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## **Drafting Software Agreement Warranty, Limitation of Liability and Indemnification Provisions**

Negotiating Clauses That Protect Against Service Defects, Limit Potential Damages and Allocate Risk

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# Warranties

# Representations

- Definition - a statement of a present or past fact that induces a party to enter into the contract.
- Sample Representation: *“Provider represents that, as of the Effective Date, the Software is not the subject of a claim alleging infringement of any patents or copyrights of a third party.”*
- Consequences of False Misrepresentation:
  - Damages - the amount paid under the contract minus any benefits obtained, cost of cover, extra labor expenses, costs of equipment and maintenance, program conversion costs, etc.
  - If misrepresentation was intentional:
    - fraudulent misrepresentation claim
    - rescission
    - contractual limitations of liability voided.

# Covenants

- Definition – a pledge that something will be done or shall not be done during a period of time
- Sample Covenant – “*Provider will comply with all applicable laws, rules and regulations in the performance of its obligations under this Agreement.*”
- Types: express and implied
- Consequences of Breach of Covenant -
  - damages
  - injunctive relief
  - if breach of covenant is sufficiently material:
  - excuse the future performance of the non-breaching party

# Warranties

- Definition – a promise that certain existing or future material facts or condition are or will be true
- Types – Express and Implied
- Sample Warranty: *“Provider warrants that the Software does not infringe any patent or copyright of a third party.”*

## Consequences of a Breach of Warranty

- Subject to the remedies available under contract law:
- Damages
- Parties may contractually limit available remedies. For example:
  - Limit to return of goods and repayment
  - Limit to replacement of non-conforming goods and parts
  - Under the UCC, consequential damages may be excluded or limited (unless unconscionable or upon failure of essential purpose where there was an exclusive remedy)

## Examples of Express Warranties

- Software will operate according to functional specifications and current documentation
- Documentation accurately describes the functional and operational characteristics of software
- Software media will be free from defects
- Services will be rendered in a professional and workmanlike manner
- Software free from trap doors, viruses and other malware
- Any enhancements to the software will be compatible with existing
- Backward compatibility with prior versions
- Non-infringement, Title
- Violation of Law
- Use of open source software

# Implied Warranties

- Implied warranties are deemed made unless specifically disclaimed.
- UCC Implied Warranties:
  - Fitness for a Particular Purpose
  - Merchantability
  - Non-infringement
  - Title
  - Course of Dealing and Usage

Sample Disclaimer: *“EXCEPT FOR THE EXPRESS WARRANTIES IN THIS AGREEMENT, PROVIDER HEREBY DISCLAIMS ALL WARRANTIES, WHETHER EXPRESS, IMPLIED, STATUTORY OR OTHERWISE, INCLUDING ANY IMPLIED WARRANTY OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, TITLE, NON-INFRINGEMENT, OR ARISING FROM A PRIOR COURSE OF DEALING.”*

## Representations, Warranties and Covenants - Differences and Benefits

- Representations can give rise to tort of misrepresentation and therefore damages under tort law as can breach of the implied covenants of good faith and fair dealing
- Warranties are primarily governed by the UCC, so the law is well developed
- Breach of a covenant may give rise to injunctive relief (unlike a breach of a representation or warranty)
- Breach of warranty does not give rise to a right to void the contract (unlike a representation)

## What is the Burden of Proof?

- Representation – preponderance of the evidence
- Covenant – preponderance of the evidence
- Warranty – preponderance of the evidence
  - Note: a higher standard, clear and convincing, is required to prove that an express statement made by the seller was retracted prior to the deal and did not become the basis of the bargain

## Does a Breach of Warranty Increase the Amount of Damages?

- Probably not.
- A warranty is conclusively presumed to be material while the burden is on the party that is claiming the breach to show that a representation is material.
- If the contract breach must be a material breach, a breach of warranty may help buyer to prove a material breach has occurred, but it likely won't increase damages v. breach of a covenant because they are both subject to remedies under contract law.

## Does Breach of Warranty Give Rise to Consequential Damages in Addition to Direct Damages?

- Yes, unless consequential damages have been expressly excluded in the contract.

## Does Breach of Warranty Give Rise to an Implied Indemnification Claim?

- A warranty amounts to a promise to indemnify a promisee for any loss if the fact warranted proves untrue. See *Paccon Inc. v. US*, 399 F.2d 162.
- “Indemnity” means payment by way of compensation so the above could be read to mean “a promise to pay for any loss if the fact warranted proves untrue”.

# Issues for Cloud Agreements

- Software Warranty –
  - Scope (material failure – remedy – money back? v. any defect – remedy – repair or replace?)  
Note: warranties are supposed to be material
  - Length of Warranty – 90 days, 3 months or could it be material failure anytime during the subscription or cloud term?
  - Remedy – Money back? Repair or replace? Right to sue?

# Issues for Cloud Agreements

- Other Warranties

- Authorization
- Service Levels?
- Security – providing commercially reasonable protection
- Non-Infringement – knowledge?
- Compliance with law – name specific laws?
- Breach Notification / Electronic Discovery - Cooperation
- No Malicious Code / No Viruses
- Business Continuation / DR Plan
- Skilled workers, professional workmanlike manner (where there are consulting/professional services)

## Issues for Cloud Agreements

- Service Levels – what will be negotiated?
  - Response Time (v. Resolution Time)
  - Availability (service, network, servers, power)
  - Help Desk (Level 1 service)
  - Migration time (i.e. complete within X time)
  - Data Conversion (i.e. accuracy)
  - Reports and Reporting

# Issues for Cloud Agreements

- Remedies for Failure to Meet Service Levels
- Fix the Problem
- Service Credits –
  - what credits for what service levels?
  - Critical v. KPIs?
  - At-Risk Amount?
  - Weighting of the service levels?
  - Sole and exclusive remedy (v. remedy for specific occurrence v. material breach)?
  - Paid credits exceptions counted toward the cap on limitation of liability

# Indemnification

## Indemnification

- What is the purpose of it?
  - (1) provides a contract remedy to supplement other remedies, including any tort or common law remedies;
  - (2) can be used to shift the risks;
  - (3) allows for the recovery of reasonable attorneys fees, defense costs, investigation expenses, discovery costs and court costs.

## Scope of Indemnity — What is the difference between “defend customer, through final judgment or settlement” and “indemnify and hold them harmless”?

- What does “defend” mean?
- What does “indemnify” mean?
  - Payment by way of compensation
- When do the duties of defend and indemnify arise?
- What does “hold harmless” mean?
  - FL and CA - Holding the other party without any responsibility for damage or other liability arising out of the transaction involved.
  - IL – No distinction between defend and indemnify and hold harmless
  - PA, DE and NY – there is a difference but have yet to determine the precise nature of the distinction

- Different jurisdictions may have differences in their rules on these obligations
- Key differences between “defend” and “indemnify” are in scope and the points at which they trigger → the obligation to defend is broader (i.e. the duty to defend contingent on allegations of complaint v. the duty to indemnify triggering on final judgment or the actual loss).

## Indemnatee Duties – Good Faith etc.

- An indemnitee does not have a separate duty to defend itself to the indemnitor prior to, or absent, an assumption of the defense; however, it may have other duties
  - CA – good faith
  - PA – mitigate damages
  - IL and FL – duty to cooperate – indemnitee would carry the burden of proof to show that it did not breach this duty
  - DE and NY – they do not recognize breach of good faith claims (i.e. may be better jurisdictions for indemnitees)

## Indemnitee Duty to Notify

- If there is a duty to notify in the contract, CA, FL, IL, DE and NY require indemnitee to notify indemnitor of a claim, and if indemnitee breaches this duty, it waives its rights to defense and indemnity costs
- For PA, the failure to notify indemnitor is not fatal to the indemnitee's action for defense costs, but the indemnitee will have the burden of justifying the payment of damages or settlement by offering against indemnitor practically the same evidence that the 3<sup>rd</sup> party relied on to establish its case against the indemnitee in the first action, as well as reasonableness of settlement.
- In FL, IL, DE, NY and PA, if indemnitee notifies the indemnitor of a 3<sup>rd</sup> party claim and indemnitor refuses to defend, then in the indemnitee's subsequent action seeking defense or settlement costs, indemnitor may raise certain defenses such as untimely or improper notice or that the claim for which the indemnitee incurred defense costs wasn't contemplated under the contract.
- CA → a judgment against the indemnitee is conclusive as against indemnitor if indemnitee properly notified indemnitor of the 3<sup>rd</sup> party action.

## Drafting Tips

- Indemnitee should include “defend”, “indemnify” and hold harmless
- Indemnitor may wish to exclude the term “defend” but if it does, it needs to be clear that this duty will not arise under any circumstances (under the law) and indemnitee will only strictly be entitled to an indemnity and not defense costs, including any attorneys’ fees.
- NY and CA – without an exclusion of defense costs, an indemnitor under a duty to indemnify must pay such costs, including attorneys’ fees, as part of the total indemnity amount
- CA – In the absence of an express agreement to exclude a duty to defend, the term indemnity in and of itself not only includes the payment of defense costs, but the assumption of the defense itself by the indemnitor.
- If duty to indemnify only, indemnitor can narrow responsibility to a final judgment (in which case a court may exclude settlements made by the indemnitee). However, if indemnitee includes the term “loss”, this could include settlements.
- Use of the term “claim” has been interpreted more broadly than the term “suit”
- Best for indemnitor to provide a cut off for time period for indemnitee to provide notice (i.e. 30 days) or address whether it has been prejudiced by a delay in the notice.

# Scope of Indemnity

- Vendor should limit its indemnity liability by indemnifying only for third-party claims
- An indemnity for a direct claim essentially says that, if there is a breach, vendor is responsible for both the claim as well as any attorneys' fees and costs of purchaser with respect to the claim
- No indemnification obligation should be outside of the limitation on the type of damages or the cap if it is an indemnification for a claim by the purchaser that is directly against the vendor.

## Common Indemnities

- Violation of Law
- Breach of Confidentiality
  - Inadequacies in the physical and data security control systems
- For the above, an indemnification obligation for third-party claims are thought to be a better way to address the actual harm and limit the scope of the vendor's responsibility. In other words, a vendor can be responsible for third-party claims for violation of a statute or a failure to protect any nonpublic personal data, but will not be responsible or have less responsibility for the damages that the buyer itself might incur relating to a breach.

# Common Indemnities

- **Bodily Injury/Death**
  - Solves the problem of applying the state law of pure and modified contributory negligence type states because it identifies the responsibility.
  - Contractually though these indemnities can be drafted so that the party is only responsible for what occurs from its gross negligence or willful misconduct or it is responsible for its negligence but a sentence is added that (i) it will only apply if the other party is not contributing or (ii) the indemnifying party reserves all of its rights or remedies under the law with respect to contribution.

## Other Indemnities for Third-Party Claims

- vendor or subcontractor's breach of an agreement between vendor and that subcontractor;
- act or omissions of vendor in its capacity as an employer of a person;
- arising from or related to the inaccuracy, untruthfulness or breach by vendor of any of the representations, warranties or covenants related to (i) ability to perform, (ii) lawsuits to prevent performance; or (iii) fact that it won't stop performing services for any reason other than specifically provided (with provisions in agreement that termination occurs only after certain events).
- Government claims for regulatory fines/penalties

## IP Indemnity – Scope and Jurisdiction of the Indemnity Coverage

- Scope – copyrights and trade secrets – a vendor can limit its risk with respect to patent infringement and trademark infringement by doing a search, but for copyrights and trade secrets, there is no ability to search to discover issue.
- Jurisdiction – should be limited to same jurisdiction in which services are performed – In other words, if the services are limited to the US, then it should be limited to the US.

## IP Indemnity – are there separate third-party IP indemnities for third-party software?

- “are there” v. “should there be”
- Many vendors state that they are not responsible under the IP infringement provision for third-party supplied items
- Other vendors may not have IP indemnities for third-party software, but they do have separate warranties for third-party software.
- A vendor’s IP indemnity provision may say any “Services” without specifically calling out third-party software; however, this doesn’t mean that, for these vendors, a buyer will not try to call out third-party software when third-party software is a part of the service.

Example: Managed Services – Vendor often provides certain third-party software

## IP Indemnity – Risks Associated with Broader Coverage than Coverage Vendor has obtained

- Does the vendor have an indemnity from its own third-party software vendor that covers itself and its customers?
  - If yes, then no need to have them be separate
  - If no, then vendor will be responsible to its customer for third-party infringement claims for the software and may find itself exposed (e.g. it will need to pay for its customer's defense when its own defense is being handled by the third-party software vendor).
  - In this respect, vendor should be careful about indemnifying the customer for claims regarding the service itself (because it may not itself have coverage by the third-party vendor for its customers)

## IP Indemnity – Exceptions and Cross Indemnity

- Exceptions – Situations where vendor is no longer responsible for providing the customer with an indemnification
- Cross Indemnity – Situations where the Customer itself should now provide vendor with an indemnity
- Example: If Customer modifies the Software and the claim is related to this modification, then vendor should no longer have any indemnification obligation to the Customer. Further, the Customer should now have to indemnify the Vendor for any third-party claim made with respect to the modification made by the Customer.

## IP Indemnity – Exceptions

- Use by Customer of the service/software not in compliance with any vendor documents/materials
- Any information or materials that are not provided by the vendor
- Vendor acting in compliance with any Customer specifications
- A modification of any service/software by Customer (or its agents) provided that the third-party claim would not have arisen without the modification
- A combination of any service/software by Customer (or its agents) with products, services or materials not provided by the vendor (provided that the third-party claim would not have arisen without the combination)
- Use of any software other than the most current release
- Any IP right owned and licensed by the Customer other than what is provided by vendor
- Any grossly negligent or willful act or omission by or attributable to Customer.

## IP Indemnity – Cross Indemnity

- Customer will indemnify the vendor for any customer IP, specifications, modifications or combinations made by the customer.
  - Customers may request that its indemnity not apply to (i) any vendor modifications made to its IP except to the extent the modification is needed for vendor's performance of the services or the vendor use was known to customer prior to customer providing the IP or (ii) the vendor's use of the customer IP in combination of any materials not approved by customer.
- If Customer does not agree to a cross indemnity, the vendor may reserve its rights and remedies under the law with respect to claims against customer.

## Other Indemnity Issues Negotiated

- Effect of Notification Not being prompt → helps bolster indemnitor defense when it has refused to indemnify
- Scope of Control of Defense
  - Non-monetary settlements not adverse to the Indemnified Party (except vendor software use)
  - No judgments entered against Indemnified Party
  - No monetary settlements beyond cap amount of Indemnifying Party
  - Cooperation v. reasonable cooperation
  - The Indemnified Party's Right to Monitor
  - What happens in the case of an injunction? Repair, replace or modify (to substantially the same functionality) or terminate (reimbursement of prepaid fees, but the customer may request more – i.e. service fees)
  - What happens if the Indemnifying Party doesn't defend the third-party claim? Indemnitee may wish to expressly say that it has a right to recover if Indemnitor has not fulfilled its defense obligation.

# Limitations of Liability

# Limitations of Liability

- **Purpose:** Limits, defines or excludes damages arising from a party's breach of contract or other conduct in connection with an agreement
- Limitations of liability are generally enforceable, except in the case of willful misconduct (e.g., fraud).
- **Categories:**
  - Liability Cap
  - Exclusion of Damages

# Liability Cap

- Function: To limit a party's overall amount of monetary liability under the agreement.
- Limitations of liability agreed in a contract are generally enforceable unless unconscionable.
- Failure to include an express liability cap may subject a party to uncapped liability under an agreement.
- Typically varies depending on the value of the contract.
- Sample Liability Cap: *“Provider’s total liability in connection with this Agreement, whether in tort, contract, or otherwise, shall in no event exceed the greater of the total fees paid by Customer during the twelve (12) months preceding the event leading to liability, or \$\_\_.”*

## Liability Cap Carve-outs

- Parties may agree to an enhanced liability cap or to exclude certain types of damages from the liability cap.
  - Breaches of a party's confidentiality or data security obligations
  - Notification-related costs resulting from a security breach
  - Indemnities
  - Provider's IP infringement indemnity
  - Failure to comply with laws
  - Customer's payment obligations
  - Customer's breach of license
  - Breaches of Customer's confidentiality obligations
  - Gross negligence or willful misconduct of a party
  - Bodily injury, death or tangible property damage

## Liability Cap Carve-outs

(1) Losses resulting from a breach of Provider's data security obligations

*versus*

(2) Notification-related costs resulting from a security breach, including:

- preparation and mailing of legally required notifications
- establishment of call center
- public relations and other similar crisis management services;
- legal, forensic investigation and consulting fees
- consumer credit reporting services

# Liability Cap – Drafting Tips

- Common Customer Pitfalls:
- Including a one-sided liability cap
- Omitting critical carve-outs to the liability cap
- Cap is too narrow
  - Only fees actually paid by Customer
  - Only fees paid for the relevant Service
  - Time period too short
- Agreeing to cap liability to the extent of Provider's insurance coverage

# Exclusion of Damages

- Most parties agree to limit the types of damages that a party may recover under an agreement (typically, only “direct damages” are recoverable, except as otherwise provided).
- Sample provision:

*“In no event will either party be liable for any indirect, special, incidental, punitive or consequential damages of any kind, including lost profits in connection with this Agreement, regardless of the form of action, whether in contract, tort (including negligence), strict liability or otherwise, even if informed of the possibility of such damages.”*

# Type of Damages – Direct/General Damages

- **Direct Damages** – Losses that naturally and usually flow from the breach itself.
- **Examples of Direct Damages:**
  - Expenditures incurred before the breach occurred and in reliance on the contractual warranties
  - Cost of corrections
  - Lost Profits (may be direct or consequential, depending on circumstance)

# Type of Damages – Consequential Damages

- **Consequential Damages:** Losses that directly arise out of a contract breach, but are not ordinarily predictable
- Whether a particular loss constitutes a “direct damage” versus a “consequential damage” is a question of fact.
- Parties to a contract may generally agree to exclude consequential damages (unless such exclusion is unconscionable).
- Common examples (depending on the particular facts)
  - Lost profits from business interruption
  - Lost use
  - Notification related costs arising from security breach
  - Attorneys’ fees and other expenses
  - Third party claims (in some cases)
  - Government fines or penalties

# Type of Damages – Incidental Damages

- **Incidental Damages:** Any commercially reasonable charges, expenses or commissions incurred after the breach has occurred in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

## Enforceability Challenges

- No clear bright line test for separating direct damages from consequential damages.
- Due to the lack of clarity, the parties may pre-agree that certain types of damages will always constitute “direct damages”. For example:
  - Reasonable costs for recreating or reloading data that is lost or damages
  - Reasonable costs of implementing a workaround in respect of a failure to provide the services;
  - Reasonable costs of replacing lost or damages equipment, software or materials
  - Reasonable costs and expenses incurred to procure the services from another source.

## Limitation of Liability – Drafting Considerations

- Confusing Provisions – If a court finds that a limitation on liability provision is confusing to understand, it might strike it down
- Need to make sure they are clearly drafted
- Be careful when creating double caps  
Duty to Mitigate – “Each party has a duty to mitigate damages for which the other party is responsible.”

## Issues for Cloud Agreements

- Limitation on Liability Exceptions
  - Negotiation of breach of confidentiality provisions
    - Vendors are much more careful about their own responsibilities regarding this exception
  - Negotiation of abandonment of services and the failure on the part of vendor to perform
  - Specific Provisions
    - Double caps – 2 times or 3 times 12 months for breaches regarding customer data
    - Specific Types of Damages (i.e. cover type damages)

## Thank You

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