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Re-examination of the use of indemnity clauses: Drafting and Reviewing Indemnities

In this issue, we consider how careful drafting of indemnity clauses assists minimising disputes between contracting parties. John Matthews breaks contractual indemnities into their basic components and discusses how to improve drafting and interpretation of these clauses.
Patrick Mead provides a short update on what constitutes Unforseen Damage under contract works insurance.

Introduction

Previously (in Constructive Notes' August 2009 edition), we predominantly focussed on the background theory as well as the value of achieving efficient risk allocation (based on the contracting parties' relative ability to manage that risk). Regardless of (and in many senses because of) the recent fluctuations in the local and global economic outlook, managing risk is more crucial than ever. The appropriate use of contractual indemnities, as well as a broader attention to detail on risk allocation through contracts is a critical part of managing risk. Even where risk is allocated to the party best placed to manage it (with control over the variables that may lead to occurrences), a failure to review or draft an indemnity provision with precision can result in protracted and costly disputation.

We now endeavour to provide a simple treatise on reviewing as well as the key considerations when drafting indemnity clauses.

Indemnity mechanisms

The mechanisms or causal links used in an indemnity to provide the boundaries of its operation are critical. Parties who are either reviewing or drafting should take particular care to address these points, which may be classified in the following three ways:

1. the operational width of the indemnity (often seen by way of example in proportional reductions or 'linking words' between the types of losses subject of the indemnity and the circumstances in which it applies);
2. the circumstances in which the indemnity applies (literally the facts which will trigger the indemnity); or
3. the types of loss / liability that are subject of the indemnity.

For example, an indemnity that may be given by a contractor in a works contract, could be divided as follows (adopting the above numbering):

> *"Insofar as this clause applies to property, it applies to property other than the Works.* (**1 – width**)
>
> *The Contractor must 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,* (**3 – types of losses**) *arising out of or as a consequence of the carrying out of the Works* (**2 – circumstances**)*, but the indemnity will be reduced proportionally to the extent that the act or omission of the Superintendent, the Principal or its consultants, agents or third parties may have contributed to the injury, death, loss or damage.* (**1 – width**)*"*

All three facets are important (albeit interrelated) and we will consider them separately below.

1. The operational width of the indemnity

The width of an indemnity is derived from the link between the literal circumstances in which the indemnity applies (discussed below) and the conduct required by the party giving the indemnity to trigger it's operation.

The words 'in connection with', which in the above example may be used in place of the words ('arising out of or as a consequence of'), are considered *"words of the widest import, do not require any direct or proximate relationship with the contract in question, but must have some causal or consequential relationship with it"*[1]. In other words, little is required in the way of a direct link between the loss and the conduct of

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the party giving the indemnity for that party to be considered liable according to the terms of the indemnity. Significant protection is afforded to the beneficiary of the indemnity. Accordingly, parties providing them should be cautious.

Now, looking at width that is closer to what is used in the main example:

- [circumstances of occurrence] *"arising out of"* [width - conduct linking the person being relied on]; and, another different width link,
- [circumstances of occurrence] *"as a result of"* [conduct linking the person being relied on].

Ipp JA[2] considered that the width link 'arising as a result of' was *"a particularly broad expression of the notion of causation…* [but was not] *open ended… more is required than the mere existence of connecting links between an act, neglect or default and the liability incurred…"*.

In this case, the link is not as wide as 'in connection with'; a tangible nexis would be required between the circumstances and the loss suffered for the indemnity to operate. 'As a result of' may be considered to be slightly more narrow again, because a more direct connection can be discerned between the occurrence or loss and the conduct of the party providing the indemnity.

- [circumstances of occurrence] *"caused by"* [conduct linking the person being relied on].

Similar to *"as a result of"*, *"caused by"* creates a higher and more direct threshold of link between the circumstances of loss and the conduct of the party giving the indemnity before it operates.

Contracting parties should always be mindful of the different effect of width / linking words such as those set out above – their use will in part determine whether a party to the contract's contribution to the circumstances leading to loss will be sufficient to result in it being held liable for the loss or liability suffered.

2. The circumstances in which the indemnity applies

The circumstances are the specific factual basis / occurrences that, as a result of which, an indemnity will be triggered.

As seen in the our example above, the circumstances will often be left quite general so that the net is cast widely and the indemnity responds to a variety of circumstances (subject to the width and types of losses covered).

Key here is the consideration of what a party giving the indemnity should be responsible for. The circumstances may be tested against a series of questions:

- Are the circumstances limited to those within the control of the party giving the indemnity?
- Do the circumstances include liability for the actions of third parties (this may be excluded / addressed in the width checks)?
- Do the circumstances include matters (commonly, breach of contract or negligence) which may be otherwise provided for at law?

In terms of the third point, there are advantages and disadvantages in providing for an indemnity to operate in case of breach. While it potentially simplifies the resolution of any dispute between the parties (so a claim may be made subject to the indemnity rather than at common law) the flipside is that the party relying on the indemnity does not have to prove the elements of their claim to the extent which would otherwise be required. In effect, it is the simplistic application of an indemnity compared to a stricter and more onerous dispute resolution at common law.

Relevantly, industry participants may also recall the case of *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton*[3] in the New South Wales Court of Appeal which confined the operation of an indemnity provided by a sub contractor to a head contractor on the basis that the head contractor had itself been negligent. It appears that express words in an indemnity will be required to demonstrate the parties' intent for the indemnity to operate where the beneficiary of the indemnity has in fact caused or contributed (through its fault of negligence) to the occurrence that led to the loss. In other words, it is *"inherently improbable that one party to the contract should intend to absolve the other party from the consequences of the latter's own negligence"*.[4]

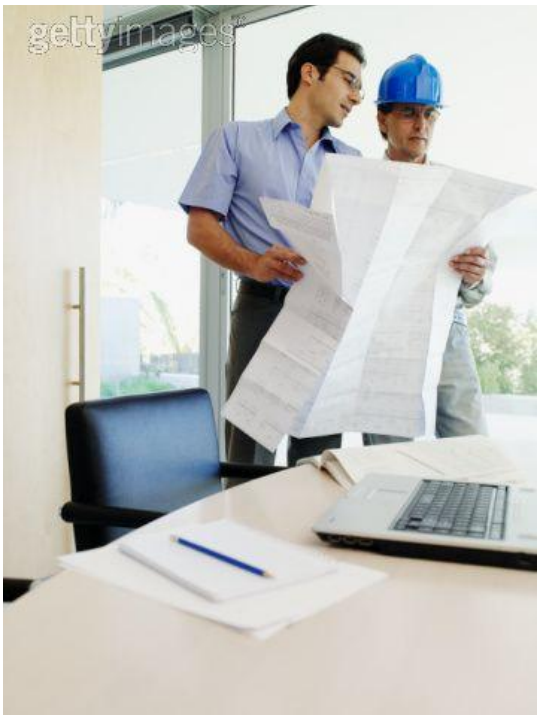
3. Which types of loss / liability are subject to the indemnity?

While an indemnity may be narrow in terms of the circumstances in which it will operate, it may potentially provide for the recovery of a wide range of losses.

Parties may seek to include items such as:

- environmental damage;
- damage to property;
- liability to government (or other) authorities;
- personal injury or death;
- intellectual property infringement; or
- negligence (some clauses may operate in respect of the negligence of the party receiving the benefit of the indemnity).

On occasion, parties may also seek recovery for other matters, including legal expenses and indirect or consequential losses (the concept of which should now be treated with extra caution due to recent judicial decisions[5]).



Often this is a matter of commercial negotiation. However, parties should be conscious of a number of issues, including:

- in some circumstances, consequential losses can be extremely large (by way of example in relation to sub contracts where large liquidated damages may be levied under the head contract or contracts where performance is measured by production such as mining contracts or the like);
- whether the losses being indemnified are covered by policies of insurance; and
- whether, in the case of legal expenses, these are on an 'indemnity' basis or on the court scale – further, whether the party to be responsible for legal costs has a say over the conduct / settlement of the matter.

Proportional reduction / Cap on liability

For commercial certainty, parties giving contractual indemnities often seek to limit or cap their exposure under the indemnity.

A cap may commonly operate by reference to a numerical limit, a percentage of the contract sum or even the cost of having the services performed again (for instance in a consultancy agreement).

A limit on liability may be framed in either a positive or negative manner:

- negative: *"the indemnity under this clause is reduced to the extent that the loss or damage arose from or was contributed to by the acts or omissions of the [party receiving the benefit of the indemnity] and its employees and agents.";*
- positive: *"the indemnity under this clause is reduced proportionally to the extent that the acts, defaults or omissions of the [party receiving the benefit of the indemnity], its servants, agents or employees caused or contributed to the loss of life, personal injury, illness, destruction of or damage to property".*

Either, where drafted correctly, may be effective. However the positive proportional reduction will more strictly reduce the party giving the indemnity's liability to that for which it is responsible.

Conclusion

Careful consideration and drafting can minimise the risk of a dispute over the terms or operation of an indemnity. A bipartisan appraisal of the risks and variables at the outset of a particular project will enable sophisticated contracting parties to pursue an efficient allocation of risk (and draft their contractual indemnities accordingly).

The three key components (affecting the operation of an indemnity) discussed above are the most prominent mechanisms which parties negotiating an indemnity may use to achieve an appropriate allocation of risk.

This is an area (negotiation of indemnities, as well as drafting and undertaking a risk analysis of proposed contract documents) where professional advice can add significant value – by avoiding disputation through factoring legal costs into a project up front, significant savings may be made through avoiding protracted and costly disputation in the future. The greatest benefit can often be derived from the prevention of dispute, not its subsequent management.

[1] State of NSW v Tempo Services Ltd [2004] NSWCA 4 per Meagher JA
[2] In F & D Normoyle Pty Ltd v Transfield Pty Ltd [2005] NSWCA 193
[3] [2008] NSWCA 114. This point is further considered and reinforced in the case of Ellington v Heinrich Constructions P/L & Ors [2004] QCA 475.
[4] Ellington v Heinrich Constructions P/L & Ors [2004] QCA 475 at paragraph 19 referring to the comments of Buckley LJ in Gillespie Brothers & Co Ltd v Roy Bowles Transport Ltd [1973] QB 400 at 419.
[5] Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd [2008] VSCA 26

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Was the Damage "Unforeseen"?

By Patrick Mead, Partner

A question which often arises in relation to Contract Works/Material Damage policies, is whether the physical loss or damage to the contract works could be said to be "*unforeseen*".

In *CA Blackwell (Contractors) Ltd v Gerling Allegeneine Verischerungs AG [2008] 1 All ER (Comm) 885,* a good deal of evidence was given at trial as to how the contractor had protected (in that case) its earthworks from water damage during the course of the works.

Although it had been contended by one of the parties in that case that "*disaster was inevitable with work continuing [through a period of predicted wet weather*]", the Court found that "*proactive*" measures taken by the insured to seek to protect the works from water damage, were such that there was no suggestion that the policy would not otherwise respond (other than with respect to any loss that was excluded due to the defective workmanship exclusion).

Attention is also drawn to comments in *L'Union Des Assurances De Paris IARD v Sun Alliance Insurance Ltd CA40232/94*, in which the New South Wales Court of Appeal noted that "*unforeseen" does not mean "unforeseeable*" either as a matter of language or law. The Court of Appeal concluded that the former is subjective and speaks of the mind of the insured. The latter is objective and speaks of the object of perception or thought. In that case, the court observed that before the event, nobody at the insured, knew that the damage which resulted from [in that case contamination] would occur. Therefore it was *"unforeseen"*.

Similarly, in a case at first instance of *Rickard Constructions v Rickard Hails Moretti [2004] NSW SC1041* the insurer submitted that as there were design defects, and that the failure was a result of those defects, it could not be said that the damage was either sudden or unforeseen. Alternatively, the insurer submitted, that the failure could not be characterised as unforeseen, because the insured, (or a reasonable and competent civil engineering contractor in its place) should have known or understood or foreseen that the failure was a likely consequence of the practices [which the Court had identified as amounting to defective workmanship].

The Court of Appeal concluded [at 209]:

> *"I do not think that this is what 'unforeseen' means in the context of the policy. To construe that word [unforeseen] as [the insurer] submits would be, in effect, to limit the insuring clause in the same way that [the insurer] says its obligations are limited by [another unrelated clause] of the exclusions … if foreseeability of loss is an essential element of liability in negligence, then [the insurer's] construction of the word "unforeseen" would mean that the Policy could never indemnify [the insured] for the negligent performance of its obligations as a civil engineering contractor*".

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