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Do Clouds Remain After the 'Pacific Sunwear' Decision?

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Our patent system was intended to provide coverage for anything under the sun made by man. Yet, in comparison to that seemingly boundless breadth, ask any buyer who has sought indemnification for a patent infringement claim, and you likely will hear of an even more expansive scope of potential defenses against indemnification. Fortunately, in Pacific Sunwear of California v. Olaes Enterprises Inc., 167 Cal.App.4th 466 (2008), the California Court of Appeal has provided some clarity that should help focus future arguments over indemnification.

Pacific Sunwear involved a retailer's demand that its supplier indemnify it for a trademark infringement claim brought against it by a third party in federal court. Pacific Sunwear settled the underlying claim, and then filed suit in California state court against its supplier seeking indemnification for the settlement. In the California suit, Pacific Sunwear claimed that the supplier breached the California Uniform Commercial Code Section 2312(3) implied warranty that goods are sold free of "the rightful claim of any third person by way of infringement." In a case of first impression, the Court of Appeal reversed, holding that a "rightful claim" under Section 2312(3) did not have to be valid or meritorious. Instead, a claim is rightful if it constitutes "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."

To reach that decision, the Court of Appeal reviewed the legislative history of California Uniform Commercial Code Section 2312(3) and its identical counterpart, Uniform Commercial Code Section 2-312. Noting that few cases had addressed the meaning of a "rightful claim," the court rejected the view that *any* claim submitted to litigation was, by definition, a rightful claim. But it also declined to hold that the section *only* covered claims proven meritorious.

In adopting its view equating a rightful claim with a nonfrivolous claim, the court relied heavily on the official comment to Uniform Commercial Code Section 2-312 that a merchant seller warrants that there will be "no claim of infringement" and that the buyer's remedy for breach arises immediately upon notice of infringement. The court explained that it adopted the "nonfrivolous" standard because it is familiar in a variety of litigation contexts

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and does not require an infringement claim be filed and pursued in litigation.

Although the decision provides helpful clarity regarding a rightful claim, it leaves many unresolved issues. For example, corporate counsel may incur considerable outside counsel costs evaluating the potential merits of patent infringement claims. But a determination that a patent infringement notice is not substantial enough to merit outside counsel review may unwittingly support a seller's later argument that the claim must have been frivolous. Moreover, the "nonfrivolous" standard may still subject buyers to the risk of potentially significant costs associated with litigated claims that ultimately lack merit. The defense costs for even meritless patent infringement claims may force defendants to enter into nuisance settlements that can still represent a significant drain on corporate revenues. Thus, the *Pacific Sunwear* court's rejection of a bright-line test for any litigated claim will continue to enable sellers to argue that early nuisance settlements represent the compromise of frivolous claims.

In addition, the "frivolous" standard can be construed differently under state and federal standards. For example, the *Pacific Sunwear* claim arose in the context of a federal court trademark infringement action but Pacific Sunwear filed its indemnification complaint in state court. Because the underlying action was governed by federal substantive and procedural rules in the first instance, one might assume that federal standards for frivolous actions, such as Rule 11 of the Federal Rules of Civil Procedure, would provide the appropriate definition. Yet, in discussing the "nonfrivolous" standard, the Court of Appeal relied solely on the counterpart California procedural standards.

Finally, in holding that Section 2312(3) does not encompass every asserted claim, the Pacific Sunwear court confirmed that each indemnity demand may require some evaluation of the merits of the underlying infringement claim. Thus, the court reignited the debate regarding whether federal courts should have exclusive jurisdiction over contract disputes for indemnification of third-party patent infringement claims. To the extent that resolution of an indemnification demand may depend on whether the third-party claim was "frivolous" under federal patent law standards, that inquiry may necessitate that buyers file their complaints for indemnification in federal court. Thus far, courts have failed to reach a consensus on this question, and the Federal Circuit has not addressed the issue. If a demand under Section 2312(3) is limited to simply whether a third-party claim is "frivolous," the court could conclude that the question is not so substantial as to implicate federal patent law. Alternatively, as it recently ruled in a case of attorney malpractice that arose out of a patent infringement suit, the Federal Circuit could decide that it would be incongruous to hold that the federal courts must decide the underlying infringement claim but should not hear a related case that depended, at least in part, on an evaluation the merits of the underlying claim.

In sum, clouds still remain after the *Pacific Sunwear* decision, but a few rays of light shine through. And, with the added clarity of the *Pacific Sunwear* decision, counsel should consider several steps to clarify and preserve issues that may arise in the event of third-party patent infringement claims.

First, contracting parties may modify, enhance or eliminate the provisions of Section 2312(3). Buyers, for example, may want to avoid arguments relating to the "frivolous" standard and insist on express indemnification for "any" claim of infringement. On the other hand, sellers should consider whether the market will allow them to reject or limit their indemnity obligation for third-party claims.

Similarly, in contract negotiations, buyers should consider contract provisions that obligate sellers to both indemnify and defend third-party claims. Although Uniform Commercial Code Section 2-607 gives sellers the right to take control of and defend underlying third-party claims, it does not obligate sellers to do so. Without a contractual obligation for the

seller to defend, buyers could be forced to incur the substantial costs of defense and later seek recovery for those expenses. In the case of patent claims, many buyers could find the costs of successful defense overwhelming.

Once a potential claim becomes known, either by a demand letter or otherwise, buyers should consider the implications of their response to the underlying infringement issues along with the potential for indemnification. Many express indemnification agreements require early notice of claims. And buyers should strive to ensure that they notify their sellers within a reasonable time after any litigation is filed.

Before communicating substantive views regarding the infringement issues, both the buyer and seller should seek to implement a joint defense or common interest agreement in an effort to protect the communications from discovery in litigation with the third party. Unfortunately, buyers and sellers must also recognize that some courts may refuse to recognize any privilege arising out of such agreements.

Finally, before settling third-party infringement claims, where appropriate, buyers should consider soliciting participation in the settlement from their sellers. And, for their part, sellers should recognize that they ignore those solicitations at their peril. Sellers’ refusal to engage in discussions or failure to object to proposed settlements may hamper their ability to object to the basis for or amount of resulting indemnity claims in subsequent litigation.

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