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# Commercial law Update

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# **Allocating risk:** the advantages of an indemnity and practical tips for a pain-free indemnity negotiation

## WHY ARE INDEMNITIES SO DIFFICULT TO NEGOTIATE?

Indemnities are usually one of the most dreaded, emotive and time-consuming topics in contract negotiations.

There are a number of reasons for this, including misconceptions about the nature of indemnities (often resulting in undue concern about liability exposure) and the widespread use of unreasonably broad "boilerplate" indemnity clauses.

To facilitate a productive and less painful indemnity negotiation, it is important to approach indemnities from a risk allocation perspective.

## PRICING – A POWERFUL NEGOTIATION TOOL

One of the most effective ways to approach an indemnity negotiation is to put a price on relevant risks at the start of a procurement process (i.e. before the negotiation).

If you are bidding for work, you could prepare a pricing proposal on the basis that you are not responsible for certain risks. For example, you might specify that you will only give a limited indemnity and / or that you will not be liable for specific categories of "consequential loss".

Similarly, if you are requesting bids, you could state that you require pricing proposals on the basis of a specific risk profile, for example including an indemnity on the terms you require.

A pricing approach to risk allocation can help you avoid a combative, point-scoring indemnity negotiation which could harm your commercial relationship with the other party.

## ADVANTAGES OF AN INDEMNITY

It is critical to understand exactly what's at stake from both a legal and commercial perspective.

An indemnity is essentially a contractual promise to "make good" losses suffered by another party if a specified event occurs.

Generally, the aim of an indemnity is to alter common law and / or statutory rights. For example, indemnities are often drafted to require the party giving the indemnity to pay for loss caused by a third party; in contrast, at common law a party will only be liable for loss it causes.

An indemnity can be an effective risk allocation tool, but its effectiveness will depend on how well it is drafted. It is crucial to carefully consider the terms of each indemnity and you should not assume that the mere existence of an indemnity will provide adequate protection.

A well drafted indemnity can provide the recipient with significant advantages:

- *Remoteness of damage:* If an indemnity is drafted correctly, the party seeking to rely on the indemnity will simply need to prove that a particular event occurred and that a relevant loss was suffered, without needing to prove causation. This can be a significant procedural advantage.
- *Mitigation of loss:* Generally, a party to a contract has an obligation to mitigate loss resulting from a breach of contract. However, this does not apply to a claim under an indemnity (although it can be difficult for a party to argue that it should not be required to mitigate losses).
- *Statutory limitation period:* A contract damages claim will be statute-barred six years after the breach. But if an indemnity is properly drafted, the clock will only start if the party giving the indemnity fails to respond to a claim under it, so the normal statutory limitation period is effectively extended.

## KEY THINGS TO WATCH OUT FOR

It is important to identify and describe as precisely as possible the types of "loss" which are recoverable under an indemnity. For example, if "loss" is defined too broadly, it may not be enforceable.

When considering "loss", you also need to consider "consequential loss", its meaning and when it is recoverable. There is real uncertainty in Australia about the meaning of "consequential loss," so it is usually best to specifically list the types of loss (e.g. loss of profits or loss of opportunity) that are excluded.

Another key thing to consider is whether liability under the indemnity should be "capped" (e.g. by reference to a specific dollar amount or a multiple of the price) and whether certain categories of loss should be "carved-out" from the scope of the indemnity (e.g. negligence of the party seeking to rely on the indemnity is a common "carve-out").

## DON'T FORGET FINANCIAL DUE DILIGENCE AND INSURANCE

The most robust, carefully drafted indemnity in the world will be worthless if the party providing it does not have the financial capacity to meet its obligations under the indemnity. Undertaking appropriate financial due diligence is crucial if you are receiving an indemnity and, if necessary, you should consider some form of security arrangement to support the indemnity.

Finally, if you are giving an indemnity, you should consider any gaps between your obligations under the indemnity and your insurance coverage. Usually, insurers will not provide coverage for liability under a contractual indemnity which is beyond the insured's liability at common law.

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