Article Information

Author: Karyn Reardon
Service: Arbitration, Commercial Disputes, Construction Litigation, Dispute Resolution & Litigation, Projects & Construction, Property & Development
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Construction Contracts: the complexities of indemnities

Construction contracts are often encyclopaedic, imposing extensive obligations upon contractors. Typically, several indemnity clauses are also included, occasionally with at least one party labouring under a misapprehension that these types of clauses are endowed with unique and magical qualities.

However, as is the case for any other contractual clause, the meaning and effect of any indemnity clause turns on the specific words used. Indemnity clauses do not attract unique or unusual rules of interpretation and unusual meanings will not be implied (absent remarkable circumstances).

While it is often the case that indemnity clauses have severe consequences, the effect of any indemnity ought to be clear from the words used in that clause.

That is, the effect of any indemnity clause on a contractor's risk profile turns on:

- the particular terms of the contract;
- the particular indemnity; and
- the particular circumstances that trigger the indemnity.

Baseline: what if there is no indemnity?

It is helpful to consider the parties' rights and obligations under contracts with no indemnity clauses in order to identify the pros and cons of including indemnities in any deal.

Parties to contracts are obliged to honour the contract's terms irrespective of whether the contract includes indemnity clauses.

While other remedies might also be available, when one party breaches a contract's terms causing the innocent party to suffer loss, the innocent party may recover that loss as 'damages' from the defaulting party.

The courts' approach to valuing these 'vanilla' flavoured damages is discussed here.

However, the amount recoverable can be quite different if an indemnity clause is included in a contract.

What is an Indemnity?

Indemnities come in many different flavours, including:

- ***Bare Indemnities***: Party A indemnifies Party B against any and all losses and liabilities that occur in connection with the contract;
- ***Reflexive Indemnities***: Party A indemnifies Party B against losses that occur as a result of Party B's own conduct (often negligent conduct);
- ***Proportionate Indemnities***: Party A indemnifies Party B against all losses, except those that arise out of Party B's own conduct;
- ***Indemnities for Third Party claims***: Party A indemnifies Party B against claims by third parties arising out of the

contract;

- ***Indemnities excluding Third Party claims***: Party A does not indemnify Party B against claims by third parties arising out of the contract;
- ***Party / Party Indemnities***: Each party indemnifies the other for losses incurred as a result of the other party's breach; or
- ***Indemnities by Third Parties*** (usually Financiers / Related Companies): Party C indemnifies Party A against any and all losses and liabilities that as a result of Party B's breach of a separate contract or negligent conduct.

Also, an indemnity clause might not include the words '*indemnity*' or '*indemnify*'. Instead, '*hold harmless*', '*defend and hold harmless*', '*reimburse*', '*be liable for*', '*pay*' or '*make good*' potentially have the same effect as '*indemnify*'.

The natural and ordinary meaning of words[1] included in any particular indemnity clause are important, and should be considered within the context of the contract as a whole.[2]

Potentially, the effect of indemnity clauses can include that:

- loss or damage that was not caused by an act or omission of the indemnifier is recoverable;
- loss or damage that is not a direct consequence of a breach by the indemnifier is recoverable;
- unreasonably incurred costs are recoverable; and
- the period within which claims may be made under the indemnity is significantly longer than 'vanilla' flavoured claims for damages.

Recovery of indirect, unreasonable and unforeseeable costs under an indemnity requires clear drafting. However, if the court is satisfied that this was the agreement struck between the parties, then the court ought to apply the indemnity clause with that effect.[3]

Similarly, the words included in a particular indemnity clause can also increase the term of a contracting party's potential liability.

This is because claims for damages for breach of contract must be made within:

- 3 years from the date of the contractual in the Northern Territory; and
- 6 years from the date of the contractual in all other States and Territories.

If the relevant agreement was made in the form of a deed, then claims must be made within:

- 15 years in Victoria and South Australia; and
- 12 years in all other States and Territories.

Breaches of construction contracts (or deeds) rarely occur later than the date of final completion: meaning the limitation period usually commences no later than the date of final completion.

Similarly, if an indemnity clause requires that an indemnifier '*hold harmless*' an indemnified party, the indemnifier will be in breach as soon as the indemnified party suffers any loss or damage: the breach being failing to '*hold harmless*'. That is, the limitation period will start running immediately from the date of the breach.

However, if an indemnity clause requires that an indemnifier '*make good*', then the indemnity will only be breached if the indemnifier fails to '*make good*'. That is, the indemnifier will only be in breach of contract when (and the statutory limitation period will not commence until) the indemnified party takes steps to recover loss or damage suffered and the indemnifier wrongly refuses to honour the indemnity. As the breach of the indemnity clause might occur much later than, say, final completion of the contract, this type of indemnity clause has potential to substantially extend the period within which claims might be made under a construction contract.

Issues to Consider when Negotiating Indemnity Clauses

If an indemnity is either required or requested from another party, care must be taken to ensure that the terms of the indemnity reflect the parties' agreement.

When considering the scope of any indemnity that might be required, or ought reasonably be given, parties ought to consider:

- the relevant contract's purpose, and whether recovery of only the 'vanilla' damages described here might undermine that purpose. For example, if your particular circumstances are such that a 6 foot 9 inches deep swimming pool will be of no utility to you, then you ought to include an appropriate indemnity that will be triggered

if your builder fails to construct a pool that is 7 foot 6 inches deep;

- the type of loss or damage that ought to be indemnified, for instance:
    - any and all breaches of the contract;
    - breach of only specific obligations;
    - damage to real or personal property owned by one or both contracting parties;
    - damage to real or personal property owned by third parties;
    - injuries suffered by employees, subcontractors, or the general public;
    - negligence;
    - statutory breaches (eg, *Australian Consumer Law*);or
    - something else.
- which party ought to give the indemnity?
- who is best able to manage the relevant risk?
- can and should the risk / indemnity be apportioned or shared?

Parties ought to use boilerplate indemnity clauses with caution. Just because a particular indemnity clause worked for one deal does not mean it is automatically suitable for your next deal.

Also, there is very little value in a broad indemnity given by an insolvent company. If the indemnified party requires an entitlement to potentially recover a significant amount under an indemnity clause, consideration ought to be give to whether:

- the indemnifier has sufficiently deep pockets to pay any indemnified amount;
- insurance (from a third party insurer with deeper pockets) is available; and
- an indemnity ought to be requested from another entity (eg, parent company guarantor).

The indemnifier must also carefully identify and value its potential exposure under any indemnity before signing on the dotted line. For example, an indemnity '*against any loss or claim suffered or incurred by the Principal directly or indirectly arising from or otherwise in connection with the project as a whole*' potentially exposes the indemnifier to liability for matters:

- unrelated to any contractual breach;
- beyond the scope of the contract; and
- over which the contractor could not possibly have any control.

As well as ensuring the indemnity clause is clearly drafted and correctly aligned with the scope of the agreed indemnity, a prudent potential indemnifier ought to:

- require a causative link between the relevant breach and recoverable loss so that the indemnifier is not exposed to liability for costs incurred by the indemnified party that were not caused by the indemnifier. Beware clauses that impose liability for losses '*arising from or in connection with*' matters, or liability beyond breaches of the contract or negligence;
- limit recoverable loss to the portion of loss caused by the indemnifier[4], and ideally no broader than the indemnifier's potential liability for 'vanilla' damages under the contract (or potential liability in tort or under statute);
- consider whether insurance is available in the event the indemnity is enforced, or as an alternative to an indemnity clause. For example, many companies only agree to indemnify in respect of personal injury, loss of life, and property damage caused by their own negligence, and ensure they maintain insurance that will respond to these types of claims;
- oblige the indemnified party to mitigate its loss;
- exclude liability for matters outside its control or types of loss it can not foresee.
- beware of indemnities that extend to indirect or consequential loss. Limit liability to '*reasonably foreseeable*' or '*direct*' loss;
- limit the total value of liability under indemnities (and / or under the whole agreement), or otherwise limit the obligation to rectification of impacted contract works;
- limit the time within which any indemnity might be enforced to a hard date;
- limit the class of indemnifiers. That is, resist requests for indemnities from parent companies, directors, officers or employees;
- if the indemnity relates to claims made by third parties, require that the indemnified party gives you control of the defence of any proceedings commenced by the third party against the indemnified party; and
- if an indemnity potentially exposes you to liability for matters beyond your control or damages that are not 'vanilla', ensure that the contract price includes an appropriate risk premium that compensates you for assuming these risks.

[1] If the indemnity clause is unclear or ambiguous, then it will be construed in accordance with the usual principles applied by courts to resolve ambiguity – being a topic for another day.

[2] *Erect Safe Scaffolding (Aust) Pty Ltd v Sutton* (2008) 72 NSWLR 1 per Giles JA at [5]

[3] See *Total Transport Corporation v Arcadia Petroleum Ltd, ("the Eurus")* [1998] Lloyds Rep 351 and *Church Commissioners v Ibrahim* [1997] 1 EGLR 13

[4] Also, in Queensland, parties can not contract out of the Civil Liability Act 2003 (Qld): meaning that indemnity clauses do not reduce the extent to which a party is proportionately liable for another party's loss where claims are made for property damage or pure economic loss.