Article Information

Authors: Andrew Rankin, Amelia Coleman
Service: Commercial Contracts, Corporate & Commercial

Indemnity clauses in commercial contracts: how to achieve desired contractual risk allocation

An indemnity clause is a contractual transfer of risk between two or more contractual parties generally to prevent loss or compensate for a loss which may occur as a result of a specified event.

Introduction

Indemnity clauses play an important role in managing the risks associated with commercial transactions by protecting against the effects of an act, omission, a contractual default or another party's negligence. The usual tendency is to seek an indemnity which will protect a party to the greatest extent against liabilities arising from the actions of another. Care should be taken when drafting indemnity clauses since, by reason of the breadth of commercial arrangements and often the complexities of the contracts themselves, the resulting interpretation of an indemnity and the manner in which it operates may in fact be very different to that which the parties thought they were agreeing.

We set out below some practical drafting tips and identify how to avoid some common pitfalls in contractual indemnity clauses.

Types of Indemnity Clauses

There are loosely six types of indemnity clauses, which vary as to their scope and operation, including:

1. ***Bare Indemnities*** – Party A indemnifies Party B for all liabilities or losses incurred in connection with specified events or circumstances, but without setting out any specific limitations. These indemnities will be silent as to whether they indemnify losses arising out of Party B's own acts or omissions, and may be interpreted to have the effect of a reverse indemnity
2. ***Reverse or Reflexive Indemnities*** – Party A indemnifies Party B against losses incurred as a result of Party B's own acts or omissions (including Party B's own negligence)
3. ***Proportionate or Limited Indemnities*** – These are the opposite of Reverse Indemnities. Party A indemnifies Party B against losses except those incurred as a result of Party B's own acts or omissions
4. ***Third Party Indemnities*** – Party A indemnifies Party B against liabilities to or claims by a third party related to the contract
5. ***Financing Indemnities*** – Party A indemnifies Party B against losses incurred if Party C fails to honour the financial obligation (ie the primary obligation) to Party B (most often these are coupled with a guarantee), and
6. ***Party/ Party Indemnities*** – Each party to a contract indemnifies the other(s) for losses occasioned by the indemnifier's breach of the contract.

Common indemnity clause drafting pitfalls

Scope of Indemnity

Indemnities are often drafted too widely seeking to cover third parties and circumstances beyond the ordinary breach circumstances actionable under the common law.

In some circumstances indemnity clauses also seek to apply even when there is no breach of contract by the party. A well known instance of this is a guarantee where one party indemnifies another party for the act, default or breach of a third party. Indemnities in these circumstances can therefore extend into unintended onerous obligations which the common law

would not otherwise impose.

Clauses that completely indemnify Party A for damage or loss caused or contributed to by Party A, including as a result of Party A's own negligence, wilful acts, mistake, fraud or breach of contract will likely be considered to be unnecessary and unfair to Party B.

It is not uncommon for a party with the most commercial influence and bargaining power in respect of a project, particularly where the project is large or risky, to insist on indemnities from the other participants. Such indemnity clauses are often drafted in the broadest possible terms and cause significant imbalance in the parties' rights and obligations under the contract. The adoption of broad-ranging indemnities is not always, however, the best tool for achieving risk apportionment.

Ambiguity in the drafting of an indemnity clause presents a risk that the indemnity will not be held to cover losses, which the indemnified party expected it to cover. The indemnified party should avoid drafting clauses too widely to risk unenforceability. Ambiguity is also a risk to the indemnifier that it will be held to cover losses that were not within their contemplation.

It is important to take care in commercial negotiations to confine and document the intended scope of the indemnity being negotiated and to identify precisely what is sought to be achieved economically.

Duration of Liability

Another significant issue surrounding the utility of an indemnity clause is the extended time for which it may remain available for enforcement compared to a claim for breach of contract. Statutes of Limitation exist in all states and territories of Australia that limit the time by which a claim must be brought for breach of contract. Normally, the period is 6 years for an ordinary agreement, commencing from the date of the breach.

It is critical to understand that the limitation period in relation to an indemnity clause starts from the date on which the indemnifier refuses to honour the indemnity. The indemnified party would then have a further 6 years from that date within which to bring legal proceedings to enforce the indemnity. Consequently, an action on the indemnity to seek recovery of its loss may be brought many years after the right to bring damages for breach of contract has expired. In most instances, parties granting indemnities are not adequately advised of this potential impact and the extended period of risk they are assuming as part of their indemnity obligations.

Drafting Recommendations

The precise scope and operation of an indemnity will depend fundamentally on how it is drafted and the extent to which that drafting properly reflects the intention of the parties. Some indemnity clause negotiation and drafting tips include:

- Consider whether or not there is a need for an indemnity at all. You should ask whether it is intended that an indemnity give rise to greater protection than would normally be available for breach of warranty or breach of contract. If not, the indemnity is not needed.
- Pay close attention to the drafting of the indemnity and do not treat it as a "boilerplate" provision.
- If you are the indemnifier:
    - limit the amount of indemnities that you give when entering into an indemnity clause. For example, you may find adequate protection under the common law in relation to breaches of contract and negligence,
    - consider imposing an express obligation to mitigate loss, and
    - limit the time during which claims can be brought under the indemnity clause. For example, within 6 years from the completion of work.
- If you are the indemnified party:
    - avoid drafting the clause too widely as it risks achieving the effect of being read down to exclude even some anticipated liabilities,
    - avoid ambiguous wording of the clause, and
    - consider including indemnities for breach of contract and negligence in addition to the existing common law rights.
- Take care to confine the effect of the indemnity to one that either gives rise to damages for breach of contract (debt) or damages generally (ie compensation). Identify whether, in the event of a breach of contract, the effect of the indemnity should be that:
    - the breach will give rise to other remedies under the contract (eg termination or liquidated damages or rights to payment, suspension or termination of payments), or
    - the breach will allow the indemnified party to an entitlement to a payment, compensation or a reimbursement.

Agreements containing indemnity provisions should be construed on the assumption that the parties intended to produce a commercial result, one which avoids making commercial nonsense or working commercial inconvenience.[1] Where there is still ambiguity or doubt regarding the construction of the indemnity provision either from the uncertain meaning of the particular expression or the apparent width of possible application, a last resort is to construe an indemnity provision in a manner which favours the indemnifier and against the interests of the indemnified party.[2]

Conclusion

The scope and operation of indemnity clauses are often misunderstood. Typically indemnity clauses arise out of commercial negotiations and seek to protect specific commercial risks, which almost always render indemnity clauses the subject of contractual interpretation. The above tips are designed to assist you to help avoid contractual disputes surrounding contract construction and avoid protracted and costly after the event interpretation of the true scope and enforceability of an indemnity clause.

Read a related article written by Andrew Rankin.

If you have a commercial negotiation involving protection of risk and indemnity or would like more information on this topic, please contact our partner, Andrew Rankin.

[1] *Woolworths Group Ltd v Twentieth Super Pace Nominees Pty Ltd* [2021] NSWSC 344 at [24] citing *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd* [2015] HCA 37 at [51] .

[2] Ibid [26]; *Central Coast Council v Norcross Pictorial Calendars Pty Ltd* [2021] NSWCA 75 at [123] – [126].