

Indemnity

Construction Law Terms: A to Z

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is for Indemnity

Introduction

Indemnities are common in construction contracts, and will often be a major discussion point in contract negotiations, but they are often misunderstood. There are a number of reasons for the uncertainty around indemnities, including:

- there is limited caselaw as to the implications of indemnities; and
- indemnities are often subject to fierce negotiation and the resulting drafting is ambiguous and open to interpretation.

The purpose of this article is to outline what makes an indemnity different to a term of a contract and to address some of the issues that parties should consider when drafting indemnities.

What is an indemnity?

An indemnity is a promise to protect someone against a loss or other financial burden. But, an indemnity is different to both a guarantee and a breach of contract.

- A guarantee is a secondary obligation – it only arises on breach of another obligation. In contrast, an indemnity is a primary obligation in its own right (i.e. it doesn't arise only on the breach of another obligation).
- Whereas a breach of contract requires a party to be in breach of its contractual obligation, an indemnity doesn't require a breach of contract at all – a contractor might give an indemnity to the employer in respect of personal injury to a person caused by the carrying out of the Works. Such an indemnity would be triggered on the occurrence of that event even though the contractor had complied with all of its contractual obligations.

Common indemnities in the construction industry

Construction and engineering contracts commonly include indemnities from contractors to employers. The JCT and FIDIC standard forms include indemnities in respect of:

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- personal injury to or death of any person arising out of or in the course of or caused by the carrying out of the works, except to the extent due to any act or neglect of the employer;¹
- any loss, injury or damage to any property, due to the carrying out of the works, and to the extent due to any negligence, breach of statutory duty, omission or default of the contractor;² and
- fees or charges legally demandable under statutory requirements³ or arising from the use of a patented article, process or other invention.⁴

However, although previous editions of NEC contracts included indemnities, the NEC4 suite of contracts does not use the term "indemnity", in part because the term is not well understood outside the UK. NEC4⁵ now lists the client's liabilities in clause 80.1, and the contractor's liabilities in clause 81.1.

Interpreting indemnities

The usual rules of contractual interpretation apply to indemnities (in fact, the leading case on contractual interpretation, *Wood -v- Capita Insurance Limited*,⁶ concerned the interpretation of an indemnity). The scope and application of an indemnity clause will, therefore, depend on its terms. So, when drafting and negotiating an indemnity, parties should avoid ambiguities – which can be difficult when indemnities are commonly heavily negotiated.

Do the rules about remoteness of loss apply to indemnities?

A party bringing a claim for a breach of contract may not be able to recover all its losses. It will only recover those losses falling within one of the two limbs set out in the case of *Hadley -v- Baxendale*⁷ being:

- **Limb 1:** "those losses which arise naturally in the usual course of things" (which are often referred to as 'direct' losses); and
- **Limb 2:** "those losses as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it" (which are often referred to as 'indirect' or 'consequential' losses).

It is often thought that the beneficiary of an indemnity is entitled to 100% of its loss, irrespective of how remote that loss is. As is often the case, the reality is not quite so clear.

- If the indemnity falls into the category of a claim to recover a debt, then the rule of remoteness will not apply.⁸ However, whether or not an indemnity gives rise to a debt claim will depend on the wording of the indemnity. An indemnity in respect of a specified sum (for example, liquidated damages under a building contract) may be more likely to give rise to a debt claim.
- Alternatively, the indemnity may be for a damages claim, in which case the usual rules as to remoteness of loss will apply. In *Total Transport Corporation -v- Arcadia Petroleum Ltd* ("*the Eurus*"),⁹ Lord Justice Staughton recognised that parties may refer to indemnities in two senses. He said, "It may mean simply damages awarded for tort or breach of contract ... Alternatively the word 'indemnity' may refer to all loss suffered which is attributable to a specified cause, whether or not it was in the reasonable contemplation of the parties." For Lord Justice Staughton, it was a "question of interpretation of the contract: does the clause provide that the charterers can recover even if the loss suffered was not within the reasonable contemplation of the parties?"

So, if contracting parties intend to exclude the rule of remoteness, they should make that clear using very clear and unambiguous wording. In the case of *Capita (Banstead 2011) Limited -v- RFIB Group Limited*,¹⁰ the parties referred to "liabilities costs claims demands or expenses which [it] may suffer or incur arising directly or indirectly ..." which the Court considered to include losses under both the first and second limb of *Hadley -v- Baxendale*.¹¹

1. See for example clause 6.1 of the JCT SBC/Q 2016 and 17.4(a) of the FIDIC Silver Book.
2. See for example clause 6.2 of the JCT SBC/Q 2016 and 17.4(b) of the FIDIC Silver Book.
3. See for example clause 2.21 of the JCT SBC/Q 2016.
4. See for example clause 2.22 of the JCT SBC/Q 2016.
5. NEC4, engineering and construction contract [2017] EWVC Civ 839
6. [1854] EWHC Exch J70
7. *Jervis -v- Harris* [1995] EWCA Civ 9
8. [1998] C.L.C. 90
9. [2015] EWCA Civ 1310
10. [1854] EWHC Exch J70

Do the rules of mitigation apply to indemnities?

A party bringing a claim for a breach of contract must demonstrate that it has taken reasonable steps to mitigate its loss. Any losses that could have been avoided (or it should reasonably have avoided) will not be recoverable.

It is commonly thought that an indemnified party is not subject to the usual requirement to mitigate its loss. But, whether or not there is a requirement to mitigate will be determined in the same way as whether the rules of remoteness apply – if the indemnity is for a debt claim, there will be no requirement to mitigate. But, if the indemnity relates to a damages claim, then it will be a question of contractual interpretation.

Do contractual caps on liability cover indemnities?

Whether or not a contractual cap on liability will cover an indemnity is a question of contractual interpretation. So, to be sure that the cap on liability applies to indemnities (as well as claims for breach of contract), the contract should expressly state that to be the case. This can be done either in the indemnity clause or, more likely, in the clause which includes the cap on liability.

Is an indemnity an exclusive remedy?

Unless there is clear wording to the contrary, an indemnified party will also be able to pursue a claim for damages (although it will not be able to recover the same loss twice, in line with the usual principle against double recovery).

Drafting considerations

It is likely that arguments around indemnities will continue between parties negotiating construction contracts. Employers will likely continue to include indemnities in their drafts, which contractors will look to exclude, or reduce, the impact of. There are some lessons to be learnt from the caselaw around indemnities for contractors:

- Use clear and unambiguous wording.
- Rather than referring to '*all losses*', try to identify what categories of loss or damage are intended to be covered by the indemnity (which might flush out what an employer is really concerned about). If an employer is not prepared (or able) to do that, exclude certain categories of loss.
- Make clear that the employer is subject to a duty to mitigate its loss under the indemnity.
- Agree an overall cap on liability, which is expressly said to cover any contractual indemnities and, if possible, agree sub-caps for any indemnities.

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