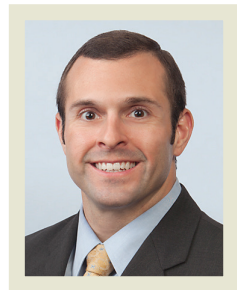


Warranties of Noninfringement and Allocation of Infringement Risk

In the electronic age, purchases move fast and often without a contract. The parties to a transaction may give little thought to allocating the risks involved. Even when the parties do enter a written agreement, with so many terms to negotiate and consider,

the risk of intellectual-property infringement might seem too remote or difficult to address. Alternatively, they might choose to engage in the

“battle of the forms” rather than enter expensive negotiation over entrenched terms prescribed by each party’s legal department. Or, as yet another

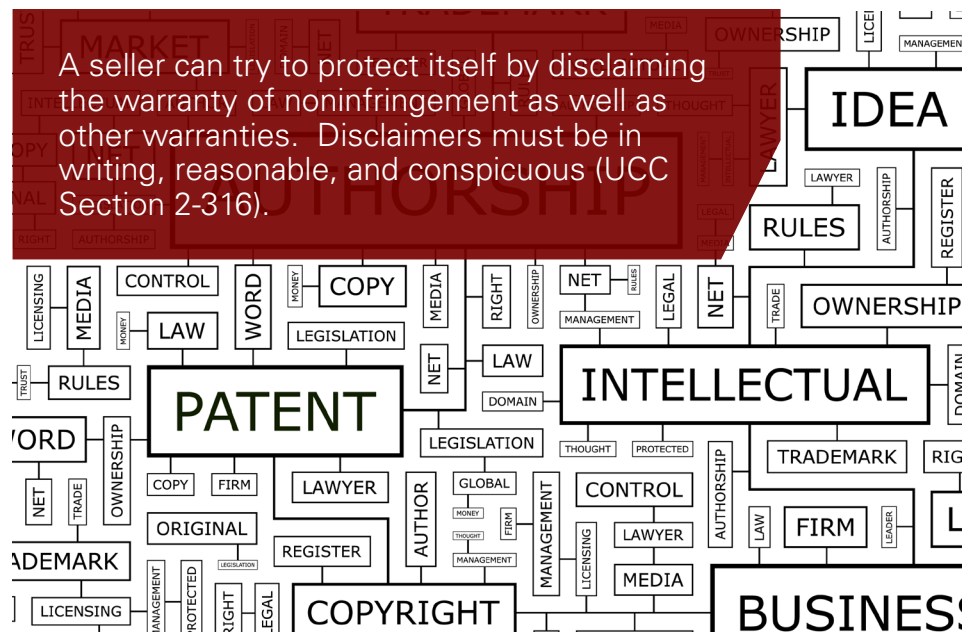


By Jeffrey B. Fabian

alternative, the parties enter a contract in which the seller warrants that “title conveyed shall be good, and its transfer rightful, free from any security interest or other lien or encumbrance of which the buyer has no knowledge,” or something equivalent, without other disclaimers.

So what happens then if the buyer or seller is accused of infringing the intellectual-property rights of a third party? The answer to this question can

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have serious consequences. The mere threat of infringement can drive buyers to a different supplier. And the cost of litigating intellectual property disputes can be substantial. A 2013 American Intellectual Property Law Association survey reported that the average cost of litigating a patent-infringement suit through trial was \$930,000 for cases where the amount of damages at stake was less than \$1 million. The average cost of litigating even the smallest copyright, trademark, or trade secret disputes can range from \$373,000 to \$581,000.

When the issue is not addressed by a written contract or not otherwise agreed, and the seller is a merchant

regularly dealing in the goods sold, sellers are generally deemed to have sold goods subject to an implied warranty of noninfringement—that is, sellers warrant that the goods are free from any “rightful” infringement claim (UCC Section 2-312(C)). A seller might be responsible to indemnify a buyer for damages as well as the attorneys’ fees and costs of defending an infringement claim. In some cases, this can be akin to writing a *carte blanche* for a buyer to defend the claim, and seller might even be on the hook for settlements entered by a buyer.

Importantly, proof of infringement is not necessary to breach the warranty, and a seller’s duty to indemnify a buyer

arises upon receiving notice of the infringement claim. Court opinions vary on what constitutes a “rightful” infringement claim triggering the duty to indemnify, but under the most lenient standards, a rightful claim is any nonfrivolous claim having a significant impact on a buyer’s ability to use purchased goods. In short, a seller might be on the hook to indemnify a buyer even when the claim is relatively weak, and the monetary penalties can be substantial.

A seller can try to protect itself by disclaiming the warranty of noninfringement as well as other warranties. Disclaimers must be in writing, reasonable, and conspicuous (UCC Section 2-316). It is a best practice to disclaim specific warranties by name. For obvious reasons, buyers might not accept a warranty disclaimer. And in some cases the parties exchange differing contract forms that “knock out” any warranty disclaimers.

The best way to avoid these problems is for the parties to negotiate a signed agreement specifically addressing this matter. The parties should consider their options in allocating infringement risk, such as: requiring a judgment based on a contested claim before indemnity is triggered; limiting infringement obligations to, for example, “valid U.S. patents”; adding the right to negotiate a license; refunding the purchase price or cost of a substitute product; or an option for the seller to defend infringement claims.

Negotiation can be time consuming and expensive, but it is the best way to avoid surprises and ensure an enforceable agreement.

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