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Supplier Transitions and Intellectual Property Litigation Risk: A Practical Guide for Businesses

By Terry J. Wikberg

Changing suppliers is a routine business decision that can be driven by a number of factors, including cost savings, quality improvements and strategic realignment. However, supplier transitions carry underappreciated intellectual property (IP) risks that can expose companies to costly litigation and risk. These relationships typically start out in a “sunshine and roses” environment when things are friendly and cooperative. But like many things, these relationships can come to an end and when a company moves from one supplier to another, the tone of the relationship dramatically changes, and the former supplier may assert claims based on trade secrets, patents, copyrights or other proprietary rights.

Further, more often than not, the story of the “value” of any supplied product or service dramatically changes between the supply of the product and afterward during litigation. Understanding these risks and implementing appropriate mitigation strategies are essential for any business contemplating a supplier change. However, like many things in business, it is better to mitigate this risk

early in any supplier relationship rather than later or at the end.

NATURE OF THE RISK

A customer-supplier relationship often involves the exchange of confidential information, technical specifications and proprietary processes. Either before or during the customer-supplier relationship, the supplier may develop innovations, improvements or specialized knowledge directly related to the products or services it provides. In fact, some proprietary aspect(s) of the supplier’s technology or solution could be integral or necessary to the supplied product or solution. When the business relationship ends, which can often be an “emotional” transition, the departing supplier may claim that its IP is being misappropriated by the company or its new supplier. This can be done either in an effort to force a rekindling of the business relationship or simply enforce its IP for an alleged misappropriation.

Both patent infringement and trade secret claims represent the most common IP risks in supplier transitions. As for trade secret claims, a former supplier may allege that confidential manufacturing processes, formulas, customer data or technical know-how developed during the relationship are being improperly used or disclosed to a competitor. These claims can arise even when the company believes it

The author, a partner in the Washington, D.C., office of Holland & Knight LLP, may be contacted at terry.wikberg@hklaw.com.

is simply using information it legitimately owns or independently developed. For patent infringement, a supplier may hold patents covering components, processes or methods used in the products it manufactures. When a company transitions to a new supplier, it may inadvertently, or necessarily, continue using supplier-patented technology, particularly if the original supply agreement included an implied or explicit patent license that terminates with the relationship.

Though rarer, copyright claims may also emerge if the former supplier developed software, technical documentation, designs or other copyrightable works during the engagement. Absent clear contractual provisions assigning ownership, the supplier may retain rights in these materials and object to their continued use by the company or its new supplier.

COMMON SCENARIOS THAT TRIGGER LITIGATION

Several situations heighten the risk of IP disputes during supplier transitions. These situations can include the hiring of former employees from the supplier, sharing of confidential technical data or information, or presence of protected or patented technology in the supplied products or solutions.

When a company hires employees from the former supplier or the new supplier recruits such employees, allegations of trade secret misappropriation often follow, with the former supplier claiming that departing employees carried confidential information to the competitor. Alternatively, the supplier can claim that it shared proprietary trade secrets during the relationship that should have been held in confidence by the customer but were improperly shared with any new supplier. Similarly, trade secret disputes can arise when the customer provides the former supplier's designs, specifications, samples or processes to the new supplier to facilitate the transition. The former supplier may argue that these materials contain its proprietary information and that sharing them constitutes misappropriation or breach of confidentiality obligations.

Similarly, litigation risk can present itself when the original supplier obtained patent protection for its products or components of its products, and these protected attributes are necessary to the supplied

components or otherwise utilized in the new products provided by the new supplier. The former supplier may contend that the similarity demonstrates continued use of its IP, particularly if the supplier contributed to the product's development.

MITIGATION STRATEGIES

Companies can take several steps to reduce the risk of IP litigation when changing suppliers. Many of these steps are well known and incorporated in most supply agreements already. Though there is no single magic bullet or solution to avoiding post-supplier risks, it is always beneficial to be proactive rather than reactive in a supplier relationship and, with some early mitigation, the supplier transition risks can be greatly minimized. Further, it is always easier for a customer to secure significant risk mitigation terms in the beginning of a supplier relationship, when things are generally "rosy" and a supplier is more willing to be cooperative to secure a relationship. Set forth below are some less common, but effective, proactive steps a customer can take to greatly mitigate any post-relationship litigation risk.

Conduct Pre-Signing Due Diligence and Provide Ongoing Reporting Requirements

Before onboarding a supplier, it is important to have the supplier identify all IP that will be incorporated into any supplied product or service with as much specificity as possible, whether patents, trade secrets or copyrighted material. This notice should be clearly added to any supply agreement. This provides the customer a clear understanding of any IP that is incorporated in the supplied product. Thus, when the customer determines that it is time for a new supplier, the customer will have a clear understanding of any potential IP risks with the change of supplier.

A supply agreement should also include a provision that creates an ongoing obligation that requires the supplier to identify any newly developed IP or follow-on patent applications, etc., incorporated into the products during the customer-supplier relationship for the same reasons.

These identification provisions should require as much specificity as possible, even for trade secrets, to make it clear to both parties what IP, if any, is being used or present in the supplied products. Of course, suppliers will be reluctant to "open the hood"

for all of the details of trade secrets, but the trade secrets should be identified sufficiently to clearly indicate what they are such that the customer has clear notice of what is, and is not, considered a trade secret. These provisions could be used to mitigate the risk of “shifting” trade secrets claims during any post-relationship litigation.

These provisions can and should include limitations on any potential liability if the IP is not properly disclosed during the term of the supply agreement.

Provisions such as these will allow the customer, and any potential new supplier, to have a clear idea of what is ahead of them before replacing a supplier.

Clearly Define the “Value” of any IP or Provided Products

To the extent possible, it is beneficial to define the alleged “value” of any supplied product that is covered by any IP. This can be critical in mitigating any potential risk if a claim of IP misappropriation is made. In today’s world of IP litigation, damages theories are becoming more and more creative in an effort to seek the maximum possible damages in any litigation. These theories often claim that the alleged “value” of the IP greatly exceeds the actual price point of the supplied product or service and can include claims that the supplied product represents or provides the entire value or commercial benefits of the customer’s completed product or service. In fact, there are number of Federal Circuit decisions that support these damages models and are heavily relied on by plaintiffs during patent litigation.

Though it may be easier said than done, making an effort to define the value or benefits of a supplied product or service to an overall finished product can represent a significant risk mitigation technique by clearly defining or limiting the value of any potential post-relationship litigation. Not only could such a provision create a limit or cap on any potential damages – it could also discourage any litigation investor from working with the previous supplier, because the investor could see these terms as preventing, or strongly cutting against, the use of “creative” litigation damages theories that often result in large jury damage awards. That is, having the ability to show a jury what the old supplier agreed was the reasonable “value” of its supplied product and contrasting that with a litigation-conceived theory that

diverges from that value by orders of magnitude can be a persuasive tool to convince a jury of a clear overreach of value.

Of course, a supplier may be reluctant to identify a “value” of its solution or wish to define an overinflated value (most suppliers believe their products to be “game changers”), but these terms can be well worth the effort for the reasons stated above. Further, because any such negotiation is taking place at the beginning of a relationship, it is often much easier for the customer to secure terms that are favorable because the supplier desires the business. For example, even a provision that states that the “value” of the supplied product to an overall product is no more than the cost of the supplied product as compared to the cost of the overall product can greatly limit damages theories that can be reasonably asserted during any post-relationship litigation.

Negotiate Clear IP Ownership Provisions and Contributions

Though quite common already, supply agreements should include explicit provisions addressing ownership of IP developed during the relationship or as part of a bidding or development process. Customers should ensure that work product, designs and improvements created specifically for the company and/or at the direction of the company are assigned to the company, while acknowledging that the supplier retains rights in its preexisting and independently developed IP. Very often, the development of a new solution for a customer uses critical, proprietary and inventive concepts that were supplied by or contributed to by the customer. Any supply agreement can specifically identify or describe the technical requirements, specifications or contributions provided by the customer to evidence the inventive contributions made by the customer and that any resulting IP was not based solely on the “genius” of the supplier. Addressing these issues at the outset of a supplier relationship helps avoid ambiguity when the relationship ends.

It is also beneficial to include contractual terms that offer clear reporting provisions that provide for reporting and documenting ongoing contributions made by the customer during any supply contract. It is hardly surprising or uncommon that customers are significant contributors to innovation in

supplied products, and documenting this can go a long way to mitigating post-relationship risk.

Though many supply (and joint development) agreements include these provisions, very often they are forgotten as the relationship continues. Thus, it is critically important to strictly follow any such provisions in a supply agreement to provide the best opportunities to mitigate post-relationship risk.

Document Independent Development

Companies should internally and independently document all innovative contributions made to any supplied product. As discussed above, customers are often significant contributors to any supplied technology that it uses. Any independent and contemporaneous documents that reflect the customer's detailed contributions can be used to mitigate the story of "invention" that ex-suppliers often make. It is always easier to counter these arguments with old documents and records, rather than testimony or recollections that come up during the litigation.

Further, any agreement with a new supplier should have similar requirements, where the new supplier should maintain detailed records demonstrating that its products, processes or technologies were developed independently and without reliance on the former supplier's proprietary information. Contemporaneous documentation of design decisions, engineering analyses and development timelines can be invaluable evidence if litigation arises.

Such provisions can also be used to demonstrate to a jury that no ill intent existed and that the customer "did everything right."

Implement Information Barriers with any New Supplier

When transitioning to a new supplier, companies should establish protocols to prevent the inadvertent transfer of any supplier's confidential information. This can include conducting an internal audit or analysis to identify and segregate proprietary materials, instructing employees not to share confidential supplier information and requiring the new supplier to develop solutions independently, rather than relying on the former supplier's work product, to avoid any patents that may cover an aspect of the supplied product.

Of course, this exercise can be made easy if the previous supply agreement includes IP identification provisions as discussed above.

Obtain Appropriate Indemnification

As is commonly done, supply agreements with both current and new suppliers should include robust indemnification provisions covering IP infringement claims. Companies should ensure that the former supplier's indemnification obligations survive termination for a reasonable period and that the new supplier agrees to indemnify against claims arising from its work. Moreover, to the extent specific IP can be identified, it often strengthens the indemnification agreement.

Consider Transition Agreements

In some circumstances, negotiating a transition agreement with the departing supplier can reduce litigation risk. Such agreements may include mutual releases, clarification of IP ownership, clarification of IP "value," licenses to use certain technology during a transition period and commitments not to sue. Though these agreements may be hard to obtain as they are often negotiated at the end of a relationship, it can be worth the effort to mitigate or eliminate a risk going forward.

Typically, if needed, it is easier to negotiate a license at the end of a relationship to receive a reasonable value for any needed IP, rather than a few years later when a litigation funding entity is involved seeking significant increased value for any used IP.

Exercise Caution in Hiring

To avoid any potential appearance of trade secret misappropriation, companies or their new suppliers hiring former employees of a departing supplier should implement appropriate onboarding procedures. These should include reminding new hires of their confidentiality obligations to former employers, instructing them not to bring or use proprietary information from previous employment, and documenting these communications.

Follow the Provisions of the Supply Agreement

To the extent a supply agreement includes any reporting or ongoing provisions or obligations, they should be followed diligently and in a timely manner. It is considerably easier to explain to a jury the appropriateness of any conduct when relying on properly recorded, contemporaneous documents, rather than after-the-fact testimony or attorney

arguments. This is particularly true in a time when juries very often have a skewed view of the conduct of larger companies or are skeptical of the motives behind companies' decisions, especially when dealing with smaller supplier companies.

Monitor Relevant Supplier Patent Activity

Even if there is an IP reporting provision as part of a supply agreement, more often than not it is important to monitor the IP filings of a supplier. To the extent a supplier is keeping patent families alive (e.g., through the use of continuation applications) and crafting claims with ever-changing scopes, especially after a relationship has ended, this can signal that the ex-supplier is planning on pursuing an action. Monitoring this activity can help the customer and new supplier stay ahead of any potential litigation.

Avoid “Overstating” the Value of any Supplied Products

Though this is admittedly difficult to manage and police, customers should avoid advertising or sharing internal documents or communications that overvalue or overstate the importance of any supplied components or products. To be sure, many companies survive and thrive based on their supplier relationships. However, overstating or overhyping the value of products or components that are supplied can increase the risk of large damages arguments in an ex-supplier infringement or misappropriation litigations. These documents will be used to tell the story that the success of any customer product or service is solely based on the supplied component and, thus, the “value” of the supplied technology either greatly exceeds its purchase costs or provides a much larger benefit to the customer – which should form the basis of the damages award. Thus, wherever possible, efforts to avoid overstating the importance of any supplied product or supplier relationship can go a long way in countering the undoubtedly overhyped and overvalued damages arguments that are often a part of today's IP litigation activities.

The “Specter” of Willful Infringement

Many companies choose to avoid some of the notice, reporting or monitoring actions described

above for fear of being accused of willful patent infringement in any litigation action, as the customer is now aware of the ex-supplier IP. To be sure, this is a legitimate concern that should be strongly considered. However, experience shows that allegations of willful infringement are extremely common in customer/ex-supplier litigation regardless of whether or not the customer was actively monitoring the ex-supplier's IP. In fact, it is often harder to overcome an argument to the jury that the customer “buried its head” or “just did not care enough to look” than an argument that suggests the customer was aware of the IP and did everything reasonable to avoid it.

Yes – being aware of a company's IP can allow for a claim of willful infringement to be made in any IP-related litigation. However, experience shows that being aware early allows for the ability to avoid any IP outright through design changes or improvements, negotiate an early, reasonably valued license, or prepare for a potential litigation in the future through appropriate planning.

In almost every case, being aware and having a plan is more valuable than being surprised by litigation. This is particularly true because regardless of whether or not a company is aware of supplier IP, willful infringement claims are almost always made, and defending a “buried their head in the sand” argument in front of a jury is never easy.

CONCLUSION

Supplier transitions present legitimate business opportunities but also create meaningful IP litigation risk. Former suppliers may assert any number of IP claims that can result in expensive litigation that has damages theories that significantly diverge from the real value of the supplied product or service. By utilizing any number of the foregoing, companies can significantly reduce these risks. Thoughtful planning before and during a supplier relationship, and during a supplier transition, can be far less costly than defending against IP litigation after the fact, especially when that litigation fundamentally changes or exaggerates the value of the original supplied product or service.

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