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Contract Indemnities – why the fuss?

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Indemnities are regularly used in contracts in order to allocate risk between contracting parties.

An indemnity is an agreement to cover loss and damage suffered by another party.

Indemnities give rise to a form of contingent liability, the magnitude of which is often not possible to quantify with any certainty at the time a contract is entered into. It is therefore common for a party from which indemnity is sought to object to it.

The existing position and under statute

The nature of any loss or damage that is recoverable in connection with a contract varies depending on the subject matter of the contract. Often a contract gives rise to loss or damage from breach of the contract, property damage or personal injury.

Common law and statutory rights of recovery for loss or damage can be extensive. However, there are some limitations on the type of loss or damage that is recoverable. For example, damages may not be recoverable from a party in respect of a breach of contract if they are too remote.

A party's contractual liability may also be reduced to the extent that a concurrent wrongdoer is also liable for the loss or damage and proportionate liability legislation applies.

A party who suffers a loss may need to take steps to mitigate their loss. If they do not, their contractual rights of recovery may be impacted.

Statutory limitation periods also bring to an end causes of action to recover loss.

Indemnities alter the existing position under common law and statute.

Remoteness of Damage

Liability under an indemnity may extend to cover loss or damage that is not ordinarily recoverable for breach of contract. Loss or damage which does not usually flow from a breach of contract, or which was not contemplated by the parties at the time the contract was entered, may be recoverable under an indemnity. This will depend on the wording of the indemnity.

Extending the limitation period

The statutory limitation period that would ordinarily apply in respect of cause of action can be extended under an indemnity.

For example, the statutory limitation period for a breach of contract is six years and begins to run from the time of the breach. If there is an indemnity under which the party who breaches the contract is obliged to indemnify the other party for losses incurred as a result of the breach, the rights of that other party under the indemnity will continue for as long as the indemnity remains in force.

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If the party in breach refuses to honour its obligations under the indemnity, there will be a cause of action for breach of the obligation to indemnify. The limitation period will begin to run from the time of the refusal to indemnify, which may occur long after the original breach of contract.

No obligation to mitigate

Ordinarily a party to a contract has an obligation to mitigate any loss suffered as a result of a breach of contract. However, this obligation is unlikely to apply to a party claiming under an indemnity (unless the indemnity expressly requires them to mitigate losses).

This is because the obligation to mitigate arises in respect of damages following a breach of contract. In the case of an indemnity, the relevant breach of contract will be the refusal to indemnify, rather than the event giving rise to the right to claim under the indemnity in the first place. In this context, it could be said that a party with a claim for breach of an indemnity cannot be expected to mitigate its loss, where that loss represents the very amount for which it should be indemnified.

Objections to Indemnity

Some of the more common objections include that it is not commercially reasonable for the party from which indemnity is sought to be required to:

- accept responsibility for events over which it has no effective means of control or in respect of which it is unable to obtain insurance;
- agree that its liability is to be determined other than by reference to the common law damages rules developed by the courts; or
- effectively act as the other party's insurer.

The ultimate position negotiated by the parties will turn on a range of factors including a party's appetite for risk. The outcome will often be a simple reflection of the relative bargaining power of the parties.

Where it is determined to entertain an indemnity, a number of mechanisms can be employed to try to dilute its effect. These include:

- limiting the indemnity to "direct" or "reasonably foreseeable" loss and damage;
- avoiding the use of phrases such as "arising from or in connection with", "arising directly or indirectly in relation to";
- requiring the indemnified party to take reasonable steps to mitigate its loss;
- limiting the indemnity to "reasonable" costs and expenses incurred by the indemnified party (as opposed to "indemnity" costs); and
- restricting the indemnity to a particular type of loss, eg. loss in relation to damage to property or injury to people.

Conclusion

Properly used, indemnities can help provide increased certainty to contracting parties. They can be a useful device to shift liability to the party best placed to manage a particular risk and can also help to simplify recovery.

On the other hand, if not used with care, indemnities can produce unintended and sometimes costly outcomes.

Either way, maintaining a clear and consistent approach to indemnities, and promoting awareness of their nature and effect, is an important component of any organisation's risk management program.

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