

Negotiating indemnity clauses

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A contractual indemnity is a requirement that one person must pay certain costs, losses and expenses of another. This is a seemingly simple concept, but one that should be carefully considered. This article outlines some key issues for negotiating indemnity clauses.

Indemnities vs warranties

The starting point is to understand the difference between indemnities and warranties, as the two are often discussed together. While there is some overlap, there are key differences:

- A warranty is a statement of fact, or an assurance (for example, a warranty that the seller owns the goods that are being sold). A breach of a warranty is a breach of the contract, and the wronged party may be able to sue for damages.
- An indemnity is simply a requirement to reimburse the wronged party for specified loss (which may or may not arise from a breach of contract).
- Liability for breach of a warranty will generally be limited to the damages available for breach of contract, which is to put the wronged party in the same position as if the warranty had been observed. This is subject to contract law rules of remoteness (damages will be limited to losses “reasonably foreseeable”) and mitigation (whether the wronged party took reasonable steps to mitigate loss).
- Liability under an indemnity is not necessarily limited by remoteness or mitigation requirement, and may impose essentially unlimited liability on the indemnifier, though it will always depend on the specific terms of the indemnity.

Therefore, the additional burden of indemnities over warranties (to the party giving the indemnity) are:

- Indemnities usually seek to extend liability beyond mere breach of contract. Notably, they often seek to make the indemnifier liable for the legal costs and expenses of the wronged party that are not otherwise fully recoverable.
- Indemnities will typically be enforceable as a debt rather than a breach of contract, which means that the indemnified party does not necessarily need to prove breach of contract, or any “wrongdoing” by the indemnifying party.

Indemnities can be used together with warranties, for example an indemnity for any loss arising from breach of contract. Depending on the wording, an indemnity may do little more than duplicate an existing warranty, but typically the aim is to extend liability and provide additional benefits or protection to the indemnified party.

In any case, an indemnity (or warranty) will only be as ‘valuable’ as the party providing it.

Types of indemnities

With limited exceptions, parties are free to negotiate any indemnities they wish. They can range from simple blanket indemnification to detailed provisions tailored to specific requirements. While each indemnity will be interpreted based on its specific wording (according to standard contract law principles), there are some common situations:

- A blanket indemnity against losses arising from use of a supplied product or service;
- An indemnity against losses arising from a breach of the contract by a party, including the requirement to pay the wronged party’s legal costs and expenses;
- An indemnity for claims by third-parties;

- Intellectual property indemnities (e.g. an indemnity that the supplied IP does not infringe any other person's rights).

Indemnities can also have provisions limiting the scope or amount of the indemnity.

When are indemnities appropriate?

As a simple commercial principle, it is generally in a party's interest to obtain any indemnities that they can, and avoid giving any indemnities. In reality, this is not always feasible and one party often seeks an indemnity from the other which cannot simply be rejected. This requires an assessment of the proposed indemnity.

Indemnities are a classic "allocation of risk" exercise: a party being asked to provide an indemnity is being asked to assume the risk for the events covered by the terms of the indemnity. They should therefore consider:

- What risks does the proposed indemnity cover?
- What events could trigger the indemnity?
- Who controls those risks – are they fully in my control, partly in my control, or entirely outside of my control?
- If the risks are partly or entirely outside of my control, why should I be assuming those risks?
- If a risk is dependent on a third party, what assurances do I have (or can I get) from that third party? Is there an equivalent indemnity from the third-party? Or will I be providing an indemnity for a risk based on a third party in circumstances where the third party is not providing me with the same protection?
- What is the likelihood of the indemnity event occurring?
- Might those factors change over the duration of the indemnity (i.e. the term of the contract)?
- What are the potential losses that could arise under the indemnity?
- Can the risks be instead addressed by a warranty or some other provision?
- How does the proposed indemnity correspond to my insurance cover, and are there any other insurance implications?

Overall, the question is whether the indemnity is appropriate in the circumstances, or whether it can be rejected altogether, or limited in some way. While such a conversation will be influenced by the parties' relative bargaining positions and is ultimately a commercial issue, it is important to consider these issues carefully. In particular, a party should be very careful about assuming responsibility for any matter outside of their control.

Conversely, the party seeking the indemnity should be able to explain why it is appropriate that the other party gives the indemnity in the terms sought.

Limiting indemnities

While an indemnity can be tailored to any situation, ways to limit an indemnity (where appropriate) may include:

- Limiting the indemnity to a maximum loss amount;
- Limiting types of loss recoverable (e.g. excluding loss of profits);
- Excluding loss caused or contributed to by the indemnified party;
- Excluding loss caused or contributed to by a third party;
- Imposing mitigation obligations on the indemnified party.

Key issues for negotiating an indemnity clause

While the specific wording of the indemnity (and its context and other contractual provisions) will determine its effect, the following issues should be considered when negotiating an indemnity clause:

- What risks does the indemnity cover?
- Who controls that risk, what factors affect it, and who should bear the liability?
- Is the indemnity limited or unlimited, and is that appropriate?
- What is the potential exposure under the indemnity?
- Could the risk change over the course of the indemnity?
- How does the indemnity align with any relevant insurance?
- What is the financial standing of the party giving the indemnity?
- Are there suitable alternatives to the proposed indemnity?

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