The interplay between indemnity clauses, releases and insurance

By

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Introduction

1. An indemnity is a provision in a contract which provides that one party is to be maintained harmless for the actions or inactions of another[2]. In simple terms, an indemnity clause is a provision which has the effect of allocating or transferring risk between the parties to a contract to prevent loss or compensate for loss which may occur as the result of a specified event.

2. Thus, when properly understood, an indemnity is a clause in a contract which has the effect of allocating risk, and perhaps altering where risk and liability might otherwise fall at common law, between the parties to the contract[3].

3. The use of indemnity clauses can be fraught for contracting parties, and also their legal and other advisors. It is not uncommon for a party with the greater commercial influence and bargaining strength to insist on an indemnity from another party, frequently in the broadest possible terms. In such circumstances, the indemnity provision may not be given sufficient consideration when the contract is drafted. Too often, the indemnity is based on a "boiler-plate" clause obtained from the electronic precedent files of the practitioners who have been retained to settle the relevant contractual arrangements.

4. Where the indemnity allocates risk between the parties in a way which is not reflective of the inherent or underlying risk of their relationship, and which is otherwise inconsistent with their respective common law

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[2] Kelly, A *Recent developments in Indemnities* (Thomsons Lawyers)

[3] Youngblood, DH and Flocos, PN *Drafting and Enforcing complex indemnification provisions* (2010) The Practical Lawyer 21

rights and obligations, unanticipated results may follow. This can be especially so when the indemnifier is not insured or cannot obtain such insurance for the full extent of the liability imposed by the indemnity. This may occur as the availability and scope of liability insurance in the Australian insurance market does not reflect certain of the risks undertaken by contracting parties by reason of entering into a broad indemnity.

The indemnity and the common law

5. The contractual indemnity can and is frequently used in order to expand the range of losses that can be recovered at common law by the person in whose favour the indemnity is given (principal) against the indemnifier, whether in contract or tort. This is achieved in a variety of ways.

6. First, the indemnity may alter the test for causation. The extent and nature of the causal nexus is determined by the words used in the indemnity provision. In certain circumstances and depending on the form of words used, it may not be necessary for the innocent party to demonstrate that the wrongdoer caused the loss claimed.

7. Second, the indemnity may alter the test for remoteness of damage and foreseeability[4]. That is, an indemnity provision may operate in such a way as to remove the tests of foreseeability and remoteness and to replace them with other criterion for assessing these matters. If this occurs, then the principal may no longer be confined in its recovery by how far the loss extends.

[4] In contract, the innocent party is able to claim damages against the wrong-doer where the losses are either, first, the natural consequence of the breach (assessed objectively), or second, the parties contemplated that the losses would result from breach at the time of contract (assessed subjectively): *Hadley v Baxendale* (1854) 9 Ex. 341. In negligence, the test of remoteness is that of reasonable forsseability, in that a wrongdoer is considered to be responsible for the probable consequences of his act: *Overseas Tankship (UK) Ltd v Morts Dock and Engineering Co Ltd ["Wagon Mound (No. 1)"]* [1961] AC 388.

8. Third, the indemnity may remove the common law duty of the innocent party to mitigate its loss. That is, an indemnity may operate in such a way as to permit the principal to recover damages against the wrongdoer in circumstances where the principal has not taken steps to reduce its loss consequent upon the breach of contract.

9. Fourth, the indemnity may alter the common law rule that damages are recoverable "once and for all". That is, a principal who brings proceedings to recover damages under an indemnity provision may be permitted to bring a subsequent claim for on-going losses at a later time.

10. Fifth, the indemnity may protect the principal from damage suffered by the conduct of strangers to the contract. That is, the indemnity provision may be drafted to extend to liability in respect of third party actions or claims.

11. Sixth, the indemnity can have the effect of extending the statutory limitation period. Of particular relevance to the utility of an indemnity is the extended time for which it may remain available for enforcement, when compared to a claim for breach of contract[5]. In Victoria, section 5 of the *Limitations of Actions Act* 1958 limits the time period within which a claim may be brought for breach of contract. Normally, that period is 6 years, calculated from the date of the breach. However, the limitation period in relation to an indemnity, which gives rise to a contingent liability, commences from the date on which the indemnifier refuses to honour the indemnity[6]. The principal has a period of 6 years from that date within which to bring legal proceedings to enforce the indemnity.

[5] Selkirk, S and Williams, G *Indemnity clauses in commercial contracts: how to achieve desired risk allocation* (Lexology, 7 June 2011)
[6] *Wardley Australia Ltd v State of Western Australia* (1992) 175 CLR 514

The principles illustrated

12. The leading Australian authority in the area of contractual indemnity and how indemnities are construed and applied by the Courts is the decision of Applegarth J in *Samways v Workcover Queensland*[7]. The facts in that case demonstrate some of the issues addressed above[8].

13. Deluca was a building contractor located in Brisbane. It was retained as principal contractor at a construction site. Deluca required a bobcat and operator to prepare part of the site for a concrete slab to be poured, and entered into a "Wet Hire" contract with Lynsha Pty Ltd. Lynsha, the contractor, supplied a bobcat and operator at the site in exchange for the payment of an hourly fee.

14. The plaintiff, Mr Samways, was employed by Tessman Concreting as a concreter. Mr Samways was injured when he walked into the teeth of a metal bucket hanging from the bobcat. Mr Samways sued a number of parties in negligence including his employer (Tessman), the owner of the bobcat (Lynsha) and the hirer (Deluca).

15. Applegarth J found each of the three defendants liable. In terms of the apportionment between defendants, Applegarth J found 60% of the liability against Lynsha, 30% against Deluca and 10% against Tessman. He also reduced the plaintiff's damages by 20% on account of contributory negligence. Thus, most of the liability was attributed to the owner of the bobcat, Lynsha.

16. Lynsha sought an indemnity from Deluca in reliance on the indemnity contained in the contract of hire concerning the bobcat. The clause provided as follows:

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[7] [2010] QSC 127

[8] For a useful analysis of this case, see Lynch, RJ *Indemnity Clauses – Their Impact and Interpretation by the Courts* Issue 43; August, 2010

"HIRER'S RESPONSIBILITY FOR LOSS AND DAMAGE

7. The hirer shall fully and completely indemnify the indemnifier in respect of all claims by any person or party whatsoever for injury to any person or persons and/or property caused by or in connection with or arising out of the use of the plant and in respect of all costs and charges in connection therewith whether arising under statute or common law."

17. It was argued on behalf of Deluca that the indemnity did not protect Lynsha against the consequences of its own negligence. Further, it was argued on behalf of Deluca that the plaintiff's injury was not caused by/in connection with, or arise out of the "use" of the plant, as the bobcat had not been used for at least 14 hours, was unoccupied and was rendered useless by reason of its breakdown. In those circumstances, it was argued that it could not be concluded that the injury had any connection with the "use" of the bobcat.

18. Applegarth J held at [66] that an indemnity must be construed strictly and that any doubt as to its construction should be resolved in favour of the indemnifier[9]. The Court acknowledged that such doubt may emerge from the uncertain meaning of an expression contained in the clause, but also its apparent width of application[10]. In so holding, Applegarth J held at [67] that clearly drafted clauses will not be rewritten because they retrospectively seem commercially unfair, or lacking in balance[11].

19. Applegarth J held at [68] that 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,

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[9] In the case of contracts of guarantee and indemnity, it has been held that they are to be construed *contra proferentem* – that is, in favor of the guarantor: *Ankar Pty Ltd v National Westminster Finance (Australia) Ltd* (1987) 162 CLR 549. The same principle applies to indemity provisions: *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424. See generally Lewison, K and Hughes, D *The Interpretation of Contracts in Australia* (Lawbook Co) 2012 at [7.08.5].

[10] *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269

[11] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (2008) 72 NSWLR 1

whether or not insurance is in fact taken out[12]. The absence of a provision for insurance against the liability may also be taken into account. 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.

20. His Honour referred at [70] to the authorities which construe contracts "of the present kind" and the assumption that it is inherently improbable that a party would contract to absolve the other party against claims based on that other party's own negligence[13]. Applegarth J noted also the competing view that at least the principal purpose for obtaining such an indemnity is to protect a party against liability for its own fault. Thus, it seems desirable that clauses of indemnity should specifically address whether the indemnity is intended to cover a party's own negligence.

21. Applegarth J considered the test of remoteness and foreseeability established by the indemnity, and held at [72] that the expressions "arising out of" and "in connection with" have slightly different meanings. His Honour held at [72] that the words "arising out of" require that 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. The words require the existence of a causal or consequential relationship between, in that case, the use of the plant and the injury. His Honour held at [73] that 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. The words "in connection with" were considered as being capable of describing a spectrum of

[12] For the position in Canada, see Keyes, CP and Donnelly, TJ *Getting it right before the loss: Indemnity, additional insured, and Waiver of Subrogation Issues* (Thomas Gold Pettingill) October, 2011

[13] Referred to in *Westina Corporation Pty Ltd v BGC Contracting Pty Ltd* (2009) 41 WAR 263

relationships between things, one of which is bound up with or involved in another[14]. The question that remains in a particular case is what kind of relationship will suffice to establish the connection contemplated by the contract.

22. Ultimately, Applegarth J held at [74] that the apparent breadth of clause 7, in extending the indemnity to claims for personal injuries 'caused by or in connection with or arising out of the use of the plant', including claims in respect of Lynsha's own negligence, arose from the ordinary language of the clause. In circumstances in which Lynsha gave control over the operator and Deluca assumed that control, the clause was to be construed according to its ordinary meaning to extend the claims for liability for personal injury in circumstances in which Lynsha was vicariously liable for the negligence of its employee. Lynsha was thereby entitled to an indemnity against the plaintiff's claim and in respect of costs. In short, the indemnity was found to be sufficient to protect Lynsha in circumstances where the primary finding was that its operator had been the primary tortfeasor.

Issues and strategies – the role of insurance

23. There are lessons to be learned from the decision in *Safeway*. This is so regardless of whether the contracting party is the principal or the indemnifier. In either case, the draftsman must have regard to three general but essential factors[15], being:

    (a) The operational width of the indemnity[16]. This is derived from the connection between the literal circumstances in which the indemnity applies and the conduct required by the indemnifier to trigger its operation[17];

    (b) The circumstances in which the indemnity applies. This is the specific factual occurrence as a result of which an indemnity will

[14] *Fraser v The Irish Restaurant and Bar Co Pty Ltd* [2008] QCA 270
[15] Matthews, J and Mead, P *Re-examination of the use of indemnity clauses: Drafting and Reviewing Indemnities* (Carter Newell; Construction Notes, July 2010)
[16] *State of New South Wales v Tempo Services Ltd* [2004] NSWCA 4
[17] *F&D Normoyle Pty Ltd v Transfield Pty Ltd* (2005) 63 NSWLR 502

be triggered. Issues relevant to this issue include whether the circumstances are confined to matters within the control of the indemnifier, whether the circumstances extend to liability for the actions of third parties, and whether the indemnity extends to matters that are provided for by law[18];

(c) The types of loss subject to the indemnity. This may extend to environmental damage, liability to government, personal injury or death, and negligence of the principal, and more generally, consequential losses[19].

24. In the case of the principal, it should be remembered that the Courts have adopted an approach which results in the construction of ambiguities in an indemnity in favour of the indemnifier. Ambiguity in the drafting of the indemnity raises the possibility that the indemnity will not be held to cover losses which they are expected to address.

25. The successful drafting of indemnity provisions is often linked to an assessment of the reasons for passing particular risks to the indemnifier. Understanding the risk and likely impact of a particular event or incident can assist when drafting an indemnity to provide specific risk management, and thereby avoid uncertainty. The decision in *Samways* confirms that such uncertainties may arise from the manner of expression as well as the width of possible application that the indemnity may have. Accordingly, care should be exercised when drafting a broad indemnity to ensure that the clause is not vague or ambiguous. Care also should be taken to ensure that the indemnity intersects with other provisions in the contract so that the indemnity is not inadvertently restricted or limited.

[18] *Erect Safe Scaffolding (Australia) Pty Ltd v Sutton* (2008) 72 NSWLR 1; *Ellington v Heinrich Constructions Pty Ltd* (2005) 13 ANZ Insurance Cases 61-646

[19] *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* (2008) 19 VR 358

26. The use of insurance as a mechanism for the management of risk by a principal cannot be overlooked. The astute principal[20] may insist that the indemnifier obtain and maintain insurance that will respond to a claim under an indemnity, and require:

    (a) A copy of all policies of insurance in order to confirm that the policies will respond to the indemnifier's liabilities under indemnity; and

    (b) Confirmation from the indemnifier that the policies will respond to the full extent of the indemnity.

27. It is at this point that attention must be directed to the limitations inherent in securing insurance to safeguard the interests of the parties to an indemnity. As already explained, an indemnity apportions responsibility for risk between the contracting parties. The degree of this apportionment can be considerable, and quite inconsistent between contracting parties, and contracts. Frequently, contracts and indemnities can be one-sided with regard to allocation of responsibility. Some agreements direct all responsibility of whatever nature to the indemnifier, including in respect of an event for which the indemnifier would not be held liable at common law.

28. The purpose of insurance requirements in the context of contract conditions which include an indemnity is to transfer risk inherent in the performance of the contract to a third, and often more financially substantial, party[21]. This is in order to provide a level of comfort to the contracting parties in the protection of their financial interests arising from the performance of the contractual arrangements between them, including the rights and obligations imposed by the indemnity.

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[20] Kelly, A *Recent developments in Indemnities* (Thomsons Lawyers)

[21] Mecon Winsure Insurance Group – *Indemnity v Insurance* (available at http://meconwinsure.com.au/indemnity-v-insurance/)

29. Specification of the scope of insurance cover in the contract is as important as it is difficult[22]. It is important because it provides the necessary level of comfort to the contracting parties in terms of their financial protection. However, difficulties arise because the level of risk acceptance by insurers is diverse as to, for example, terms, conditions, excess and deductible provisions and amounts, and so forth. The difficulties inherent in the insurance of risks arising under contractual indemnities are the outcome of some of the following factors:

    (a) Policy coverage amongst insurance companies is not identical;
    (b) Insurance market risk acceptance parameters are subject to alteration from time to time, and insured to insured;
    (c) Insurance policies may not insure liability beyond that which would be imposed at common law, in tort;
    (d) Insurance policies do not recognise or even attempt to coincide with contractual requirements;
    (e) Contractual requirements and obligations differ, especially in terms of the scope of the obligations imposed by an indemnity;
    (f) Contractual and insurance policy terminologies are dissimilar.

30. These difficulties may be readily demonstrated in a construction law context.

31. It is sometimes the case that a principal with the benefit of an indemnity from the head contractor will be indemnified for loss caused by the head contractor and all sub-contractors or consultants when performing the works under contract. To cover its liability, the head contractor may enter into liability insurance covering itself and its sub-contractors, and it may name the principal as an insured. However, public liability insurance policies usually exclude liability assumed by way of contract, unless that liability would have existed in the absence of the contract[23]. The effect of this exclusion is that the insurance policy will cover liability only where the contractor or sub-contractor has been negligent. The

[22] Mecon Winsure Insurance Group – *Indemnity v Insurance*; op cit
[23] Tan, C *Indemnities and insurances – Risky business* (On Site, October 2010)

insurance policy may also cover the proportionate liability of the contractor/ its sub-contractors, but not the proportionate liability of a concurrent wrongdoer who is not covered by the insurance. The insurance is, therefore, narrower than the indemnity.

32. Public liability insurance policies may also be narrower than an indemnity in that such insurance may only cover liability in respect of personal injury (or death) and property damage. Although public liability insurance policies may cover liability for loss consequent on property damage, they may not cover liability where it does not arise or flow from property damage. For example, such policies may not cover liability for loss caused by delay or lack of performance (defects, whether due to negligence or not). Lastly, public liability insurance policies will inevitably exclude professional services and design, specification or advice[24].

33. The result of the issues identified in the preceding paragraph are as follows:

(a) The scope of the contractual indemnity may be broader than the liability (and other) insurance that is available;

(b) The contractual indemnity may require the assumption of more liability by one of the parties than the law requires, and therefore more than liability insurance policies in Australia cover;

(c) Insurance requirements imposed in contracts can be too optimistic in the requirements and expectation of insurance.

34. The outcome of these issues can be devastating for the contractor who has entered into an indemnity. If the contractor is not covered by insurance in respect of a claim made under an indemnity (perhaps because the insurance is narrower than the indemnity) then the indemnifier must bear the loss itself, at least to the extent some other

[24] This is because liability incurred in the conduct of those activities is generally covered by professional indemnity insurance.

party is not liable for the loss or damage[25]. It is not unusual for insurance claims, involving an indemnity contractually assumed by an insured party, to be declined where such an assumed liability would not be enforceable in tort. The insurance industry may regard the assumption of broad liabilities between contracting parties (whether insured or not), undertaken by means of an indemnity, as an entrepreneurial risk. Because indemnities can be as broad as the contracting parties care to make them, an insurer cannot price for the transfer of risk inherent in the entry into an indemnity, particularly on a "generic policy" basis.

35. Nonetheless, there are a number of strategies potentially available to an indemnifier to enable it to address these issues in terms of the drafting of the indemnity.

36. Although the prudent indemnifier will wish to resist an indemnity, commercial exigencies can and often do have the effect of limiting the indemnifier's ability to do so. As a matter of prudence, indemnifiers should ensure that indemnity provisions are covered by the insurances in place, and do not invalidate policies of insurance. Limiting the scope of the indemnity agreed to by the indemnifier may make it more possible for the indemnifier to obtain appropriate insurance coverage. When negotiating an indemnity, an indemnifier may consider a number of strategies to limit the scope of the indemnity:

(a) The indemnifier may seek an overall liability limit on the indemnity. In doing so, the indemnifier may seek to limit the cap at 100% of the contract price, plus the proceeds of available insurance policies;

(b) The indemnifier may require the indemnity to extend only to loss or damage within the control of the indemnifier, and only apply to loss or damage caused by the indemnifier;

[25] If otherwise applicable, the proportionate liability regime established in Victoria under Part IVAA of the *Wrongs Act* 1958 (Vic) should not be overlooked. The decision in *Hunt & Hunt Lawyers v. Mitchell Morgan Nominees Pty Ltd* [2013] HCA 10 has expanded the range of circumstances under which claims may be apportionable within the meaning of the *Wrongs Act*.

(c) The indemnifier may require the indemnity to reduce proportionately to the extent the loss, claim or damage is caused or contributed to by the principal and its agents;

(d) The indemnifier may require the indemnity to be limited to losses foreseeable at the time of contract. To broaden the losses beyond this may expose the indemnifier to liability not contemplated at the time of contract, which the indemnifier may not be able to manage, and for which the indemnifier may not be able to secure insurance;

(e) The indemnifier may require the indemnity to be subject to an obligation on the principal to use its best endeavours to mitigate its loss;

(f) The indemnifier may require the indemnity to exclude consequential loss;

(g) The indemnifier may seek to limit the time period within which claims can be brought under the indemnity. This may be achieved by, for example, limiting that period to 6 years from the date of completion of the relevant work.

The indemnity and releases

37. When resolving a dispute, it is necessary to consider whether the release from liability should extend to persons who are not directly involved in the dispute, but who are nonetheless associated with the release. This issue may especially arise in circumstances where one of the parties to the release has entered into an indemnity.

38. Consider the following example: Person A claims that he was injured while working as an employee of Company B. However, Company B is the sub-contractor on a construction site operated and managed by a head contractor, Company A, and Company B has entered into a broad contractual indemnity in favour of Company A. If Company B (indemnifier) compromises with Person A (releaser), it should consider a release from liability that extends to Company A (principal). Otherwise, it is possible that a claim will be brought by Person A

against Company A, which may in turn bring a claim under the indemnity against Company B.

39. In principle, Company A may be protected through the use of a deed poll, the creation of the trust of a contractual promise, legislation (if applicable) or direct release[26]. Which alternative is used depends on whether the indemnifier wishes for the principal to have a right independent of the indemnifier to enforce the release, and the relative bargaining strengths and general circumstances of the case.

40. When determining which device to use, the indemnifier must also consider whether it wishes the principal to have a right to enforce the release from liability independently of the indemnifier. If the answer is in the affirmative, the indemnifier has several alternatives. First, the indemnifier may cause the principal to become a party to the deed of settlement. Were the principal to be a party to the deed, then the principal may enforce the deed by direct action. However, making the principal a party to the deed of settlement may be commercially impractical, for a variety of reasons.

41. Second, the indemnifier may arrange for the releaser to execute a deed poll in which the principal is provided to be released, by covenant, from liability[27]. A person for whose benefit a covenant in a deed poll is expressed may sue upon that covenant, if that person is sufficiently named in the deed poll[28].

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[26] See the analysis of this issue appearing in Sise, P *Sealing the settlement: don't forget to invite the third parties* (Clayton Utz Insights, 20 December 2012). The analysis in this paper applies, in the context of indemnities, the general approach adopted by the learned author.
[27] *Halsbury's Laws of Australia* (LexisNexis) at [140-185]
[28] *Moss v Legal and General Life Assurance Society of Australia* (1875) 1 VLR (L) 315; *Re A & K Holdings Pty Ltd* [1964] VR 257

42. Third, the indemnifier and principal may make use of legislation that exists in certain jurisdictions which permits persons who are not parties to a contract to enforce an obligation in certain circumstances[29].

43. If the above alternatives are unavailable or unacceptable to the parties, the indemnifier has other alternatives. These do not allow the principal to enforce the release from liability independently of the indemnifier, at least in the first instance. First, the deed of settlement may include a provision stating that the principal is released from liability and the releaser will enter into a deed of settlement with the principal when requested to do so by the indemnifier. If this alternative is adopted, the principal does not have the right to enforce the release and is dependent upon the indemnifier.

44. Second, a provision may be included in the deed of settlement that the indemnifier has sought and obtained the release as agent of the principal and holds the release on trust for its benefit. The indemnifier then becomes a trustee of that release, and the principal is beneficiary[30]. The principal is compelled to rely on the indemnifier to enforce the release. However, if the indemnifier is unable or unwilling to do so, the principal may itself bring proceedings.

Conclusion

45. The decision in *Samways* indicates that the Courts will henceforth adopt a more literal approach to the interpretation of indemnity clauses. If the indemnity is unambiguous, then it can be expected that the Courts will construe and apply the clause in accordance with its terms. This is especially so in circumstances where the Courts have generally adopted a much more *laissez faire* approach to the construction of

[29] Section 11 of the *Property Law Act* 1969 (WA), section 55 of the *Property Law Act* 1974 (Qld) and section 56 of the *Law of Property Act* 2000 (NT)

[30] This is based on the principles expressed in *Trident General Insurance Co Ltd v McNeice Bros Pty Ltd* (1988) 165 CLR 107; see also *Specialist Diagnostic Services Pty Ltd (formerly Symbion Pathology Pty Ltd) v Healthscope Pty Ltd* [2012] VSCA 175

contracts, and have in doing so been willing to assume a much greater degree of commercial sophistication.

46. However, the strict application of indemnity clauses gives rise to challenges in circumstances where the indemnifier may not be able to secure insurance for the full extent of the risk taken under the indemnity. In such circumstances, the indemnifier may be required to bear some or all of the loss suffered as the result of a claim being made against it under the indemnity. Indemnity clauses, and the availability of insurance to the indemnifier to cover the risk undertaken by entering into such a clause, may not be given sufficient consideration when contracts are drafted. They are typically “boiler-plate” clauses contained within precedents. Legal practitioners must be aware of whether insurers offer insurance to cover the obligations undertaken under the specific indemnity proposed to be entered into.

47. When settling a dispute, it is important to consider whether the release from liability should extend to persons who may have the benefit of an indemnity. There are several alternatives open to the indemnifier to protect itself, and also the interests of the principal. The selected alternative will depend on the wishes of the parties, the outcome of the negotiated settlement, and the strength of the bargaining position of each of the parties.

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