

Indemnities – A Brief Explanation

The subject of indemnities is one which causes a good deal of confusion, not only among clients but also among some lawyers.

What is an indemnity? Should you give, or ask for, an indemnity? If so, what should it cover?

In this Update, we give a brief explanation of indemnities and explain why it is crucial that you understand them and treat them with caution.

What is an Indemnity?

At its simplest, an indemnity is a promise to pay money. They can be framed in many different ways but the core of an indemnity is where one party to a contract makes a promise to be responsible for losses suffered by the other, most usually arising from a breach of contract or warranty.

There is huge variation in how indemnities are framed. They can range from wide-open coverage e.g. “all costs, losses, damages, expenses...” to more specific coverage, e.g. by reference to the key areas of risk in the contract. Whatever their form, the basic premise is that the party which has the benefit of the indemnity can obtain payment of the losses covered. Payment terms also vary widely but increasingly indemnities are framed on the basis of when costs arise and often too without apparent check or control over the extent of the costs.

Should you agree to an indemnity?

There is a growing trend, particularly among large companies, to include indemnities in standard contractual terms. This trend unfortunately also extends to ensuring that the indemnities are framed very widely, in some cases even extending to losses which arise outside the contract.

Companies which have a strong commercial position in their market will present the indemnity as a ‘must-have’, non-negotiable and simply the ‘price’ of being able to do business with such a leading company. The truth, however, is that very few things in contracts are non-negotiable. Everything has its price and everything can be modified or deleted if the circumstances are right. Even small companies can ensure significant contractual changes and concessions if they have an offering which is sufficiently attractive or compelling from a commercial point of view.

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If you have such an offering, so much the better. However, even if you don't you should still be very careful over what indemnities you agree to, for they carry a potential double problem which, if not avoided, might threaten your entire business.

The Indemnity Problem

The fundamental problem with indemnities is that they are often out of step with what the Courts would typically order you to pay for an equivalent default.

English case law contains detailed rules on which types of loss are recoverable and which are not; the general principle being that a party should not be responsible for losses which that party did not cause, or which are too 'remote' to be seen as arising from or related to the breach or default at issue.

Many indemnities fly in the face of these long established legal principles and allow the beneficiary of the indemnity to recover all losses, irrespective of the key issues of causation or remoteness of damage. By agreeing to such an indemnity, a party is effectively agreeing to pay costs in excess of those which would be awarded by a court – a kind of 'super-damages', if you like.

Paying more than the law demands is bad enough but indemnities can also lead to serious problems regarding insurance cover.

The Insurance Problem

Not surprisingly, insurers are not keen on paying out damages which are more than a Court would order to be paid and therefore many insurance policies, such as professional indemnity policies, will contain wording which means that you will not be able to recover all of the monies you may have to pay out under an indemnity.

In extreme cases, the policy may contain wording which negates cover if the insured agrees to terms which are 'onerous'. In other cases, the policy wording may mean a very hefty restriction on the amount you can recover – e.g. by excluding certain types of losses or imposing low standards for the level of damages to be covered.

All of this means that you may very well suffer from an insurance point of view if you agree to an indemnity. The exact extent of the suffering will depend on the indemnity you agree to and the insurance policy you have - but suffer you almost certainly will.

The Limitation Confusion

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There is also a degree of confusion between an indemnity and the concept of limitation of liability.

This confusion often seems to stem from limited indemnities – i.e. statements in the contract that the party in default will indemnify up to a certain financial limit. The problem is that some interpret this as forming a cap on liability, when in fact all it is saying is that the indemnity will only stretch so far, after which recovery will have to be founded on a different footing.

For example, if the contract were to say that one party indemnifies the other to the extent of £1Million, this would not act as an overall limit of liability under the contract but rather that the indemnity would be exhausted at the £1Million point and the claimant would then have to look elsewhere, for example by suing under a warranty, for any damages in excess of this amount.

Conclusion

There are a great many ways of framing indemnities and every situation is different. The important thing to bear in mind is that very few indemnities are set in stone and in most cases there is scope to negotiate an indemnity which is more suitable to your business.

If you are in any doubt, you should contact your lawyer straight away. These areas of the contract are too important to be treated lightly.

When dealing with indemnities, here are some key points to bear in mind:-

- ✓ Take a sensible look at the contract and decide what are the key areas of interest and risk.
- ✓ Try to limit the indemnity to only the identified key risk areas and avoid giving wide and loosely-worded indemnities.
- ✓ Be aware of what your policies of insurance cover and try to ensure that you align the indemnities with the policy cover.
- ✓ Make sure that any areas not covered by your insurance are carved out of the indemnity.
- ✓ In particular, exclude indirect, consequential losses and other excludable losses, such as loss of profits and loss of contracts.
- ✓ Above all, ensure that the indemnity is within the limitation of liability agreed for the contract – which should be set out in the clearest possible language.
- ✓ Ensure that contracts are signed only by officers of the company who have a good understanding of the issues and associated risks.
- ✓ Get your solicitor to check the indemnity and limitation sections of the contract prior to signature.

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