

Software Licenses and Indemnities: What Obligations Are You Taking On?

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License agreements often contain indemnities. An indemnity is a contractual obligation to step in and reimburse some financial obligation such as a liability, loss, or damage. In essence, the party giving the indemnity will make the injured party “whole” by recompensing losses and expenses.

The court in *Coastal Contacts Inc. v. Elastic Path Software Inc.*, 2013 BCSC 133 reviewed the meaning and scope of an indemnity for intellectual property infringement, which is a common clause in many intellectual property (IP) license agreements. This is what’s known as an IP indemnity clause. Coastal Contacts was an online retailer of eyeglasses. Elastic Path sold software for running e-commerce websites. The two companies entered into a Software Licensing Agreement allowing Coastal to use the Elastic Path software in Coastal’s eyewear business.

One of the clauses in the Agreement was an IP indemnity which required Elastic Path to defend any claims made against Coastal based on allegations that Elastic Path’s software infringed any patent and compensate Coastal in the event of any damages or losses.

Coastal was sued for alleged patent infringement in the U.S. based on Elastic Path’s software. Coastal in turn sued Elastic Path to bring it into the patent infringement lawsuit, after Elastic Path refused to defend. Eventually, Coastal made a \$200,000 settlement payment to the patent holder.

After the third-party patent infringement case settled, the dispute between Coastal and Elastic Path ultimately wound up in court to decide the question of Elastic Path’s obligations under the IP indemnity. Elastic Path had refused to defend and indemnify Coastal. Was Elastic Path entitled to refuse to defend the patent infringement claim, or was it wrong to refuse? A second twist to this case was a mandatory arbitration clause which was triggered when Elastic Path referred the dispute over its indemnity obligations to binding arbitration.

Elastic Path’s contractual obligations were two-fold. There was an obligation to defend and an obligation to indemnify. The clause stated: “Elastic Path shall defend or settle any claim made or any suit or proceeding brought against Licensee insofar as such claim, suit or proceeding is based on an allegation that any of the software supplied to Licensee pursuant to this Agreement infringes (directly or indirectly) any patent [...] Elastic Path shall indemnify and hold Licensee harmless from and against any and all such claims and shall pay all damages and costs finally awarded or settlement agreed to be paid in the settlement of such claim, suit or proceeding.” [Emphasis added.]

However, there were some conditions attached: “...Licensee shall notify Elastic Path in writing promptly after the claim, suit or proceeding is known to Licensee and shall give Elastic Path information and such assistance as is reasonable in the circumstances, at Elastic Path’s expense. Elastic Path shall have sole authority to defend or settle the same at Elastic Path’s expense.” [Emphasis added.] Elastic Path claimed that Coastal failed to satisfy these conditions since it did not provide prompt notice of the claim, and it did not cede control of the litigation to Elastic Path. Then Elastic Path relied on a favourable arbitrator’s decision to refuse any payment to Coastal. The arbitrator has decided in favour of Elastic Path by saying it was “highly unlikely” that the software directly infringed the U.S. patent. He based his decision on a balance of probabilities analysis that the software was unlikely to have infringed the U.S. patent.

In the end, the court sided with Coastal: Elastic Path's duty to defend the patent infringement lawsuit depended on whether there was a "mere possibility" that Elastic Path's software could have infringed the U.S. patent. The arbitrator applied the wrong test, since he essentially judged the merits of the infringement claim, and concluded it was highly unlikely that the infringement claim would succeed.

In coming to its conclusion that Elastic Path was on the hook for the \$200,000 settlement payment made by Coastal, the court quoted an insurance decision, saying "...an insured who is entitled to indemnity for damages or costs is entitled to make a reasonable settlement and to recover the amount so paid where the insurer denies its liability under the policy, even though the liability of the insured to the claimant has not been determined by judgment."

This analysis in the Coastal v. Elastic Path decision shows that courts will treat an IP indemnity clause like a type of insurance policy. A software vendor, by providing such an indemnity in favour of its customers, is essentially taking on the role of an insurer, bound to provide coverage against this risk. In this case, the risk is that of a third-party patent infringement lawsuit. Here are some points to consider:

- Software vendors should review these clauses carefully. IP indemnities are often considered "boilerplate" (a term which many interpret as "I don't have to read it..."). However, the implications are important, as illustrated by this case. If you are a software vendor, ensure that you understand the obligations that you are taking on.
- Remember that under the clause in this case, the indemnity obligation was triggered by a "mere possibility" of infringement. The merits of the infringement claim are not weighed at the stage of determining whether the defense and indemnity obligation is triggered. The obligation has a very low threshold.
- Licensees should also review the IP indemnity clause in their license agreements. In some cases, such as exclusive technology licenses, it is common for licensees to take on certain IP indemnity obligations, since they have control over the use of the technology in the marketplace.
- In the event of a claim that triggers the indemnity clause, review the indemnity clause immediately to ensure that you are taking the appropriate steps described in that clause – for example, some clauses require notice of the claim to be given within a certain number of days.

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