

Can I Settle Now? Determining the Existence of a “Rightful Claim” of Patent Infringement

By Christopher M. Arena and Chad A. Rutkowski

Pity the patent defendant who was sued just for using or selling a product made by one of its vendors. It did not design the product. It did not manufacture the product. It does not specialize in the vendor’s industry and thus is probably not generally aware of the patent landscape in that industry. It likely did not have either the incentive or the know-how to undertake an expensive freedom-to-operate analysis. And now it is facing the long slog through a litigation that will assuredly cost it in the six figures (if not seven figures, as is often the case) in legal bills, not to mention the internal administrative resources needed to assist litigation counsel. If it wins, it will have spent that money simply to continue what it had been doing, namely selling someone else’s product. These are costs that the typical buyer did not factor in when it reached agreement on the purchase price of the product at issue. It thought it was buying a product, not a lawsuit.

Pity that patent defendant all the more if it does not have a written contract with the vendor containing a clear indemnification provision. Without such a provision, our patent defendant is subject to the tender mercies of the implied warranty against infringement, and its attendant indemnity provision, under the Uniform Commercial Code (UCC). In addition to having several unique prerequisites to indemnification, including that the seller must be a merchant regularly dealing in such goods and that the infringement claim must exist at the time of delivery of the goods, indemnity claims under UCC section 2-312(2) are “infrequently litigated.”¹ Add to this the fact that UCC claims are governed by state law and thus subject to whatever specific gloss the courts of each individual state care to put on it, it is hard to give that patent defendant any assurance that it will not be stuck with the loss. This uncertainty in turn may have an impact on the patent defendant’s ability to reach a reasonable settlement with the patentee.

The Indemnitee Does Not Have to Take the Case to Verdict

A body of case law is developing, however, that is bringing some needed clarity to at least one prerequisite for indemnity under the UCC—the requirement that the claim of infringement be “rightful.” UCC section 2-312(2) provides as follows:

Unless otherwise agreed, a seller that 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 that furnishes specifications to the seller must hold the seller harmless against any such claim that arises out of compliance with the specifications. (emphasis added)

Thus, in order for the potential indemnitee to prove its claim of indemnity, it has to demonstrate that it was liable for a “rightful claim” of infringement. This is easy enough if the infringement claim was actually adjudicated and a verdict of infringement issued against it. In that case, ironically, it wins by losing. But what if it wants to settle a claim? Is a patent defendant condemned to long, expensive discovery and a long, expensive trial?

The answer to this question has been “no” for some time. The Federal Circuit in *Cover v. Hydramatic Packing Co., Inc.*, rejected an argument that a verdict of patent infringement was necessary before entitlement to indemnity under section 2-312(2) could be established. To find otherwise “would not lead to judicious public policy inasmuch as parties would eschew settlement and be forced to go to trial to discern whether a ‘rightful claim’ exists under federal patent law.”² The Federal Circuit, however, came to this conclusion in the context of a preemption analysis and thus did not define the parameters of what constitutes a rightful claim. Even if it

had, such an opinion would be persuasive precedent only, because UCC interpretation is a state court, not a federal court, responsibility.

The Indemnitee Does Not Have Carte Blanche to Settle

Cover has, nonetheless, proven influential in both state court decisions and with federal district courts charged with interpreting state law. *Cover* left open, however, the question of under which circumstances an indemnitee may settle a case with a patent plaintiff short of a verdict. A tension is created here, for the following reason: Although courts wish to encourage settlements, from the indemnitor’s perspective, it ought not be obligated to reimburse an indemnitee that made a “volunteer” payment. Otherwise, the indemnitee could “give away the store” and simply settle frivolous patent infringement claims knowing that it was spending the indemnitor’s money.

In recognition of this competing interest, courts have rejected arguments from indemnitees that the mere filing of a lawsuit sufficiently establishes the rightfulness of the claim or that a rightful claim can be established if the indemnitee had a “reasonable belief that the alleged infringement will be upheld” at the time of the settlement.³ In trying to strike that balance, however, courts have not been very precise in identifying how the rightfulness of a claim will be measured. One district court has written, “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.”⁴ Any seasoned litigator knows, however, that there is a vast gulf between purely frivolous claims and adjudicated successful claims when it comes to analyzing whether a case is one that should be settled.

Further complicating the matter is the fact that some courts have also found that indemnification for costs of litigation is

appropriate even when the claim is adjudicated in the indemnitee/patent defendant's favor. That is, a claim need not be adjudicated in favor of the patent owner to constitute a rightful claim; it is possible that a patentee's claim is rightful even where the patentee loses. All that is necessary for demonstrating that a claim is rightful in these jurisdictions is a demonstration that the claim was non-frivolous and had an adverse effect on the buyer's ability to use the purchased goods.⁵

The policy behind the section 2-312(2) indemnification provision is to provide a ready means of enforcing the warranty against infringement. When a buyer bargains for a certain price to purchase the subject good, it is doing so without the expectation that it will have to pay a hidden litigation cost on top of the purchase price just to secure the right to use what it bought. If such a "right of use" fee is necessary, it should be explicitly contracted for between the parties. Thus, where the infringement claim casts a "substantial shadow" over the buyer's use of the product, regardless of the ultimate outcome of the claim, the warranty of noninfringement has been breached. Courts analyzing section 2-312(2) in this fashion borrow from the more substantial precedent regarding the warranty of good title, UCC section 2-312(1), under which a buyer is deemed to have the right to be free from the worry that use of his bargained-for property will subject him to lawsuits.⁶ Where the indemnitee has to engage in litigation to buy that peace, reimbursement by the seller is normally appropriate to restore the benefit of the bargain to the buyer.⁷

Settlement Can Be Reached Before Claim Construction

So when, exactly, can an indemnitee in a patent case buy that peace? The United States District Court for the Northern District of California, in *Phoenix Solutions, Inc. v. Sony Electronics, Inc.*, was recently confronted with the issue of "how far a patent infringement case must proceed in order to establish a rightful infringement claim . . ." ⁸ In that case Sony Electronics, Inc., was sued by a patentee claiming to hold a patent covering Sony's use of an interactive voice recognition system on Sony's customer service phone lines. Sony had contracted with another company, Edify Corporation (later bought out by Intervoice), to provide the software necessary

to enable interactive voice recognition on the system. Sony litigated the case for 11 months but settled prior to claim construction. Sony asserted by way of defense both that the patentee's claims were invalid and that Sony did not infringe.

Prior to settling with the patentee, Sony filed a third-party complaint against Edify/Intervoice for indemnification under California's version of UCC section 2-312(2), California Commercial Code section 2312(2). Edify/Intervoice moved for summary judgment, claiming, inter alia, that the patentee's claims were not rightful in light of Sony's invalidity and noninfringement positions, which Sony effectively abandoned by settling prior to claim construction. Edify/Intervoice asserted that claim construction was required at a bare minimum in light of the impact the court's construction of disputed terms would have on Sony's defense positions.

The court rejected the argument that claim construction was per se necessary to determine whether a patent claim was rightful. Although the mere filing of litigation did not itself demonstrate a non-frivolous, rightful claim, claim construction was not necessary to engage in an evaluative inquiry into the merits of the claim itself. Because the terms of the settlement indicated that Sony undertook such an evaluative exercise, enough evidence was presented for Sony's claim to survive summary judgment. Thus, the court rejected adoption of any specific milestone in patent litigation before a determination of rightfulness could be made, suggesting that an indemnitee/patent defendant need not await any specific milestone before exploring settlement with the patentee.

Conclusion

Ultimately, the determination of whether an indemnitee settled a rightful claim of patent infringement will ordinarily be a fact question requiring jury determination. The buyer will need to establish that a breach of the warranty of noninfringement occurred, which in turn will require evidence that the underlying patent claim was non-frivolous and threatened to have an impact on the buyer's ability to use the purchased goods. This is not the same as establishing actual liability for patent infringement, though. In fact, the indemnitee should argue that it is not even necessary for the patentee's claim to be successful before the breach of warranty can be

established. It is only necessary that a non-frivolous claim affected the benefit of the bargain it thought it had reached, and imposed a hidden cost that was not reflected in the purchase price of the subject good.

Moreover, the indemnitee is not obligated to incur the expense associated with specific milestones in a patent case, such as claim construction or the close of discovery, before it can safely consider settlement. Rather, the indemnitee needs to gather sufficient evidence to perform an evaluative process of the risk involved by the claim and the impact the claim will have on the indemnitee's use of the good. This might reasonably occur once infringement contentions are served, but it could theoretically be sooner. In fact, one can foresee an indemnitee settling before litigation is filed, such as when an indemnitee receives an offer to license from a patentee with detailed claim charts. Future cases will decide how far back courts are willing to go before a determination of whether a claim is rightful can reasonably be made. What is certain is that a body of case law is finally being developed on this subject, offering more guidance for the future. ●

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Endnotes

1. Sun Coast Merch. Corp. v. Myron Corp., 922 A.2d 782, 795 (N.J. App. 2007).
2. Cover v. Hydramatic Packing Co., Inc., 83 F.3d 1390, 1394 (Fed. Cir. 1996).
3. See 84 Lumber Co. v. MRK Techs., Ltd., 145 F.Supp.2d 675 (W.D. Pa. 2001).
4. *Id.*
5. See, e.g., Pac. Sunwear of Cal., Inc. v. Olaes Enters., Inc., 84 Cal. Rptr. 3d 182 (Cal. App. Dep't Super. Ct. 2008).
6. See, e.g., Pacific Sunwear, 84 Cal. Rptr. 3d 182; Sun Coast Merchandise, 922 A.2d 782.
7. It should be noted that although the policy is discussed here, and in the case law, in terms of what is fair to the buyer, the section 2-312(2) indemnification is bilateral in the sense that the buyer may have to indemnify the seller for infringement claims arising out of the seller's conformance with the buyer's specifications.
8. 637 F. Supp. 2d 683, 697 (N.D. Cal. 2009).