

## **Intellectual Property Issues within the Supply Chain**

by Philip Totaro, Principal, Totaro & Associates

Intellectual Property Rights (IPR) are of the utmost importance in today's capital markets. Not only do they provide protection for innovations which have been developed, but they now offer revenue generating opportunities for proactive companies looking to license or sell their products into new markets.

Unfortunately, there is an oft overlooked aspect of IPR. This is the impact to a company's supply chain. Specifically what happens if a third party hits you with an infringement claim for technology which is in a vendor supplied component? Or what happens if a vendor goes out of business or decides to get out of a line of business which manufactures a key part for your product? Will your business be hamstrung by someone else's decision?

Let's examine how to mitigate the risks associated with those scenarios so that you can keep selling your products.

### **Build to Spec vs. Build to Print**

First some definitions which you should already be aware of, but are worth refreshing. "Build to spec" is when a company literally instructs a vendor to build something that is a certain size and has specific operational parameters. The degree to which the component is specified may vary, but ultimately the vendor is free to use their own design expertise and manufacturing know-how to produce the parts they will supply to you. The benefit is that the vendor retains the responsibility and liability for design and part quality, which may reduce your overhead since you do not need to maintain in-house expertise in an area of subject matter that is not a core competency for your company. The definitive drawback is that the vendor owns the IPR on that part, which may be a key component to your product. More on the impact of this later.

"Build to print" is when a company not only specifies the functional requirements of the part, but they produce assembly drawings, work instructions and call out specific manufacturing practices to be used in producing the parts. This method requires more work and development cost on the part of the company, but the advantage lies in maintaining control of the IPR and having the ability to select any appropriate vendor to produce parts for you. This approach is more costly since you would likely be responsible for design and quality liability issues. Nevertheless, if you possess the subject matter expertise it is always better from the perspective of IPR to design "in-house." This approach also makes subsequent vertical integration of your business easier.

## **Clearance Search / Non-Infringement Assessment**

When introducing a new product, a patent clearance search is an essential part of business risk mitigation. A clear path to non-infringement of existing patents and applications provides confidence to launch your new ideas.

While most companies work with their legal counsel to ensure their own intellectual property position is secured and they have freedom to operate, most neglect to consider the risk mitigation needs within their vendor base.

All companies need to work with their vendors to ensure a clear path to non-infringement exists. If not, the company may be subject to a claim of direct or contributory infringement resulting from an issue with a vendor supplied component.

These claims can damage the company's brand and reputation and could even lead to monetary damages to the third party, even though the infringement was on the part of the vendor.

There is a way to mitigate this risk, but there is more than just simply requesting indemnification. Protocols such as a patent clearance search and non-infringement analysis by your vendors should be mandated as part of the qualification process.

Be wary of someone who tells you they've looked into third party IPR and it "doesn't matter" or "won't be a problem" without sufficient supporting material.

## **Indemnification Clauses in Supply Agreements**

Beyond mandating that a patent clearance search be completed for vendor supplied parts, as the buyer/licensee, you should require explicit language in the supply agreement(s) to cover indemnification from third-party infringement lawsuits.

"The use of [product] by [the buyer/licensee] shall not infringe or otherwise violate the industrial or intellectual property rights of any third party of which [the seller/licensor] has knowledge. If any third party shall assert that [the buyer's/licensee's] practice of the Licensed Rights under [the Supply Agreement], whether resultant from explicit knowledge [the buyer/licensee] had or should have had through reasonable due diligence, shall constitute an infringement or misappropriation of that party's industrial or intellectual property rights, [the seller/licensor] shall in accordance with this Article defend, indemnify and hold [the buyer/licensee] harmless against any and all such claims."

A request for the licensor to carry insurance in regards to this matter may also be inserted into the supply agreement depending on how much negotiating leverage the buyer maintains. Additionally, most supply agreements provide a use license to the buyer, which is typically transferrable to the end consumer in the case of OEMs and system integrators. Therefore, your customers should be at ease that they will not be subject to a "stop-use" injunction as a result of their purchase of your product.

However, this indemnification requires the additional work of the patent clearance. The language used above necessitates that you are explicitly aware or you should have known about third party patents. At the very least, the language above helps to mitigate any claims of gross negligence, but if a patent clearance initiative is not conducted your company may still be subject to misconduct and damage awards. This misconduct would not be covered by the indemnity, so mitigating this risk requires appropriate steps in the vendor qualification process.

It should be the responsibility of the vendor to convince you that the product they are offering for sale does not infringe on a third party's IPR. Additionally, you may be aware of certain patents as a result of your own product clearance search or landscaping efforts. You should make it a point to maintain a catalogue or "watch-list" of patents which refer to sub-component items that are sourced from vendors. This watch list should be communicated to the vendor during the qualification process to provide them the opportunity to address these issues if they have not already.

In conducting the patent clearance search the vendor should have legal opinions from their counsel if necessary to demonstrate non-infringement position or a reasonably comprehensive approach to invalidation. Much like your own efforts those opinions should address 1) literal infringement, 2) infringement via the doctrine of equivalents, 3) prosecution history and/or file wrapper estoppel, 4) inequitable conduct, and 5) means for invalidation (if necessary).

### **Second Source – Another Potential IPR Impediment**

For manufacturers who have parts "built to spec" instead of "built to print" another issue arises when it comes to second sourcing and spare parts.

Imagine a scenario in which one of your vendors is providing you a key component of your product, but they subsequently discover a quality issue which leads to a massive recall of that part. The financial and PR cost of an extensive warranty claim may put them out of business, but it can also damage your business if you have numerous units of your own product sold and no way to repair/replace the vendor supplied parts.

If you have something built to spec, then you must have a clause in your supply agreements that refers to your ability to take the vendor's drawings, manuals, and manufacturing know-how to a second source in the event that they are unable or choose to not provide you with sufficient supply of parts for use or replacement in your product(s).

Also, the more highly you specify the parts to be supplied the more you are in control of the supply scenarios. If you have more than one vendor of a part and these parts are not "interchangeable" then the question should be asked about the risk exposure in case one of those vendors is unable or unwilling to supply you for whatever reason.

Taking precautions to protect your company when it comes to counter-party IPR is not just a good idea... it is a must!

### **About the Author**

Mr. Philip Totaro is the Principal at Totaro & Associates, a consulting firm focused on innovation strategy, competitive intelligence, product development and patent search. Mr. Totaro has experience in strategic planning as well as creating and protecting intellectual capital. He has worked for such companies as General Electric, United Technologies Corporation and most recently he oversaw Intellectual Property and Competitive Assessment for Clipper Windpower. He has helped cultivate and disposition over 450 innovations, and his assessment has led to over 250 issued patents. His strategic market analysis has led to the funding justification of over \$500M in R&D investment and the development of multi-million dollar product and service offerings. He has provided legal and technical due-diligence for over \$1B in M&A, including the recent takeover of Clipper Windpower by United Technologies Corporation. To find out more or get in touch please visit [www.totaro-associates.com](http://www.totaro-associates.com).