Indemnity 101 – From the Perspective of Technology Contracts

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Faulk & Associates, LLC takes a practical approach to indemnity in technology agreements and provides this non-binding general guidance commentary. The key to indemnity provisions, which can be written broadly or narrowly, is to remember that good drafting upfront is essential to avoiding downstream risk. There are so many factors that can impact the indemnity under commercial agreements, making it crucial for the parties involved with understanding such provisions to give them due care and consideration. In a nutshell, these are not provisions to be overlooked, undervalued or worse, ignored.

Drafting, negotiating and interpreting indemnity provisions is not to be taken lightly. In general, it is extremely difficult to negotiate an indemnity clause for any agreement. Admittedly, it is even more challenging when negotiating an indemnification provision for information technology ("IT" or "technology") or technology-enabled agreements.

Historical Context on Indemnity

The historical origins of indemnity derive from legal theories of unjust enrichment and restitution. The basic notion of common law indemnity is fairness. Courts have long determined that it is unfair for a party to cause another party injury, harm, damage or otherwise (collectively, "Legal Injury") and be unjustly enriched by no obligation to compensate the party who suffered the Legal Injury by such party. Therefore, when a party is responsible for a Legal Injury suffered by another party, restitution and/or compensation equates to notions of justice and fairness for the party who suffered the Legal Injury. Indemnity provisions seek to provide a sage remedy on such grounds and can be viewed as separate insurance.

The parties to an agreement can agree to have indemnity for matters not covered by insurance (or even if there is insurance). Some indemnity provisions are written to indicate that the indemnity covers that which the indemnified party's insurance does not cover. In such instance, the indemnified party is well-served to confer with its insurance carrier when taking a company position on contractual indemnity obligations so as to avoid a conflict with its policies of insurance or incurring liability intended to be covered by insurance that may not be covered under such policies. It is equally important for a party to know the governing law state's position on indemnity. All fifty (50) states have anti-indemnity statutes and in some states, a party cannot be indemnified for its own negligence even if there is an expressed intent documented in an agreement to do so whereas in other states a court will uphold such indemnification if the contract contains a clear expression of an intention to so indemnify.

What is indemnity and what does it mean to be indemnified?

Some common definitions of indemnity follows:

- "A duty to make good any loss, damage, or liability incurred by another and the right of an injured party to claim reimbursement for its loss, damage or liability from a person who has such a duty." Black's Law Dictionary 772 7th Ed. (1999). Indemnity is oftentimes used synonymously with "hold harmless," which is "a contractual arrangement whereby one party assumes the liability inherent in a situation, thereby relieving the other party of the responsibility." Black's Law Dictionary 658 5th Ed. (1999).
- "A collateral contract or assurance, by which one person engages to secure another against an anticipated loss or to prevent him from being damnified by the legal consequences of an act or forbearance on the part of one of the parties or of some third person." See Civ. Code Cal.
- US Legal provides "indemnity means compensation in money or property for a loss suffered. It also means a contract to save another from the legal consequences of the conduct of one of the parties or of a third person. It is an agreement whereby one party agrees to secure another against an anticipated loss or damage. Indemnity is a right which insures to a person who, without active fault on his/her own part, has been compelled, by reason of some legal obligation (e.g., contractual), to pay damages occasioned by the initial negligence of another, and for which s/he himself is only secondarily liable. See Builders Supply Co. v. McCabe, 366 Pa. 322 (Pa. 1951)."

When does indemnity make sense?

Who should indemnify whom and for what? The scope of who will be indemnifying and indemnified should be clear in the indemnification provision along with what will be indemnified.

An indemnity makes sense where one party creates a risk that the other party will be sued and the suit is either very likely or would cost a lot to resolve. Therefore, a foreseeable risk exposure under the agreement should serve as a guiding principle. So, it is important to focus on risk and not just wrongdoing (e.g. willful/intentional misconduct versus negligence/gross negligence), as the latter is risk-based while the former is motivated by wrongdoing. The indemnity is about the risk created by the nature of the engagement. Indemnity may be applied by law in certain circumstances. However, with exceptions, the parties in a commercial setting are for the most part also pretty much free to negotiate

contractual indemnity and apportion the allocation of risks, including tort liability, regardless of fault, if unambiguously stated in the agreement.

Why should someone be indemnified?

Because a party believes that it needs to shift payment or liability of payment, in whole or in part, to another party.

So when does an indemnity clause belong in an IT agreement and when might you retreat or pushback?

Well, ask yourself, will the party seeking indemnity be at risk of facing lawsuits related to the reason it engages the other party (i.e. will the other party's performance obligations or activities under the agreement, subject the party seeking indemnity to lawsuits)? If yes, then an indemnity clause belongs in the IT agreement. Particularly, the parties should evaluate the types of risk exposure and apportion such risk proportionally. In this regard, indemnity serves to shift risks from the party-indemnitee to the party-indemnitor. This is why indemnification for potential claims alleging that a vendor's technology infringes a third party's patent or copyright or misappropriates any trade secret ("IP Infringement") are indemnities more commonly seen in most technology agreements (hereinafter, collectively "Vendor IP Infringement Indemnity"). Provisioning technology poses an inherent risk to the party procuring the technology. The well-known risk is that such party could face third party claims alleging IP Infringement when used by the party seeking indemnity.

Indemnity for IP Infringement shields the party indemnitee against very frequently and costly infringement related lawsuits and the vendor is in the best possible position to prevent and defend such claims. However, indemnity should not always be limited to just IP Infringement. Rather, IP Infringement indemnity should just be the easier indemnity to negotiate in IT agreements.

When should the vendor be entitled to indemnity from the customer?

It depends. The cloud has made this question more prevalent today. When the customer uses a vendor's technology for customer's business purposes and activities that create a risk of legal exposure that the vendor would not otherwise have except for how customer will use the vendor's technology, then it is certainly not unreasonable for the vendor to seek indemnity from the customer for certain liability risk exposure. In such case, the vendor should receive indemnity to protect against that known risk. For example, if the customer is a drug or medical device manufacturer and will use vendor's technology in the sale, promotion, supply or manufacture of a customer's product, it is reasonable for vendor to seek indemnification from customer for potentially related liability claims. However, the indemnity provided for the sale and promotion of customer's product may be a very different indemnity than that for the supply and manufacturer of customer's product using vendor's technology. The latter may be essentially linked to the production of the customer's product whereby if the production or vendor's equipment (which may or may not be enabled by technology) deviates from customer's instruction and the product is defective as a result thereof, then technology, including equipment-enabled by technology) may have a causal relationship to risk that gave rise to for example, a product liability claim. In this instance, an indemnity provided to the vendor against product liability claims would be ill-advised. On the other hand, technology utilized to sale or promote products (e.g. using vendor's platforms or websites created for customer, etc.) would unlikely have any nexus to the cause giving rise to a product liability

claim. In this regard, a product liability claim in which a vendor's technology was only used to facilitate the sale or promotion of the customer's product, indemnity against product liability claims is reasonable.

In most instances, a drug or device manufacturer customer or any customer involved in a high risk business, has the greatest ability to mitigate such risks by following relevant regulations governing its business operations (e.g. Good Manufacturing Practices, current Good Manufacturing Practices). Similarly, if a customer's business creates safety risks for vendor's employees or contractors visiting customers' premises then the vendor would be reasonable in its intent to be indemnified against the risk of injury posed to its employees by the nature of the customer's safety risks posed. For such high risk or dangerous conditions, the vendor will prudently seek indemnity to shift the risk of lawsuits from the vendor to the customer.

Mutual Indemnity Obligations in Technology and Technology-Enabled Agreements

Emphasis on Cloud Agreements

Technology and technology-enabled agreements inherently expose both parties to risk of security incidents and cyber liability. However, arguably cloud agreements pose a greater risk to the parties and so mutual indemnities are often sought. Mutual in this context is often deemed identical and frequently referred to as reciprocal indemnities that mirror each other. The trickiness with this approach is, are the parties' risk exposure and liability proportional making mutual [or reciprocal] indemnities in the context of cloud agreements, prudent? For example, if the parties simply mirror the indemnity provisions between them, have they allocated their risk proportionally? Some customers believe not while many cloud service providers believe otherwise. Most cloud service providers believe that they have taken on unnecessary risk, by even agreeing to a mutual [or reciprocal] indemnity for its customers using its cloud services. Some attorneys contemplate whether the risks are the same when drafting and negotiating indemnity provisions in cloud service agreements. Arguably, perhaps the risks are not the same. If the technology or technology-enabled vendor's cloud services could ultimately expose the customer's data accessed, uploaded, managed, stored and/or otherwise in the cloud environment creates the same risk exposure for the parties depends on the how, what and why. In instances where risks may arise out of both parties' businesses and involvement with a customer's data, the cloud may pose the greatest likelihood where both parties could be sued over what may be viewed as the other party's actions under the cloud agreement.

A cloud agreement is where mutual indemnity obligations seem to defy the old adage that "indemnity would be a poor fit." While mutual indemnity obligations may be a poor fit and difficult to negotiate, it is not impossible to negotiate. The difficulty is convincing the parties that perhaps the mutual [or reciprocal] indemnities should not mirror one another, but rather reflect the how, what and why of the risk as well as whether there may have been wrongdoing. But the risk assessment and root cause analysis of a perceived or actual Legal Injury in a cloud services agreement is the critical factor. Our approach is to evaluate each stage of the data points and craft indemnity provisions that mirror the parties' touchpoints with where the risk exposure occurs or is likely to occur and then provision indemnity accordingly versus simply mirroring the indemnity provision for the parties.

Cloud Agreements and Indemnity

It is essential for customers to get an indemnity from its cloud service providers ("CSPs") and perhaps where the customer can demonstrate a greater likelihood of a negative event resulting from the CSP's activities or actions than the customer's, an indemnity should be achievable. Many factors are evaluated in apportioning risks relating to the possibility or probability of data compromise arising with customers' engagement with CSPs. The tougher question is what aspect(s) of the engagement increases the customer's risk and similarly when is such risk determined as either not or less attributable to the CSP under the engagement?

Many CSPs believe that if its services involve a brief encounter with the data or if a security incident occurs, but is not caused by them, then any data compromise should be borne by and attributable to the customer; not the CSP. Many customers (and supported by their legal counsel), however, believe that the nature of the cloud service places equal or greater risk on the CSP such that the CSP should acknowledge this risk as the cost of doing business. To the contrary, the cloud business model dictates otherwise. Admittedly, these types of issue debates do make negotiating with CSPs more challenging, but again, not impossible. What some customers lack is what is deemed essential to an effective and crucial aspect of the negotiation – the customer's leadership's position on the risks associated with cloud services and the mitigation of those risks, which includes, but is not limited to such factors as insurance, indemnification, due diligence on the CSP, security and privacy protocols of both parties.

The Interplay of Insurance, Indemnity, and Joint and Several Liability

How do indemnity contracts affect the indemnitor's insurance carrier and how is the party-indemnitee protected under the indemnitor's insurance? These two questions make it important to give practical consideration to the nexus between insurance and contractual indemnity. A contractual indemnity obligation does not necessarily bind an indemnitor's professional liability carrier. Moreover, a contractual indemnity obligation can have unintended consequences and insurance implications that the party-indemnitor is well-served to take into consideration and the party-indemnitee should give immense forethought to whether and how it can bind the party-indemnitor's insurance carrier. For example, professional liability policies typically exclude coverage for "liability assumed by a contract," unless the insured would be liable even if a contract did not exist. In the context of a negligence tort, a failure to perform professional services in conformance with professional standards of care or industry standards, is a coverable event. As such, non-performance or poor performance if effectively covered in a scope of services, can be properly redressed in a breach of contract claim that is coverable by professional liability coverage while the contractual indemnity obligation is an added layer of protection. However, unlike general liability coverage that provides a defense to additional insureds under the policy, professional liability does not work the same way.

Since defense obligations are interpreted more broadly than indemnity obligations, it is extremely important to pay special attention to contract language that includes a duty to defend and the provision setting forth the duty to defend should be dissected and analyzed with extra care, including state specific case law interpretation. For example, in New Jersey, the Supreme Court and Appellate Division have held that a contract will not be construed to protect the indemnitee against its own negligence unless the indemnification is explicit and "unequivocal on the subject of the indemnitee's negligence."

When a CSP or any vendor is asked to be liable for damages caused by others and promises to defend at no cost to the party indemnitee (customer or client of a CSP), it is imperative for the party indemnitee to know that if such promises fall outside the vendor's coverage granted under its insurance policy, even if the vendor accepts such responsibility for damages, it does not mean the vendor's insurance policy will cover the vendor's promises. Again, the vendor's insurance coverage will likely only cover for vendor's damages to the extent caused by the vendor's negligence. It is far better for the party indemnitee to know what the vendor's insurance policy covers and either stay within the confines of such coverage or ascertain the vendor's solvency to cover any promises made that extend beyond the vendor's policy coverage and limits. In the end, getting indemnity commitments are only beneficial if they can withstand adverse conclusions from the indemnifying party's insurer and/or a court of law. A party indemnitee should insist on being named an additional insured under the indemnitor's policy to be covered by the indemnitor's insurance policy. Failure to do so, as commonly done under the erroneous belief that the party indemnitee is covered by such policy can expose the indemnitee to more harm (i.e. no insurance coverage for Indemnitee from indemnitor). Now, what if the CSP or vendor is financially unable to cover the party indemnitee's Legal Injury. Basically, the party indemnitee is screwed and will have to cover all costs out-of-pocket; its own pockets.

For more information or assistance negotiating commercial agreements, especially high risk technology, cloud services, outsourcing and data center agreements, contact our firm. We mitigate your risk and help you do your due diligence before and during the negotiation of such agreements.

Reference Sources

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