Indemnity Procedures and Liability in IT Contracts

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In our last article, we considered issues relating to the scope of an IT product and service seller's obligation to indemnify—specifically, types of covered losses and claims and special issues relating to indemnity for intellectual property infringement. In this article, we will look at the seller's obligation to defend against indemnifiable claims, the procedures for carrying out that defense, and the relationship between indemnity and contractual limits on liability.

This article focuses specifically on indemnification by the seller (where seller is the indemnitor and buyer is the indemnitee).

While indemnity and defense are typically addressed by a single section of the contract, the obligation to indemnify does not imply an obligation to defend. If the buyer wants the seller to defend against third-party claims, the contract should clearly state the seller's responsibility for defense.

In many contracts, the indemnitor's defense obligation applies to all claims against which it is required to indemnify and the indemnitee is required to yield control over the defense and settlement of all indemnified claims, but this approach may not be appropriate in all cases. For example, a governmental investigation of the indemnitee could have outcomes other than money damages—the investigation and resulting claims could lead to criminal penalties, increased oversight or director or officer liability.

Consequently, the indemnitee may prefer to retain full control over these types of claims. The indemnitee should carefully consider the types of claims covered by the indemnity and whether it is comfortable with the indemnitor conducting the defense in all cases.

The indemnitor will almost certainly object to assuming financial responsibility for a claim that it does not control. An arrangement where the indemnitee makes decisions about how to defend and settle the claim while the indemnitor writes the checks presents a moral hazard. Knowing that its defense and settlement costs are being borne by the indemnitor, the indemnitee may be encouraged to engage a more expensive legal team or pursue a riskier defense strategy than it would otherwise. For this reason, most indemnitors are unwilling to indemnify against claims when they do not control the defense of the claim.

When the indemnitor has the right to control the defense of a claim, the indemnitee should contract for a right to participate in the defense. The ability to participate gives the indemnitee a window into the progress of the defense, helping the indemnitee to make its own decisions about the likely outcome and to plan accordingly. In addition, the indemnitee can use its seat at the table to provide advice regarding the conduct of the defense (even if the indemnitor is not required to heed such advice).

While establishing the scope of the indemnitor's defense obligations, the indemnitee should carefully examine the interaction between indemnity and the contract's limits on liability. Most negotiated contracts for IT goods and services include a waiver of consequential and certain other types of damages, along with a cap on direct damages. The waiver of consequential damages should not apply to indemnification and defense obligations.

As described in our preceding article, the parties will have carefully negotiated what types of costs, expenses and damages are recoverable under the indemnification and defense section of the contract. The indemnitee's waiver of consequential damages for other kinds of contract claims should not be applied to upset the parties' mutual agreement about the scope of indemnifiable losses.

The situation is not so simple when it comes to the cap on damages. The indemnitee may prefer that the indemnitor own the liability for indemnified claims completely. But the indemnitee should be prepared to respond to an indemnitor that is unwilling to accept unlimited liability for indemnified claims. In some cases, the indemnitor's willingness to indemnify for certain types of claims will be conditioned upon a cap on its maximum liability for indemnification obligations.

In weighing the indemnitor's position, the indemnitee must consider whether the proposed cap is commensurate with the foreseeable liability and whether other avenues are available under the contract for recovering the kinds of losses covered by the indemnity.

The indemnitee should also beware the moral hazard described above that arises when one party conducts a defense without being responsible for its entire outcome. To protect itself, the indemnitee should contract for the right to control the defense and settlement of any claim that could result in damages, costs and expenses that exceed the cap on the indemnitor's liability.

In addition to establishing the scope of the indemnitor's defense obligations and associated limits on the indemnitor's liability, the contract will typically address key procedural points relating to the parties' responses to indemnified claims.

First, the indemnitor should require timely notice of claims that it is obligated to defend. The indemnitor cannot effectively respond to a claim of which it is not aware. The contract should include language excusing the indemnitor from its defense obligations to the extent its ability to defend the claim is harmed by the indemnitee's failure to give prompt notice.

However, prompt notice should not be a condition to the indemnitor's obligation to defend—otherwise, the indemnitee may completely forfeit its remedies due to a delay that had no real impact on the indemnitor's ability to defend the claim.

Second, many contracts require the indemnitee to cooperate with the indemnitor's defense so that the indemnitor will have access to evidence held in the indemnitee's files or by indemnitee personnel. The indemnitee will want to include language to clarify that such cooperation will be provided at the indemnitor's expense. The indemnitee may also wish to limit its cooperation only to what is reasonable and necessary to conduct the defense.

Third, the indemnitor will typically contract for the right to settle any claims that it is required to defend. Even if the indemnitor is generally entitled to settle claims, the indemnitee should impose a right to pre-approve any settlements that require more of the indemnitee than the payment of money by the indemnitor. For example, a settlement that requires the indemnitee to admit to wrongdoing may damage the indemnitee's brand or, depending upon the nature of the wrongdoing, expose the indemnitee to criminal liability.

Likewise, the indemnitor should object to paying damages, costs and expenses to which the indemnitee has agreed without the indemnitor's consent.

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