

## How Licensors Can Limit Risk for Defective Products — Part I

BY AMY GOLDSMITH



In prior columns, we discussed the benefits of licensing intellectual property and set forth criteria for a license. The focus of this two-part column is more specific: to provide guidelines how a licensor can limit risk and responsibility for defective products manufactured by a licensee.

### Quality control provisions

A trademark is an indication of a product's source or sponsorship to a consumer. A familiar trademark evokes a feeling of comfort. The consumer trusts that the trademark owner — even if it doesn't manufacture the product itself — is watching over the licensee to ensure the quality doesn't slip. In trademark law, the licensor is required to watch over the licensee and ensure that products bearing the trademark are well made. Indeed, in order to have a valid trademark license, the trademark owner must have control over the products which bear its trademark. A license without control is deemed a naked license, which can lead to a licensor losing rights to the trademark. To avoid the fate of a naked license, most trademark licenses incorporate quality control provisions whereby the licensor has the right to review the products before, during, and after production. If a licensor is too involved and the licensee makes a mistake and creates a defective product the licensor is liable with the licensee for the harm that the defective product has caused.

The quality control provision can be general in nature, stating the licensee will manufacture goods to the same standards as its prior products. The license should avoid obligating the licensor to be integrally involved in designing, testing, manufacturing, and distributing the product. However, the licensor can be obligated to review how the mark is used on labels, hang tags, the product, packaging, advertising, and promotion. These provisions do not relate to design, testing, and manufacture and, thus, are unlikely to increase the risk that the licensor will be liable for a defective product. These provisions directly relate to the

way the trademark is used, which is one of the primary interests of the licensor. It's appropriate for the hang tag, label, and advertising to state that the product is manufactured by the licensee under license so the public is clearly informed of who is the manufacturer and who is the licensor.

### Protecting the licensor in the agreement

In anticipation of a defective product lawsuit, the licensor should seek complete indemnification from the licensee. An indemnification provision typically provides that the licensee holds the licensor harmless from claims by third parties relating to the manufacture, distribution, exploitation, advertising, use, sale, or consumption of the licensed products. The licensee guarantees payment of all damage and profit awards and attorney's fees. In order to ensure that the licensee is not forced out of business as a result of a defective product lawsuit, the license should contain a provision requiring the licensee to have product liability insurance which will cover both licensee and licensor. Even with the indemnification clause and licensee's insurance, a prudent licensor should consider acquiring its own product liability insurance, just in case complex issues arise during a product's liability lawsuit.

This type of indemnification by the licensee does not insulate the licensor from all liability. The licensee's indemnification of the licensor does not include claims resulting from wrongful use of trademark, such as a lawsuit claiming the licensed trademark infringes upon a third party's rights. Those claims are the responsibility of the licensor and the indemnity runs the other way — from licensor to licensee. So it's important for the licensor to have insurance to cover its defense.

Another issue to consider is whether the licensee or licensor controls the lawsuit. In a defective product situation, it's common for the licensee to control, given that it performed the design, testing, and manufacture of the product. Yet from the licensor's perspective, the licensor should be kept advised of the lawsuit and settlement discussions and have the ability to veto any decisions and resolutions which may negatively impact the licensor. Lastly, the license should make it clear that the licensee is not an agent or representative of the licensor.

All of these provisions will help to provide the licensor with a defense to a defective products claim. In the second part of this column in the February/March 2003 issue, we'll explore what happens if the licensor is sued. □

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## LEGAL EASE

Making sense of the law

# How Licensors Can Limit Risk for Defective Products — Part II

BY AMY GOLDSMITH



In the first part of this two-part column, we discussed guidelines of how a licensor can limit risk for defective products. Herein, we address steps to take if the licensor or licensee is sued.

### What if the licensor is sued?

If both licensor and licensee are sued for damages for a defective product, the court will evaluate the following: the terms of the

license agreement; the actual practice of the licensor with respect to design, testing, and manufacture of the product and use of trademark; and the public's perception. Between licensee and licensor, the indemnification clause will control. There have been several lawsuits where both licensor and licensee were named. The outcome of each case is dependent upon the particular law applied in each state. However, there are certain doctrines which do apply across state borders. One of these is known as the "apparent manufacturer doctrine," which arose from a legal theory which says, "One who puts out as his own product a chattel manufactured by another is subject to the same liability as though he were its manufacturer."

This doctrine was discussed in a class action suit involving people claiming injuries from TMJ joint implants, some of which were manufactured by Dow Corning. Dow Chemical and Corning were also sued since each owns 50% of Dow Corning and the trademark used on the TMJ implants combines the trademarks of the two entities. But the Court held the apparent manufacturer doctrine did not apply to Dow Chemical or Corning for several reasons: the trademark 'Dow Corning' was owned by Dow Corning, not Dow Chemical or Corning; and the two companies had no manufacturing or sales responsibilities for the TMJ implants. The Court stated that

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the law did not impose liability on companies who failed to police their trademarks if those companies did not manufacture or sell the allegedly defective products.

In a recent Connecticut case, the lawsuit involved the

purchase of defective Dexron automotive transmission fluid. The defendant seller in turn sued the supplier, Atlantic Coast Oil, as well as General Motors, since GM licensed the use of the Dexron trademark. The Court held the apparent manufacturer doctrine did not apply because GM was not a significant part of the manufacture, sale, or distribution of Dexron. GM exercised no actual control over the actual formulations that its licensees used to meet the performance standards, and many licensees considered their own formulations to be trade secrets which they did not disclose to GM.

In addition to the apparent manufacturer doctrine, the courts also look at the actual relationship between the licensor and licensee to determine whether the licensee is the agent of the licensor. One factor the courts will consider is whether a "no agency" provision is present in the license agreement. The court will also evaluate the licensor's statements and the way the licensor presents itself to the public to see if a consumer could reasonably expect that the licensee had the "apparent authority" of the licensor with respect to the defective product.

The doctrine of apparent authority has arisen most often in the context of franchise relationships. In an Alabama case, a guest's oil company credit card was taken and kept by a clerk at the franchised Holiday Inn at the direction of a credit information company. The guest sued, requesting damages against the oil company, the franchisor, the franchisee, and the motel clerk. The court ruled that the franchised Holiday Inn was "readily recognizable by the public as part of the national system of Holiday Inns." Other franchise cases use similar reasoning as the appellate court in the Holiday Inns case. Basically, for a licensor to be held liable under the "apparent authority" doctrine, it must have acted in such a way that the consumer believes there is a close relationship between the licensor and licensee which exceeds simply the permission to use a trademark.

A licensor concerned about future product liability lawsuits should begin analyses of the provisions of the license agreement. If necessary, an existing license agreement should be modified to incorporate the provisions suggested above. Also, a licensor's actions with respect to the license and its relationship to the licensee should take into account the doctrines of "apparent manufacturer" and "apparent authority" to avoid liability in a later product liability action. For more information, call us at (212) 684-3900. □