Top Ten Indemnity Mistakes

By David Downie, Partner, McCullough Robertson

Some boards rightfully have policies requiring contracts containing indemnities to be escalated for approval before execution. However, many people – lawyers included – are unaware of the true nature of the risk posed by an indemnity, and the importance of its wording in determining whether or not it is something the business is prepared to agree to.

Unfortunately, we are often approached by clients who have not considered the wording of indemnities until they receive a claim under one. It is at this time they usually wish they had never given the indemnity or paid more attention to its wording when the agreement was being negotiated.

Here are the top 10 mistakes we see that are made by companies asked to provide an indemnity.

1. Agreeing to give one

Your first reaction to an indemnity in a draft agreement should be to consider deleting it.

To give an indemnity is a very serious commitment. It is, in effect, offering to hold someone harmless should a particular event occur, similar to an insurer. The event may, in fact, be completely outside your control or even caused by the party being indemnified.

The most common event companies are asked to provide an indemnity in relation to is a breach of the agreement they are entering. This should be rejected on the basis that the indemnified party could always sue you for breaching an agreement without the benefit of an indemnity.

Also common is a request for an indemnity relating to any act or omission (or any negligent act or omission) of the party granting the indemnity. This should also be rejected on the grounds the agreement itself sets out in detail the agreed obligations of each party. An indemnity such as this creates uncertainty as to what is required of the party giving the indemnity and the circumstances in which they will be liable under the agreement.

To help with the decision-making process you should speak to someone who knows what the 'usual' range of acceptable risk allocation is in the context of the deal being proposed. This should include industry specific information about what is generally considered a favourable and unfavourable position for someone in your situation.

2. Agreeing to indemnify in relation to events outside your control

Insurers offer indemnities in relation to events outside their control, for example storms, theft or death. That is their business. However, it is unlikely to be your business.

For this reason, you should consider very carefully the events you are offering to hold the indemnified harmless in relation to. You may, for example, be in a position to determine whether or not use of a product being licensed will infringe third party intellectual property and hence be prepared to grant an indemnity in relation to such an infringement occurring. However, a broad indemnity would not extend just to actual infringement, but also to allegations by a third party that use of the licensed product infringes their intellectual property.

Whether or not a third party makes such an allegation is outside your control, and yet under the indemnity you may be liable for the cost of defending the claim (including legal fees on an indemnity basis), the cost of settling the claim and the cost of the damage to the business due to the claim.

Some indemnities even extend to events that would almost never be commercially acceptable if properly understood. For example, we have even seen companies asked to provide an indemnity in relation to breaches of the agreement by the indemnified party, in which case the indemnity is effectively operating as an exclusion clause.

In many cases the indemnified party will agree to remove extreme events such as these from the indemnity, should you take the time to ask them to do so.

3. Using expansive words rather than limiting words

Even if you agree to indemnify a party in relation to particular events, the words you choose to express the scope of the indemnity will affect the loss recoverable under it. The narrower the words you agree to in the indemnity, the narrower the scope of the indemnity. Hence, loss "directly caused by" an event being recoverable is preferable to loss "in connection with" an event.

Similarly, one approach to

indemnities is to limit them to "direct loss" caused by a breach of the agreement. An alternative approach to indemnities applying to a claim by a third party is to limit the indemnity to the amount the indemnified party is ordered to pay by a court. So rather than the indemnity applying from the date an allegation is made, a court order would be required to trigger the indemnity. Not only is this much less likely to occur than an allegation, but the indemnity in this case does not extend to other losses such as legal costs.

4. Not clarifying whether or not exclusion clauses apply to indemnities

The nature of a claim under an indemnity is not clear. Specifically, it is not settled whether or not a claim under an indemnity is an action for breach of contract, where recoverable damages would be subject to exclusion or limitation clauses, or an action to compel the payment of a debt where such clauses may not apply.

Given this, the safest approach is to expressly clarify that any exclusion or limitation clauses under the agreement apply to liability under any indemnity given. Without such a clarification there is a risk that your liability under the indemnity will be unlimited, notwithstanding the existence of the limitation and exclusion clauses.

5. Accepting an indemnity because it's reciprocal in operation

Some parties will encourage you to accept their indemnity clause as it is reciprocal in operation – that is, you indemnify each other in relation to the same events. This is often not as attractive as it sounds, as the other party is likely to be suggesting this as it is in their interest. Whether or not this will be acceptable will depend on the nature of the agreement and the events indemnified against.

For example, if a party you are supplying goods or services to offers a reciprocal indemnity for a breach of the agreement, this may offer little comfort as they are unlikely to have any substantive obligations other than the payment of fees. However, if you are a customer and a supplier insists on a reciprocal indemnity then you may be comfortable agreeing to it for the same reason.

6. Not excluding loss caused by the indemnified

Although courts are reluctant to interpret an indemnity as applying to damage suffered due to the indemnified party's own negligence, they will do so if the intention of the parties is clear. Given this, you should always attempt to clarify that you are not liable under an indemnity where loss is caused by an act or omission by the indemnified party.

7. Not requiring the indemnified to mitigate their loss

Another consequence of it not being clear whether a claim under an indemnity is an action for breach of contract or a claim for a debt is that there is uncertainty as to whether the indemnified party is required to mitigate its loss when making a claim for compensation. The better approach is to make any liability under the indemnity conditional upon them doing this.

8. Failing to insist on a process for defending third party claims

The moment businesses that grant indemnities fear the most is when they receive notice an indemnified party is being sued and all costs associated with the action, including legal fees and settlements, are considered to fall within the scope of the indemnity.

As the entity giving the indemnity you have an interest in this process, including from a reputational and costs perspective. Depending on the nature of the claim, other issues may include the fear that a court finds your product infringes the intellectual property rights of a third party, which may have catastrophic legal and commercial consequences for your business.

While you should have a general right of subrogation to step into the indemnified party's shoes and defend the claim, it is preferable to expressly acknowledge this in the contract and make the indemnity conditional upon the indemnified party immediately notifying you of the claim and providing you with all reasonable assistance in relation to the claim.

You should resist attempts by the indemnified party to waive your right of subrogation or to require you follow their, or their lawyers, directions when defending the claim. These concessions tend to be requested by large corporates that have reputation concerns and want the ability to quickly and quietly settle the matter at your expense. Obviously this loss of control is not desirable.

9. Not limiting the timeframe under which a claim must be made

You should carefully check the survival clause in your agreement to ensure that your indemnity

does not last longer than the term of the agreement.

10. Not obtaining consent from your insurer

If you do not obtain consent from your insurer when granting rights to other parties that are greater than that under the general law, then you risk not being insured for amounts recoverable under the indemnity. You should always obtain the consent of your insurer to ensure indemnities will not affect your insurance.

Conclusion

You are likely to see more and more agreements containing indemnities in the current economic climate as businesses attempt to shift the risk of deals not going as planned onto you.

Whether or not you proceed with an agreement under which you grant an indemnity will depend on both the risk posed by the indemnity and the importance of the overall deal to your company. In analysing the risk, you will need to consider both the probability of the indemnified event occurring and the consequences of the indemnity being applicable, including effects on your insurance cover.

If ultimately the negotiated risk cannot be priced into the deal or otherwise mitigated then you may have to consider rejecting the proposed agreement. As with all negotiations, often the best position with respect to indemnities is only reached after you give the appearance, even if it is not the reality, that you are prepared to walk away from the deal if your position is not accepted.

David Downie can be contacted on (07) 3233 8842 or via email at ddownie@mccullough.com.au.

The Northern Territory Bar Association
and
The Law Society of the Northern Territory

Ian Morris Memorial Golf Day

2pm, Friday 28 August 2009
RAAF Darwin Golf Club
9 hole shotgun start - Ambrose rules - entry fee $30 per person

All profits will go to NT Variety

The competition is open to lawyers and friends of Morrie who would like to participate. Form your own teams or allow us to place you in one.

RAAF Darwin Golf Club will be the venue for the Ian Morris Memorial Golf Day; a nine hole Ambrose competition teeing off at 2pm and concluding at about 5pm with a sausage sizzle and prize giving.

Following the format of the same as in the last couple of years, there will be the standard prizes of longest drive, longest putt etc with each player having to record a drive, fairway shot or putt and the team have to return home with the team golf ball to avoid a two shot penalty. Handicaps will be at the roll of the dice.

Entry forms are available from William Forster Chambers or the Law Society NT. Further entry forms will be circulated with the "Practitioner".

Individual entries should contact Emily at William Forster Chambers (clerk@williamforster.com or 89824700) to be placed in a team.

Send your registration form and cheque to NTBA, GPO Box 4369, DARWIN, TN 0801 by Monday 24 August 2009.