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Information contained in this newsletter is current as at January 2005

Volume 1 Number 10

Print Post Approved 255003/00769

to be frank ...

by **Frank Adoranti** CORPORATE LEGAL EDUCATION & DEVELOPMENT

Unlocking the mysteries of indemnity clauses

An indemnity is a contractual commitment by a party to make good a specified loss suffered by the other party. In other words, it is an acknowledgment and promise by one party to cover the potential liability of another.

A key feature of an indemnity is that the obligation created by it can often extend *beyond* that which would otherwise be imposed on a party under the general law; that is the liability under an indemnity is not necessarily limited by the dollar value of the contract under which it was given.

The very concept of an indemnity involves making the injured party whole again, as if the loss had not occurred, even if the person who agrees to indemnify would not otherwise have had any obligation to do so.

In contracts the typical reasons for indemnities are:

- transferring or reversing liability from one party to a contract to another; and
- confirming and reinforcing existing liability.

Purpose of an indemnity

The purpose of an indemnity clause in a contract is to protect a party from the effects of an action, non-performance, negligence or wrongdoing of another.

Essentially, it amounts to a promise to keep another party to the contract free from harm *to* the extent specified by the wording of the indemnity clause. This is often why indemnity clauses can become such long winded arrangements.

The consequences can be far reaching and serious for any business not exercising due care in the indemnities it provides. Quite literally, ill considered indemnities could lead to financial ruin.

Difference between warranties and indemnities

A warranty is an assurance or promise in a contract. It usually relates to assurances about past or present facts in the transaction which is the subject of the contract.

The purpose of a warranty is to give its recipient the right to sue for damages if such assurance later proves untrue or inaccurate.

The breach of a warranty gives rise to a claim for damages. Such damages, if awarded, are subject to the common law rules relating to the assessment of damages. For example, damages will be subject to the test of remoteness, the duty to mitigate the loss and so on.

The ultimate effect of such common law rules is that the recipient of the warranty may recover substantially less than all losses connected with the breach.

A properly worded and well worded indemnity, instead, can make the *entire* loss recoverable.

Other issues to consider

Indemnities are an important and complex area of contracts. The extent of the problems created by indemnities tends to be magnified when grappling with the issue of consequential loss and damage.

Indemnities are not always simply black or white issues. The issue is not always confined to 'Do I provide an indemnity or not?'.

Indemnities can be qualified by certain exceptions and exclusions. With careful evaluation, subtle changes can often create significant effects in reducing or minimising liability. You should exercise great caution here, as the converse can also apply.

In considering any indemnity provision, it is important to pay close attention to the substance of the party with whom you are contracting. Having a clause to 'protect' you is not sufficient if the other party has no means to satisfy any potential future claim.

Remember that it is not the clause itself that protects you, but the standing and substance behind the entity providing it — so the best worded indemnity clause in the world may be useless when the time comes to enforce it against an organisation with no means or substance behind it.

Consequential loss

Consequential loss provisions extend the (already potentially problematic) liability created by indemnities even further.

It can be argued that consequential loss clauses are not normal or reasonable commercial terms.

By their very nature, consequential losses are uncertain and difficult to quantify. The argument against the use of a consequential loss clause is that it allows the category of damages that can be claimed to be unfairly broadened and extends liability beyond the normal commercial realm.

Consequential loss clauses involve the acceptance of responsibility for risks that are not foreseeable and not within the ordinary knowledge of the party being required to provide such protection. Indeed, in some circumstances the risks can even extend to include the losses of persons who are not parties to the agreement!

Many organisations will have a firm policy against the acceptance of consequential loss clauses in commercial contracts. This is a wise move to prevent the unintentional or inadvertent acceptance of such clauses.

Conclusion

When used correctly and prudently, indemnities can be an extremely powerful risk transfer tool.

On the other hand, they can have far reaching and devastating effects when misunderstood or blindly accepted. Their impact is not necessarily limited to the dollar value of the contract, or even to the length of the contract term, so the potential liability can be ongoing and perhaps unlimited in scope (in the absence of careful qualifications and exceptions).

The general 'plain English' principle to be applied in indemnities is:

- if *we* mess up, *we* are responsible for the direct consequences;
- if *you* mess up, *you* are responsible for the direct consequences;
- if someone under *our* control is to blame, *we* are responsible;
- if we *share* the blame, then we *share* responsibility to the extent that we are each to blame; and
- if someone *not* under our control is to blame, we are *not* responsible.

Anyone involved in the review or acceptance of commercial contracts owes it to themselves and to their employer to have an understanding of the fundamentals of indemnity clauses. ●

Frank Adoranti,
Corporate Legal Education and Development,
<www.cled.biz>, <info@cled.biz>.