

## Updating Reps, Warranties, and Indemnification Provisions in Software and Cloud Computing Contracts

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# **Negotiating Representations, Warranties, and Indemnification Clauses in Technology Agreements**

Presented By:

Michael Overly & Steve Gold

# Overview

- Alarming Trends
- Impact of rapid technological change
- Representations and Warranties
- Indemnification Obligations
- Questions/Discussion

# Alarming Trends

- Where in the world is my data?
  - Frequently no controls whatsoever
  - (Impossible) compliance burden shifted to customer
- “Contract float”: SLAs, Service Description, Support Program
- New trend in liability
- Age of the as-is contract
- “Virtual Cloud Vendors” – Subcontractor Responsibility
- The non-negotiable agreement – NIST

# Technology adoption has accelerated

- Approximate time\* to reach one billion users:
  - Telephone > 100 years
  - Television ~ 50 years
  - Internet ~ 15 years
  - Smartphone < 10 years

\*according to various internet sources

# We can all agree that these things are NOT new:

- Big screen monitor
- Smart phone
- Music player
- Social network

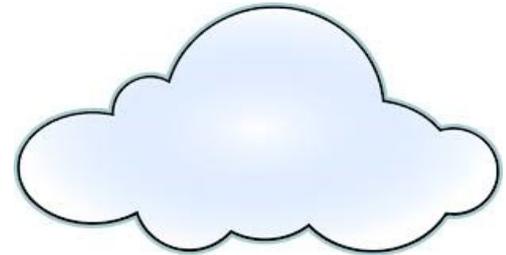


# Is your contract language from an earlier era?

- Viruses?
- Scope of software versus cloud services?
- Use of open source software?
- Modern security threats?

# Cloud computing dominating premises software

- Cloud computing supplementing and often replacing traditional IT infrastructure model
- Cloud has a very different business and legal model
  - Traditional model
    - Purchase computer equipment (cap ex)
    - License and/or develop software (cap ex)
    - Customize, implement software (op ex)
    - Ongoing support (op ex)
    - Update and revise
    - Outsource
  - Cloud model
    - Contract for standardized services remotely provided (op ex)

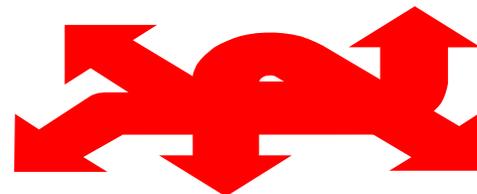


# Cloud computing advantages/drivers

- Reduced capital expenditure
- More flexible capacity planning and available scalability
- Quicker access to newer features reduced lock-in/inertia with prior versions
- Better economics for software firms
- Delegation of security/privacy risks
  - Security and privacy become contract terms rather than operational activities

# The cloud changes the legal character of IT

- Shift away from “IP license” arena to “service contract” arena
  - Software licensed for use within the enterprise, often captured as licensed intellectual property
  - Cloud may involve little to no IP being licensed, but services provided by third parties
- Simultaneous shift to a larger number of smaller contracts
  - Legacy IT contracts where very high value service arrangements (e.g. a large IT or business process outsourcing)
  - Cloud more commonly involves a larger number of much smaller service arrangements



# Warranties

- Avoid stock warranties of performance in accordance with the “published documentation”
  - “Published documentation” is a moving target over which the vendor has complete, unilateral control
- What does the warranty *really* cover?
  - Frequently overlooked issue
  - Make sure the warranties cover all of the following:
    - Licensed Software
    - Enhancements, releases, and new versions
    - Documentation
    - Hardware
    - Support and other professional services

# Warranties (cont'd.)

- What is the warranty period? What triggers the start? How long does it run?
  - Sixty days from initial delivery
  - Greater of one year from Acceptance or the period in which support is purchased
  - Cloud engagements
- Exclusive remedies should be avoided
  - Does the remedy even make sense?
  - Time period for fix
  - Tolling of other remedies, but no waiver

## Warranties (cont'd.)

Vendor Example: *In the event of a breach of the foregoing warranties, Customer's sole and exclusive remedy and Vendor's sole and exclusive liability shall be for Vendor to use reasonable efforts to repair or replace the defective software.*

Response: *In the event of a breach of [reference warranty of non-conformance], Customer shall afford Vendor [thirty days] to remedy the breach before pursuing any other remedies hereunder.*

# Warranties (cont'd.)

- Types of warranties
  - Performance (Specifications, Service Levels)
  - Intellectual Property Infringement – Why is this important if you have an indemnity?
  - Services
  - Legal compliance
  - Privacy Laws and Regulations
  - Viruses and Disabling and Phone-Home Mechanisms
  - Offshoring of data

# Warranties (cont'd.)

- Types of warranties
  - Open source/Third Party Software
  - Pass through of third party warranties
  - Known performance issues
  - Authority
  - Changes in functionality
  - Documentation

# Warranties (cont'd.)

## Performance Warranty

Vendor Example: *For a period of thirty days from the Effective Date, the Software will materially conform to its then current Documentation.*

Response: *For the greater of six months or the period during which Customer purchases Support Services, the Software will materially conform to the requirements of this Agreement, including any statements of work, and, to the extent not inconsistent with the foregoing, the Documentation.*

# Warranties (cont'd.)

## Infringement Warranty

Vendor Example: None.

*Response #1: The Software will not infringe the intellectual property rights of any third party.*

*Response #2: To the best of Vendor's knowledge as of the Effective Date, Customer's licensed use of the Software will not infringe the intellectual property rights of any third party.*

# Warranties (cont'd.)

## Service Warranty

Vendor Example: *The Services will be performed in material accordance with this Agreement.*

Response #1: *The Services will be performed in material accordance with this Agreement and in a timely, workmanlike manner.*

Response #2: *The Services will be performed in (i) material accordance with this Agreement , (ii) a timely, workmanlike manner , and (iii) in accordance with industry best practices for services of this kind.*

# Warranties (cont'd.)

## Legal Compliance Warranty

*Vendor Example: Vendor will comply with all laws and regulations applicable to its business in the performance of the Agreement.*

*Response: Vendor will comply and will ensure its Software and Services comply with all applicable laws and regulations. Vendor shall, at no additional charge, promptly furnish all updates to the Software necessary for compliance with any change in laws or regulation during the term of this Agreement.*

# Warranties (cont'd.)

## Legal Compliance Warranty

*Example general warranty: Vendor further represents and warrants it shall, in connection with its performance hereunder, comply with all applicable laws, ordinances, rules, regulations, building codes, electrical codes, business licenses, visas, work permits, court orders, and governmental or regulatory agency orders (collectively, “Laws”), including, without limitation, laws relating to non-discrimination, human rights, child labor, and other employment and labor laws and applicable foreign export laws, and laws pertaining to health, safety, the environment, and hazardous materials.*

# Warranties (cont'd.)

## Privacy Laws and Regulations

*Vendor represents and warrants that at all times during and after the term of the Agreement it will comply, at its sole expense, with all applicable local, state, federal, and international privacy, confidentiality, consumer protection, advertising, electronic mail, data security, data destruction, and other similar laws, rules, and regulations, whether in effect now or in the future, including, but not limited to the Gramm-Leach Bliley Act and its implementing regulations (all of the foregoing will be collectively referred to as the “Privacy and Security Requirements”). Vendor acknowledges that it alone is responsible for identifying, understanding, and complying with its obligations under the Privacy and Security Requirements as they apply to its performance of this Agreement and possession of the Personal Information.*

# Warranties (cont'd.)

## **Anti-Virus Warranty**

*Basic Version: Vendor shall use industry practices to scan and remove from the Software all viruses, Trojan horses, worms, key loggers, and other similar code.*

*Alternate: Vendor has taken every commercially reasonable precaution to ensure and to the best of Vendor's knowledge, the Software does not contain any virus or similar code that may destroy, modify, alter, or cause the destruction, modification or alteration, in whole or in part, of any of Customers, data, equipment, devices, networks, or software.*

# Warranties (cont'd.)

## **Anti-Virus Warranty**

*Extended Version: Vendor shall not insert into any Software any Destructive Mechanisms, as defined below, and shall use industry best practices to scan and remove any such mechanisms created by third parties from the Software. Vendor shall not invoke such mechanisms at any time, including upon expiration or termination of this Agreement for any reason.*

# Warranties (cont'd.)

## Anti-Virus Warranty

**“Destructive Mechanisms”** means computer code that: (i) is designed to disrupt, disable, harm, or otherwise impede in any manner, including aesthetic disruptions or distortions, the operation of the Software or any other software, firmware, hardware, computer system or network (sometimes referred to as “viruses” or “worms”); (ii) would disable or impair the Software or any other software, firmware, hardware, computer systems or networks in any way where such disablement or impairment is caused by the passage of time, exceeding an authorized number of copies, advancement to a particular date or other numeral (sometimes referred to as “time bombs,” “time locks” or “drop dead” devices); [ cont'd]

# Warranties (cont'd.)

## **Anti-Virus Warranty**

(iii) would permit Vendor to access the Software or any other software, firmware, hardware, computer systems or networks to cause such disablement or impairment (sometimes referred to as “traps,” “access codes” or “trap door” devices); or (iv) which contains any other similar harmful, malicious or hidden procedures, routines or mechanisms which would cause such programs to cease functioning or to damage or corrupt data, storage media, programs, equipment or communications or otherwise interfere with operations.

# Anti-virus is no longer the whole malware story: Unsupported and unpatched systems

- Lifecycle of a software flaw:
  - Faulty programming, oversight, or changed circumstances (or intentional espionage) creates a security vulnerability
  - Flaw discovered by testers, researchers, or threat actors (zero-day)
  - Preferred order of remediation steps:
    - Vendor becomes aware of the issue
    - Patch developed and made available
    - Flaw (and patch) cataloged and disclosed
  - Has the patch been applied? (n-day)
- Enhanced reporting and cataloging of security flaws
  - Assigned CVE number by US CERT of DHS (and others)
  - Vulnerabilities Equities Process
- High profile examples include: Equifax breach, "WannaCry" event



# If the fix was known, why the outbreaks?

- While there may be mere failures to update, often there are good reasons
- Some software that contains a vulnerable component is no longer updated by vendor
- Unsupported components are often required for compatibility with other systems
- In some installations, there aren't mechanisms to update, even if an update is available
- In some cases, software is on equipment not controlled and managed by IT professionals
- In some cases there is a lack of resources



# These issues not always covered by virus/malware warranty

- Typical software virus/malware warranties cover:
  - No malware present
  - No malware will be introduced
  - IT has appropriate procedures/measures in place
- These leave a gap:
  - Failure to address the capabilities of the underlying systems to be updated
  - Failure to address equipment outside of IT's purview
- Recommendation: new language

# Elements of a new warranty

- Define “Obsolete Software,” including anything with a known vulnerability (minimally including a defined list)
- Define “Critical Update” – any change needed to correct obsolete software
- Broadly scope IT systems
- Assure that:
  - Systems aren’t dependent on Obsolete Software
  - Updates have been applied
  - Systems have the means to receive updates

# Warranties (cont'd.)

## **Offshoring of Data**

Example: all Services shall be performed and rendered within the continental United States; and Vendor shall not transmit or make available any Customer Confidential Information, including Personal Data, to any entity or individual outside the continental United States.

# Warranties (cont'd.)

## **Open Source and Third Party Software**

*Example: Vendor represents and warrants that it shall not deliver to Customer any third party software, including open source software, that would require Customer to accept and be bound by any third party terms and conditions, except to the extent such terms and conditions are expressly identified in and attached to Exhibit A. Except as provided in Exhibit A, Customer hereby rejects all such third party terms and conditions.*

# The bar has been raised on open source warranties

- Early open source reps were unsophisticated
  - A rep that the company doesn't use open source, except as provided on a list
  - Didn't distinguish between permissive and copyleft license terms
  - Didn't capture the process and compliance program
- Massive uptake within corporate IT
  - Free and high quality
  - Affects all businesses, including those not in the software business
    - Customer mobile apps
    - Integration of cloud systems
  - Not unusual to find hundreds or thousands of open source components in an audit

# Distinguish open source models

- Permissive model
  - Simple license terms: notice, attribution, disclaimer
  - Permit closing the source
- “Businesslike” model
  - Look like corporate licenses
  - Often require some source disclosure
- Copyleft model
  - Free software philosophy: “Free as in free speech”
  - “Viral” requirements to provide source
  - Applied differently depending on
    - Use? Distribution? Modification?

# Warranties (cont'd.)

## **Pass-Through Warranties**

*Example: Vendor shall assign and pass-through to Customer all representations, warranties, and indemnities provided to Vendor in its contracts with third party licensors and suppliers relating to the Software.*

# Warranties (cont'd.)

## **Known Performance Issues**

Example: There is no existing pattern or repetition of customer complaints regarding the Software, including functionality or performance issues, and that Vendor's engineers have not currently identified any repeating adverse impact on the Software, including functionality or performance, for which the root cause is believed to be a flaw or defect in the Software.

# Warranties (cont'd.)

## Authority

*Example: Vendor has the full power, capacity and authority to enter into and perform this Agreement and to make the grant of rights contained herein, including without limitation, the right to license any ancillary or third party programs licensed to Customer under this Agreement, and Vendor's performance of this Agreement does not violate or conflict with any agreement to which Vendor is a party; Vendor further represents that there is no pending or threatened litigation that would have a material adverse impact on its performance under this Agreement.*

# Warranties (cont'd.)

## Changes in Functionality

*Example: Vendor shall not modify or change the Software to reflect a material diminution in the form, features or functionality of the Software from that existing as of the Effective Date, and, accordingly, Vendor shall not change the form, features or functionality of the Software in any material adverse manner from that originally licensed under this Agreement.*

# Warranties (cont'd.)

## Documentation

*Example: The Documentation shall be complete and accurate so as to enable a reasonably skilled Customer user to effectively use all of its features and functions without assistance from Vendor and, on each date on which Vendor delivers it to Customer, the Documentation is Vendor's most current version thereof.*

# Warranties (cont'd.)

- Be mindful of broad disclaimers that could override specific warranties (“as-is”; no liability for errors; not interrupted or error-free)
- Beware of extensive customer warranties
- Disclaim all other warranties of the customer
  - Where appropriate, disclaim representations, warranties, and guarantees as to vendor revenue (e.g., in processing or other transaction agreements)

# Indemnification - a definition

**Indemnification** \in-dem-nŏ-fŏ-kã-shŏn\ n

- 1) The action of securing against hurt, loss or damage
- 2) The action of making compensation for incurred hurt, loss or damage
- 3) The condition of being indemnified

*syn* see PAY

**Source: Webster's**

# The more common definition

**Indemnification** \in-dem-nŏ-fŏ-kã-shŏn\ n

- 1) that legal stuff at the back of the contract that nobody ever reads
- 2) Something completely unintelligible and completely irrelevant to my business deal
- 3) Something that gets in the way of signing the deal

*syn* see PAIN

**Source: Many executives**

# Indemnities – What is an indemnity?

- An indemnity clause is a **contract** – a contractual transfer of risk between two contractual parties – often subject to intense negotiation.
- Wording should be customized to fit the specific deal requirements.
- Indemnity language allocates risk as between the indemnifying party and the indemnified party.
- Indemnity language in any agreement should be as unambiguous and explicit as possible.
- Assess the financial strength of the indemnifying party – is a guarantee from a related party (or other financial support) required?

# Most common: IP indemnity

- Vendor commitment to protect the licensee against intellectual property claims
- Scope issues
  - Types of IP covered
  - Geography
  - Exclusions
    - Licensee requirements
    - Licensee modifications
    - Combination
    - Unauthorized/out of license scope use

# Most common: IP indemnity (continued)

- Defense
- Alternate/additional remedies
  - Repair or replace
  - Obtain license
  - Refund
  - Terminate
- Interplay with limit of liability

# Elements of indemnity clauses: Who does the indemnity apply to?

- Only the contracting parties?
- Should it extend to the relevant party's directors, officers, agents, subcontractors and affiliates as well?
- Is an extension of the indemnity to customers, end users, successors or assigns too broad in scope – exposing the indemnifying party to unforeseeable risk?
- It all depends on the circumstances of the contract and which party is in the best position to insure against the risk.

# Elements of indemnity clauses: The scope of the damages indemnified

- Claims, demands or suits not yet proven, settled or decided;
- Damages awarded by a court of competent jurisdiction;
- Damages awarded by an arbitrator or agreed upon pursuant to a mediation settlement;
- Only final damages, where appeal has been exhausted?
- Only damages related to third party claims?
- Losses and damages of the indemnified party, which may or may not include indirect damages;
- Expenses and costs, including legal fees, etc.; and/or
- Fines or penalties.

# Elements of indemnity clauses: How is the indemnity triggered?

- Indemnifying party wants: (i) adequate notice of claim; (ii) ability to conduct and control any settlement or defence; and (iii) assistance from the indemnified party.
- An indemnity for a claim of infringement of a third party's rights could also provide that the indemnifying party will: (i) modify the infringing material to make it non-infringing; (ii) replace the infringing material; or (iii) obtain the right to use the infringing material.
- Indemnifying party will generally ask: (i) that the indemnified party and all users cease using, remove, return or destroy the infringing material; or (ii) for the ability to terminate the license for the infringing material (and possibly the entire agreement).

# Limitations of liability

- Limitations and exclusions of liability are a significant part of the overall allocation of risks between the parties.
- Based on case law and long standing practice, provisions are often broken down into: (i) exclusions of liability, with respect to certain types of damages and causes of action; and (ii) limitations on liability where a prescribed type of liability, such as direct damages, is accepted by the parties, often with certain limits or caps with respect to such liability.
- Exceptions to the limitation of liability provisions may exclude any indemnities in the agreement. It is best to identify the indemnities contained in the agreement and analyze which may (or may not) be appropriate for exclusion.

# Limitations of liability (continued)

- Traditional model
  - Cap on direct damages
  - Exclusion (i.e. cap at zero) of consequential damages, etc.
  - Exceptions from both
- Evolving models
  - Questioning the exceptions
  - Supercaps
- Key areas of concern
  - Intellectual property
  - Privacy/security
  - Compliance with law

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