



RISK ALLOCATION TOOLS: INDEMNITIES

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WHAT IS AN INDEMNITY?

In its simplest form an indemnity is an agreement between two parties in which one party agrees to cover loss and damage suffered by another. As such indemnities are a very effective tool to allocate risk between transacting parties. The risk we are talking about is the risk of something specific going wrong, and the allocation of that risk being who has to pay for it.

For example a contractor may agree to indemnify the principal for loss the principal suffers as a result of the contractor damaging the principal's property during construction works.

WHY DO I NEED AN INDEMNITY TO RECOVER LOSS I SUFFER?

You don't. But if you don't have the benefit of an indemnity the amount you recover from the offending party may be less. This is because the innocent person will need to rely on the remedy of damages to recoup its loss.

Under a damages claim the loss may not be recoverable unless:

- (a) the loss arises naturally as a consequence of the breach;
- (b) the loss was foreseeable at the time of the contract;
- (c) the innocent party can demonstrate that it has taken appropriate steps to minimise their loss.

A carefully drafted indemnity will not be constrained by the above factors because indemnities are not governed by the law relating to damages. So the inclusion of an indemnity and how it is drafted can have significant financial implications on the party granting the indemnity if anything goes wrong.

THINGS TO LOOK OUT FOR WHEN NEGOTIATING INDEMNITIES

- Look to see how narrow or broad the scope of the indemnity is by looking for words such as *loss directly caused by* an event compared to *loss in connection with* an event. The latter being a lot broader will result in more loss being recoverable.
- Check to see if the indemnity relates to loss caused by any breach of contract or whether it is limited to damage to the innocent person's property or injury to its people. Caution should be used if asked to indemnify for any breaches of contract because it will result in far greater liability being assumed by the person giving the indemnity i.e. effectively all loss suffered by the other person can be recovered on an indemnity basis as opposed to only specific losses.
- The provider of an indemnity should always seek to include a clause which expressly excludes them from being responsible for any consequential or indirect loss (such as loss of profit or opportunity) that the recipient suffers. This is often regarded as a reasonable request.

COMMERCIAL AND PRACTICAL CONSIDERATIONS

Every commercial arrangement is unique. Whether or not a party proceeds with an agreement under which it grants an indemnity will depend on both the risk posed by the indemnity and the importance of the overall deal to the party. In analysing the risk it will be up to the indemnifying party to consider both the probability of the indemnified event occurring and the consequences of the indemnity, including effects on its insurance cover. It is also important to be realistic and take into account the capacity of the party giving the indemnity to meet the obligations of the indemnity.

A broadly worded indemnity clause will be useless to an indemnified party if the person giving the indemnity does not have the financial resources to make good on its obligations to pay the innocent party.

In short, be commercial about the way you go about negotiating indemnities. Identify the risk, assess it from a commercial perspective and negotiate accordingly. In business it's all about keeping deals on track, keeping the momentum going.

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