

An Overview: Indemnity Clauses



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In this Newsletter, we explore indemnity clauses in depth. We'll define their scope, examine their purpose and effect, discuss the benefits they offer, and explore how these contractual provisions are interpreted.

Introduction

Depending on how a contractual provision is drafted, an indemnity can offer broader protection and certainty to the indemnified party rather than relying on a claim for damages under a breach of contract. For instance, an indemnity claim may not be limited to principles of causation, remoteness and mitigation as it would under a claim for a breach of contract. Indemnities may also be utilised to allocate liability where there would be no underlying breach of contract, such as in circumstances where there would otherwise be no basis to bring a claim to be compensated for loss or damage that has incurred.

This newsletter will offer a comprehensive exploration of indemnity clauses, including their definition, scope, objectives, and effects. It will also delineate the different types of indemnities available. Furthermore, it will delve into key considerations regarding the advantages of seeking indemnity, along with insights into its interpretation and implications.

Definition and Scope

The definition of an indemnity clause in a contractual provision releases one party from loss or legal liability for the actions or omissions of another party under specific conditions.

In *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at [254], the High Court defined indemnity as a commitment made by the promisor to “*keep the promisee harmless against loss as a result of entering into a transaction with a third party.*”¹

Similarly, in *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424, the High Court noted that indemnities are designed to address the liabilities owned by a party other than the indemnifier to a third person.²

The **scope of obligation** for one party to compensate another hinges on how the indemnity is drafted (although it may also extend to loss that would not be recoverable as contractual damages). As articulated by Giles JA in *Erect Safe Scaffolding (Aust) Pty Ltd v Sutton* (2008) 732 NSWLR 1 at [5]:

“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.”

Object and Effect

The **object and effect** of a contractual indemnity is to alter the common law or statutory rights of the respective parties.

An indemnities and liability clause can keep the principal harmless from any loss or damage suffered or expense incurred by the principal on account of third-party actions or claims; change the principal’s common law obligations to mitigate its loss, damage, or expenses; and alter the rules for causation remoteness of damage and foreseeability in various circumstances and depending on the words used, as it may not be necessary for the innocent party to demonstrate that the indemnifier caused the loss,

¹ *Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245 at 254; 77 ALR 205; 62 ALJR 195; (1988) Q ConvR 54-295.

² *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424 at 437; 206 ALR 387; [2004] HCA 28.

damage or expense claimed by the innocent party. Instead, the innocent party may only have to demonstrate that the injury occurred (which is discussed below).³

Overview of the Types of Indemnities

Indemnities can be categorized into five main types:

1. **Party-Party Indemnity:** The contractor indemnifies the principal against losses resulting from the contractor's breach of the agreement.
2. **Reverse Indemnity:** The contractor indemnifies the principal for losses arising from the principal's breach of the agreement.
3. **Third-Party Indemnity:** The contractor indemnifies the principal against losses resulting from the principal's contract with a third party.
4. **Third-Party Claims Indemnity:** The contractor indemnifies the principal against claims made by third parties regarding specific matters, persons or entities.
5. **General Indemnity:** The contractor indemnifies the principal for any losses suffered by the principal and its personnel in connection with their agreement.

The Benefits of Claiming Indemnities

Understanding the implications of claiming an indemnity necessitates consideration of factors, namely the principles of causation, remoteness, limitation periods and mitigation obligations. A party claiming an indemnity should not be subject to issues of causation or remoteness or obliged to mitigate loss.

Causation

The claimant will likely need to establish a relation between the trigger event and the loss being claimed.

However, depending on how the indemnity is drafted, it may be less onerous than the legal standard of causation that applies to a breach of contract claim. They are not necessarily determined by the principle of causation, as is generally the case with damages (although, in interpreting an indemnity, a court may refer to what the parties reasonably contemplated as the scope of the indemnity provided). As a result, an indemnity may provide a broader range of 'causal' events and may specify exclusions or limitations.

'Construed strictly'

In *Andar Transport*⁴, the key issue was whether an indemnity clause was to be construed in favour of the indemnifier or the indemnified. Ultimately, Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ at [29] and Kirby J at [68] held that the terms of the contractual indemnity should be "**construed strictly,**" and any doubt should be resolved in favour of the indemnifier. The doubt may arise not only from the uncertain meaning of a specific expression but also from its apparent width of possible application: *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 at 292 [53].⁵

Similarly, Applegarth J in *Samways*⁶ held that indemnity clauses must be strictly construed and any doubt relating to its construction should be resolved in favour of the indemnifier. Moreover, the indemnified

³ Alan Cullen, 'Indemnities', *Building Contracts Australia* (LexisNexis, May 2014).

⁴ *Andar Transport Pty Ltd v Brambles Ltd* [2004] HCA 28; (2004) 78 ALJR 907 at

⁵ [2009] HCA 44.

⁶ *Samways v WorkCover Queensland & Ors* [2010] QSC 127 at [66].

party should also consider indemnities for breach of contract and negligence to the existing common law rights.

Remoteness principles do not apply

Under an indemnity, liability may extend to cover loss or damage that is not ordinarily recoverable for breach of contract due to the concept of remoteness of damage and the rule in *Hadley v Baxendale*.⁷

However, in some circumstances, courts may still read limitations into broadly drafted indemnities. For example, in some cases, broad indemnities that purported to cover 'all loss' have been read down to only apply to losses that were proximate to the trigger event.

The limitation period extended

The statutory limitation period that would ordinarily exist regarding cause of action can, in effect, be extended under a contractual remedy. The limitation period will begin to run from the time of the refusal to indemnify, which may occur long after the original breach of contract.

No obligation to mitigate

The obligation to mitigate is unlikely to apply to a party claiming under an indemnity (unless the indemnity expressly requires mitigating against losses regarding damages following a breach of contract). A party with a claim for breach of an indemnity is not expected to mitigate its loss, where the loss represents the amount for which it should be indemnified.

Debt or Damages?

An issue that often arises is whether a claim for indemnity can give rise to a right to claim in debt or damages. The authorities demonstrate divergent views.

In *Jervis v Harris*⁸, Millett LJ examined the nature of a repairing covenant in a commercial lease. In doing so he commented on 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.”

It is evident that Millett LJ views an indemnity as a contractual right of reimbursement which requires evidence of expenditure. Moreover, an indemnity is a contractual right of recoupment that necessitates proof that some kind of liability has been discharged.

Nonetheless, it should be noted that the House of Lords, in an insurance context, considered that the nature of indemnity is founded in damages, not in debt.

Interpreting Indemnity Clauses and the Implications

The Law: “Hold Harmless” or “Make Good”?

⁷ *Hadley v Baxendale* (1854) 2 CLR 517; [1843-60] All ER Rep 461; (1854) 9 Exch 341; 156 ER 145.

⁸ [1996] Ch 196.

Despite both definitions of an indemnity clause from *Sunbird* and *Andar* being held accurate, different outcomes may flow when claiming an indemnity because of the obligation to “hold harmless” the indemnified party, as opposed to the obligation to “make good” any loss or damaged suffered.

If construed as a “**hold harmless**” obligation, the party giving the indemnity will effectively be in breach of the contract as soon as the indemnified party suffers any loss of damage. As a result, the limitation period will commence immediately from the date of the loss

In the context of a “**make good**” obligation, the party giving the right to claim indemnity when they suffer loss or damage. Nonetheless, the party giving the indemnity is not obliged to do anything until they are called on to make good the loss or damage. Hence, the party giving the indemnity will not be in breach of the contract until the indemnified party has made a claim under the indemnity and the claim is refused. It is only at this point in time that the limitation period will commence.

Ultimately, the form of a contractual indemnity may affect the operation of limitation periods. It is advised that a drafter consider the intended duration of any indemnity when drafting the clause to reflect the party’s intent.

“Arising Out Of” and “In Connection With” and Other Expressions

Care should be given to the expressions “arising out of” and “in connection with,” as Applegarth J in *Samways* said:

- a. *“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’. The phrase connotes a weak causal relationship. However, more is required than the mere existence of connecting links.⁹ The words require the existence of a causal or consequential relationship between, in this case, the use of the plant and the injury.*
- b. *“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.¹⁰ 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. In the present context there must be a sufficient nexus between the use of the plant and the injury.”*

An indemnity construed as an obligation to compensate may provide greater protection for the indemnified party than a general claim in damage for breach of contract. The use of the words “pay” or “reimburse” is more likely to support the characterisation of the indemnity provision as an obligation to compensate. Contrastingly, the terms “hold harmless” or promising to “indemnify,” is likely to be characterised as an obligation to prevent loss. A claim under this type of indemnity will likely be treated similarly to a claim for breach of contract damages.

Conclusion

Ultimately, contractual indemnities are a useful method to transfer the risk from one contracting party to another regarding a defined event. Indemnities offer the opportunity to extend the time for a claim, to avoid issues of causation, remoteness and mitigation. Nonetheless, they are treated strictly by the

⁹ *F & D Normoyle Pty Ltd v Transfield Pty Ltd* (2005) 63 NSWLR 502 AT 515 [90].

¹⁰ *Fraser v The Irish Restaurant and Bar Co Pty Ltd* [2008] QCA 270 at [40].

Courts and will be construed in a manner against those interests of the person claiming the right of indemnity.