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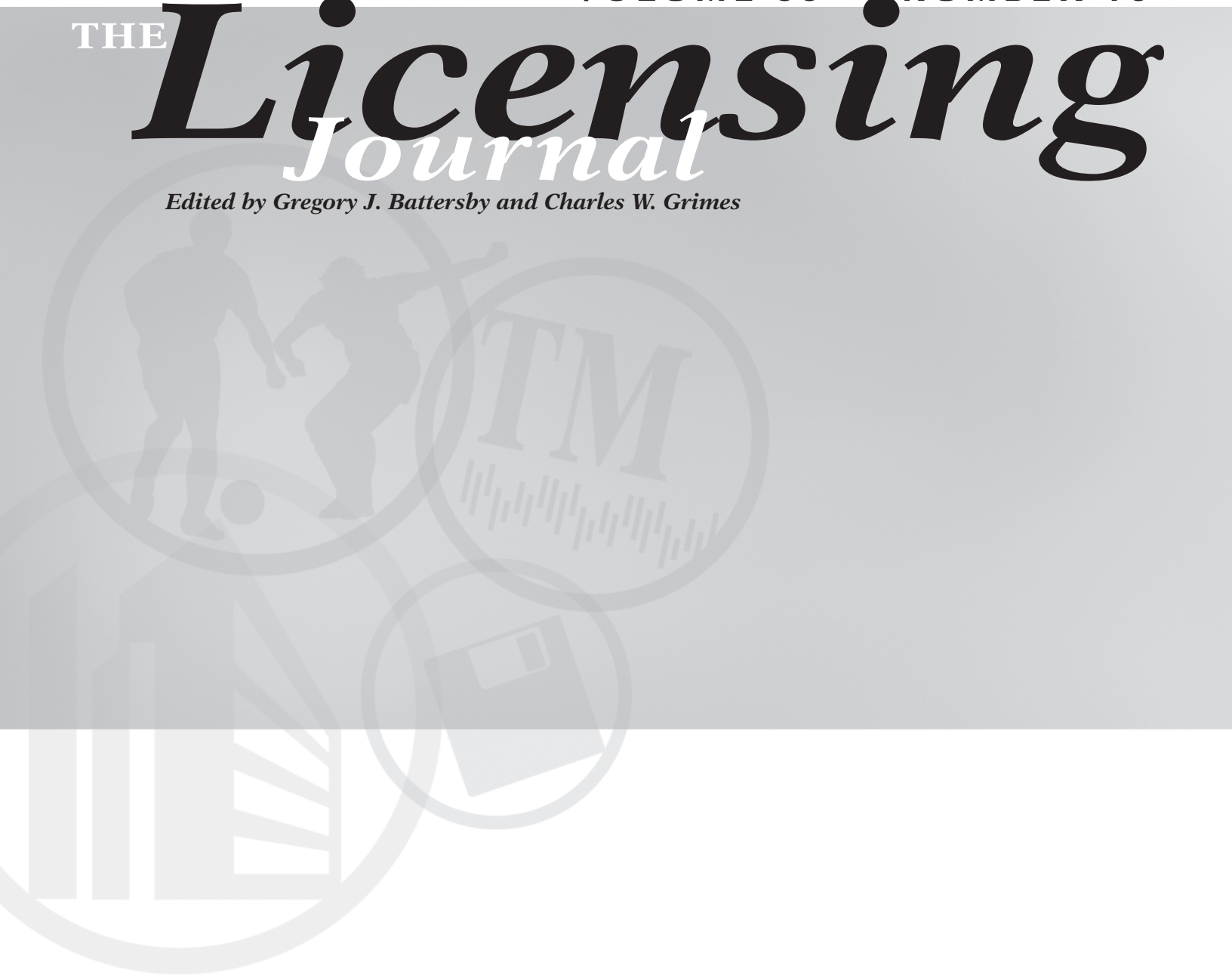

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Negotiating Software Contracts—Successfully Negotiating an Indemnification Section

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Indemnification is a very important provision in a software agreement. It transfers legal risk between contracting parties, and the indemnification provision acts like an insurance policy for future lawsuits where a contracting party is sued by a third-party to the contract. Because this provision is a risk transfer mechanism, it is crucial to understand it and to successfully negotiate it to prevent unwanted risk.

Before jumping into how to negotiate an indemnification provision, there are some basic definitions that need to be understood:

- An **Indemnitee** is a contracting party who is entitled to be indemnified.
- On the other hand, an **Indemnitor** promises to defend, indemnify, and hold harmless the Indemnitee against liability from a third person, or against loss resulting from liability.
- A **third-party** is a person or entity that is not a party to the original contact, but who sues one of the contracting parties.

So how does an indemnification provision operate? Typically, an indemnification provision is triggered when a third-party to the contract brings a claim against one of the contracting parties (*i.e.*, contracting party vs. third-party claimant). Very rarely is it triggered when there is a direct party claim (*i.e.*, contracting party vs. contracting party). At its core, an indemnification provision allows the party who is responsible for liability (the Indemnitee) to transfer his loss or liability to another party who will represent them in court (the Indemnitor), and pick up the litigation costs and liability from a third-party who brings a lawsuit against the Indemnitee.

One of the major pitfalls in negotiating an indemnification section is contained in the structure of the contract provision itself and the intent of the software licensor. Many contracts include boilerplate language, thus, contract negotiators must develop a systematic way to review the language and then develop a strategy to address the indemnification section for their side of the deal. To do this, the parties must first understand the risks involved with a particular software license and negotiate for the specific risk type.

The best way to put this into action is to review the indemnification section and put the language into a more concrete roadmap to negotiate the contract by asking the following questions: (1) What are the licensor's objectives in the indemnification section? (2) What are the licensee's objectives in the indemnification section? (3) What is a checklist of elements and questions that should be negotiated in an indemnification section? and (4) What is a general checklist of provisions that should be included in an indemnification section?

Licensor's Objectives in an Indemnification Section

The licensor's (software vendor) objective is to protect itself from any claims resulting from the licensee (business) from breaching the license grant. For example, if the licensee modifies the software contrary to the license grant, then the software vendor

may be exposed to third-party claims. The licensor often will seek indemnification from those types of claims through the indemnity clause called "IP Indemnity."

On the other hand, another objective of the licensor is to indemnify the least amount of loss or liability possible. For some contracts, and indemnification section will not exist for a licensor to indemnify, and for others it will be detailed and extensively negotiated. Usually, a licensor at the very minimum will indemnify for intellectual property infringement for its own liability.

The Licensee's Objectives in an Indemnification Section

Alternatively, the licensee is looking to be protected from third-party lawsuits for intellectual property infringement resulting from a situation where the licensor has intellectual property (typically software code) that infringes on the property of someone else (third-party claimant). In this scenario, the licensee also is infringing on the rights of the third party and can be sued for infringement. For this reason, the licensee would want to seek protections in the indemnification provision.

Questions That Should Be Asked When Negotiating Performance Warranties

Consider the following negotiation elements when drafting, negotiating, or entering into a contract with an indemnity provision:

1. *Applicability*—Who is indemnifying whom? Is the indemnification mutual or unilateral?
2. *Scope of Indemnity*—What is the scope of the indemnification? Will the Indemnitor indemnify/reimburse for losses, defend (a duty to provide a defense), or hold harmless (bar claims against the Indemnitee)?
3. *Nature of covered claims*—What risks of doing business under the contract are being indemnified, that is, inter-party claims based on breach of representation, warranty, or other contractual obligation, third party claims based on product liability, infringement, fraud, or negligence, governmental claims based on regulatory matters, or other specified claims, such as personal injury, property damage, economic loss, and attorney fees, and costs of defense?
4. *Exceptions*—Are there any exceptions to indemnification such as taking control of the claim? Or not causing the indemnifying circumstances such as not modifying code?
5. *Limitations*—Should there be a monetary limit on the extent of the indemnity? If so, the limitation should bear a reasonable commercial relationship to the contract. Is there a limitation as to the time a party can bring an indemnification claim (*i.e.*, within six months, one year, etc.)? Is there a limitation on the amount that can be recovered for an indemnified claim in the Limitation of Liability (*i.e.*, preferably a licensee will want an exclusion where the limitation of liability does not apply and damages are uncapped)? Or, does the contract include a provision requiring coverage of certain risks by insurance such that the indemnity is limited to the amount of the insurance coverage (*i.e.*, contractual liability insurance)?
6. *Procedure*—Does the indemnity provision specify procedural requirements for recovery, like submitting a claim within a certain time period, or follow certain procedures to submit a claim for Indemnitee? Is there a duty to mitigate any portion of the claim before submitting it to the Indemnitor?
7. *Exclusivity of remedies*—Do the terms of the contract determine whether the Indemnitor is obligated to reimburse the Indemnitee for a particular claim, and if so, when? Does the contract clearly express an intent to indemnify a party against its own negligence, and if so does it make sense under the circumstances?
8. *Review other corresponding provisions in the contract*—Does the indemnification provision harmonize with the warranty and limitation of liability section in the contract? Does the insurance section of the contract harmonize with the indemnity section? Are there enough insurance limits for this type of claim scenario for the licensor? Is the limitation of liability uncapped for intellectual property claims for the licensee?

Provisions That Should Be Included in a Typical Indemnification Section

- **Licensor Provisions:**
  - — Licensor will defend, indemnify, and hold harmless licensee for third party intellectual property infringement.

— Licensor will pay all costs and damages awarded.
— Conditions—Licensor's obligations for indemnification are conditioned on the following:
  i. Licensee notifying Licensor promptly in writing of such action
  ii. Licensee giving Licensor sole control of the defense or settlement thereof
  iii. Licensee cooperating with Licensor in such defense
— Exclusions—Licensor will have no liability if the following occurs:
  i. any use of the Software not in accordance with the Agreement
  ii. any modification of the Software made by any person other than Licensor
— Entire Liability—This is the entire liability of licensor and exclusive remedy.

- **Licensee Provisions:**
  — Licensor will defend, indemnify, and hold harmless licensee for third party intellectual property infringement.
  — If Licensee's continued use of the Software is restricted or prohibited as a result of any such infringement, Licensor shall, at Licensee's option and at no charge to Licensee:
    i. secure for Licensee the right to continue using the Software
    ii. modify or replace the infringing components of the Software so that they are non-infringing
    iii. refund to Licensee all amounts paid by Licensee for the Software
  — Exclusions—Licensor will not be obligated to indemnify Licensee to the extent of the infringement claim based upon
    (i) use of the Software in breach of this Agreement
    (ii) any modification of the Software made by Licensee (other than at Licensor's direction)
  — Defense of Third-Party Suits—Licensee will notify Licensor of third party suits promptly. If licensee tenders claim to Licensor, Licensor will have right and obligation to defend such claim. Once Licensor assumes defense of a Claim, it will be conclusively presumed that Licensor is obligated to indemnify Licensee. No settlement of a Claim will be binding on Licensee without Licensee's prior written consent

This Is Not an Exhaustive List of Provisions

Remember, an indemnification section is a specialized risk transfer section within a software contract. It is crucial to understand it and to successfully negotiate it to prevent unwanted risk. It is always important to seek advice from experienced legal counsel in order to understand all the risks involved when negotiating these types of provisions in a software contract.

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