Indemnity Terms and Conditions Key to Negotiating Information Technology Contracts

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Indemnity is one party's promise to protect another party from loss. This is the first of two articles that will analyze key indemnity issues as they relate to IT contracts.

When negotiating a contract, the parties must agree upon which events will trigger the seller's obligation to indemnify. The buyer may initially prefer that the seller indemnify against all losses arising from any seller act or omission. But this approach, even if achievable, may require a significant outlay of the buyer's negotiating capital and can make the seller more cautious when it comes to negotiating other aspects of the indemnity or related liability-allocating provisions of the contract.

Circumstances may require the buyer to develop a list of specific triggers for indemnity. Developing such a list requires careful consideration of the ways in which the seller's products, services, and actions expose the buyer to risk. The list will vary from transaction to transaction, and the buyer should avoid over-reliance on forms and prior agreements as it approaches each agreement.

Several guiding principles can help the buyer develop the list of indemnity triggers. The list should include third-party claims for which the buyer is at increased risk because of the transaction covered by the contract. It should include claims for which the damages available under contract law are likely to be insufficient.

Typical bases for indemnification in an IT contract include infringement claims, claims by the seller's subcontractors or employees, losses arising from confidentiality and data security breaches, losses arising from violations of law, losses arising from the seller's failure to satisfy its obligations regarding continuity of the services under the contract, losses arising from personal injury and property damage, and losses arising from the seller's gross negligence or willful misconduct.

The parties must also agree on the types of losses that will be recoverable. The buyer will prefer a comprehensive approach that includes not only the contract damages that flow directly from indemnifiable events (including consequential and incidental damages), but also the buyer's costs and expenses in investigating and responding to the event, the buyer's fees for attorneys and other professional advisers, taxes, fines and interest imposed in connection with any third-party claims, as well as and litigation expenses.

Sellers, on the other hand, will prefer a narrower definition of indemnifiable losses. Sellers often attempt to limit their indemnification obligations to the payment of amounts finally awarded to a third party claimant by a court or amounts paid in settlement. This approach not only allows the seller to defer any payments to the buyer until judgment is made and all avenues of appeal have been exhausted. But it leaves the buyer responsible for losses that are not redressed by the judgment or settlement.

Each party's position regarding the losses that are recoverable under the indemnity provision will also influence (and, in turn, be influenced by) the parties' positions regarding the losses that are excluded from the contract's liability limiting provisions. For example, a buyer may concede to limits on the seller's liability for breaching a noninfringement warranty, if the buyer's losses for the breach would be covered by an indemnity that is excluded from the liability limitations.

Common areas of negotiation

The seller's liability for intellectual property infringement takes a prominent position when negotiating IT contracts. In particular, the seller's indemnity for infringement in an IT contract poses unique challenges. We describe the most common areas of negotiation below, but it is important to bear in mind that specific negotiations and their outcomes will depend greatly on factors such as the nature of the seller's products, the role those products will play in the buyer's IT environment and the parties' respective leverage. The parties' willingness to accept certain outcomes also will depend upon how the contract's liability limiting provisions apply to the seller's indemnity for intellectual property infringement.

1) Sellers typically seek to limit their responsibility solely to losses caused by third-party claims. If no third party is raising an allegation of infringement, the seller reasons, why should anything change in the day-to-day bargain struck by buyer and seller in the contract? Buyers often concede this point but before making this decision should carefully consider two things: (i) the potential harm to buyer if the buyer or the seller comes to believe that the buyer's use of the products or services is infringing, and (ii) the buyer's ability to address that harm through a warranty of noninfringement.

2) Sellers may attempt to limit the types of intellectual property covered by the indemnity. For example, the seller may offer an indemnity that covers infringement of third-party rights other than patent rights as a way to avoid taking responsibility for spurious claims by "patent trolls." Or, the seller may propose only to indemnify against violations of U.S. intellectual property rights. The buyer must examine the risk of these proposals on a case-by-case basis, keeping in mind that the buyer has less ability than the seller to mitigate the risk of infringement claims. The buyer should try to stand firm in leaving the risk of infringement with the seller, no matter the type of intellectual property right being infringed.

Sellers will not want to indemnify against infringement losses caused by the buyer. The seller usually addresses this concern by including a list of exceptions to its infringement indemnification obligations. The buyer can often accommodate part of the seller's concern by ensuring that the seller's requested exceptions are narrowly tailored to situations where the buyer is truly at fault. For example:

• If the seller excludes infringement caused by modifications made by someone other than the seller, the buyer may be able to agree, provided that the exclusion is limited to only those modifications actually made by the buyer without the seller's approval.

• If the seller excludes infringement caused by the seller's compliance with buyer's instructions, even if the buyer agrees that the seller has a legitimate concern for the contract under negotiation, the buyer may still wish to limit the exclusion to cases where there was no reasonable noninfringing way for the seller to comply with the instructions.

3) The seller may seek to exclude infringement arising from a combination of the seller's products or services with the products or services of third parties (sometimes referred to as "combination claims"). Contract terms regarding combination claims can be fraught with risk for the buyer, particularly when working from the seller's form agreement.

In some seller forms, the seller's indemnification obligations do not apply if the seller's products or services are combined with the products or services of third parties. But nothing is ever used in isolation! Such language could undermine the buyer's right to any kind of indemnity for infringement claims. Therefore, the buyer should take care to ensure that combination claim exceptions apply only to the extent that the claim is actually caused by the combination and that the combination was not foreseeable or necessary to use the seller's products and services. Moreover, if the buyer believes that combination claims pose a significant risk, it may prefer a more nuanced approach that apportions responsibility among the seller and the third-party providers.

Resolving complex combination claims can require the active cooperation of several parties, and buyers who have agreed to forego protection for combination claims may find themselves without a right to receive that cooperation.

4) In addition to negotiating an infringement indemnity that covers a wide range of claims, buyers may seek to define specific actions the seller must take to remediate ongoing infringement. Most commonly, these remedies include (i) repairing or replacing infringing products so that they no longer infringe and (ii) obtaining the third party licenses necessary for continued use. In response, the seller may propose a third option as a way of preventing further infringement: terminating the allegedly infringing product or service.

But termination of a product or service is an extreme remedy that can leave the buyer unexpectedly without a solution—if forced to stop using a product, it makes no difference to the buyer whether the reason is infringement or product failure. Therefore, if the buyer is willing to consider the seller's proposed termination right, the buyer should require that the seller terminate only if the alternatives (i.e., repair, replacement, or third party licenses) are not possible.

The buyer should carefully consider the consequences of such a termination. If the seller has the right to terminate a particular product or service, the buyer should contract for the right to include related products or services that the buyer would not want to keep in the absence of the infringing item. Similarly, the buyer should be mindful of any rights or remedies that depend upon the buyer terminating the contract for breach. (For example, the buyer may be entitled to receive a refund of prepaid maintenance fees only if the maintenance agreement is terminated by the buyer for the seller's breach.) For purposes of such rights or remedies, the seller's termination of an infringing item should be treated as a termination by the buyer for the seller's breach.

In the next article, we will examine the contract terms that govern the procedures for responding to indemnifiable third party claims.

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