges that HP’s statements

concerning refillability of cartridges caused it to suffer damages because Nu-kote could possibility claim damages to domestic business based at least in part on HP's extraterritorial acts. The Court finds that the policy territory requirement is satisfied."

IV. INDEMNIFICATION FOR INTELLECTUAL PROPERTY CLAIMS

- Clarifying the scope of the alleged wrongful conduct implicating infringement of intellectual property rights
    - No matter where your client stands on the chain of distribution there may be issues as to which entities either upstream or downstream from your client have obligations to it or may demand performance from it initially.
    - The review should be broad and possible sources of insurance not only for your client's immediate claims but those of parties within the chain of distribution including co-defendants must be evaluated.
- Where your client is generating indemnification provisions in agreements standardization of forms can minimize transaction time to evaluate likely pathways for pursuit of indemnification

- This of course assumes that your client is in a position to negotiate indemnification provisions on its own terms.
- Complication arises where the party who would normally owe indemnity obligations is in the Far East and may not be easily subject to suit.
- This is a circumstance where substituting insurance policy proceeds for an otherwise available indemnification claim may be essential.

- Outside intellectual property can provide insight into the proper structure of demand letters re indemnification
    - Outside counsels' expertise should be conjoined with general counsel knowledgeable about insurance issues so that "buried treasure" in the form of insurance proceeds available to parties who have indemnity obligations.
    - These resources can both lessen its burden and enhance the prospects for full defense fees/settlement or indemnity reimbursement

- Communications between indemnitors business partners authored on company letterhead following informal initial communications by one executive or purchasing employee to the party against whom indemnity claims are asserted may allow leveraging the business relationship to avoid what could otherwise be troublesome disputes about the nature and scope of indemnification duties.
- Informal communications should be initiated first
  - Potential indemnitors should be contacted, again by business people, to ascertain their position and encouraged to become part of the team, avoiding liability and minimizing damages for intellectual property violations.
    - Flexibility in solutions that focus on insurance coverage available to indemnitors must be structured in a way that doesn't diminish the indemnitor's rights to pursue its own insurance to satisfy its indemnity obligations.
    - Any proposals for a fixed fee or payment plan arrangement, or a sharing of defense fees and/or proposed settlements, should be structured to assure maximum insurance coverage availability.

- Drafting narrower indemnity agreements defining indemnitee rights in intellectual property lawsuits.
  - One curious aspect of the indemnification for intellectual property claims (especially those for patent infringement) is that it is far easier to procure a broad indemnity agreement than an insurance policy insuring patent infringement risks. Insurance carriers, who understand what the risks of litigation expense and indemnity are, rarely place themselves in a position where they can be responsible for such expenses. Parties negotiating an indemnity provision when patent rights are at issue should be just as wary because the monetary consequences to indemnitors can be significant.
  - Exposure for patent indemnity claims can be especially problematic when a sizable settlement is negotiated by the claimant and indemnitee and then enforced by the indemnitee against an indemnitor who may not have directed the defense. How vigorously was the suit litigated? Was the sum settled for reasonable? Was the indemnitor not apprised of settlement negotiations? Did it have sufficient meaningful information to consent to a proposed settlement?

V. METHODS OF RESOLUTION OF INTELLECTUAL PROPERTY DISPUTES AND THEIR IMPACT ON INDEMNIFICATION PROVISIONS

A. Consent Agreements (Trademark Infringement Disputes)

- A typical agreement for co-existence as a form of "Consent Agreement" permits each party to continue use in its market without any actual confusion and if it does arise and either party recognizes it, clarification will be provided by the party whose conduct engenders such confusion.
  - Restrictions reflect how the parties use logos, type fonts, color waves, trade and advertising channels, and focus on changes in use that limit the manner of presentation of the mark that would impinge upon the public perception of the competitor's market. The trademark office generally accepts such agreements.
- Consent agreements do pose issues:
  - First, a third party can view a consent by the parties that there is no likelihood of confusion when either of the two parties to the Consent Agreement challenge its use as evidence that the third party's conduct cannot evidence a likelihood of confusion.

- Most sensible courts find evidence of supplement agreements not determinative of the strength of the mark at issue because “A host of factors may affect the litigant’s decision to settle.” *Playboy Enterprises, Inc. v. Chuckleberry Publishing, Inc.*, 486 F. Supp. 414, 418, n.10, S.D. NY 1980.
- ***In Re Buhler Tex***, 79/034, 792, 2009 TTAB Lexis, 110 at *4 (TTAB Feb. 12, 2009) (Not presidential) (Acceptance of lack of likelihood of confusion as based on naked consent which recited no restrictions or background considerations of evidence of a lack of likelihood confusion.)

- The development of new technology such as internet promotion and advertising should be taken into account in drafting consent agreements where the potential for conflict in geographic markets may be enhanced by use of this modality.
    - Parties who have changing business models since the date of the consent agreement, may find themselves in disputes that were not earlier anticipated and learn that the consent agreement is an impediment to expansion plans that were not originally anticipated.

- ***Fuddruckers, Inc. v. Fudpucker's of Fort Walton Beach, Inc.***, 436 F. Supp. 2d 1260, 1260, 1263 (N.D. Fla. 2006) (Fuddruckers precluded from expansion into Fudpucker's territory, the court rejecting its request of Fudpucker's added disclaimer of non-association with Fuddruckers in permitting its expansion into the territory of Fudpucker's.).

B. License Agreements

- Unlike the Consent Agreement, a License Agreement requires yielding the claim of trademark ownership to the licensor to resolve the trademark dispute and subjecting when sells to quality control mechanisms.
  - Where there are distinct fields of use and the mark differs, permitting a junior user to, upon assignment of its rights to the senior user, license those rights back to the junior, can be an effective solution to avoid litigation costs and off-set existent fees by the license amount secured.
  - Another viable scenario is where the senior user is in the U.S., has no right in territories of the junior user in the U.S. who has both registrations and market presence.

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