

## **Implied Warranty Of Noninfringement Depends On State**

Law360, New York (June 9, 2015, 10:22 AM ET) -- In almost every state, a buyer of goods subject to a rightful claim of intellectual property infringement can bring a claim against the seller for indemnification under the implied warranty of noninfringement. If the buyer succeeds on its claim, the seller becomes liable for costs incurred by the buyer as a result of the infringement claim, including damages and attorneys' fees.[1]

Privity of contract between an original seller, such as a manufacturer, and a direct buyer, such as a distributor, allows the distributor to bring a breach of warranty claim against the manufacturer, but also allows the manufacturer to disclaim the warranty against the distributor.[2] Lack of privity between a manufacturer and an indirect buyer farther downstream, such as a retailer who purchases goods from the distributor, leads to varied results depending on each state's statutory and common law rules on privity. Each state determines, first, whether the warranty can be invoked without privity, and second, whether disclaimers are effective without privity.

There are often many downstream buyers. For example, Company A could manufacture an infringing subcomponent that is distributed by Company B to Company C, who incorporates the subcomponent into a component that it sells to Company D, who incorporates the component into a device that Company E distributes to Company F for retail sale. If Company F is sued for patent infringement, it could bring a claim for breach of the implied warranty of noninfringement against Company E in any state, because it has privity. Company E could then sue Company D, and so on. Conversely, Company A's disclaimer would be effective against Company B, and Company B's disclaimer would be effective against Company C, and so on. Some states' privity rules obviate this daisy-chain approach. In order to simplify the discussion, we use the terms manufacturer, distributor and retailer as shorthand for original seller, direct buyer and downstream buyer respectively.

### **UCC §2-312 And Privity**

Every state except Louisiana has enacted a version of Uniform Commercial Code Section 2-312(3), which establishes the implied warranty of noninfringement.[3] UCC Section 2-318 allows each state to choose one of three alternatives describing who, in addition to the direct buyer, may invoke the warranty. All three alternatives affirmatively extend the warranty to certain people, and do not expressly deny it to anyone. However, courts cannot interpret a statute as creating a private right of action absent the legislature's intent that it do so, and a plaintiff would be hard-pressed to argue that a state's legislature intended to extend the implied warranty of noninfringement to anyone not covered by that state's version of UCC Section 2-318.[4]

Many state legislatures chose one of the three alternative versions of UCC Section 2-318, but some drafted their own or did not enact any version. According to the United States District Court for the Eastern District of Pennsylvania, 31 states "do not require privity of contract to recover for breach of the implied warranty of merchantability where only economic damages are involved." [5] In each of those 31 states, privity rules for the warranty of noninfringement should be the same as for the implied warranty of merchantability, unless they are altered by that state's enacted version of UCC Section 2-318.

Texas, as discussed below, enacted a version of UCC Section 2-318 that simply points to its courts' privity rules. Hawaii, North Dakota and Utah enacted versions of UCC Section 2-318 Alternative C, which creates a cause of action for "any person who may reasonably be expected to use, consume or be affected by the goods and who is injured by breach of the warranty," which essentially means "anybody." Colorado, Delaware, Kansas, Maine, Minnesota, South Carolina, South Dakota and Wyoming enacted versions of the narrower UCC Section 2-318 Alternative B, which creates a cause of action only for "any natural person" meeting the same criteria as Alternative C.

The remaining states enacted versions of the narrowest UCC Section 2-318 Alternative A, which creates a cause of action only for "any natural person who is in the family or household of his buyer or who is a guest in his home." Practically speaking, the "natural person" limitation in Alternatives A and B limits the warranty of noninfringement to the direct buyer, because natural persons are rarely sued for infringement.

A comparison of the approaches in California and Texas demonstrates the variance in states' privity rules affecting the implied warranty of noninfringement. In California, the Legislature did not adopt any version of Section 2-318, and under common law "the general rule is that 'privity of contract is required in an action for breach of either express or implied warranty and that there is no privity between the original seller and a subsequent purchaser who is in no way a party to the original sale.'"[6] The Texas Legislature enacted a unique version of Section 2-318 under which the issue is "left to the courts for their determination." [7] The Texas Supreme Court has held that "privity is not a requirement for a Uniform Commercial Code implied warranty action for economic loss." [8]

## **Enpro**

The lack of any common-law privity requirement in Texas permitted at least one indirect buyer to successfully sue an upstream seller under the similar implied warranty of merchantability, while avoiding the upstream seller's disclaimer and forum selection clauses in the seller's contract with its direct buyer.

In *Enpro Systems Ltd. v. Namasco Corp.*, 382 F. Supp. 2d 874 (S.D. Tex. 2005), a South Carolina steel supplier named Nucor sold steel plate to Texas-based Namasco. Enpro bought the steel plate from Namasco and used it to manufacture pressure vessels, one of which malfunctioned after Enpro sold it to an oil refinery. Enpro sued both Namasco and Nucor in Texas under the implied warranty of merchantability. [9] When Nucor moved for summary judgment, the court ruled that Enpro's implied warranty claim against Nucor did not require privity, and that Nucor's disclaimer and choice of law provision in its contract with Namasco were ineffective against Enpro. Nucor settled without appeal. Because the Texas version of UCC Section 2-318 simply points to the courts as the authority on privity issues, there is no reason to believe that the outcome would have been different if Enpro's claim had been under the implied warranty of noninfringement instead of the implied warranty of merchantability.

Anticipating the Enpro scenario, Oklahoma's unique version of UCC Section 2-318 provides that "an exclusion, modification, or limitation of the warranty, including any with respect to rights and remedies, effective against the buyer is also effective against any beneficiary" of the warranty. [10] In other words, if Enpro had sued in Oklahoma, then Nucor's disclaimer in its contract with Namasco would have been effective against Enpro, who was a beneficiary of the warranty.

## **What Can a Manufacturer (or Other Seller) Do?**

While Oklahoma's legislators drafted an elegant solution to the Enpro problem, in at least Hawaii, North Dakota, Texas and Utah, the only solution for manufacturers is to rely on downstream contractual clauses to disclaim the warranty as to downstream buyers. For instance, a manufacturer could draft a "viral" disclaimer that would require all distributors and other downstream buyers to include the original disclaimer in any successive sale of the manufacturer's goods. This would at least give the manufacturer a claim for breach of contract against any distributor who failed to pass on the disclaimer.

To avoid the problem of distributor insolvency, a manufacturer could also include disclaimers on the inner-most packaging of its goods, or on the goods themselves where possible, so that such "box-top" licenses would bind all downstream buyers. But retailers, as opposed to consumers, might not read or be bound by such licenses.

The upshot is "seller beware." A manufacturer whose products are resold by distributors to retailers in Texas (and perhaps other states) has no guaranteed method to disclaim the implied warranty of noninfringement, and must be prepared to address the merits of any claim that the implied warranty was breached.

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[1] See *Cover v. Hydramatic Packing Co.*, 83 F.3d 1390, 1394 (Fed. Cir. 1996); *Pacific Sunwear of California Inc. v. Olaes Enterprises Inc.*, 167 Cal. App. 4th 466, 483 (2008).

[2] See, e.g., *Landis & Staefa (UK) Ltd. v. Flair Int'l Corp.*, 60 F. Supp. 2d 14, 21-23 (E.D.N.Y. 1999) (warranty disclaimed under UCC § 2-316).

[3] UCC section 2-312(3) provides: "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."

[4] See *Alexander v. Sandoval*, 532 U.S. 275, 286 (2001) (unless a statute demonstrates congressional intent to create a private remedy, "a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute.").

[5] *Powers v. Lycoming Engines*, 272 F.R.D. 414, 420 (E.D. Pa. 2011).

[6] *Arnold v. Dow Chem. Co.*, 91 Cal. App. 4th 698, 720 (2001) (quoting *Burr v. Sherwin Williams Co.*, 42 Cal. 2d 682, 695 (1954)).

[7] *Tex. Bus. & Com. Code* § 2.318 (West 2013).

[8] *Nobility Homes of Texas Inc. v. Shivers*, 557 S.W.2d 77, 81 (Tex. 1977).

[9] See *Tex. Bus. & Com. Code* § 2.314 (West 2013).

[10] *Okla. Stat. tit. 12A*, § 2-318 (West 2014).

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