Indemnities are a common talking point during contractual negotiations, and a common cause of disputes. If the issues are not properly negotiated, or the indemnity clause is poorly drafted, the consequences can be serious regardless of whether you are the party giving or receiving the indemnity. So, knowing what a contractual indemnity is (or is not), recognising the different types of indemnities, understanding the nature and scope of indemnities in law and what sets them apart from other risk allocation techniques will assist you in negotiating and drafting an effective indemnity clause.

What is an indemnity and how is it different to a guarantee?

It is a common misconception that guarantees and indemnities are the same and that they are treated similarly at law. Reasons for the misconception could be that the two terms are often used together and drafted as one, namely as a ‘guarantee and indemnity’. Contracts of guarantees and contracts of indemnities do have much in common – they were initially only enforceable in equity, are contractual in nature and they both share the same risk allocate function. However, understanding the differences and their common law evolution will assist in providing a better understanding of the two concepts, which to use, when and how to draft an effective clause.

A guarantee has been commonly defined as a promise to answer for a third party's debt, default or miscarriage.¹ From that definition, a guarantee requires:

1. third party obligations to exist; and
2. the intention by the parties to secure the performance of that obligation.

An indemnity, on the other hand, is not so easily defined and is often defined in the negative, in other words, what it is not.² It is generally accepted though, that obligations under an indemnity are primary and independent of any underlying obligation. Indemnities do not require there to be a third person who is primarily liable. The simplest way to understand an indemnity is as a contractual means for transferring all liability for a known risk from one party to another.

In more recent times, indemnities were described as being “designed to satisfy a liability owed by someone other than the guarantor or indemnifier to a third person”.³

¹ Sunbird Plaza v Maloney (1988) 166 CLR 245 at 254
³ Andar Transport Pty Ltd v Brambles Ltd (2004) 217 CLR 424 at 437
While two judicial definitions of indemnities are similar, the consequences of defining indemnities as a “hold harmless” obligation as opposed to an obligation to “make good” any loss or damage can be different, as discussed later in this paper.

Guarantees and indemnities are both based in contract and share the same objective namely “to protect a person against loss suffered through entering into a transaction with a third party”⁴; however there are four crucial differences.

Firstly, a contract of guarantee is a secondary or collateral contract that relies on or is linked to a primary contract, namely the contract the debtor has with the beneficiary of the guarantee, and with that a guarantee is said to be coextensive and co-terminous with the primary contract. Such that if the primary contract fails or the debtor satisfies its contractual obligations under the primary contract, then the guarantee falls away and is no longer required, despite the beneficiary suffering loss or damage. Following on with this difference, “if anything nullifies, reduces or extinguishes the liability of the principal obligor, prima facie it has the same effect on the liability of guarantor”.⁵ Conversely, a guarantor may be discharged, to some extent, by a transaction between the beneficiary and the debtor that was not consented to or approved by the guarantor or that otherwise expands the guarantor’s liability or disadvantages the guarantor’s position. The intent of the law here is to prevent the debtor expanding or extending the guarantor’s liability unilaterally.⁶

A contract of indemnity however is independent of any other contract and obligations of the indemnifier are principal obligations.⁷ That does not necessarily mean that these factors cannot apply to indemnities, it does mean that the usual position at law is that they do not normally apply to indemnities.

The second significant difference between guarantees and indemnities is that guarantees must be in writing (or evidenced in writing) while indemnities do not have to be in writing and may be implied by the courts on the basis of a particular conduct, subject to the intervention of certain legislation such as consumer credit laws. The Statute of Frauds (and the various Australian equivalent legislation)⁹ has not only defined what a guarantee is but also imposed the restriction that a guarantee must be in writing. The courts are prepared to imply an indemnity based on the general principle of law that when an act is done by a person at the request of another and that act injures the rights of a third party, the person doing it is entitled to an indemnity from the person who requested the act be done.¹⁰

While both guarantees and indemnities are contractual and thus governed by contractual rules, guarantees were (and still to a degree are) afforded special rules in equity. Historical reasons aside, equity intervenes in the case of guarantees in the following ways: reliance on the existence of a valid primary contract, the release of the guarantor through the beneficiaries conduct and the guarantor’s right after payment in respect of the primary obligation to the beneficiary to then recover payment from the debtor or co-guarantors by way of subrogation or contribution. It is especially this last rule, namely the guarantor’s right to claim against the co-guarantor or the debtor that is normally associated with guarantees but not indemnities. Essentially, if the beneficiary calls on the guarantee and the guarantors pays out the debt, he or she can then claim on the debtor for that amount or she or he can call on a co-guarantor to contribute to the payment of that amount. While there may be special rules that apply to indemnities (discussed later in this paper), it can be acknowledged that indemnities at least, do not have the benefit of these special rules, except as statute may prescribe.

Finally, as a guarantee is coextensive and coterminous, the beneficiary may only expect to recover that part of the primary obligor’s debt which is owing but unpaid and which has been guaranteed. For indemnities the position regarding the assessment of damages for the breach of the indemnity is somewhat unclear, as discussed in greater detail later. Suffice to say the difference is that a guarantee’s assessment of damages, by its very nature, relies entirely on the underlying primary contract whereas the indemnity does not, being an independent obligation.

---

⁴ Halsbury’s Laws of Australia [220-1]
⁶ See note 5 at 44
⁷ Halsbury’s Laws of Australia [220-20]
⁸ Halsbury’s Laws of Australia [220-20]
⁹ See s 126(1) of the Instruments Act 1956 (Vic); s 56(1) of the Property Law Act 1974 (Qld); s 2 of the Law Reform (Statute of Frauds) Act 1962 (WA); s 6 of the Mercantile Law Act 1935 (Tas); and s 58 of the Law of Property Act 2000 (NT).
¹⁰ Israel v Foreshore Properties Pty Ltd (In Liq) (1980 30 ALR 631
Types of indemnities

In understanding indemnities, it is important to consider the different types of indemnities which appear in practice.\(^{11}\)

The first type is a **bare (or general) indemnity** for example; *A indemnifies B against all liabilities or losses incurred in connection with a certain event or circumstance* without specifying any limitations. These indemnities are commonly silent on whether the indemnity extends to the party’s own negligence.

The second type is a third party claims indemnity or “**third party indemnity**” for example:

\[
A \text{ indemnifies } B \text{ against claims or liabilities by } C \text{ or, } \\
A \text{ indemnifies } B \text{ against claims that a product supplied by } A \text{ infringes a third party’s intellectual property rights.}
\]

The third type is an indemnity against claims by the promisor or “**reverse indemnity**” for example; *A indemnifies B against claims by or liabilities to A*. This is the type of indemnity used in a release or settlement deed where the indemnity is intended to be support for a bar to a claim by A against B.

The fourth type of indemnity is against performance by a third party or “**financing indemnity**” for example; *A indemnifies B against C’s failure to perform as agreed in a contract between B and C*. This indemnity is similar to a guarantee and is often used in a guarantee and indemnity document in finance transactions.

The fifth type is an indemnity against breach or “**party/party indemnities**” as in: *A indemnifies B against loss caused by A’s breach of contract with B*. This indemnity is usually included in commercial contracts to provide for additional rights for the indemnified in the event of contract breach.

Each type of indemnity is only intended to “exactly” protect the indemnified – with the protection giving the indemnified “no more, no less” than the loss suffered.\(^{12}\)

Negotiating indemnity clauses

When preparing to negotiate a contract generally, paying particular attention to the specifics in the indemnity clauses is strongly recommended. By identifying the potential loss and damage (in other words, the risks) in the transaction and understanding liability at common law and under statute, will greatly assist in effectively negotiating the clauses. The nature of loss or damage that is recoverable in connection with a contract varies depending on the subject matter of the contract. Often the subject matter of a contract will be such as to give rise to loss or damage from breach of the contract, property damage or personal injury.

Understanding that a draftsman needs to consider the risks in a transaction are much easier than actually listing or identifying the risks themselves.

Before altering the law to one’s own benefit, it would be useful to first briefly outline some of the basic contract law concepts. While a contract itself is a means of allocating risk between parties, understanding how contract law or common law operates is important so as to better understand the role of indemnities, as a tool for reallocating risks within contracts.

**Common law contract damages**

At common law, the right to damages is implied by law and does not need to be stated in the contract. It follows that once an established primary obligation (or duty) has been breached, the law implies a secondary obligation to pay damages\(^{13}\).

A contract itself can (and commonly does) provide for its own regime for breach of contract and subject to some limitations, at law and by statute, can alter the risks allocation between the parties for example, liquidated damages clauses (especially in construction contracts), exclusion clauses and limitation of liability clauses (as well as indemnities) are some common techniques used to alter the risks and the common law.\(^{14}\)

---

\(^{11}\) Note there could be many types see for example, in D’Angelo N, “The Indemnity: It’s all in the drafting” (2007) 35 ABLR 93, six types of indemnities were discussed.


\(^{13}\) D’Angelo N, “The Indemnity: It’s all in the drafting” (2007) 36 ABLR 93 at 104.

\(^{14}\) Ibid.
Contract damages at law are premised on balance and fairness rather than punishing a wrong doer. As such while the wronged party is entitled to be compensated, they are not allowed to enjoy a windfall, or to sit on their hands and let preventable loss accumulate. Conversely, the wrong doer must make good the loss they have caused however they are exposed to open-ended liability.

To limit open-ended liability the concept of remoteness was developed at law – essentially the claimant cannot recover compensation for losses which are too remote. The rule in Hadley v Baxendale in essence provides that damages recoverable for breach of contract must be:

1. fairly and reasonably considered either as naturally flowing (i.e. in the usual course of things) from the breach (first limb), or
2. in the reasonable contemplation of the parties at the time of making the contract, as the probable result of the breach (second limb). It is this second limb that is referred to as the remoteness test – if the damages are too remote, no damages will be recoverable for that head of damages claimed.

Another common law contractual concept developed is a defensive rule - namely the duty of mitigation whereby a claimant who asserts a secondary right to damages will not be entitled to recover damages to the extent that he or she has not taken all reasonable steps to mitigate his or her loss.

Common law canons of contract interpretation

Another aspect of contract law that is worth noting briefly at this stage is the construction of contracts at common law. In preparing to draft or negotiate indemnity clauses, it is important to understand how courts interpret them. For instance, if a request is made to amend an indemnity clause, deciding whether or not the amendment will have any significant impact to the operation of the indemnity clause requires an assessment of how that amended indemnity clause will be interpreted.

Many commentators have discussed and analysed cases interpreting indemnity clauses both in Australia and abroad. This paper only considers the elementary concepts from the main cases.

On first principles, where there is ambiguity in meaning, legal effect or application of a contract, the courts begin a process of construction of the contract as a matter of law and not fact. The fundamental basis of construction is the objective test by which the courts look at the intention of the parties, the legal rights and obligations under the contract and then decide what their words would be “reasonably” understood to mean without consideration of the actual or subjective intentions of the parties.

Mason J in the landmark case of Codelfa put it this way:

“when the issue is which of two or more possible meanings is to be given to a contractual provision we look, not to the actual intentions, aspirations or expectations of the parties, before or at the time of the contract, except in so far as they are expressed in the contract, but to the objective framework of facts within which the contract came into existence, and to the parties’ presumed intention in this setting. We do not take into account the actual intentions of the parties.”

The objective test of contract interpretation was further developed over the years so as to encompass what was referred to as “natural and ordinary meaning” or some also refer to this as the “commercial” construction or the “literal” construction of the contract. One author succinctly summarised the more modern canons of contract interpretation as follows:

- taking into account the surrounding circumstances or “factual matrix” of the contract, in all cases and not only in exceptional cases;

---

15 (1854) 156 ER 145
17 Codelfa Construction Pty Ltd v State Rail Authority of NSW (1982) 149 CLR 337 at 352.
18 For example, Dr Wayne Courtney in a presentation to the Commercial Law Association on 15 August 2014 at Sydney.
• approaching the matter in a practical manner, so as to give the contract a reasonable business operation;
• asserting a common sense approach, favouring a commercially sensible construction, even if it means ignoring a lack of clarity;
• adopting a construction that seeks to avoid the contract failing for want of certainty;
• adopting a uniform approach to all contracts, regardless of their type or nature (ie avoiding “special” rules for particular types of contract); and
• a preference for rejecting particular construction approaches such as “strict” or “literal” construction, in favour of an approach which a reasonable commercial person would take to be the intended meaning or application of a contract.

Until about 1990, these canons were accepted by the courts in Australia and were found to apply to indemnities. However the High Court since 1990 has not been so clear. While in one case the court held that indemnities were akin to exclusionary clauses and special rules apply to their interpretation (namely that they be strictly interpreted or construed in favour of the indemnifier) the court in another case held that ambiguity in indemnity clauses are to construed “by what a reasonable person in the position of [the indemnified party] would have understood them to mean. That requires consideration, not only of the text of the documents, but also the surrounding circumstances known to [the parties] and the purpose and object of the transaction.”

The latter test resembling a “natural and ordinary” meaning.

**Indemnity contract – special rules?**

So what is the appropriate test or rules governing the construction of indemnity clauses?

With contractual indemnities being based in contract, it is not an unreasonable conclusion to assume that the usual rules of construction of contract should apply, with no special rules. However as noted earlier , the nature of indemnities, being similar to guarantees and exclusion clauses, lend themself to special rules such as, the contra preferentum rule - strictly construing indemnities in favour of the party burdened by the indemnity.

Traditionally, the general principle behind strictly construing indemnities is that “an indemnity is designed to satisfy a liability owed by someone other than the indemnifier to the indemnified and as such the courts should construe a contract in favour of the indemnifier unless the indemnifier’s liabilities are expressly and clearly articulated.” Courts have recently used this principle as the basis to justify applying the contra preferentum rule to indemnities.

However not all indemnities are for the benefit of third parties for example a bare indemnity, reverse indemnity or party/party indemnity are not third party indemnities. So query whether that principle will still apply in those cases.

One judges made the comment that calling on the contra preferentum rule was to be used only as a “last resort” when interpreting indemnity clauses, preferring to “struggle with the words actually used as applied to the unique circumstances of the case”. Such trend highlights the importance of clearly identifying the risks and specifying exactly the circumstances to which the indemnity is to apply to shift those risks accordingly.

One would have to accept, however that at this time, the law in Australia regarding interpreting indemnity clauses is that decided in the *Andar* case: indemnities are to be interpreted *strictissimi juris* (at least in third party indemnity cases) or where there is ambiguity in the indemnity clause, the courts would apply the contra preferentum rule against the indemnified party.

---

20 Schenker and Co (AUS) Pty Ltd v Maplas Equipment and Services Pty Ltd [1990] VR 834.
21 *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424
22 *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451
23 Ibid at 462
25 See for example *Andar* case (refer note 21) and the cases sighted in that case.
26 *McCann v Switzerland Insurance Australia Ltd* (2000) 203 CLR 579 at 602. Also see Kirby J in *Andar*, note 5 above at 68.
Liability under statute

Statute or legislation has intervened in potential hardship cases suffered by guarantors and indemnifiers in assuming their liability. In the past, guarantees were considered particularly in need of intervention by, for example, requiring a certain formality in order to have a guarantee enforceable. Now indemnities are considered essentially on the same footing as guarantees under, for example, the Competition and Consumer Act 2010 (Cth), the Australian Securities and Investments Commission Act 2001 (Cth), the National Consumer Credit Protection Act 2009 (Cth) and state bases legislation such as the NSW Contract Review Act 1980.

This paper does not intend to expand on liability of a person under statute other than to note that legislation (including insurance legislation) has been worked and reworked over the years, both in Australia and abroad, to continually attempt to shift the risk away from the indemnifier and the courts are generally accommodating the legislature’s efforts in that shift. Most statutes also prohibit any contracting out of such shift in liability or risk however even when the statute is silent on “contracting out”, in at least one UK landmark case, the statute was still construed narrowly so as to favour the indemnifier, at the cost of arguably, rendering the statute contrary to its clearly stated objective (discussed further a little later).

Negotiating to alter liability between the parties

The operation of contractual rules can be affected by special equitable rules. Statute too has intervened, in certain circumstances, to alter the contractual position at general law.

Contracts of indemnities, again being contracts, are governed by contract law. The common law applicable to contracts are clearly outside the scope of this paper, however relevantly, there are certain characteristics in contract law that may not apply or may not apply in the same way to indemnities. Contract law principles of remoteness, limitation periods and obligation to mitigate are the main contract law characteristics that may not apply to indemnities.

It has long been established that damages may not be recoverable from a party in respect of a breach of contract if they are too remote. Liability under an indemnity may extend to cover loss or damage that is not usually recoverable for breach of contract because of the principle of remoteness of damages following the rule in Hadley v Baxendale. However, depending on the wording of the indemnity, loss or damage which does not usually flow from the breach of contract, or which was not contemplated by the parties at the time the contract was entered into, may be recoverable under an indemnity.

The statutory limitation period that would usually apply in respect of a cause of action may, in effect, be extended under a contractual indemnity. While the statutory limitation period for a breach of contract is six years and commences from time of the breach, the rights of the indemnified under an indemnity continues to run for as long as the indemnity remains in force. If the breaching party does not comply with its obligation to indemnify, there will be a cause of action for breach of the obligation to indemnify. The limitation period for that breach will begin to run from the time of the non-compliance with the indemnity, which may occur well after the initial breach of contract.

Common law places an obligation on a contracting party that has suffered loss to mitigate any loss as a result of breach of contract. However, this obligation to mitigate does not apply to indemnity clauses, subject again to the wording of the indemnity itself. While it is not settled law, the logic behind the principle that an obligation to mitigate any loss does not apply to indemnities is that a party with a claim for breach of an indemnity cannot be expected to mitigate its loss where that loss represents the very amount for which it should be indemnified. The basis of this principle assumes that an indemnity is defined as a promise to compensate for loss, rather than a promise to prevent the loss.

---

27 Halsbury’s Laws of Australia [220-10]
28 Firma C-Trade SA v Newcastle P&I Association (The Fanti) [1990] 2 All ER 705
29 (1854) 2 CLR 517
Third party losses

Under general contract law the remedy for non-performance, apart from establishing a valid contract basically requires the plaintiff to establish a breach of contract, causation and damages (that are not too remote). It is a common adage under contract law that just because a party suffered a loss, it does not necessarily result in that party being entitled to damages for that loss. On the other hand, there is no need for these contractual concepts to be established for indemnities. In fact, depending on the drafting of the clause, there does not even need to be a default for an indemnity to be enforceable. Usually all that is required is that the specified indemnifiable event occurs or trigger happens (usually a loss suffered or claim made).

This is one of the main reasons for indemnities to be included in contracts. Where contract law does not provide the remedy expected, relying on contractual indemnities may be a better remedy.

In practice, third parties to a contract can become involved in the performance of a contract in which they are not party or seek to take the benefit under the contract with a direct right to enforce non-performance for their benefit.

There are two aspects to contractual indemnities that favour third parties and their right to enforce non-performance or covenants in their favour: Firstly, the establishment of a valid and enforceable contract containing the indemnity; and secondly, the entitlement to damages or other remedy for the breach of the contract.

Relevantly the main contractual rules are:
1. consideration must move from the promisee;
2. the rule of privity of contract; and
3. only a person who has suffered loss may claim substantial damages for breach of contract.

In most third party indemnity situations, the benefiting third party is not a party to the contract, does not provide any consideration for the promise of indemnity and is the person that suffers loss that is the subject of the indemnity. Based on the usual contract rules, the third party would not normally be able to enforce the contractual indemnities directly. They may need to enforce them through the contracting party but even then, the loss suffered by the contracting party is arguably nominal (as they may not have suffered any loss).

There are drafting techniques that can be employed to address these issues, namely30:
1. joining the third party as a party to the contract;
2. creating a trust arrangement;
3. using a deed or deed poll to provide for the indemnity.

While each technique has its attractions, not all will be appropriate in all circumstances.

Clearly joining the third party to the contract will overcome the contract issues however this will mean they will no longer be “third parties”, but a party to a contract. In many cases it is not practical or possible to join the third party to the contract for example where the indemnity is in favour of “employees and agents”.

Even if the third party was known or specified, in some circumstances joining that person as a “promisor” in a contract may open that party to other unexpected liability based on the view that if “B and C are joint (or joint and several) promisees they must also be joint promisors in order to be parties to the contract.31 This view is held by some despite the law in Australia allowing one person (B) alone to be the party who bears the burden of promising to pay for whatever the other person (A) has agreed to supply under the contract even though there are other parties to the contract.

Another technique that can be used to overcome contract laws denying a third party a right of indemnity in their favour, is the creation of a trust where by A promises B to indemnify B and C and B acts on its own behalf and as trustee for C. The trust technique operates through property law not contract law and thus overcomes the operation of the usual contract rules.

30 Furmston MP and Carter JW, “Indemnities for the Benefit of Other” (2011) 27 JCL 82
31 Furmston MP and Carter JW, see note 30
The trust technique however is not without issues, most significantly:

1. the acting party assuming fiduciary duties towards the co-indemnified may be inconvenient or inappropriate, for example where the co-indemnified is an employee or agent of the indemnified;
2. varying and terminating the trust without reference to the co-indemnified is problematic or not practical;
3. stamp duty may be payable on the contract where it creates or establishes a trust; and
4. the rule against perpetuities may still apply.

While the creation of a trust is sometimes used, the more common technique is to draft of the contractual indemnity into deeds or drafting the indemnity clauses as deed polls (whether within a deed or as separate deed polls). This technique avoids the contractual rules of consideration, privity of contract and entitlement to claim loss for contract breach.

Ensuring indemnity obligation are met

A contractual indemnity is only as valuable as the financial resources of the party giving the indemnity. Conversely, the party giving the indemnity should ensure it is financially able or has sufficient resources to fund the indemnity given. As part of that consideration, the party agreeing to indemnify another, might consider protecting itself from these risks by taking out appropriate insurance or require a guarantor to support the indemnity.

The main issue with effecting insurance to protect the indemnifier is to marry up the insurance cover with the indemnity obligation. In most cases, insurance may cover the indemnifier for only some of the risk.

Exclusions or qualifications in insurance policies can lead to gaps in the protection for the indemnifier, resulting in the indemnifier and the indemnified exposed and uninsured for the relevant risk. A common exclusion is contractually assumed liability where liability would not otherwise exist at common law or statute.

The other issue with insurance to cover the indemnifier’s risk is to ensure that the insurance policy remains current and enforceable. In most cases, the insurance policy holder is the indemnifier (and named on the policy) and may cancel or modify the insurance policy so that its effectiveness is either diluted or lost entirely, without the beneficiary of the indemnity knowing. For this reason contracts often require the insurance policy to be taken out in joint names or at least naming the indemnified party as the beneficiary under the policy.

Another issue with insurance provisions in contracts is their overlap or interplay with indemnity clauses. For example, where insurance covers the risk under contract, can the indemnified claim under the indemnity as well as claim the insurance? Courts usually construe the insurance clause as taking priority or that the indemnity clause is subordinate to the insurance provisions. In these circumstances, the courts tend to consider: who is obtaining the insurance? What is it intended to protect? Is it intended to support or back up the indemnity clause?

Indemnities for one’s own negligence

One question that often arises with indemnities is whether or not an indemnity clause can operate to cover the risk of one’s own negligence or default. There does not appear to be any reason at common law at least, why a very clear and specific indemnity clause drafted to cover the indemnified’s own negligence or default could not work.

In Samways v Workcover Queensland and Ors the court confirmed that an appropriately worded indemnity clause can effectively lead to a party compensating another for the negligence of that other party if the ordinary meaning of the clause clearly provides for the indemnity and the “commercial and contractual context” supports such a construction.

Underlying the case law in this area is the concept of a party’s freedom to contract on whatever terms they consider appropriate. Although onerous to require a party to compensate another for that other party’s own negligence, the court decided it did not have a role in overruling the parties bargain by rewriting a provision that simply seems unfair or lacks balance.

32 [2010] QSC 127
33 Mulligan P and Neal C, “Is indemnity for a party’s own negligence possible?” (March 2011) LSJ at 32
Case studies: “Hold harmless” vs. “Make good”

Before concluding with drafting issues and tips, it is worth briefly exploring the case law on indemnity clauses. As noted earlier, there are two common interpretations for indemnity clauses – one is that the promisor will prevent or avert loss to the promisee; and the other is that the promisor will compensate the promisee or make good the loss sustained by the promisee.

The consequences of an indemnity clause interpreted as a preventative obligation (hold harmless) rather than a compensatory one (make good) may result in differing remedies for its breach.

If an indemnity is defined as preventative or to hold harmless as the primary right, then once the loss or damage occurs, there is a breach of contract and a secondary right to compensation or unliquidated damages arising from that breach (or wrong). However, does that mean that contract damages can only flow for the breach of indemnity? Some cases have considered this question and by and large decided that contract damages flow from the breach and as such an assessment of the quantum of damages would be required. This may include consideration of contract law damages limitations such as remoteness or the obligation to mitigate, however the courts do not tend to use those terms in describing them when it involves indemnity clauses.

On the other hand, if an indemnity is interpreted as a make good or compensatory right, then the right to pay compensation arises once the loss has occurred and as such the right to be indemnified would be a primary right to compensation for the loss (not secondary). The assessment of damages for the loss closely follows that of a liquidated debt or debt due (namely a sum certain contemplated at the date of the contract). It should be noted that the sum certain need not beascertainable at the contract date for it to be considered a liquidated debt. For example in Jarvis v Harris, a claim by a landlord for costs of repair which he was entitled to under the lease was held to be a debt claim even though the sum was not fixed at the date of the lease.

The difference was clearly stated by Millet LJ in that case as follows:

“a debt is a definite sum of money fixed by the agreement of the parties as payable by one party to the other in return for the performance of a specified obligation by the other party or on the occurrence of specified event or condition; whereas damages may be claimed from a party who has broken his primary contractual obligation in some way other than to pay such a debt”

Practically, the consequential differences between an indemnity resulting in contractual damages or a liquidated debt include:

1. Compensatory damages (preventative loss) – are subject to the contractual rules such as remoteness and mitigation. A claim in debt is not subject to contract rules of remoteness and mitigation;
2. A claim in debt is assignable to third parties whereas an assignment of a claim for damages as well as the underlying indemnity could result in the commission of the tort of maintenance or champerty;
3. The contract breach of a preventative indemnity could result in cross defaults in other agreements. With debt claims an indemnifier is spared being put into breach of contract by events s/he might not be able to control. Debt claims may not result in default until demand is made under the indemnity (especially if the indemnity is drafted as an “on demand” A will indemnify B...) and the claim is not paid;
4. Limitation periods differ between the assessment of contractual damages and the assessment of the debt due.
5. Procedurally, for a debt claim the onus of proof in denying a debt lies with the defendant and proceeding for their enforcements is simpler with the level of evidence lower than contract damages. As such claims for debt have a greater level of certainty as to assessment of damages compared to contract damages.

Below is a table of various British and Australian cases that have made statements regarding indemnities as either a “hold harmless” or as a “make good” and the consequences of the categorisation:

34 [1996] Ch 195 (CA).
## Prevent Loss/Hold harmless cases

<table>
<thead>
<tr>
<th>The statements made about an indemnity</th>
</tr>
</thead>
</table>
| **Re Richardson**
[1911] 2 KB 705 (esp at 716) | Buckley LJ stated that an '[i]ndemnity requires that the party to be indemnified shall never be called upon to pay ...'' |

| **William Pickerspill & Sons Ltd v London & Provincial Marine & General Insurance Co. Ltd**
[1912] 3 KB 614 (esp at 622) | Hamilton J stated that "a policy of insurance is only a promise of indemnity giving a right of action for unliquidated damages in case of non-payment" |

| **Israelson v Dawson**
[1933] 1 KB 301 | Greer LJ stated "what they have promised is to indemnify him against such payment as he may have to make, and they may do that, not by paying him anything, but by paying to some other persons the amount the insured has to pay them. That is not a promise to pay him anything; it is one of the risks they undertake -- namely, to indemnify him against legal liability incurred by him"

| **Yeoman Credit v Latter**
[1961] 1 WLR 823 (esp at 831) | Holroyd Pearce LJ held that '[a]n indemnity is a contract by one party to keep the other harmless against loss ...'

| **Sunbird Plaza Pty Ltd v Maloney**
(1988) 166 CLR 245 (at 256) | Mason CJ stated: "A promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transition with a third party"

| **Chandris v Argo Insurance Co. Ltd**
[1963] 2 Lloyd's Rep 65 | Megaw J had to decide when a cause of action arose under a marine insurance policy and thus had to determine whether it was a claim for breach of contract. His Lordship observed:

In each of the cases in which this doctrine has been laid down, so far as I can trace, there had been a concession by Counsel in argument that the nature of the claim was a claim for unliquidated damages, and there was no discussion, or decision as to how or when the cause of action for unliquidated damages arose.... The claim, since it is not for a debt or liquidated sum due under the contract, is presumably a claim for breach of contract.

| **Firma C-Trade SA v Newcastle P & I Assn (The Fanti)**
[1991] 2 AC 1 (HL) | Lord Goff rejected the argument that prior payment is a precondition to enforce an indemnity in equity, stating:

I accept that, at common law, a contract of indemnity gives rise to an action for unliquidated damages, arising from the failure of the indemnifier to prevent the indemnified person from suffering damage, for example, by having to pay a third party. I also accept that, at common law, the cause of action does not (unless the contract provides otherwise) arise until the indemnified person can show actual loss: see Collinge v Heywood (1839) 9 Ad & E 633. This is, as I understand it, because a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense. On this basis, no debt can arise before the loss is suffered or the expense incurred; however, once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense. There is no condition of prior payment; but the remedies available at law (assumpsit for damages, or possibly in certain circumstances the common count for money paid) were not efficacious to give full effect to the contract of indemnity. It is for this reason that equity felt that it could, and should, intervene. If there had been a clear implied condition of prior payment, operable in the relevant circumstances, equity would not have intervened to enforce the contract in a manner inconsistent with that term.
<table>
<thead>
<tr>
<th>Prevent Loss/Hold harmless cases</th>
<th>The statements made about an indemnity</th>
</tr>
</thead>
</table>
| **Callaghan v Dominion Insurance Co Ltd**  
  [1997] 2 Lloyd's Rep 540 | Sir Peter Webster accepted the submission that 'a contract of indemnity gives rise to an action for unliquidated damages arising from the failure of the indemnifier to prevent the indemnified person from suffering loss, and that once the loss is suffered the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense'. |

<table>
<thead>
<tr>
<th>Make Good/Compensatory cases</th>
<th>The statements made about an indemnity</th>
</tr>
</thead>
</table>
| **Green & Silley Weir Ltd v BRB (Note)**  
  [1975] 1 WLR 570 at 574 | Dillon J referred to an earlier authority and stated: 'I do not think that that really helps because the particular contract in that case was construed by the court as not being a contract of indemnity in the ordinary sense; it was a contract not merely to repay but also to take care that the plaintiff should not be called upon to pay'. |
| **Royscot Commercial Leasing Ltd v Ismail**  
  Unreported CA (93/0266/C) 29 April 1993 | The Court of Appeal unanimously held that non-payment under the following indemnity clause did not give rise to a claim for damages: In consideration of your entering at my request into the proposed Lease Agreement annexed hereto with the Lessee herein in respect of the goods described in the Schedule thereto I ... agree upon written demand to indemnify you against all loss damage costs and expenses you may sustain. |
| **Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd**  
  [1996] LRLR 32 at 41. | HHJ Kershaw asserted that it was open to him to hold that an insurer under a policy of property insurance does not necessarily contract that the relevant contingencies will not occur and preferred to construe the indemnities in question as promises to pay. |
| **Total Transport v Arcadia Petroleum (The Eurus)**  
  [1998] 1 Lloyd's Rep 351 at 358 (CA) | Staughton LJ referred to an indemnity clause in a bill of lading and stated: 'There the word "indemnify" is used in what might be regarded as its primary meaning, to compensate one person in respect of his liability to another. |
| **Caledonia North Sea Limited (Respondents) v British Telecommunications plc (Appellants) (Scotland) (The Piper Alpha)**  
  [2002] 1 Lloyd's Rep 553 (HL) | [A case that involved a claim on an indemnity in a services contract given by a certain contractor to an operator in relation to the operation of an off shore oil rig. The indemnity clause provided: "indemnify and hold harmless and defend the [operator and others] from an against" certain liabilities and losses] Lord Hoffmann, after dismissing claims that Hadley v Baxendale applied and that indirect or consequential damages should be excluded, responding to an argument by counsel that the claim for damages for breach of the indemnity should be limited under clause 21 of the relevant contract and then stated: Clause 21 limits the liability of the parties for losses caused by breach of contract. Certain kinds of losses are excluded. But this is not a claim for breach of contract. It is a claim to an indemnity for a liability incurred by the operator outside the contract. In my opinion clause 21 has no application to such a claim. The liability either falls within the scope of the indemnity or it does not.  
  Lord Goff also stated: I accept that, at common law, a contract of indemnity gives rise to an action for unliquidated damages, arising from the failure of the indemnifier to prevent the indemnified person from suffering damage, for example, by having to pay a third party. I also accept that, at common law, the cause of action does not (unless the contract provides otherwise) arise until the indemnified person can... |
## Make Good/Compensatory cases

<table>
<thead>
<tr>
<th>The statements made about an indemnity</th>
</tr>
</thead>
<tbody>
<tr>
<td>show actual loss: see <em>Collinge v Heywood</em> (1839) 9 Ad &amp; E 633. This is, as I understand it, because a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense. On this basis, no debt can arise before the loss is suffered or the expense incurred; however, once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense. There is no condition of prior payment; but the remedies available at law (assumpsit for damages, or possibly in certain circumstances the common count for money paid) were not efficacious to give full effect to the contract of indemnity. It is for this reason that equity felt that it could, and should, intervene. If there had been a clear implied condition of prior payment, operable in the relevant circumstances, equity would not have intervened to enforce the contract in a manner inconsistent with that term.</td>
</tr>
</tbody>
</table>

---

<table>
<thead>
<tr>
<th>CV Scheepvaartonderneming Flintermar v Sea Malta Company Ltd (The Flintermar) [2005] 1 Lloyd's Rep 409 at 421 (CA).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Where it was stated: 'The charterers' counsel] accepts that the claim under cl 4 and 13 is in damages for breach of contract and not merely under an indemnity clause'.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Andar Transport Pty Ltd v Brambles Ltd 217 CLR 424 (at 437)</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Indemnities are designed to satisfy a liability owed by someone other than the guarantor or indemnifier to a third party”</td>
</tr>
</tbody>
</table>

---

We will now consider two authoritative cases in this area:

**Firma C-Trade SA v Newcastle P&I Association (The Fanti)**

This case concerned the rules of a Protection and Indemnity Association (P&I Club). The P&I Club provided mutual insurance to its members, the owners of ships, in relation to loss or damage to cargo carried on their ships. Relevantly, the two indemnity clauses to be considered by the courts in the rules:

> a member shall be protected and indemnified against all or any of the following claims and expenses which he shall have become liable to pay and shall in fact have paid ... (q) for loss or damage caused to ... property ... carried on board a ship entered in this class ...

and rule 2 pursuant to which the P & I Club undertook to:

> Protect and indemnify members in respect of losses which they as owners of the entered vessel shall have become liable to pay and shall have in fact paid.

So, a member of the P&I Club, in order to be entitled to an indemnity in respect of liabilities or expenses incurred by it, must first have discharged the liabilities or expenses concerned. In this instance, the ship owner member became insolvent and could not discharge such liability or expense and so the owner (third party) of the lost or damaged cargo was claiming under this indemnity instead. The question for the court was whether or not the indemnity applied to allow the third party a right to be paid from the Club without the ship owner actually paying the third party.

It was held that the indemnity was not activated as the precondition to its application was not satisfied and could not be satisfied because of the member’s disability. The ruling made a non-sense of the UK legislation that was specifically enacted to allow third parties to claim and take the benefit of insurance policies held by insured entities in the event of that insured entity becoming insolvent or bankrupt (ie a disability). The legislation did not

---

36 [1991] 2 AC 1 (HL)
apply to protect third parties who suffer loss at the hands of a bankrupt or insolvent company where the indemnity contract itself imposed preconditions on its application that were impossible to be satisfied in the circumstances.

However, in reaching their conclusion the court also made statements regarding the meaning of indemnities summarised by one commentator as follows:

a. an indemnity is a contractual promise by the indemnifier to keep the indemnified party harmless against a particular loss or expense;

b. therefore, a claim under an indemnity is a claim for unliquidated damages in respect of a breach of that promise; ie once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense;

c. therefore, the usual rules applicable to contract damages apply.

Caledonia North Sea Limited (Respondents) v British Telecommunications plc (Appellants) (Scotland) (The Piper Alpha).

This case also involved a claim on an indemnity in a services contract given by a certain contractor to an operator in relation to an offshore oil rig. The oil platform, the Piper Alpha, was destroyed by a fire in the North Sea. All those on board were either killed or injured. The operator settled the claims of the victims and relatives of those killed for more than the UK law would have required (noting if they took action in the US they would need to pay a much higher amount). The operator then claimed against the contractor under an indemnity in the contract. The contractor ran arguments claiming remoteness of the loss over and above the UK cap, as remote under Hadley v Baxendale. One judge dismissed that argument stating:

“I do not think that they have any application to this case. Clause 21 limits the liability of the parties for losses caused by breach of contract. Certain kinds of loss are excluded. But this is not a claim for breach of contract. It is a claim on an indemnity for a liability incurred by the operator outside the contract. In my opinion cl 21 has no application to such a claim. The liability either falls within the scope of the indemnity or it does not.”

Lord Hoffman construed the indemnity liability as something different to a contract liability and more of a promise to compensate rather than a promise to prevent loss. In this latter case, once the loss was established as having occurred, the indemnifier was liable for all loss that follows without reference to the rules of contract, mentioned earlier in this paper.

Liquidated damages or unliquidated damages for breach of indemnity?

Some commentators have attempted to reconcile the various cases, concluding that whether or not an indemnity is construed to be an unliquidated damages claim or a liquidated one is determined by reference to the risk or liability being indemnified rather than categorising an indemnity. So where the creditor’s claim is fixed by reference to the debtor’s obligation to pay money to the creditor, and the amount due has been ascertained or is readily ascertainable by calculation at the time of enforcement, an indemnity can be construed as a liquidated debt. Otherwise an unliquidated claim would occur.

Another way of reconciling the different court approaches is to consider the scope of the indemnity itself on a case by case basis and determine whether or not the event or risk in question is within the scope of the indemnity. It can then be argued that the same decision would result with either approach as a consideration of

38 [2002] 1 Lloyd's Rep 553 (HL)
39 Ibid at 100 per Hoffman LJ
limitation factors such as causation, remoteness and mitigation would be applied without using those concepts or terms.41

**Drafting tips and issues**

Out of this brief excursion though indemnities and their scope, nature and construction we can outline a number of techniques or tips to keep in mind to effectively draft and negotiate indemnity clauses:

1. Before starting to draft indemnities – prepare a list of risks or potential losses that might arise from the transaction.
2. Clearly avoid ambiguity and be as clear and concise as possible in the drafting of an indemnity clause to avoid adverse judicial construction of the indemnity clause.
3. Include all provisions (and limitations) regarding the indemnity into the indemnity clause, avoid relying on provisions elsewhere in the contract to aid in the constructions of the indemnity clause.
4. If the indemnity is to cover one’s own negligence, then the indemnity clause needs to be clear and specific in that regard.
5. Consider drafting the indemnity clause to cover both a preventative and compensatory construction – it is possible to make more than one indemnity/promise: a promise to ensure performance, a conditional promise to perform if another person does not and a promise to indemnify against loss from non-performance.
6. If the indemnified party is clear that it seeks liquidated damages or an amount of compensation for the loss, then clearly draft the clause as a liquidated debt indemnity and include the consequences of breach as such. Avoid use of the words “hold harmless”, and use words like “pay”, “compensate”, “reimburse” and “make good” instead.
7. Avoid drafting a bare (or a general) indemnity to cover a known risk.
8. Simplify and define words such as ”Loss” or “Claim” or “Liability” so that when used in indemnity clauses, they can be interpreted to their broadest meaning.
9. Specify the consequences of breach of the indemnity in damages or debt. Specifically provide for the indemnity clause to be a right in addition to other rights under contract or law and specify that the loss is not limited to those contemplated at the time of entering into the contract.
10. Consider including a “claim” being made against the indemnified as a “loss” to be covered by the indemnifier and that the indemnified does not need to pay or suffer a loss to claim under the indemnity.
11. Include as an indemnified event, a breach of the contract or failure to observe and perform the obligations under the contract.
12. Make sure insurance provisions in the contract are separate and independent of indemnity clauses and include provisions to overcome any overlap in the operation of the insurance clause and the indemnity clause.
13. For the indemnifier:
   a. always try and negotiate the indemnity clause so that it is limited to acts or omissions within your control or power;
   b. include contractual rules such as remoteness, mitigation, exclusions and limitation of liability in the indemnity clause itself (as opposed to elsewhere in the contract and assuming it will apply to the indemnity clause), so as to avoid open-ended liability, focus on the definition of “loss” and the events which trigger the liability. An insurance policy is a good example of limiting liability – specific events, specific terms and conditions, exclusions and specific caps on amounts;
   c. Check to ensure the insurance obtained fully covers the indemnities given.

---

41 Dr Wayne Courtney at a presentation to the Australian Commercial Law Association on 15 August 2014 in Sydney

---

KEMP STRANG LAWYERS
About the Author

Roger Mattar, Partner

Roger has almost 20 years of experience in property, leasing, banking and finance and commercial law, ranging from complex legal issues to transactional work.

Roger acts for a variety of clients in each of these areas of law from large institutional entities, banks, property developers and joint venture partners to insolvency practitioners. He has significant expertise in drafting and advising on loan and security document, property and leasing documents and in the sale and purchase of a variety of businesses and assets. Roger represents property developers in the acquisition and negotiation of property acquisitions, development (joint venture) agreements and other property matters. Roger also acts for a number of clients in a variety of leasing transactions (both as tenant and landlord) on a national basis.
Contact Us

For more information about how any of the issues discussed in this publication may affect your organisation, please contact your Kemp Strang adviser or one of the following partners:

Lisa Berton  
Partner  
(02) 9225 2502  
bertonl@kempstrang.com.au

Glen Cussen  
Partner  
(02) 9225 2536  
cusseng@kempstrang.com.au

Steve Godding  
Partner  
(02) 9225 2512  
goddings@kempstrang.com.au

Jim Graham  
Partner  
(02) 9225 2527  
grahamj@kempstrang.com.au

Vicki Grey  
Partner  
(02) 9225 2614  
greyv@kempstrang.com.au

Peter Harrison  
Partner  
(02) 9225 2533  
harrisonp@kempstrang.com.au

Michael Joseph  
Partner  
(02) 9225 2575  
josephj@kempstrang.com.au

Phil Kaunitz  
Partner  
(02) 9225 2795  
kaunitzp@kempstrang.com.au

Peter Kerr  
Partner  
(02) 9225 2510  
kerrp@kempstrang.com.au

Jason Lambeth  
Partner  
(02) 9225 2629  
lambethj@kempstrang.com.au

Alex Linden  
Partner  
(02) 9225 2515  
lindena@kempstrang.com.au

Roger Mattar  
Partner  
(02) 9225 2563  
mattarr@kempstrang.com.au

David Murray-Nobbs  
Partner  
(02) 9225 2714  
murray-nobbsd@kempstrang.com.au

David Nolan  
Partner  
(02) 9225 2619  
noland@kempstrang.com.au

Rory Nott  
Partner  
(02) 9225 2509  
notr@kempstrang.com.au

Matthew Pike  
Partner  
(02) 9225 2769  
pikem@kempstrang.com.au

Mark Procajlo  
Partner  
(02) 9225 2597  
procajjom@kempstrang.com.au

Sarina Roppolo  
Partner  
(02) 9225 2505  
roppolos@kempstrang.com.au

Michael Rozdal  
Partner  
(02) 9225 2734  
rozdalm@kempstrang.com.au

Nick Simpson  
Partner  
(02) 9225 2517  
simpsonn@kempstrang.com.au

Archie Smith  
Partner  
(02) 9225 2604  
smitha@kempstrang.com.au

Emma-Jane Stevens  
Partner  
(03) 8535 3510  
stevense@kempstrang.com.au