

Recent Developments in Indemnities

The Supreme Court of Queensland recently reaffirmed the approach previously adopted by courts with respect to the interpretation of indemnity clauses.

The decision in *Samways v WorkCover Queensland & Ors* [2010] QSC 127 (**Samways**) serves as a timely reminder regarding the use of, and the strategies and approaches to drafting indemnity clauses which serve to manage risks in construction projects.

The importance of indemnity provisions

At its simplest, an indemnity is a provision which deems one party harmless for the actions or inactions of another or others or in specified circumstances. It is a contractual clause which allocates risk. Indemnities are used to manage risk by expanding the scope of recovery to which a party may have recourse in respect of agreed matters, such as property damage or breach of contract.

Indemnities often raise red flags in construction contract reviews and negotiations. Properly used, indemnities are an important tool for risk management. Improperly used,

indemnities may result in risk allocations which can prove difficult to manage and enforce.

Losses recoverable at law

Contracts contain promises from one party to another. If, in carrying out the proposed work, a contractor breaks its promises to a principal and causes loss, the principal has historically been able to claim against the contractor for loss in the following circumstances, losses which:¹

1. are the natural consequence of the breach (measured objectively); and
2. the parties knew were possible at the time of contract (measured subjectively).

Recovery in each of these circumstances is subject to a test of (i) what losses were foreseeable at the time of the contract, and (ii) the extent to which the principal could have reasonably mitigated the loss.

An indemnity can be used to expand the scope of losses recoverable at law.

How an indemnity can change the position at law

An important feature of an indemnity provision is that it may be used to account for losses on a dollar-for-dollar basis. However, depending on the manner in which an indemnity is drafted, indemnities can also be used to change the position at law in other ways, as demonstrated in the table below:

Examples Of How An Indemnity May Change The Position At Law	Comment
Extend limitation periods.	An indemnity may operate by reference to a loss or claim being incurred or made. Consequently, an indemnity provision may continue to operate following the expiry of a contractual limitation period.

¹ *Hadley v Baxendale* (1854) 9 Ex 341

Remove the test of causation.	The requirement to prove causation is determined by the language used in the drafting of the relevant indemnity. For example, if party A indemnifies party B for all losses it suffers in connection with a contract, it is not necessary for party B to show that party A caused the loss – only that the loss was suffered in connection with the contract.
Remove the foreseeability and remoteness tests.	An indemnity provision may operate to remove the requirement that recoverable losses must be foreseeable and not too remote. The practical significance of this is that the principal is not limited in its recovery by how far a loss extends.
Remove the requirement to mitigate loss.	The drafting of an indemnity provision may mean that the indemnified party can claim compensation for losses even in circumstances where it has not taken reasonable steps to mitigate the loss.
Provide the ability to seek compensation for ongoing losses.	An action to recover losses under an indemnity does not prevent the indemnified party from bringing a further claim under the indemnity for ongoing losses at a later stage. This can be contrasted with the “once and for all” principle of damages at law.
Protect against losses caused by the acts and omissions of third parties.	Indemnities may be drafted to extend liability in respect of third party actions or claims.

The decision in *Samways*

The decision in *Samways* provides guidance on how indemnity clauses will be construed by courts. Set out in the table below is an executive summary of the principles together with Justice Applegarth’s learned reasoning.

Executive Summary	The Principles in <i>Samways</i>
Indemnity clauses are construed strictly and resolved in favour of the indemnifier.	Applegarth J at [66]: ...an indemnity clause falls to be construed strictly, and any doubt as to the construction should be resolved in favour of the indemnifier. ² The doubt may arise not only from the uncertain meaning of a particular expression but from its apparent width of possible application. ³
Clearly drafted clauses will not be rewritten by courts simply because they seem unfair.	Applegarth J at [67]: The authorities that require ambiguity to be resolved in favour of the indemnifier do not require that ambiguity be detected where the natural and ordinary meaning of the language, taken in its contractual context, requires no such conclusion. ⁴ Absent statutory authority, a court has no mandate to rewrite a provision to avoid what it retrospectively perceives as commercial unfairness or lack of balance. ⁵

² *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424 at [17] – [23].

³ *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269 at 292 [53]; [2009] HCA 44.

⁴ *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (2008) 72 NSWLR 1 at 21 [87].

⁵ *Ibid* at [88].

<p>Clauses must be read in context and effect is given to the ordinary meaning of the language used. Issues such as whether a risk is insured or required to be insured under the contract may help provide that context.</p>	<p>Applegarth J at [68]:</p> <p>The clause should be construed in its contractual context which allocates risks of different kinds between the parties, and, relevantly in this case, provides that the operator shall be under the control of the Hirer. Effect should be given to the ordinary meaning of the language used (absent use of technical expressions or terms of art) so as to provide certainty as to where responsibility may lie, against which insurance may be obtained.⁶ The fact that the contract requires a party to take out insurance against the indemnified liability may be taken into account in concluding that the indemnity applies to that liability, whether or not insurance is in fact taken out.⁷ The absence of a provision for insurance against the liability may also be taken into account.⁸ However, the fact that the indemnifier is not required by the contract to take out insurance, and chooses not to take out insurance should not affect the construction of an indemnity that unambiguously allocates responsibility for the liability against the indemnifier.</p>
<p>Clauses should specifically deal with whether the indemnity is intended to cover a party's own negligence in order to ensure this is captured.</p>	<p>Applegarth J at [70]:</p> <p>One line of authority construes contracts of the present kind on the assumption that it is inherently improbable that a party would contract to absolve the other party against claims based on the other party's own negligence.⁹ The competing view is that at least a principal purpose for obtaining such an indemnity is to protect a party against liability for its own fault.¹⁰</p>
<p>The term "arising out of" is construed broadly. However, more than a mere existence of connecting links is required, and a causal or consequential relationship must be established.</p>	<p>Applegarth J at [72]:</p> <p>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".¹¹ The phrase connotes a weak causal relationship.¹² However, more is required than the mere existence of connecting links.¹³ The words require the existence of a causal or consequential relationship between, in this case, the use of the plant and the injury.¹⁴</p>
<p>The term "in connection with" is capable of being construed widely but requires the establishment of a sufficient nexus to operate.</p>	<p>Applegarth J at [73]:</p> <p>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.¹⁵ 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.¹⁶ In the present context there must be a sufficient nexus between the use of the plant and the injury.</p>

⁶ Ibid.

⁷ Ibid.

⁸ *Ellington v Heinrich Constructions Pty Ltd* (supra) at [23].

⁹ *Davis v Commissioner for Main Roads* (1968) 117 CLR 529 at 534 per Kitto J (Windeyer J agreeing); *Westina Corporation Pty Ltd v BGC Contracting Pty Ltd* [2009] WASCA 213 at [64] – [65].

¹⁰ *Davis v Commissioner for Main Roads* (supra) at 537 per Menzies J (Barwick CJ and McTiernan J agreeing); *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (supra) per Basten JA.

¹¹ *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (supra) at [11].

¹² Ibid at [97].

¹³ *F & D Normoyle Pty Ltd v Transfield Pty Ltd* (2005) 63 NSWLR 502 at 515 [90].

¹⁴ *Westina Corporation Pty Ltd v BGC Contracting Pty Ltd* (supra) at [61].

¹⁵ *Fraser v The Irish Restaurant and Bar Co Pty Ltd* [2008] QCA 270 at [40].

¹⁶ Ibid at [42] – [43] citing *R v Orcher* (1999) 48 NSWLR 273 at 279.

Tips for principals

The successful use of indemnity provisions by principals is closely linked to an understanding of the rationale for passing particular risks to a contractor. Diligently scoping the risk and likely impact of a particular event or circumstance can assist a principal in tailoring an indemnity clause to provide real and specific risk management mechanisms which can be readily justified in negotiations. One method that we have found helpful for scoping such risks is the production of a contract risk matrix, which helps identify key risk areas to which indemnities can attach.

Courts have adopted an approach which construes ambiguities in the construction of an indemnity clause in favour of the indemnifier. The decision in *Samways* confirms that such uncertainties may arise both from the expressions used as well as the width of possible application that the clause may have. Principals must therefore not only take a great deal of care in ensuring that broad indemnities are not vague or ambiguous, but that where phrases such as “arising out of” are used, that a causal or consequential relationship is established between the words in the clause. Principals should also take care to ensure that indemnity provisions interact with other agreed contractual provisions so that they are not inadvertently capped, excluded or watered down through the use of restrictive provisions or carve-outs.

When faced with a request from a contractor to provide a reciprocal indemnity, a principal should consider what it is that they are being asked to indemnify. Generally, the primary obligation of a principal is to make payment to the contractor. The remedy for failing to make payment is arguably little different either under the general law or under an indemnity, and so a principal may suggest that a contractor’s risk is already adequately protected at law. Additionally, a principal is generally in a much stronger commercial position to resist requested amendments.

However, care should be taken to maintain this commercial advantage by ensuring that contracts are finalised before a contractor commences on site, after which a principal may find its bargaining position considerably eroded.

The negotiation of indemnities must be managed in line with the overall risk profile for a contract, and in the context of how those risks will be managed. In this respect, it is suggested that a principal take care to require that the contractor obtain and maintain insurance policies that will respond to a claim under an indemnity provision, and require:

1. a copy of all policies of insurance in order to independently confirm that the policies will respond to the contractor’s liabilities under the contract up to the policy limit; and
2. confirmation from the contractor and its broker that the policies will respond to the full extent of contractual liabilities up to the policy limit.

Tips for contractors

Contractors should carefully consider indemnity provisions in contracts, and diligently scope the extent of any liability to which an indemnity may expose them. Where possible, contractors should resist an indemnity provision, although commercial pressures often mean that there is limited scope for this position when competitively tendering for work. If a contractor has strong market power or is already on site and negotiating the final amendments to a contract, however, it may be possible to exert commercial pressure and avoid or narrow the scope of an indemnity provision.

When negotiating to provide an indemnity, a contractor may consider one or more of the strategies set out in the table below.

Strategy	Explanation and justification
Requiring the indemnity to be subject to an overall liability cap.	In current market conditions, an overall liability cap is often achievable. The amount of the cap can be difficult to dictate generically because it will link to the possible risk exposure of the principal for the project in question. However, a general sustainable position contractors may adopt is to negotiate up to an overall liability cap of 100% of the contract price plus the proceeds of insurance policies, with the justification being that the risk/reward paradigm is therefore an equal equation. There are a number of market standard positions to adopt on overall liability caps and carve-outs.

<p>Requiring the indemnity to only extend to loss or damage within the control of the contractor, and only to apply to loss or damage caused by the contractor.</p>	<p>A standard approach to risk allocation is to ensure that the party best placed to manage a risk is responsible for it. When agreeing to an indemnity provision, a contractor may argue that it is only best placed to manage that loss or damage which is caused by it, and is directly within its control. While a principal may, in accordance with the terms of a particular contract, still have a remedy against a contractor, that remedy will remain subject to the tests of causation, remoteness, mitigation and reasonableness which the common law dictates are to be taken into account in any compensatory assessment of liability and damage.</p>
<p>Requiring the indemnity to reduce proportionately to the extent the loss, claim or damage is caused or contributed to by the principal, its other contractors or consultants.</p>	<p>Understanding the limits of an indemnity is important for both scoping and managing risk. Contractors should consider ensuring that any indemnity plainly provides for a proportional reduction in liability to the extent that any loss, claim or damage is caused or contributed to by the principal, its other contractors or consultants.</p>
<p>Require the indemnity to be limited to losses foreseeable at the time of the contract.</p>	<p>A contractor may consider requesting an indemnity be limited to losses foreseeable at the time of the contract. The rationale for this is that if a contractor agrees to be accountable to a principal under an indemnity on a dollar-for-dollar basis, then that liability should only extend to losses which were reasonably foreseeable at the time of the contract. To broaden the scope of an indemnity beyond this would expose a contractor to losses which neither party had contemplated, and which the contractor may not be best placed or even able to manage. Limiting an indemnity to foreseeable losses also has the effect of curtailing the breadth of liability to what is recognised by the common law, whilst still providing recovery to the employer on a dollar-for-dollar basis for those losses.</p>
<p>Require the indemnity to be subject to an obligation on the principal to use its best endeavours to mitigate any loss or damage.</p>	<p>At common law, a party seeking compensatory damages is obliged to take reasonable steps to mitigate its loss. To the extent that a party does not mitigate its loss, it will be prevented from recovering that part of the loss which reasonable steps would have prevented. A contractor may suggest that such a principle is a reasonable limitation on any indemnity provision, and that to the extent that an employer can take steps to mitigate its loss, then:</p> <ol style="list-style-type: none"> 1. a principal should be required to do so; and 2. a contractor should not be exposed to losses which a principal could have taken steps to mitigate or avoid.
<p>Excluding consequential loss.</p>	<p>Consequential loss is by its nature difficult to scope and difficult to manage. When a contractor tenders for work, it is difficult to understand its potential exposure in respect of consequential loss, both in relation to what such losses cover and how large an exposure such losses potentially represent. This makes it difficult to manage such risks. As a result, it is increasingly common in the Australian marketplace for contractors to seek and obtain exclusions for consequential loss in construction contracts. If agreeing to carve-outs to consequential loss, a contractor should take care to ensure that those matters carved out are risks within the contractor's ability to manage.</p>
<p>Checking your insurance policy.</p>	<p>It is strongly suggested that contractors ensure that any indemnity provisions which are agreed in construction contracts are covered by the insurances in place and do not invalidate policies of insurance. For this reason, it is advisable that any negotiations and agreement of indemnity provisions involve your insurance broker and are made subject to acceptable insurance cover being obtained.</p>

Conclusion

Well drafted indemnity provisions strike a balance between offering a principal the protection it requires and ensuring the risks of a contractor remain manageable. Parties need to remain aware of the consequences of using and accepting indemnities, and consider not only the expanded scope of liability under the indemnity, but also the possible effect of the indemnity on other risk management tools under the contract, such as the impact on policies of insurance which may not respond to an expanded scope of liability.

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