

Indemnities – Another form of risk allocation

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1. Introduction

Proper risk allocation in contracts has become much more topical in recent years. This is hardly surprising given the increasing complexity of transactions in commerce and the potential liability which can attach to breaches of contract, negligence and other unlawful conduct.

In order to achieve proper risk allocation it is necessary to identify the risks and then properly allocate them.

In allocating them, it is important to ensure that the risk allocation is properly dealt with in the relevant contracts. This will often necessitate the use of, among other things, indemnities.

Indemnities are often very difficult to draft to properly reflect the agreed risk allocation and more often than not are not properly thought through except by highly experienced lawyers.

In order to draft indemnity clauses and properly allocate risk it is necessary to fully understand:

- (a) the purpose of indemnities;
- (b) the limitations on their enforceability;
- (c) what might be obtainable in the market place; and
- (d) the potential pitfalls in relation to their drafting.

These issues are discussed below.

2. Indemnities – the major issues

2.1 What are they?

An indemnity is a promise by one party to hold the other party harmless against one or more losses sustained by the other party. It is usually linked to acts or omissions of the party giving the indemnity.

An obligation to indemnify must be distinguished from an obligation to guarantee. A guarantor's liability is considered collateral or secondary whereas an indemnifier's liability is considered primary.

A guarantor undertakes to ensure, in the event of a default by the contracting party, that a particular obligation under contract is fulfilled on the contracting party's behalf. In contrast, an indemnity is a promise to make good a loss or keep another party free from harm.¹

2.2 Why are they used?

In short, indemnities serve at least two purposes. Firstly, they allocate risk between the parties. Second, they provide a mechanism to avoid issues such as remoteness and mitigation. Each of these issues is discussed below.

In order to be successful in an action for damages, the onus will be on the party alleging the breach to establish a sufficient connection between the breach and the loss suffered.

Causation can be established in one of two ways:

1. if it can be proved that, but for the other party's breach, the alleging party would not have suffered the loss or damage; or
2. the other party's breach is so connected with the alleging party's loss or damage that, "*as a matter of ordinary common sense and experience it should be regarded as the cause of it.*"²

Even if a causal link is established, a loss resulting from the breach may not be compensable if it is too remote. The alleging party must be able to satisfy the test for remoteness as set out in *Hadley v Baxendale* (1854) 9 Ex 341.

The two limb test in *Hadley v Baxendale* provides that damage will not be too remote if it may be reasonably considered:

1. as arising naturally according to the usual course of things from the breach (the **first limb**); or
2. to have been reasonably in the contemplation of the parties at the time they made the contract as a probable result of it (the **second limb**).

While there has been much debate as to the loss that will be considered to flow from the usual course of things as required under the first limb, Australian authority suggests that the test to be applied under the first limb is what loss is "*sufficiently likely to result*"³.

In determining whether the loss or damage was reasonably in the contemplation of the parties under the second limb, regard must be had to the actual knowledge possessed by the defendant⁴. In addition to actual knowledge of the circumstances, it is also necessary for either:

- (a) the defendant to acquire this knowledge from the plaintiff prior to entering into the contract; or

¹ *Yeoman Credit Ltd v Latter* (1961) 1 WLR 828.

² *March v E & M H Stramare Pty Ltd* (1991) 171 CLR 506 at 522.

³ *Burns v MAN Automotive (Aust) Pty Ltd* (1986) 161 CLR 653 at 667 per Wilson, Dawson and Deane JJ citing Lord Reid in *Koufous v C Czarnikow Ltd* [1969] 1 AC 350.

⁴ *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528.

- (b) for the plaintiff to know the defendant has this knowledge at the time the contract is entered into.

Assuming the losses fall within one of the limbs of *Hadley v Baxendale* the rules as to mitigation of damage might come into play, which in short are:

- (a) the innocent party is not entitled to recover damages for any loss which could have been avoided by the taking of reasonable action;
- (b) the innocent party cannot recover for any loss which has in fact been avoided; and
- (c) the innocent party is entitled to recover costs and expenses incurred in the course of taking reasonable action to mitigate loss flowing from the defaulting party's breach.

2.3 Enforcement of Indemnities

- (a) General enforceability

Generally speaking, and assuming the contract in which the indemnity is contained is enforceable, an indemnity will, in the absence of uncertainty, some form of statutory prohibition or public policy considerations, be enforceable according to its terms.

- (b) Extent of subject matter

In determining the enforceability of an indemnity, the courts will look to the specific words of the indemnity to construe the liability which arises. As an indemnity is not governed by the law relating to assessment of damages for breach of contract, factors such as remoteness and mitigation do not need to be proved unless expressly brought into play by the words in the clause.

Examples of indemnities contained in some standard form construction contracts and an indemnity from a project deed for a major PPP project are set out in Attachment 1.

Often words such as "arising out of", "in connection with", "as a result of", "in the course of" or "due to" are used to create the nexus between the type of losses, costs, etc and the event or conduct which is the subject matter of the indemnity. In addition, often indemnities will extend to conduct or events which are broader than breaches or other forms of unlawful conduct, by, for example, referring to "acts or omissions". Terms such as "arising out of" or "in connection with" have, in other contexts, been given a wide interpretation by our courts.⁵ Additionally, in other contexts, the phrase "acts or omissions" has been held to be wider than unlawful acts or omissions.⁶

Equally, the extent of recovery under the indemnity will depend on the words used to describe the subject matter of the indemnity. Indemnities often use words such as costs, expenses, losses, damages, etc.

Some indemnities, or exclusion of liability clauses which cut across indemnities, use the words "consequential" and "indirect" when referring to losses (e.g. as being excluded from

⁵ See *Walter Rau Neusser Oel Und Fett AG v Cross Pacific Trading Ltd* (unreported, Federal Court of Australia, Allsop J, 15 August 2005).

⁶ See *Graham Evans & C Pty Ltd v S P Formwork Pty Ltd* (1988) 5 BCL 149.

the indemnity). This can lead to the question of whether such losses are within the first or second limb of *Hadley v Baxendale* (if at all).

In *GEC Alsthom Australia Ltd v City of Sunshine* (Federal Court, Ryan J, 20 February 1996, unreported) GEC brought a breach of contract claim against the City of Sunshine who were contracted to provide a certain level of gas energy flow. The level actually supplied was well below the amount expected. GEC argued that it had an objective expectation of the expected revenue and as a result of the breach, it had been deprived of this revenue. The measure of damages was said to be an amount representing that loss of revenue. The indemnity provided by City of Sunshine under the contract was for direct loss and specifically excluded consequential loss. GEC argued that this indemnity for direct loss was intended to cover all loss which would flow directly from the breach, including anticipated revenue.

Ryan J accepted GEC's argument and found that the indemnity clause, in its context, was sufficient to provide GEC with an indemnity for damage flowing directly from the breach, including any loss of anticipated profits. His Honour did not regard loss of revenue as 'consequential loss' but defined this term as connoting: "*a loss at a step removed from the transaction and its immediate effects.*"⁷

Courts have been reluctant to provide a clear definition of indirect or consequential loss. Whether loss is considered to be indirect or consequential will be determined on the facts of each case. However, that is not to say that the courts will not adopt a consistent approach in interpreting these clauses. Waller LJ in *British Sugar PLC v NEI Power Projects Ltd* (1997) 87 BLR 42 stated that: "*once a phrase has been authoritatively construed by a court in a very similar context to that which exists in a case in point, it seems to me that a reasonable businessman must more naturally be taken to be having the intention that the phrase should bear the same meaning as construed in the case in point. It would again take very clear words to allow a court to construe the phrase differently.*"

In *Deepak Fertilisers & Petrochemicals Ltd v Davy McKee (London) Ltd* (1999) 1 All ER (Comm) 69, a methanol plant had been negligently built and production was lost while rebuilding took place. The court found that losses that had begun to clock up at once (eg cost of idle men and plant) were to be regarded as direct and not consequential.

In *Pegler Ltd v Wang (UK) Ltd* 25/02/2000 QBD unreported, it was held that the words "*indirect, special or consequential loss*" did not cover all loss of profits but only those profits lost which were indirect, special or consequential loss in character.

In *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] BCL 235, the Court of Appeal held that loss of profits in that case were a direct or natural consequence of the relevant breach.

Australian cases have considered the meaning of losses in the context of the two limb test of *Hadley v Baxendale*.

⁷ *GEC Alsthom Australia Ltd v City of Sunshine* (Federal Court, Ryan J, 20 February 1996, unreported) at pg 55.

In *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] FCA 50, GEC had repudiated software development contracts it had entered into with BHPIT. BHPIT was required to use its own resources to meet its obligations to its customer and claimed against GEC for loss of profit. The court held that the loss of profit claim was an indirect and consequential loss which fell under the second limb of *Hadley v Baxendale*.

In *Hungerfords v Walker* (1989) 171 CLR 125, Hungerfords had overpaid tax over a number of years in accordance with advice received from external accountants. Hungerfords claimed damages for the added cost of funding the business with borrowed money as a result of the loss of the use of money overpaid in tax. The court held that this loss was a foreseeable result of the overpayment of tax and, as a result, fell into the first limb of *Hadley v Baxendale*.

It is therefore conceivable that some economic losses might be within the first limb of *Hadley v Baxendale* and should be specifically referred to in the relevant clause rather than simply relying on generic phrases such as "*indirect and consequential*" to include them.

(c) Privity of contract

The doctrine of privity of contract provides that except in very limited circumstances only parties to a contract can enforce contractual obligations. As an indemnity is a contractual obligation (in the absence of a statutory right of indemnity) only the parties to the relevant contract will receive the benefit of it. In more recent times indemnities have been drafted to provide for parties extra the contract (e.g. related corporations, officers, employees, agents, invitees, etc) to be included in the class of people to be indemnified under contractual indemnities. The question arises as to whether these indemnities are enforceable by those persons who are not parties to the contract.

The court in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107, held that an obligation to indemnify under an insurance contract could be enforced by a beneficiary of that obligation even though he or she was not a party to the contract.

In this case, McNiece was the principal contractor for a plant being constructed for Blue Circle Southern Cement Limited. Blue Circle had effected an insurance policy with Trident, which contained the following clause:

"The insurance ...indemnifies the Assured against all sums which the Assured shall become legally liable to pay in respect of:

- (1) *Death of or bodily injury to or illness of any person not being a person who at the time of occurrence is engaged in and upon the service of the Assured under a contract of service or apprenticeship..." (where the Assured was described in the policy to include contractors and sub-contractors of Blue Circle).*

A worker was injured while under the direction of a McNiece employee. The worker made a successful claim against McNiece who then sought an indemnity from Trident. The High Court accepted there was an exception to the doctrine of privity and found in favour of McNiece even though McNiece was not party to the insurance contract and had not provided any consideration.

The majority Judges adopted different bases for the exception.

Mason CJ and Toohey J created a limited exception to the doctrine of privity. Toohey J stated that: "*when an insurer issues a liability insurance policy, identifying the assured in terms that evidence an intention on the part of both insurer and assured that the policy will indemnify those with whom the assured contracts for the purpose of the venture covered by the policy, and it is reasonable to expect that such a contractor may order its affairs by reference to the existence of the policy, the contractor may sue the insurer on the policy, notwithstanding that the contractor is not a party to the contract between the insurer and the assured.*"⁸

Gaudron J held stated that: "*a promisor who has accepted an agreed consideration for a promise to benefit a third party comes under an obligation to the third party to fulfil that promise and the third party acquires a right to bring an action to secure the benefit of that promise. The right of the third party is not a right to sue under the contract: rather it is an independent right of, but ordinarily corresponding in content and duration with, the obligation owed under the contract by the promisor to the promisee.*"⁹ Gaudron J appears to have decided on the basis of unjust enrichment.

Deane J decided in favour of McNiece on the basis of a trust of a promise.

In some cases statutes give recognition to allow enforceability of promises made for the benefit of third parties, but acceptance of the indemnity must be made by the relevant third parties. Accordingly, in these instances the third party should be advised of the indemnity and should accept it as soon as possible and accept it in a manner which conforms with the relevant legislative provisions.

For example, Section 55 of the *Property Law Act 1974* (QLD) provides an exception to the doctrine of privity as follows:

"55 Contracts for the benefit of third parties

- (1) *A promisor who, for a valuable consideration moving from the promises, promises to do or to refrain from doing an act or acts for the benefit of a beneficiary shall, upon acceptance by the beneficiary, be subject to a duty enforceable by the beneficiary to perform that promise.*
- (2) *Prior to acceptance the promisor and promisee may, without the consent of the beneficiary, vary or discharge the terms of the promise and any duty arising from it.*
- (3) *Upon acceptance –*
 - (a) *the beneficiary shall be entitled in the beneficiary's own name to such remedies and relief as may be just and convenient for the enforcement of the duty of the promisor, and relief by way of specific performance, injunction or otherwise shall not be refused solely on the ground that, as against the promisor, the beneficiary may be a volunteer; and*
 - (b) *the beneficiary shall be bound by the promise and subject to a duty enforceable against the beneficiary in the beneficiary's own name to do or refrain from doing such act or acts (if any) as may be required of the beneficiary; and*

⁸ (1988) 165 CLR 107 at 536.

⁹ *ibid* at 537-538.

- (c) *the promisor shall be entitled to such remedies and relief as may be just and convenient for the enforcement of the duty of the beneficiary; and*
 - (d) *the terms of the promise and the duty of the promisor or the beneficiary may be varied or discharged with the consent of the promisor and the beneficiary.*
- (4) *Subject to subsection (1), any matter which would in proceedings not brought in reliance on this section render a promise void, voidable or unenforceable, whether wholly or in part, or which in proceedings (not brought in reliance on this section) to enforce a promissory duty arising from a promise is available by way of defence shall, in like manner and to the like extent, render void, voidable or unenforceable or be available by way of defence in proceedings for the enforcement of a duty to which this section gives effect.*
- (5) *In so far as a duty to which this section gives effect may be capable of creating and creates an interest in land, such interest shall, subject to section 12,⁶ be capable of being created and of subsisting in land under any Act but subject to that Act.*
- ⁶ Section 12 (Creation of interests in land by parol)
- (6) *In this section –*
- "acceptance"** *means an assent by words or conduct communicated by or on behalf of the beneficiary to the promisor, or to some person authorised on the promisor's behalf, in the manner (if any), and within the time, specified in the promise or, if no time is specified, within a reasonable time of the promise coming to the notice of the beneficiary.*
- "beneficiary"** *means a person other than the promisor or promisee, and includes a person who, at the time of acceptance is identified and in existence, although that person may not have been identified or in existence at the time when the promise was given.*
- "promise"** *means a promise –*
- (a) *which is or appears to be intended to be legally binding; and*
 - (b) *which created or appears to be intended to create a duty enforceable by a beneficiary;*
- and includes a promise whether made by deed, or in writing, or, subject to this Act, orally, or partly in writing and partly orally.*
- "promisee"** *means a person to whom a promise is made or given.*
- "promisor"** *means a person by whom a promise is made or given.*
- (7) *Nothing in this section affects any right or remedy which exists or is available apart from this section.*
- (8) *This section applies only to promises made after the commencement of this Act."*

Therefore some possible exceptions to the doctrine of privity of contract include:

- (a) third party beneficiaries by virtue of the common law or statutory rights given to such beneficiaries;
- (b) where the indemnity has been received by the contracting party as agent for the other members of the class referred to in the indemnity; and

- (c) where the indemnity or the benefits of it are held on trust by the other contracting party for the benefit of the other beneficiaries.

2.4 Points to consider when drafting

There are many issues to consider when drafting indemnities. Some of these are set out below.

- (a) It is critical to identify the subjects and subject matter of the indemnities. It is important to specify who will provide the indemnity and to whom it will be provided, including any third parties. It is also important to:
 - (i) specify the types of claims, demands, actions, liabilities, damages, losses, costs or expenses to which the indemnity will apply and whether those categories of liability will also include claims by third parties made against the indemnified party for similar sorts of liabilities;
 - (ii) specify the conduct or event which is to form the subject matter of the indemnity; and
 - (iii) specify carefully the nexus between the claims, demands, etc and the relevant conduct or event.
- (b) Often reciprocal indemnities are included in contracts without any consideration given to whether this is appropriate. In some cases it may be appropriate whilst in others it might not. For example, where a contractor provides an indemnity to support the allocation to it of the care and risk of the works (i.e. the physical structure to be handed over at the completion of the project) it is not appropriate for the owner to provide a similar indemnity in respect of the same risk.
- (c) Consideration should be given to what should be excluded from the relevant indemnity. For example, it is common to exclude liabilities which arise due to the actions of the party seeking the benefit of the indemnity. Such liabilities would include those which arise by virtue of the relevant party's own negligence, breach of contract or breach of statutory duty.
- (d) Sometimes indemnities will extend beyond the liability which a party will owe at common law, and consideration should be given to seeking consent from relevant insurers before agreeing to such indemnities. If such consent is not obtained then, depending on the wording of the relevant policy of insurance, insurers might be able to deny liability for the whole or part of the liabilities the subject of the indemnity.
- (e) Interaction between the exclusions of liability and limitation of liability clauses, liquidated damages regimes and indemnity clauses needs to be carefully considered. For example, where the liability of a party is excluded or limited it might be appropriate to make the relevant indemnity subject to that exclusion or limitation. If this is the case then this should be made clear. Alternatively if that is not appropriate then the converse should also be made clear. Where a liquidated damages regime has been included in a contract and a broad indemnity for breach of contract is also included then consideration needs to be given as to whether the

liquidated damages regime is still intended to operate as a limitation of liability in respect of the relevant breach irrespective of the relevant indemnity.

- (f) Care needs to be taken when drafting indemnities for liability which might flow from breach of statutory obligations. If the contravention of the statute will amount to an offence and may attract the payment of a fine or penalty then it may not be possible to obtain an enforceable indemnity in respect of such fine or other statutory penalty.

2.5 What to ask for and what to accept

The indemnities which parties will agree to are very much, once again, dependent on the commercial context of the relevant contract, the parties bargaining positions and the insurance regime applicable to the relevant contract or project. It is not possible to provide a list of the indemnities which will or should be included in every contract. However, some observations can be made about some trends which have appeared in recent times in respect of indemnities. These include:

- (a) It is now quite common for contracts to include indemnities in respect of liability owed to third parties for damage to property and personal injury where a party is providing works or services on or in connection with another party's property. Often these clauses will exclude liability which arises due to the negligence, breach of contract or breach of statutory duty by the innocent party.
- (b) Parties are becoming less willing to provide broad reaching indemnities for breaches of contract and are more likely to insist on the innocent party relying on its rights to damages at common law or its rights under liquidated damages regimes where such rights are subject to relevant exclusions of liability and limitations of liability.
- (c) It is still quite common to see parties seeking indemnities in respect of breach of copyright and other intellectual property rights. Often these indemnities are open ended and are not subject to any limitations of liability or exclusions of liability.
- (d) It is uncommon to see indemnities for consequential loss, indirect loss, loss of revenue, profit, etc.
- (e) In appropriate circumstances indemnities are being drafted to apply for the benefit of non-parties to the contract including related corporations, officers, employees and agents.
- (f) Indemnities are often made subject to overall exclusions of liability and limitations of liability so that they do not annihilate those exclusions and limitations.

3. Conclusion

Indemnities are wonderful tools for effecting risk allocation in contracts, but must be properly understood and clearly drafted if proper risk allocation is to be effected.

Attachment 1

Indemnity clause 1 – JCC-E 1994

LIABILITIES, INDEMNITIES AND INSURANCES

P8.01 LIABILITY FOR DAMAGE TO PROPERTY

The Builder shall be liable for and shall indemnify the Proprietor against any liability, loss, claim or proceeding in respect of any injury, loss or damage whatsoever to any property real or personal insofar as such injury, loss or damage arises out of or in the course of or by reason of the execution of the Works provided always that the same is due to the negligence, act, omission or default of the Builder, the Builder's servants or agents, of any sub-contractor or of the servants or agents of any sub-contractor and provided further that the Builder's liability to indemnify the Proprietor shall be reduced proportionately to the extent that the negligence, act, omission or default of the Proprietor or any person other than the Builder for whom the Proprietor is responsible may have contributed to such injury, loss or damage.

P8.02 LIABILITY FOR INJURY TO PERSONS

The Builder shall be liable for and shall indemnify the Proprietor against any liability, loss, claim or proceeding whatsoever arising under any legislation or at common law in respect of personal injury to or death of any person whomsoever arising out of or in the course of or caused by the execution of the Works provided always that the same is due to the negligence, act, omission or default of the Builder, the Builder's servants or agents, of any sub-contractor or of the servants or agents of any sub-contractor and provided further that the Builder's liability to indemnify the Proprietor shall be reduced proportionately to the extent that the negligence, act, omission or default of the Proprietor or any person other than the Builder for whom the Proprietor is responsible may have contributed to the personal injury or death.

Indemnity clause 2 – AS4000

15.1 Indemnity by Contractor

Insofar as this subclause applies to property, it applies to property other than *WUC*.

The *Contractor* shall indemnify the *Principal* against:

- a) loss of or damage to the *Principal's* property; and
- b) claims in respect of personal injury or death or loss of, or damage to, any other property,

arising out of or as a consequence of the carrying out of *WUC*, but the indemnity shall be reduced proportionally to the extent that the act or omission of the *Superintendent*, the *Principal* or its consultants, agents or other contractors (not being employed by the *Contractor*) may have contributed to the injury, death, loss or damage.

This subclause shall not apply to:

- a) the extent that the *Contractor's* liability is limited by another provision of the *Contract*;
- b) exclude any other right of the *Principal* to be indemnified by the *Contractor*;
- c) things for the care of which the *Contractor* is responsible under subclause 14.1;
- d) damage which is the unavoidable result of the construction of *the Works* in accordance with the *Contract*; and
- e) claims in respect of the *Principal's* right to have *WUC* carried out.

Indemnity clause 3 – Project Specific

Indemnities by the Contractor

- (a) To the maximum extent permitted by Law, the Contractor indemnifies and shall keep indemnified the Principal from and against all actions, suits, claims, demands, proceedings (whether in tort or otherwise), losses, liabilities, damages, compensation, costs (including legal costs on a full indemnity basis), charges and expenses whatsoever to which the Principal shall or may become liable (notwithstanding that any such actions, suits, claims, demands, proceedings, losses, damages, compensation, costs, charges and expenses shall have resulted from any act or thing which the Contractor may be authorised or obliged to do under this Deed or the other Project Documents and notwithstanding that any time, waiver or other indulgence has been given to the Contractor in respect of any Obligation of the Contractor under this Deed or the other Project Documents) in respect of:-
 - (i) any loss, injury or damage to persons (including death) or property of whatsoever nature or kind (including loss of use of property which has not been physically damaged or destroyed) and however or wherever sustained or caused or contributed to by the use or occupation of, or any circumstance, condition or activity or other cause on the Site, or otherwise in connection with or incidental to the operation, maintenance or repair of the Works, irrespective of whether such loss, injury or damage was caused or contributed to by the act, default, omission or negligence of the Contractor;
 - (ii) any notice, claim or demand to pay, do or perform any act matter or thing to be paid, done or performed by the Contractor under this Deed or the other Project Documents except to the extent that the Principal is obliged under the provisions of this Deed or the other Project Documents to pay for or contribute to the cost of the same;
 - (iii) the negligent use, misuse, waste or abuse by the Contractor or any servant, agent, sub-tenant of or any other person claiming through or under the Contractor of the gas, electricity, water and other services and facilities in or on the Site;

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- (iv) any pollution, contamination or environmental hazard caused by the Contractor;
 - (v) any breach by the Contractor of the conditions of any Approval or of any Law which relates to the Project;
 - (vi) acts or omissions of the Contractor (or the third party approved by the Principal to act as Principal Contractor) as Principal Contractor under clause 14.1; and
 - (vii) any breach by the Contractor of its Obligations under clause 14.1, except to the extent that such actions, suits, claims, demands, proceedings, losses, liabilities, damages, compensation, costs, charges or expenses are a consequence of a fraudulent or negligent act or omission of the Principal or breach by the Principal of this Deed.
- (b) The Obligations of the Contractor under this clause shall continue after the expiration or other termination of this Deed or the other Project Documents in respect of any act, deed, matter or thing happening before such expiration or determination.