The Value of Withheld Indemnifications

A senior licensing executive from a prestigious technology transfer office recently posed the following question to me: "Our TTO is not willing to grant an indemnification to our licensee. In view of this position, to what extent should we discount the value of our licensing agreement? Should we reduce our demands for upfront payments? Seek lower running royalty rates? Waive part of our first milestone payment?"

Upon reflection, I can build an argument as to why no discount need be granted. There are three strategies I would employ to support this contention.

Corresponding Concessions First, technology transfer officers should not feel obligated to grant a concession just because the licensee requests one. Instead of making a unilateral concession, you should make corresponding requests for concessions to the licensee for indemnification. For instance, the difficulty of providing indemnities becomes crystallized for the licensee when they are asked to indemnify the TTO for any product liability claims that it receives. Many licensees would be adverse to indemnify TTOs for misappropriation of trade secrets. Similarly, you can state that the agreed upon upfront payments, milestones and running royalty rates are less than you wanted, in part, to take into account the fact that there will be no indemnification.

Michael Albert, who chairs Wolf Greenfield & Sacks' Litigation Department in Boston, points out that most businesspeople negotiating on behalf of licensees believe that indemnifications are mumbo jumbo that should be left for the lawyers to contend with. This (mis)perception is fortunate for licensors and they are well served to defer the discussion of indemnification until as late in the negotiations as possible. The rationale is that there is usually so much in the way of sunk costs and momentum by the later stages of the negotiations that the licensee will concede on the indemnity issue.

Second, the two most frequent indemnifications that a licensor may not wish to grant to a licensee—indemnifications that revolve around ownership and freedom of operation—can be dealt with separately. Other permutations of indemnifications sought by licensees are easy for the licensor to grant and are rarely a source of contention. These indemnifications include representing that there are no prior licenses, no future licenses will be granted (when negotiating with a potential exclusive licensee), and there are no security interests in the affected patents.

Patent Title As far as the hygiene of patent ownership goes, the licensee should realize if the TTO committed fraud (or inequitable conduct), they could be sued for such malfeasance. The TTO should make it clear to the licensee that they can ascertain the interaction between the patentee and patent examiner by reviewing the prosecution history at the USPTO's site.

As Eric Lund, Commercialization Manager of Technology Commercialization at the Pacific Northwest National Laboratory, indicated, "many institutions will provide representations and warranties that assure the licensee that the licensor owns the patent. While these institutions will provide documents that support the TTOs ownership claims if there is litigation, they will not indemnify for legal fees since it is impossible to know when someone will come out of the woodwork to claim that he was an inventor." Further, some challenges to patent integrity can be easily addressed; for instance, by adding a new-found inventor to the patent.

Freedom of Operation I do not think any consideration should be granted to a licensee for withholding an indemnity based on freedom to operate. As the licensee typically has far more resources than the licensor, the licensee is quite capable of hiring a law firm to issue a freedom of operation opinion letter. Since the licensor does not know all of the end applications that could incorporate its technology (indeed, the licensee does not always know all of the ways that its in-licensed technology will be deployed), the licensee cannot possibly be expected to issue indemnities in these open-ended situations.

Sumita Ghosh, Director of the University of Texas' (Arlington) Office of Technology Management, points out that some licensees take a more measured stance by requesting that the licensors affirm that there is no conflicting research occurring within the licensor's organization. It is reasonable for the licensor to decline to grant even this more limited freedom of operation indemnity since it is impossible to know all of the research occurring throughout a large university system. And looking forward, no guarantees can be made that competing research will not take place: one university campus can't tell another campus what research to pursue. Also, research institutions that receive funding from various governmental authorities can be required to research the projects their sponsors assign to them.

One course of action that can reduce the risk for the licensee without causing the licensor to make an indemnity is to have the investigator sign off on the license. This should indicate that the investigator responsible for the patent knows of no competing research initiatives. Another amenable approach for the licensor to take is to discuss what other research their organization is pursuing. Some of the further research could complement the patents currently being licensed. These forthcoming patents could eventually be licensed to the licensee in question.

If the licensee credibly claims that the failure to obtain a freedom to operate opinion letter will break the deal, you can reduce the value of the license by (half of) the $30,000 to $50,000 that such opinion letters typically cost to produce. Freedom to operate opinion letters should be written after conducting latent semantic and Boolean searches and, if the budget is limited, should focus on the licensee's competitors first. The lawyer should note which patents he has reviewed and discuss the breadth of such claims. As Steven Henry, Shareholder at Wolf, Greenfield & Sacks, counseled, freedom of operation opinion letters should discuss the specific market sizes available for the client to pursue, include an assessment of the aggressiveness of the other patent holders, and likelihood of winning any potential patent litigation. Finally, freedom of operation opinion letters should indicate that the practicing of such art will not induce infringement since 35 U.S.C. § 271(b) holds that "whoever actively induces infringement of a patent shall be liable as an infringer."

Carve Outs and Concessions Some aggressive licensees will demand that royalties be placed in an escrow account so that royalties will be returned if fraud is proven. Other licensees may push for a provision that calls on royalty payments to be reduced by a predetermined percent of legal fees expended in connection with patent quality challenges or defending against accusations of infringement. As a fallback position, when deals really may crater unless the licensor makes some compromise on indemnities, I recommend taking the following courses of action to reduce exposure to indemnities:

- State universities and government research organizations should avail themselves of sovereign immunity laws which limit the liability for such institutions. Thus, any indemnity granted should specifically state that the indemnity is limited as per (state) law.

- Instead of stating that there is no infringement, the licensor can represent that it has no knowledge of any patent infringement.
- Restrict the scope of the warranty to infringement in specific countries.
- Limit the extent of any indemnity payments to (a percent) of royalties received.
- Set time limits for indemnities.
- Restrict the indemnity to proven claims and claims settled with its consent since so many infringement suits are commenced for competitive reasons rather than on the actual merits of the patents involved. Early settlements and arbitration awards should be excluded.

- Any indemnity should become invalid if the product is improperly used, maintained or repaired or if the product was improperly combined with another product.

- Finally, it should be determined if any indemnities should be structured as thresholds or baskets. Thresholds hold that, once damages reach a threshold, the indemnitor is required to pay the indemnitee for the first dollar of damages and every dollar thereafter. If the indemnity is structured as a basket, the indemnitor is only liable for damages in excess of a ceiling.

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