

Strategies for Indemnification under the UCC Against Claims of Patent Infringement

By Paul E. McGowan

The scenario happens with some frequency: Your client purchases widgets from a seller and incorporates them into a product that it in turn sells in the marketplace. Just as your client is seeing a return on its efforts to develop a manufacturing infrastructure and sales network, it learns of allegations that use of the widgets may infringe a third party's patent rights. Although the widgets may be only a minor component in the overall product, your client faces the prospect of having its entire operations shut down in the face of a patent infringement lawsuit.

As you contemplate your client's exposure and any potential defenses to a patent dispute in federal court, consider an indemnification action against the seller under the state's Uniform Commercial Code (UCC) for breach of the implied warranty against claims of patent infringement. This often-overlooked cause of action may allow your client to recover—on an implied-contract basis—its costs to defend or settle an expensive patent infringement action, thus filling a gap in the current patent laws. This article describes an indemnification action under the UCC, including recent court decisions that appear to relax the applicable standard and provide a road map for assessing its viability from both the buyer's and the seller's perspectives.

Implied Warranty Against Claims of Infringement under the UCC

In any contract for the sale of goods governed by the UCC, certain implied warranties run from the seller to the buyer. These include the implied warranty against infringement (IWAI), in which the seller assures the buyer that use of the goods as delivered will not infringe the intellectual property rights of a third party. This makes for sound policy, because the seller ostensibly has superior knowledge of its own goods and can better identify any potential claims by a third party that would interfere with the buyer's enjoyment of the goods. As an example of how such a warranty is applied, consider

the IWAI contained in section 11-2-312 of Georgia's UCC.¹

Warranty of title against infringement; buyer's obligation against infringement . . . (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.*

Based on this statute, therefore, an indemnification action against the seller arising out of a contract for the sale of allegedly infringing goods involves the following key elements (highlighted above):

- 1. "Unless otherwise agreed."** This phrase codifies the bedrock principle that any implied warranty will be trumped by an express warranty or by other agreement of the parties. Thus, the first hurdle to asserting a statutory indemnity claim against a seller is to determine whether the contract for the sale of goods contains any express agreement to limit or exclude application of the IWAI.
- 2. By a "seller who is a merchant."** Indemnification for breach of the IWAI is limited to sales by a "merchant," defined under the UCC as one who regularly deals in goods of the kind or otherwise by his or her occupation holds himself or herself out as having knowledge or skill peculiar to the practices or goods involved in the transaction. This is broad enough to capture sellers such as retail dealers, wholesalers, and product manufacturers.
- 3. The seller warrants that the "goods shall be delivered."**

Note that the IWAI has both a temporal component and a scope-of-coverage component. As to timing, any implied warranty generally arises when the seller tenders delivery of the goods—the point at which a cause of action for breach of the IWAI arises, regardless of the buyer's knowledge of any breach of the warranty. This is discussed in more detail below.

As to scope, the seller's warranty against infringement is limited to the goods themselves as they are delivered. This was explained in the seminal case of *Motorola, Inc. v. Varo, Inc.*, which held that the UCC only requires the seller to provide goods free of patent infringement claims at the time of delivery; it does not speak to the buyer's use of those goods, even if such use infringes a third party's patent rights.² That reasoning was later adopted in *Chemtron, Inc. v. Aqua Products, Inc.*, which also found no implied warranty covering the buyer's *conduct* with respect to the goods *after* delivery.³ This essentially limits indemnification under the UCC to claims of direct patent infringement against the buyer by the patent holder (i.e., the goods themselves were subject to claims of patent infringement at the time of delivery). Thus, if the buyer is accused of contributory infringement or inducement to infringe, any indemnification action by the buyer against the seller would generally be preempted by the federal patent laws.

- 4. The goods shall be delivered "free of the rightful claim" of "infringement or the like" (by a third party).** While the UCC does not define the types of "infringement or the like" covered by the IWAI, the Official Comments and relevant case law tell us the warranty applies at least to claims of patent, trademark, and copyright infringement.⁴

It is the buyer's burden to estab-

lish the seller's breach of the IWAI for failure to deliver the goods free of infringement claims. Defining what constitutes a "rightful claim" of patent infringement has proven quite difficult. In the seminal case of *Cover v. Hydramatic Packing Co.*, the Federal Circuit suggested that an absolute finding of patent infringement is not required for the buyer to seek indemnification from the seller.⁵ Since then, courts have extended this principle to find that the actual issue of infringement need not have been adjudicated at trial—so long as the buyer can establish that the claim of patent infringement against it was more than frivolous.⁶ Indeed, recent decisions suggest that the courts are continuing to lower the bar for a buyer to meet its burden.

In *Sun Coast Merchandise Corp. v. Myron Corp.*, a New Jersey court held that while a "rightful" claim of infringement must be more than frivolous, it need only "cast a 'substantial shadow' on the buyer's ability to make use of the goods in question, in order to constitute a breach of the warranty against infringement."⁷ In so holding, *Sun Coast* further lessened the standard by suggesting the "buyer must [only] establish that the infringement claim is of a *substantial nature* that is reasonably likely to subject the buyer to litigation, and has a significant and adverse effect on the buyer's ability to make use of the goods in question."⁸ In *Pacific Sunwear of California, Inc. v. Olaes Enterprises, Inc.*, a case of first impression in California, the court went beyond the *Sun Coast* standard, stating that "[a] rightful claim under [the UCC] is a *nonfrivolous claim* of infringement that has any significant and adverse effect, through the prospect of litigation or otherwise, on the buyer's ability to make use of the purchased goods."⁹ The most significant aspect of *Pacific Sunwear*, however, may be its explicit statement that "[a] claim of infringement may be rightful under [the UCC] whether or not it is ultimately pursued in litigation," thus ostensibly allowing claims for indemnification where, "[f]or example, a . . . buyer, *prior to any litigation*, voluntarily ceases to

use purchased goods due to a third party claim of infringement."¹⁰

Although *Pacific Sunwear* was a trademark case, a California federal court, in *Phoenix Solutions, Inc. v. Sony Electronics, Inc.*, has recognized that "there is no reason to construe section 2312(3) of

actually be sued for patent infringement to seek indemnification under the UCC. Where the buyer is sued, however, it must provide notice to the seller of the infringement litigation within a "reasonable time" after learning of that litigation as set forth in section 11-2-607(3)(b). Although

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the California [Commercial] Code any differently for patent cases."¹¹ Ultimately, this line of cases has the potential to increase indemnification claims by buyers who are the targets of cease-and-desist letters sent by patent holders, thus opening the floodgates for such claims.

5. Unless the "buyer [] furnishes specifications to the seller." The IWAI operates in reverse if the seller manufactures goods in compliance with the buyer's own specifications. If so, it is the buyer who must hold the seller harmless against any rightful claims of infringement.

Statutory Requirements for Indemnification under the UCC

Predicates to indemnification under the IWAI include the buyer's compliance with the notice, timing, and vouch-in provisions of section 11-2-607, and consideration of the statute of limitations of section 11-2-725. A buyer's failure to satisfy these requirements can bar its recovery and will operate as a defense for the seller.

1. Requirement that the buyer provide timely notice of the lawsuit. As discussed, the buyer need not

the UCC does not define a "reasonable time" or specify the form of notice, it is generally understood that commercially reasonable standards will apply.

2. Requirements associated with tendering and assuming the defense.

The so-called vouch-in provisions of the UCC allow, but do not mandate, a buyer who is sued to tender the defense of the underlying litigation; likewise, the seller may demand control of the defense, including settlement. The buyer's notice must be in writing and must adhere to the form specified in section 11-2-607(5)(a), which will be binding if the seller fails to accept the defense. Similarly, the seller's written demand that the buyer tender the defense will be binding on the buyer so long as the demand specifically adheres to the form specified in section 11-2-607(5)(b).

3. Requirement to timely seek indemnification. The applicable statute of limitations for seeking indemnification will vary with the particular state's commercial code. In Georgia, for example, section

Tactical Considerations for the Buyer and the Seller

Both the buyer and the seller face certain strategic choices in assessing the viability of an indemnification action for breach of the IWAI. These include identifying the proper forum and necessary parties as well as consideration of federal preemption and removal.

1. Selecting the proper forum. Any action for indemnification due to a breach of the IWAI turns solely on a particular state's UCC, as it affects the contractual relations between the buyer and seller. Nevertheless, the elements of an indemnification action do implicate the patent laws to the extent necessary to establish a "rightful claim" of patent infringement. Therefore, such an action can generally be properly asserted in either a state court (e.g., as a separate, contract-based action) or a federal court (e.g., as a cross-claim or impleader action in the underlying federal court action), depending on the circumstances.¹

2. Identifying the necessary parties. Because any indemnification action under the UCC concerns the contractual relationship between the buyer and the seller, the patent holder is not a necessary party—whether indemnification is raised in a separate state court action or as a state-law-based claim appended to the underlying federal litigation.

3. Consideration of federal preemption. Principles of federal preemption shape the applicability of

any indemnification action for breach of the IWAI under the UCC. First, only the patent holder has standing under the federal patent laws for patent infringement claims. Thus, any other patent-related claims asserted against the buyer are generally preempted. Second, as discussed above, the buyer's claim for indemnification by the seller is proper only if the patent holder brings a claim against the buyer for direct infringement, i.e., the goods themselves were infringing *at the time of delivery*. By comparison, the buyer cannot seek indemnification from the seller if the claim against the buyer is for contributory infringement and/or inducement to infringe—both of which turn on the buyer's *conduct* with respect to the goods *after* taking delivery of the goods. Accordingly, any state law claims by the buyer for indemnification based on these theories of infringement are generally preempted by the federal patent laws.ⁱⁱ

4. Removal. If the buyer brings a state court action under the UCC's indemnification provisions for breach of the IWAI, the seller may remove that action if the federal court finds it has the requisite subject matter jurisdiction to evaluate the underlying infringement allegations to determine whether it was a "rightful claim" subject to indemnification in the first instance.ⁱⁱⁱ Even so, the federal court may wish to sever such an action claim pending a resolution of the underlying patent infringement allegations.^{iv}

Endnotes

i. *See, e.g.,* Cover v. Hydramatic Packing Co., 83 F.3d 1390, 1393–94 (Fed. Cir. 1996) (once underlying patent infringement litigation had been settled with the patent holder, the "patentee and the patent code are no longer in the picture," and the remaining dispute involves only "the legal relationship between two contracting parties [under the state's UCC]"); 84 *Lumber*, 145 F. Supp. 2d at 677 (indemnification claim filed by buyer against seller as state court action after the underlying patent infringement action had been settled, though claim was later removed by seller to federal court).

ii. *See, e.g.,* Motorola, Inc. v. Varo, Inc., 656 F. Supp. 716, 717–18 (N.D. Tex. 1986) (federal patent laws specifically identify contributory infringers and those who induce infringement, and such claims cannot be the subject of state law); Chemtron, Inc. v. Aqua Prods., Inc., 830 F. Supp. 314, 316 (E.D. Va. 1993) ("There is no claim for contribution under the U.S. patent laws, and none may arise under state law as it is preempted by federal law.")

iii. *See, e.g.,* 84 *Lumber*, 145 F. Supp. 2d at 680 (state law indemnification claim turned on substantial question of federal patent law, thus federal court had subject matter jurisdiction to compare patent scope with buyer's allegedly infringing conduct). *But see* Linear Tech. Corp. v. Applied Materials, Inc., 152 Cal App. 4th 115, 130 (Cal. 6th Ct. App. 2007) ("contract-based causes of action [involving allegations of patent infringement] can proceed in state court" because "[a] case does not arise under the patent laws merely because questions of patent law may arise in the course of interpreting a [sales] contract").

iv. *See, e.g.,* Tillotson Corp. v. Shijiazhaung Hongray Plastic Prods., Ltd., No. 4:05cv0118, 2006 U.S. Dist. LEXIS 76978, at *6–7 (N.D. Ga. Oct. 23, 2006) (court exercised its discretion to bifurcate and sever third-party claims for breach of warranty under the UCC because such claims involved distinctly separate areas of the law and standards of liability.)

11-2-725(1) states that "[a]n action for breach of any contract for sale must be commenced within four years after the cause of action has accrued," while section 11-2-725(2) provides that any such cause of action accrues when the breach occurs, regardless of the aggrieved party's lack of knowledge of the

breach. Because the IWAI pertains to the goods only at the time of delivery, any breach of that warranty would occur when tender of delivery is made, which is when the cause of action for indemnification accrues. In our scenario, therefore, any claim for indemnification for breach of the IWAI under the Georgia UCC must

be brought within four years from tender of delivery.

One word of caution: Calculating the applicable statute of limitations may be different if your particular state has adopted the model UCC (as revised). There are two significant changes to section 2-725(3)(d) of the model UCC (as revised) that

would affect the present analysis. First, while there remains a four-year statute of limitations for breach of contract claims, the clock does not begin to run on such claims until the buyer discovered or reasonably should have discovered the breach. Georgia law, by comparison, reserves this so-called discovery rule exclusively for application to personal injury cases.¹² Second, the model UCC (as revised) implements a six-year statute of limitations for breach of the IWAI measured from the tender of delivery of the goods.¹³ Thus, it pays to be aware of the statute of limitations if your client were sued in a state that adopts the model UCC (as revised) or applies the discovery rule to breach of warranty claims.

Damages Recoverable in an Indemnification Action

Generally, the buyer can recover those damages necessary to make it whole as a result of defending and settling a “rightful claim” of patent infringement. These include attorney fees, costs, and expenses, as well as the reasonable costs of obtaining a license from the patent holder or retooling the buyer’s plant to avoid future infringement.¹⁴ Provided there was a “rightful claim” of infringement, as discussed, the buyer could recover such damages without the necessity of an absolute finding of patent infringement, and, under the reasoning of *Pacific Sunwear*, the buyer could do so even if the infringement claim never materializes into litigation.

Conclusion

In any contract for the sale of goods, the buyer or seller may find that a component, or a product incorporating a component, runs afoul of the patent rights of a third party. This could land either or both parties in a federal court battle with the patent holder. Unless the sales contract says otherwise, a state law indemnification claim may arise under the UCC for breach of the implied warranty against claims of infringement. Despite some important limitations, such a claim for statutory

indemnity can allow the buyer to recover its costs to defend or settle a complex patent infringement action even if the underlying infringement issue is never adjudicated. A seller, on the other hand, must be aware of its obligations under the UCC, and avoid its application by contract, or rely upon a buyer’s failure to comply with the procedural requirements of such a cause of action to prevent its applicability. More important, both parties should be aware of the courts’ recent trend in lowering the bar for a buyer to make out a “rightful claim” of patent infringement—thus increasing the likelihood that an “innocent purchaser” can recover its out-of-pocket costs due to the misfortune of having purchased allegedly infringing goods. ●

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Endnotes

1. The Georgia UCC is similar to the commercial codes adopted by the other states and territories (except Louisiana) and generally tracks the United States UCC (“the model UCC”). The 2003 revisions to the model UCC (“the model UCC (as revised)”) include a modified statute of limitations for indemnification claims for breach of the IWAI. *See infra*. However, no state’s legislature has adopted these revisions to date.

2. *Motorola, Inc. v. Varo, Inc.*, 656 F. Supp. 716, 718–19 (N.D. Tex. 1986) (“The delivery of a good is warranted to be free of all claims of infringement. There is no warranty that a buyer’s use of the good will be free of all infringement. . . . This would be a warranty as to conduct, not as to goods.”).

3. *Chemtron, Inc. v. Aqua Prods., Inc.*, 830 F. Supp. 314, 315 (E.D. Va. 1993) (“[A] buyer . . . should not be entitled to purchase goods from a seller . . . which are not subject to any infringement action [at the time of delivery], use the non-infringing component goods in an infringing device and incur liability to a third party patentee . . . and then turn around and impose liability on the original seller of the component parts.”).

4. *See, e.g., Pure Country Weavers, Inc. v. Bristar, Inc.*, 410 F. Supp. 2d 439, 447–48 (W.D.N.C. 2006) (UCC’s warranty against

infringement applies to copyrights as well as patent and trademark infringement.).

5. *Cover v. Hydramatic Packing Co.*, 83 F.3d 1390, 1394 (Fed. Cir. 1996) (stating in dicta that “rightful claim” of patent infringement for purposes of indemnification under the UCC does not “equate” to a finding of patent liability).

6. *See, e.g., 84 Lumber Co. v. MRK Techs., Ltd.*, 145 F. Supp. 2d 675, 680 (W.D. Pa. 2001) (“If claims of patent infringement are seen as marks on a continuum, whatever a ‘rightful claim’ is would fall somewhere between purely frivolous claims at one end, and claims where liability has been proven, at the other.”); *Linear Tech. Corp. v. Applied Materials, Inc.*, 152 Cal App. 4th 115, 128–30 (Cal. 6th Ct. App. 2007) (“rightful claim” of patent infringement does not require a finding of whether buyer “actually infringed” the patent).

7. 393 N.J. Super. 55, 79 (N.J. Super. Ct. App. Div. 2007) (“We agree that a frivolous infringement claim does not generate a breach of the [IWAI] . . . any more than a buyer is obligated to prove the seller’s liability for infringement to succeed in demonstrating a breach of this warranty.”).

8. *Id.* at 79–80 (emphasis added).

9. 167 Cal. App. 4th 466, 482 & n.10 (Cal. App. 4th 2008) (emphasis added) (use of “nonfrivolous claim” standard designed to erase any “potential implication” of *Sun Coast* that the “warranty is triggered by the [mere] filing of litigation, without any evaluative inquiry into the merits of the underlying claim itself”).

10. *Id.* (emphasis added).

11. 2009 U.S. Dist. LEXIS 48208, at *36 (N.D. Cal. June 4, 2009) (rejecting argument that claim construction of the underlying patent infringement action was a predicate for finding a breach of the IWAI).

12. *See, e.g., Corp. of Mercer Univ. v. Nat’l Gypsum Co.*, 258 Ga. 365, 365–66 (Ga. 1988).

13. As the Official Comments explain, this is actually a statute of repose. *See* UCC § 2-725(3)(d) cmt. 4 (2003) (“In recognition of a need for a time of repose in an infringement case, a party may not bring an action based upon a warranty of non-infringement more than six years after tender of delivery.”)

14. *See, e.g., 84 Lumber Co. v. MRK Techs., Ltd.*, 145 F. Supp. 2d 675, 679–80 (W.D. Pa. 2001) (buyer who settled underlying patent infringement litigation with patent holder can recover costs from seller in separate indemnification action).