Drafting Effective Indemnity Clauses

A paper presented by Michael Bennett at the College of Law CLE, 18 February 2016

Michael Bennett

13 Wentworth Selborne Chambers

D 9232 7750 M 0408 029 416

E mbennett@wentworthchambers.com.au

About the Presenter

Michael is a barrister at 13 Wentworth Selborne Chambers.

He has a broad practice that includes but is not limited to the commercial and tax matters.

These materials represent the law as it stood on 13 February 2016.

1 Introduction

1.1 An indemnity is little more than an agreement to cover loss and damage another suffers. It is, however, a significant part of any contractual dealing. Despite being a seemingly straightforward concept, contractual indemnities are often a source of disputes. They can also be a prominent talking point during contractual negotiations for two reasons: first, and in large part, because the consequences that flow from an indemnity materially alter the parties' positions; secondly, unexpected consequences can flow if the drafting of the indemnity does not reflect and record the parties' intention.

1.2 This paper will address techniques for drafting indemnities, though in doing so it will pay to first consider other aspects of a contractual indemnity. This is important as knowing what an indemnity is, and is not, and recognising the different types of indemnities will assist in the drafting of them. So too will understanding the nature and scope of indemnities at law and what sets them apart from other risk allocation techniques.

1.3 The nature of indemnification is the first issue to consider. This includes their nature at law, whether they are a debt or amount to damages, the benefits they can provide, how they differ from other legal relations (being guarantees, insurance and warranties).

1.4 The different types of indemnities will be discussed. Although the number of types is limited only by the parties' circumstances and agreements, there are six commonly found types of indemnity. They will be discussed.

1.5 Considerations exist that should be considered before drafting commences. These will be set out and explained.

1.6 The principles of construction the courts apply to indemnity clauses will then be considered. This is important as the courts' approach influences how detailed the indemnity clauses need to be to achieve particular outcomes.

1.7 The types of contracts that will usually contain an indemnity clause, and the nature of negotiations to conclude them, will be considered.

1.8 Some tips and the technique of drafting indemnities are then discussed. A conclusion will be provided to end the paper.

1.9 It is to be noted that this paper discusses contractual indemnities. These are indemnities that we, as practitioners, can shape and influence on our clients' behalves.

This paper does not consider other types of indemnities, such as statutory indemnities,[1] which may otherwise alter liability between parties.

2 What is Indemnification?

2.1 A contract of indemnity is one that provides that if an indemnified party incurs a liability (whether to a third party to the contract or between the parties to the contract) as a result of the performance of the contract, that indemnified party is entitled to be indemnified by the indemnifier (the other party to the contract) against the liability. As a general proposition, indemnities look to make the party best able to manage a particular risk responsible for the consequences of the possible event occurring.

2.2 Stated simply, it is a contract by one party to keep the other "harmless"[2] against loss: *Sunbird Plaza Pty Ltd v Maloney* (188) 166 CLR 245 at 254 per Mason CJ.[3] The expression "indemnity clause" is commonly used to refer to a clause in a commercial contract[4] that attempts to shift the responsibility for an adverse event from one party to the other party.

2.3 The object and effect of a properly drafted contractual indemnity are to alter the common law, equitable and statutory rights of the parties to that agreement. It matters not whether you are, or are acting for, the party benefiting from or liable for the indemnity; it is essential that both consider the extent to which a contracting party seeks to alter their existing rights. This is one of the most profitable considerations to bear in mind when drafting indemnity clauses.

The Nature of Contractual Indemnities – Generally

2.4 There are a number of propositions to be made when considering the nature of a contractual indemnity.

[1] For instance, a statutory indemnity arises where a director who has paid an amount of penalty, quantified by reference to a company tax debt, has a right of indemnity from co-director: see s 269-45 of Schedule 1 to the *Taxation Administration Act* 1953 (Cth).

[2] Though see the discussion at paragraphs 7.4 to 7.6 regarding the difference between "hold harmless" and "make good".

[3] See also *Yeoman Credit Limited v Lattler* [1961] 1 WLR 828 at 830-831; *Total Oil Products (Aust) Pty Ltd v Robinson* [1970] 1 NSWLR 701; and *Argo Caribbean Group Limited v Lewis* [1976] 2 Lloyds Rep 289 at 296.

[4] Other than a contract for insurance.

2.5 Indemnities are contractual in nature and, absent a deed, must be supported by consideration.[5]

2.6 An indemnity against "loss" may apply to financial damage or loss of or damage to physical property. That is, the relevant loss may be physical damage or pure economic loss. The indemnity may also include loss suffered from a third party making a claim against the beneficiary of the indemnity.

2.7 Although contractual indemnities were historically treated differently at law and in equity, the distinction has been removed. Lord Brandon of Oakbrook said it thus in *The Fanti* at 28:[6]

> *There is no doubt that before the passing of the Supreme Court of Judicature Acts 1873 and 1875 there was a difference between the remedies available to enforce an ordinary contract of indemnity (by which I mean a contract of indemnity not containing any express 'pay to be paid' provision) at law on the one hand and in equity on the other. At law the party to be indemnified had to discharge the liability himself first and then sue the indemnifier for damages for breach of contract. In equity an ordinary contract of indemnity could be directed to be specifically performed by ordering that the indemnifier should pay the amount concerned directly to the third party to whom the liability was owed or in some cases to the party to be indemnified: see Johnston v Salvage Association (1887) 19 QBD 458 at 460 per Lindley LJ and British Union and National Insurance Co v Rawson [1916] 2 Ch 476 at 481--482 per Pickford LJ. There is further no doubt that since the passing of the 1873 and 1875 Acts the equitable remedy has prevailed over the remedy at law.*

His Lordship's speech seems applicable to the Australian position.

2.8 If an indemnity concern itself with illegal matters or those contrary to public policy it will be unenforceable at law. Lord Justice Morris said:[7]

> *Can A, who does what B asks him to do, enforce against B a promise made in the following terms: 'If you will at my request make a statement which you know to be false and which you know will be relied upon by others and which may cause them loss, then, if they hold you liable, I will indemnify you?' In my*

[5] *Com-Al Windows Pty Ltd v Silent Vector Pty Ltd* [2008] WASCA 99.

[6] *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti); Socony Mobil Oil Co Inc and others v West of England Ship Owners Mutual Insurance Association (London) Ltd (The Padre Island)* [1991] 2 AC 1

[7] In *Brown Jenkinson & Co Ltd v Percy Dalton (Londond) Ltd* [1957] 2 QB 621 at 635, with Pearce LJ agreement and Evershed MR dissenting.

> *judgment, the assistance of the courts should not be given to enforce such a promise.*

2.9 Although liability pursuant to an indemnity will only exist in respect of an ascertained amount, an action may be commenced under an indemnity prior to the ascertainment of that liability.[8] The proceedings may determine the amount of the liability. Further, the obligation to indemnify may arise prior to any loss or damage being suffered by the beneficiary of the indemnity.[9]

2.10 Finally, and related to the preceding point, as to limitation of liability issues, if the indemnity is an indemnity against liability the cause of action will come into existence when A incurs a liability to B. If, however, the indemnity is a general indemnity then time will not run against for the purpose of pursing the indemnity against C until A's liability to B has been established and ascertained.[10]

The Nature of Contractual Indemnities – Debt or Damages

2.11 Of fundamental importance jurisprudentially, and somewhat practical importance, is whether the claim based on a contractual indemnity gives rise to a right to claim in debt or damages. The authorities, which are mostly English, diverge on this question.

2.12 In *Jervis v Harris* [1996] Ch 196 Millett LJ (as his Lordship then was) analysed the nature of a repairing covenant in a commercial lease. In doing so he addressed the nature of indemnity clauses in commercial contracts more generally and said:

> *… a tenant's liability to reimburse the landlord for his expenditure on repairs is not a liability in damages for breach of his repairing covenant at all.* ***The landlord's claim sounds in debt not damages****; and it is not a claim for compensation for breach of the tenant's covenant to repair, but for reimbursement of sums actually spent by the landlord in carrying out the repairs himself.*

2.13 That is, an indemnity is a contractual right of reimbursement requiring evidence of expenditure. His Lordship went on to note that it is also a contractual right of recoupment that requires proof that some kind of liability has been discharged. He said:

> *The law of contract draws a clear distinction between a claim for payment of a debt and a claim for damages for breach of contracts … a debt is a definite sum*

[8] *County and District Properties Ltd v C. Jenner & Son Ltd* [1976] 2 Lloyd's Rep 728 at 734-738 per Swanwick J.
[9] *In re: Richardson; ex parte Governors of St Thomas' Hospital* [1911] 2 KB 705 at 709-710 per Cozens-Hardy MR.
[10] *Telfair Shipping Corp v Intersea Carriers SA* [1985] 1 WLR 553 at 566 per Neill J.

> *of money fixed by the agreement of the parties as payable by one party to the other in return for the performance of a specified event or condition; whereas damages may be claimed from a party who has broken his primary contractual obligation in some way other than by failure to pay such a debt.*

2.14 The House of Lords, however has held that relief under an indemnity clause, albeit in an insurance context, is founded in damages rather than debt. In *The Fanti* Lord Goff said:[11]

> *First of all, I am unable to accept his submission that a condition of prior payment is, at common law, implicit in a contract of indemnity**. I accept that, at common law, a contract of indemnity gives rise to an action for unliquidated damages, arising from the failure of the indemnifier to prevent the indemnified person from suffering damage**, for example by having to pay a third party. I also accept that, at common law, the cause of action does not (unless the contract provides otherwise) arise until the indemnified person can show actual loss: see Collinge v Heywood (1839) 9 Ad & El 633, 112 ER 1352. This is, as I understand it, because a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense.*
>
> *On this basis, no debt can arise before the loss is suffered or the expense incurred however, once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense. There is no condition of prior payment but the remedies available at law (assumpsit for damages, or possibly in certain circumstances the common count for money paid) were not efficacious to give full effect to the contract of indemnity. It is for this reason that equity felt that it could, and should, intervene. If there had been a clear implied condition of prior payment, operable in the relevant circumstances, equity would not have intervened to enforce the contract in a manner inconsistent with that term. Equity does not mend men's bargains but it may grant specific performance of a contract, consistently with its terms, where the remedies at law are inadequate. This is what has happened in the case of contracts of indemnity. As a general rule, 'Indemnity requires that the party to be indemnified shall never be called upon to pay' (see Re Richardson, ex p Governors of St Thomas's Hospital [1911] 2 KB 705 at 716 per Buckley LJ) and it is to give effect to that underlying purpose of the contract that equity intervenes, the common law remedies being incapable of achieving that result.*

[11] *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti); Socony Mobil Oil Co Inc and others v West of England Ship Owners Mutual Insurance Association (London) Ltd (The Padre Island)* [1991] 2 AC 1 at 35-36.

2.15 This conclusion is supported by Hoffman LJ who has concluded that an action for recovery pursuant to a contractual indemnity will usually not be a claim based in breach of contract, but rather a claim for an indemnity for a liability incurred.[12]

2.16 Therefore, and on balance, it seems recovery under a contractual indemnity is a right of reimbursement and not subject to the issues relevant to recovering damages. The parties' bargain is one of indemnity rather than an obligation not to cause any loss. If so, the party claiming under a contractual indemnity would not be subject to:

2.16.1 the obligation to mitigate its loss;

2.16.2 issues of causation; or

2.16.3 issues or remoteness,

though in this regard see the next heading '*The Benefits of Indemnity Clauses'* below.

2.17 The claim is therefore more in the nature of a debt, albeit unquantified at the time of entry into the contract containing the indemnity.

The Benefits of Indemnity Clauses

2.18 There are various benefits of an indemnity clause, including the following.

2.19 The measure of compensation the protected party obtains is potentially greater under indemnification than damages for breach of contract.

2.20 Mitigation of loss (probably) does not apply. Ordinarily a party to a contract has an obligation to mitigate any loss suffered as a result of a breach of contract. However, the obligation is unlikely to apply to a party claiming under an indemnity (unless the indemnity expressly requires them to mitigate losses). This follows as the obligation to mitigate arises in respect of damages following a breach of contract. As stated above, the indemnity's relief is in the nature of a right to reimbursement rather than damages. 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. It can be said that a party with a claim for breach of an indemnity cannot be expected to mitigate its loss, when that loss represents the very amount for which it should be indemnified.

2.21 Remoteness of damage, such as the rule in *Hadley v Baxendale* (1854) 156 ER 145 (probably) does not apply. That is, loss or damage which does not usually flow form 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. Although the view

[12] *Caledonia North Sea Ltd v British Telecommunications Plc* [2002] UKHL 4 at [100].

that indemnities were not subject to remoteness issues was put in doubt by the Court of Appeal of the United Kingdom in *Total Transport Corp v Arcadia Petroleum Ltd (The Euros)* [1998] 1 Lloyd's Rep 351.

2.22 Risk in any given situation, or to any given extent, can be transferred by agreement.

2.23 Proof of damage may be more difficult than proving 'out of pocket' losses and expenses for indemnification.

2.24 The proportionate liability regime or any contributory negligence scheme, where applicable, will not apply to an indemnity.

2.25 There may be an extension of any relevant limitation period where the claim is under a contractual indemnity. For example, the statutory limitation (at least in New South Wales[13]) is six years and begins to run from the time of the breach.[14]

2.25.1 As proof of damage is unnecessary in a contract action, the plaintiff is entitled to nominal damages even if no damage is proved, and the suffering of actual damage does not extent the time for limitation purposes.[15]

2.25.2 In contrast, the cause of action in relation to a contract of indemnity accrues when the plaintiff suffers the loss against which the defendant has promised to indemnify him or her.[16] The precise time at which the plaintiff suffers loss depends on the terms of the indemnity. If it is an indemnity against liability, the cause of action accrues when the liability is incurred.[17] If it is a general indemnity, that is, an indemnity by way of reimbursement, the cause of action arises only when the extent of the plaintiff liability is established, and the plaintiff is called upon to pay, and not when the event giving rise to the liability to pay happens.[18] This could occur long after the original event that enlivens the contractual indemnity.

2.25.3 In cases of indemnity insurance, the rules on contracts of indemnity apply, and the cause of action accrues at the date of the loss.[19] Where the contract indemnifies the insured against liability to third parties, time begins to run when liability to the third party is established, either by a court, or arbitrator,

[13] *Statute of Limitations* 1969 (NSW), s 14.
[14] *Gould v Johnson* (1702) 91 ER 367; *Bagot v Stevens Scanlan & Co Ltd* [1966] 1 QB 197; *Saunders & Co v Bank of New Zealand* [2002] 2 NSLR 270.
[15] *Hawkins v Clayton (t/as Clayton Utz & Co)* (1986) 5 NSWLR 109 (reversed on other grounds in *Hawkins v Clayton* (1988) 164 CLR 539).
[16] *McGillvray v Hope* [1935] AC 1 at 10 per Lord Tomlin; *Wardman v Htfield* [2003] NSWCA 293.
[17] See, eg *Bosma v Larsen* [1966] 1 Lloyd's Rep 22 (the Queens Bench).
[18] *State Government Insurance Commn (WA) v Teal* (1990) 2 WAR 105.
[19] *Penrith CC v Government Insurance Office (NSW)* (1991) 23 NSWLR 564.

or by agreement between the parties.[20] But under a contract of life insurance or accident insurance, the cause of action accrues on the occurrence of the event in question.[21]

2.26 The wording of the indemnity clause will largely determine how far the compensation will extend and when the rights under it will accrue. It is for this reason that the issues raised in the balance of this paper is important.

Contrasting Indemnities and Other Legal Relations

2.27 An understanding of the types of indemnities available can be discerned from comparing indemnities to guarantees, insurances and warranties. This is also important as an indemnity, if not properly drafted, can amount to either a guarantee, an obligation of insurance or a warranty. Each of them results in distinct legal outcomes and relationships. It is therefore important to understand the differences between them.

Indemnity and Guarantees

2.28 The general characteristic of an indemnity clause is that the indemnifier assumes a primary responsibility for the adverse event covered by the clause and undertakes to hold the indemnified party "harmless"[22] against the consequences thereof. It is to be distinguished from the liability of a guarantor or surety, which is secondary or derivative to the liability of the principal debtor. If the surety pays the creditor he may still have recourse to the principal debtor by way of indemnity of subrogation. Conversely, an indemnifying party bears the ultimate loss. For a guarantee to exist there must be: (a) a third party obligation in existence; and (b) the intention by the parties to secure the performance of this obligation.

2.29 The above distinction is often blurred, and no cognisance taken of it, when modern drafting causes documents to be described as a "*Guarantee and Indemnity*".

2.30 The basic distinction can be remembered by the following three aspects:

2.30.1 an indemnity gives rise to a primary obligation. This is to be contrasted to a guarantee.

[20] *Distillers Co Bio-Chemicals (Aust) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1 per Stephen J at 25-26.
[21] *London & Midland Bank v Mitchell* [1899] 2 Ch 161.
[22] Though see the discussion at paragraphs 7.4 to 7.6 regarding the difference between "hold harmless" and "make good".

2.30.2 a guarantee is a contract to another for the debt default or miscarriage of another who is to be primarily responsible for the promise.[23]

2.30.3 a guarantee gives rise to a security obligation which is dependent on the default of the primary obligation.[24]

2.31 The distinction is also important for these reasons:

2.31.1 In some jurisdictions a guarantee must be in writing.[25] Promises to answer for the debt of "another person" are in the nature of a guarantee and therefore must also be evidence in writing.[26] This does not apply to an indemnity, which need not be in writing.

2.31.2 A guarantor's liability is derivative and only crystallises upon the liability of the principal debtor and any liability is contingent on the original contract being enforceable. In contrast, an indemnifier's liability is independent of the status of the debt which is to be indemnified.

2.31.3 A guarantor may be discharged as a result of certain conduct by the creditor, whereas this is less likely in relation to an indemnity.

2.31.4 Unlike indemnity clauses (see paragraph 2.31.5 that follows), a court will imply a guarantee more readily. This is based on the general principle of law that when an act is done by a person at the request of another and that act injures the rights of a third party, the person doing it is entitled to an indemnity from the person requested the act to be done.[27]

2.31.5 An indemnity clause is subject to the same rules of construction as an exclusion clause. The Court's rationale is that it is inherently improbably that a party to a contract would wish to absolve the other from liability for breach of the contract, especially when such breach is attributable to that other party's negligence.[28] Lord Justice Kinkell, after setting out guidelines for exemption clauses,[29] said:

[23] *Yeoman Credit Limited v Lattler* [1961] 1 WLR 828 at 830.
[24] *Argo Caribbean Group Limited v Lewis* [1976] 2 Lloyds Rep 289 at 296.
[25] See, for instance, s 126(1) of the *Instruments Act* 1956 (Vic); s 56(1) of the *Property Law Act* 1974 (Qld); s 2 of the *Law Reform (Statute of Frauds) Act* 1962 (WA); s 6 of the *Mercantile Law Act* 1935 (Tas); and s 58 of the *Law of Property Act* 2000 (NT).
[26] *Harvey v Edwards, Dunlop & Co Limited* (1927) 39 CLR 301 at 311; see also *Marginson v Ian Potter & Co* (1976) 136 CLR 161 at 168-169.
[27] *Israel v Foreshore Properties Pty Ltd (in Liq)* (1980) 30 ALR 631.
[28] *Smith v South Wales Switchgear Co Ltd* [1978] 1 WLR 165 at 167-168. Lord Justice Dilhorne said:

> *While they apply to the construction both of a clause relied on as exempting from certain liabilities a party who has undertaken to carry out contractual work and of a clause whereby such a party has agreed to indemnify the other party against liabilities which would ordinarily fall on him, they apply a fortiori in the latter case, since it represents a less usual and more extreme situation.*

2.32 Accordingly, an indemnity clause will be construed against the person seeking to enforce it.[30] This rule of construction may not apply to guarantees.[31]

Indemnity and Insurance

2.33 In a contract of insurance, the insurer or underwriter agrees to pay money upon the occurrence of a specified event.[32] In some ways it is similar to an indemnity, it being a direct positive contractual provision, but there are several important differences.

2.34 First, the insurer makes an assessment of risk and requires that the insured disclose all material facts and the contract is one of utmost good faith.[33] The law also imposes an obligation upon the insured to disclose such material facts. This level of due diligence is often lacking in negotiations for contractual indemnities.

2.35 Secondly, the contract of insurance usually requires the insurer to pay up to a certain amount, this may not be the case for an indemnity.

2.36 Thirdly, an insured cannot make a profit from insurance, so that if the actual value of that which was insured is less than the insured figure, the insurer is liable only for the lesser of two figures.[34]

2.37 Fourthly, the rule of construction referred to paragraph 2.32 – that it is construed against the party seeking to enforce the indemnity – is not applied to insurance contracts.

> *… when considering the meaning of such a clause one must, I think, regard it as even more inherently improbable that one party should agree to discharge the liability of the other party for acts for which he is responsible.*

[29] In *Canada Steamship Linds Ltd v The King* [1952] AC 192
[30] *Canada Steamship Linds Ltd v The King* [1952] AC 192
[31] See *Andar Transport Pty Ltd v Brambles* (2004) 217 CLR 424 at [67] and [71] per Kirby J.
[32] *Dane v Mortgage Insurance Ltd* [1894] 1 QB 54 at 61.
[33] *Distillers Co Bio-Chemicals (Aust) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1 at 27-31.
[34] *Bennett v Tugwell* [1971] 2 QB 267.

Indemnity and Warranty

2.38 A warranty is a general description of the characteristics of the subject matter of a contract. A breach of such a statement will ordinarily entitle the promise to recover damages but not to treat the contract as repudiated by that breach.[35] However, and in contrast to an indemnity, the promisor makes no promises as to the recovery or extent of loss.

3 Types of Indemnity

3.1 The types of indemnity are limited only by the variety of circumstances surrounding the contract, and manner of expression of an indemnity clause in a contract, between the parties. There are, however, some more common types of indemnity clause.

3.2 The ***bare*** indemnity is where A indemnifies B against all liabilities or losses incurred in connection with a given event or given events and circumstances, but without setting any specific limitations. In particular, such indemnities will be silent as to whether they indemnity losses arising out of B's own acts and/or omissions. In this regard they could potentially become "reverse" or "reflexive" indemnity.

3.3 A ***reverse*** or ***reflexive*** indemnity is where A indemnifies B against losses incurred as a result of B's own acts and/or omissions (e.g. negligence). This is the type of indemnity used in a release or settlement deed where the indemnity is intended to be support for a bar to a claim by A against B.

3.4 A ***proportionate*** indemnity, which is the opposite of a reverse" or "reflexive" indemnity, is where A indemnifies B against losses except those incurred as a result of B's own acts and/or omissions.

3.5 A ***third party*** indemnity is where: (a) A indemnifies B against liabilities to or claims by C; or (b) A indemnifies B against claims that a product A supplied infringes C's intellectual property rights.

3.6 A ***financing*** indemnity is where A indemnifies B against losses incurred if C fails to repay financial accommodation to B. These indemnities are usually coupled with a guarantee in financing arrangements.

3.7 A ***party/party*** indemnity is where each party to a contract indemnifies the other(s) for losses occasioned by them by the indemnifier's breach of the contract in which the indemnity clause sits. This indemnity is usually included in commercial contracts to

[35] *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26 at 70.

provide for additional rights for the indemnified party in the event of contractual breach.

4 Construction of Indemnities – What to consider before Drafting an Indemnity Clause

4.1 As noted above at paragraphs 2.31.5 and 2.32, Courts will generally treat an indemnity clause extremely strictly. The reason for imposing such strict standards is the 'inherent improbability', absent clear expression, that the other party to a contract including such a clause intended to release their counterpart from a liability it would otherwise accrue to the releasing party.[36]

4.2 The Supreme Court of Queensland has recently, and helpfully, summarised the courts' approach to construing indemnity clauses. It was Applegarth J who did so in *Samways v Workcover Queensland* [2010] QSC 127 at [66]-[71], saying (footnotes inserted):

> *Principles of construction of such an indemnity clause*
>
> *[66] Such an indemnity clause falls to be construed strictly, and any doubt as to the construction should be resolved in favour of the indemnifier.[37] The doubt may arise not only from the uncertain meaning of a particular expression but from its apparent width of possible application.[38]*
>
> *[67] The authorities that require ambiguity to be resolved in favour of the indemnifier do not require that ambiguity be detected where the natural and ordinary meaning of the language, taken in its contractual context, requires no such conclusion.[39] Absent statutory authority, a court has no mandate to rewrite a provision to avoid what it retrospectively perceives as commercial unfairness or lack of balance.[40]*
>
> *[68] The clause should be construed in its contractual context which allocates risks of different kinds between the parties, and, relevantly in this case, provides that the operator shall be under the control of the Hirer. Effect should be given to the ordinary meaning of the language used (absent use of technical expressions or terms of art) so as to provide certainty as to where responsibility*

[36] *Ailsa Craig Fishing Co Ltd v Malvern Fishing Ltd* [1893] 1 WLR 964 at 970 per Fraser LJ and at 966 per Wilberforce LJ.
[37] *Andar Transport Pty Ltd v Brambles Ltd* [2004] HCA 28; (2004) 217 CLR 424 at [17] – [23].
[38] *Bofinger v Kingsway Group Ltd* [2009] HCA 44; (2009) 239 CLR 269 at 292 [53]; [2009] HCA 44.
[39] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* [2008] NSWCA 114; (2008) 72 NSWLR 1 at 21 [87].
[40] Ibid at [88].

> *may lie, against which insurance may be obtained.*[41] *The fact that the contract requires a party to take out insurance against the indemnified liability may be taken into account in concluding that the indemnity applies to that liability, whether or not insurance is in fact taken out.*[42] *The absence of a provision for insurance against the liability may also be taken into account.*[43] *However, the fact that the indemnifier is not required by the contract to take out insurance, and chooses not to take out insurance should not affect the construction of an indemnity that unambiguously allocates responsibility for the liability against the indemnifier.*
>
> *[69] The outcomes of other cases involving different contractual arrangements and different clauses do not dictate the outcome of this case. However, the principles of construction established in those cases should be followed.*[44]
>
> *[70] One line of authority construes contracts of the present kind on the assumption that it is inherently improbable that a party would contract to absolve the other party against claims based on the other party's own negligence.*[45] *The competing view is that at least a principal purpose for obtaining such an indemnity is to protect a party against liability for its own fault.*[46]
>
> *[71] The interpretation of phrases such as "arising out of" and "in connection with" in different contexts, including compulsory third party insurance, does not determine its meaning in the present context. However, guidance can be derived from authorities in which such phrases are used in comparable cases involving indemnity clauses.*

4.3 Despite Applegarths' J helpful guidance, however, it should always be remembered that they are principles rather than binding precedent. In descending order of importance, any change in language of the indemnity clause, the contract itself or the context of its being negotiated may render previous clauses from previous cases of little value. Justice Giles' warning is apt:[47]

> *… the operation of any contractual indemnity must be found in the application to the facts of the relevant clause, construed as part of the contract as a whole.*

[41] Ibid.
[42] Ibid.
[43] *Ellington v Heinrich Constructions Pty Ltd* (2005) 13 ANZ Ins Cases 61-646; [2004] QCA 475 at [23].
[44] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (supra) at [89], [166].
[45] *Davis v Commissioner for Main Roads* [1968] HCA 10; (1968) 117 CLR 529 at 534 per Kitto J (Windeyer J agreeing); *Westina Corporation Pty Ltd v BGC Contracting Pty Ltd* [2009] WASCA 213 at [64] – [65].
[46] *Davis v Commissioner for Main Roads* (supra) at 537 per Menzies J (Barwick CJ and McTiernan J agreeing); *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (supra) per Basten JA.
[47] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (2008) 72 NSWLR 1 at per Giles JA.

> *Decisions on the operation of contractual indemnities in different words in different contracts are likely to be of limited assistance.*

4.4 Therefore regard may be had to the principles but should not be relied on as a binding precedent.

5 Common Types of Contracts Where Indemnification is Important and Negotiating Them

5.1 Indemnity clauses are commonly found. They appear in a range of different types of contractual dealings. For instance, they often occur in commercial contracts such as leases, sale of goods, construction contracts, manufacturing contracts and service agreements.

5.2 When preparing to negotiate a contract, whether it be one of those just discussed or some other type that includes an indemnity clause, paying particular attention to the specific in the indemnity clauses is strongly recommended. By identifying the potential loss and damage (in other words, the risks) in the transaction, and by understanding the liability at law or in equity applicable before the indemnity clause takes effect, you will be greatly advantaged. You will both the risk at play and the contracting parties' positions absent an indemnity clause.

5.3 Once in this position you can then ask the questions in the next section to confirm what work the indemnity clause has to do and, therefore, what you must do in preparing it.

6 Questions the Drafter Should Ask Themselves

6.1 In every instance where a drafter is preparing an indemnity clause they will benefit from asking themselves, and retaining clear in their mind their answers to, the following questions.

6.2 First, what is the source[48] of any potential loss or damage?

6.3 Secondly, what is the extent of that potential loss or damage?

6.4 Thirdly, consider who is providing the indemnity?

[48] For instance, non-performance or defective performance; damage to property of the parties or third parties; injuries suffered by employees, agents or the public; et cetera.

6.5 Fourthly, who is the beneficiary of the indemnity?

6.6 Fifthly, what enlivens the obligations to indemnity?

6.7 Sixthly, what is the indemnity's extent?

6.8 Seventhly, what is the indemnity's term or duration?

6.9 Finally, what is the ability of the responsible party to meet any obligation under the indemnity?

6.10 Although these are simplistic in the form, they represent the fundamental aspects of any indemnity and clear answers to them will go some way to ensuring the indemnity clause is appropriately drafted.

7 Pitfalls to Avoid When Drafting Your Indemnification

7.1 The paper will now discuss tips when drafting indemnity clauses. Given the infinite array of:

7.1.1 issues to be addressed by indemnity clauses;

7.1.2 contractual contexts in which those clauses will sit; and

7.1.3 factual circumstances in which those contracts will be negotiated,

it is most profitable to discuss discreet tips and techniques rather than seeking to prescribe a particular form of words (though words to avoid will be discussed) or template clause.

Take Responsibility for Drafting

7.2 By taking the responsibility for drafting you can set parameters around the discussion for the indemnity clause. This gives the party who is drafting an advantage in advocating for the clause to be in terms they find satisfactory or advantageous.

7.3 Examples of items the drafter can apply by undertaking the task are:

7.3.1 exclude or extend time limits, causation issues, remoteness issues, foreseeability issues or (as discussed below) mitigation issues.

7.3.2 exclude from the indemnity, or extend the indemnity to, claims by third parties.

7.3.3 ensure clarity in drafting where the indemnity will cover the indemnified party's own negligence (as will be required due to the Court's approach to interpreting such a broad indemnity).

7.4 Given that courts are reluctant to rewrite a contract (see paragraph 4.2 above), this advantage of establishing the ambit of the clause is significant.

No Template Clauses – Tailored Drafting

7.2 the most important tip for drafting indemnity clauses is to ensure that the clause is worded to suit the particular circumstances of the contracting parties. Other than in the most simple of circumstances, using template or boilerplate clauses – without at least taking sufficient time to tailor them to the client's needs – is to invite problems later.

7.3 The contract as a whole can be helpful in drafting an indemnity clause. If there is a dispute about the operation of a contractual indemnity, the balance of the contract will help to identify the operation of the indemnity clause. It bears repeating Giles JA's comments cited at paragraph 4.3 above:

> *… the operation of any contractual indemnity must be found in the application to the facts of the relevant clause, construed as part of the contract as a whole. Decisions on the operation of contractual indemnities in different words in different contracts are likely to be of limited assistance.*

Hold Harmless or Make Good?

7.4 The High Court has described indemnities in different ways:

7.4.1 in *Sunbird Plaza Pty Ltd v Maloney*[49] the High Court said an indemnity is '*a promise by the promisor that he will keep the promise harmless against loss as a result of entering into a transaction with a third party.'*; and

7.4.2 in *Andar Transport Pty Ltd v Brambles Ltd*[50] the High Court said that indemnities '*are designed to satisfy a liability owed by someone other than the guarantor or indemnifier to a third person'*.

7.5 Whilst both statements are accurate, it seems different outcomes may flow from the obligation to "hold harmless" the indemnified party as opposed to the obligation to "make good" any loss or damage suffered. The potential difference is:

7.5.1 in the case of a "hold harmless" obligation the party giving the indemnity will effectively be in breach of the contract as soon as the indemnified party

[49] (1988) 166 CLR 245 at 254
[50] (2004) 217 CLR 424 at 437

suffers any loss or damage. The cause of action would accrue, and therefore the limitation period runs, immediately from the date of loss or damage.

7.5.2 in the case of a "make good" obligation the indemnified party's right to claim indemnity arises when they suffer loss or damage. However the party giving the indemnity is not obliged to do anything until called upon to make good the loss or damage. Therefore, there is no breach of contract until the indemnified party calls for the indemnity and that call is refused. IT is only then than the cause of action accrues, and therefore the limitation period runs. As stated at paragraph 2.25 above, this could occur long after the original event that enlivens the contractual indemnity.

7.6 If you were acting for the indemnifier, therefore, the "hold harmless" vernacular may be preferred to shorten the length of any limitation period. For the opposite reason you may prefer "make good" if you act for the indemnified party.

Ability to meet Obligations

7.7 It is critical to the effectiveness of any indemnity clause that the indemnifier actually has the capacity to meet the obligations of the indemnity. The most eloquently and effectively drafted indemnity clause will be hollow if the indemnifier cannot comply with its obligations.

7.8 It is common, where the indemnifier cannot fund the potential indemnity obligations, to obtain insurance or some other arrangement, such as the use of a guarantor. For instance, purchases of businesses that occur in stages, or the operation of businesses with multiple principals, often involve insurance over the business participant that may be obliged to buy out the interests of the other participants.

7.9 If an indemnified party is to rely on insurance obtained by the indemnifier, the indemnified party should ensure that he cover is adequate and that the policy will remain in place for a term sufficient for the indemnity clause's purposes. It must remain valid for the entire period during which the indemnified party may call on the indemnity.

7.10 If there are more than one insurance policy required or desired, it can also be beneficial to collate all relevant insurances and, once together, consider them as a whole and ensure there are no potential recovery problems or that any aspects of the indemnity obligations has not been covered someone in the policies. Further, the policies themselves should be considered to ensure any exclusion or restrictions in their individual coverage do not leave the parties unintentionally exposed.

Obligation to Mitigate Loss

7.11 Despite the "Benefits of Indemnity Clauses" set out at paragraphs 2.19 to 2.25 above, if you are acting for the indemnifier you may choose to include an obligation on the indemnified party that the mitigate their loss under the indemnity. This would bring into consideration the principles around mitigation and ensures that the indemnifier does not bear further risk of cost for the indemnified party's failure to take action to limit any exposure to loss.

Ensure Deed is Used

7.12 If the agreement containing the indemnity clause is a Deed it will remove the need to ensure valid consideration passes for the particular promises of the indemnity.

Avoid Guarantee, Warranty or Insurance Obligations

7.13 As stated at paragraph 2.27, the drafting can, inadvertently, turn an indemnity clause into a warranty, a guarantee or an insurance obligation. Avoiding those terms is the starting point to ensuring you have an indemnity rather than one of these other legal relations.

Avoid Ambiguous Phrases

7.14 Care should be had to ensure ambiguous phrases are avoided where possible.

"arising out of"

7.14.1 In *Samways v Workcover Queensland* [2010] QSC 127 at [72] Applegarth J said (again footnotes inserted):

> *[72] The words "arising out of" are wide. The relevant relationship should not be remote, but one of substance albeit less than required by words such as "caused by" or "as a result of".*[51] *The phrase connotes a weak causal relationship.*[52] *However, more is required than the mere existence of connecting links.*[53] *The words require the existence of a causal or consequential relationship between, in this case, the use of the plant and the injury.*[54]

[51] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* [2008] NSWCA 114; (2008) 72 NSWLR 1 at [11].
[52] Ibid at [97].
[53] *F & D Normoyle Pty Ltd v Transfield Pty Ltd* [2005] NSWCA 193; (2005) 63 NSWLR 502 at 515 [90].
[54] *estina Corporation Pty Ltd v BGC Contracting Pty Ltd* [2009] WASCA 213 at [61].

"in connection with"

7.14.2 In *Samways v Workcover Queensland* [2010] QSC 127 at [73] Applegarth J said (again footnotes inserted):

> *[73] The expression "in connection with" is capable of having a wide meaning, but its meaning must be derived from the context in which it is used.*[55] *The words "in connection with" have been accepted as capable of describing a spectrum of relationships between things, one of which is bound up with or involved in another. The question that remains in a particular case is what kind of relationship will suffice to establish the connection contemplated by the contract.*[56] *In the present context there must be a sufficient nexus between the use of the plant and the injury.*

7.15 Similar expressions are '*arising from or in connection with'* and '*arising directly or indirectly in relation to'*. If words of wide import are to be used they should be so used only in the knowledge that a court may see ambiguity in them or try to read them in light of the context in which the words appear.

Avoid the Right to Damages

7.16 Try to avoid the indemnity clause being characterized as a right to damages. It should be drafted as an obligation to pay money to compensate the indemnified party for a loss once it has been sustained.

Legal Costs

7.17 If the parties intend the indemnity to cover associated costs, such as legal costs or costs of recovery, it should be expressly addressed. This can be done by the wording of the indemnity clause itself or by the use of terms appropriately defined elsewhere in the agreement.

7.18 The legal costs, if addressed, should descend a level of specificity that later arguments are avoided. Whether it is a complete indemnity (100% of costs), party-party costs or some other basis should be articulated.

Minimise Cross-References

7.19 To the extent possible you should include within the indemnity clause all provisions and limitations regarding the indemnity. Avoid relying on provisions elsewhere in the contract to aid in the construction of the indemnity clause (other than the use of defined terms in the definitions section of the agreement).

---

[55] *Fraser v The Irish Restaurant and Bar Co Pty Ltd* [2008] QCA 270 at [40].
[56] Ibid at [42] – [43] citing *R v Orcher* [1999] NSWCCA 356; (1999) 48 NSWLR 273 at 279.

Use Appropriately Defined Words

7.20 As just mentioned, simplify and define words such as "Loss" or Claim" or "Liability" when used in the indemnity clause. By doing so you can ensure that they have their broadest, or narrowest, meaning as your client's interests dictate.

Align the Indemnity and the Risk

7.21 Ensure the indemnity and the risk to be addressed align. For instance, do not draft a bare indemnity when the risk to be addressed is known.

Specify Consequences

7.22 To the extent possible you should specify the consequences of breach of an indemnity clause. Specifically provide for the indemnity clause to be a right in addition to other rights under the contract or law and specify that the loss is not limited to those contemplated at the time of entering the agreement.

Events within your control

7.23 The party providing the indemnity should seek to limit its cover to events that are within the control of that indemnifier.

8 Conclusion

8.1 Although courts will interpret indemnity clauses strictly, and therefore the drafting of them must be deliberate and accurate, they afford an opportunity to exclude, or include, issues of mitigation, remoteness or causation and, significantly, extend the time in which any claim may be brought.

8.2 They remain an effective tool in transferring risk for a defined event between contracting parties.