THE USE (AND MISUSE) OF INDEMNITIES IN CONSTRUCTION CONTRACTS

By Edward Colclough

Meeting agendas often give good notice of the topics that will get negotiations heated. Watch out for: limitations on liability, rights to terminate for convenience, exclusions of loss of profit, time bar clauses to claims, and, not to be forgotten, liability for Brexit. Frequently, indemnities fall within this category.

Having watched indemnities bounce backwards and forwards in contract negotiations, Edward Colclough has often wondered if parties are fully aware of the implications that the much sought after "indemnity" brings with it.

Aside from securing the trophy of an "indemnity" in your construction contract, what extra does an indemnity get you and is it worth the fight?

Back to basics

Why are indemnities so desired? In short, they are a promise to pay money on the occurrence of a specified event.

Properly used, an indemnity allows the parties to a contract to allocate the risk of an event occurring and the losses that flow from it (which can be a fixed sum or an amount of damages to be determined). The indemnified event may be triggered by Party A (the indemnitor) either:

- breaching a term of the contract (e.g. a confidentiality undertaking); or
- taking on responsibility for a specified event occurring (e.g. a change in VAT law).

The trigger event can therefore be either "fault based" or neutral. If, however, Party A would already be responsible at law for a fault-based breach of the contract, what additional reward does the indemnity get Party B (as the indemnitee)?

Advantages of indemnities?

Full recovery of loss. The true intent behind an indemnity is normally that Party B wants 100% recovery from Party A for any losses it incurs as a result of the trigger event occurring. The aim is to fully apportion the risk of the trigger event onto Party A.

Party B will argue that any losses it incurs as a result must be covered by Party A, and should not be subject to the usual legal hurdles of remoteness, foreseeability or reasonableness which can whittle down what it can recover. The goal is for Party A, as the indemnitor, to pick up the tab for whatever losses arise. This is seldom the case. Lord Justice Staughton[1] identifies two classes an indemnity can fall within in a contract:

> "The word 'indemnity' is … used in two senses. 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. There is precious

little authority to support such a meaning, but I do not doubt that the word is often used in that sense."

As can be seen, the courts are cautious to depart from the well-established approach of not awarding unforeseeable or not properly mitigated losses, especially in the context of a breach of contract claim. There is little authority to support such an interpretation of an indemnity.

Therefore persuading a court to interpret an indemnity to allow recovery of any and all losses incurred will be an uphill task and would need to rely on express wording in the indemnity showing a very clear evidence that this is the true intention of the parties.[2]

Legal costs. Linked to 100% recovery is the belief that Party A will pay in full for all of Party B's legal costs. Again, this is unlikely to be the case.[3]

The starting point of the English courts is to award reasonable costs to the winning party. While the courts will generally look to uphold terms freely negotiated in contracts, the Court of Appeal has held that it would offend public policy to allow 100% recovery of legal costs where unreasonable costs have been incurred or in instances where the successful party is required to pay the losing parties' costs.

In contrast, indemnities covering legal costs incurred by way of third party claims can, and have managed to, obtain full recovery.

The courts themselves do distinguish between the ability to recover legal costs on a "standard basis" and "indemnity basis". CPR 44.3(3) states:

> "Where the amount of costs is to be assessed on the indemnity basis, the court will resolve any doubt which it may have as to whether costs were reasonably incurred or were reasonable in amount in favour of the receiving party."

On a standard basis any doubt falls in favour of the paying party. In addition, on an indemnity basis the court may disregard whether costs have been

proportionately and reasonably incurred or whether they are proportionate and reasonable in amount. It must, however, still consider whether the costs have been unreasonably incurred or are unreasonable in amount.[4]

In adjudications under the Construction Act,[5] parties to a construction contract are prohibited from pre-allocating liability for litigation costs of the adjudication, unless such agreement is made in writing after the giving of the notice of intention to refer the dispute to adjudication.[6]

Limitation on liability. Whether or not an indemnity falls within a cap on liability depends on how the limitation on liability is drafted. Good drafting should expressly state whether the indemnity falls within the cap or not, the risk being that indemnities do not necessarily fall outside of the cap. Contracts that seek to impose unlimited liability for an indemnity should make this clear in the drafting.

Debt claim. Debt claims are immune from issues such as remoteness, mitigation and foreseeability. While some view indemnities as giving rise to a simple debt claim this again all depends on the drafting and is not automatically the case. An indemnity in relation to a specified amount due is much more likely to be seen to give rise to a debt claim than an indemnity against general losses for a breach of the contract.

Extending liability periods. The limitation period for an indemnity starts to run from the date the loss is established and can therefore provide a longer period of liability for the claimant. It is common for indemnities to be stated as being "on demand" which can further increase the liability period, with time starting to run from the date the demand is actually made.

In summary, notwithstanding the commonly perceived advantages that an indemnity is believed to bring with it, there is no superpower to use of the word indemnity in a contract. As is more often the legal answer, the scope of the indemnity depends on the specific drafting of the clause and the context in which it is used. It is for this reason that careful attention is required by both the party giving and the party receiving the indemnity in contract negotiations.

Blanket indemnities

Commonplace in US contracts, wide-ranging blanket indemnities have crept into construction contracts this side of the pond (e.g. where Party A is forced to indemnify Party B for any loss suffered as a result of Party A breaching the contract).

This year Build UK, the representative organisation for the UK construction industry, published a list of recommendations to form a common ground between clients and the supply chain on good contractual practice. Its recommendation on negotiating indemnities is quite clear: "*Do not include a blanket indemnity for breach of contract*".

Blanket indemnities reflect bad practice, lazy drafting and, more often than not, will not even get the receiving party the upside they may be anticipating.

Specific indemnities

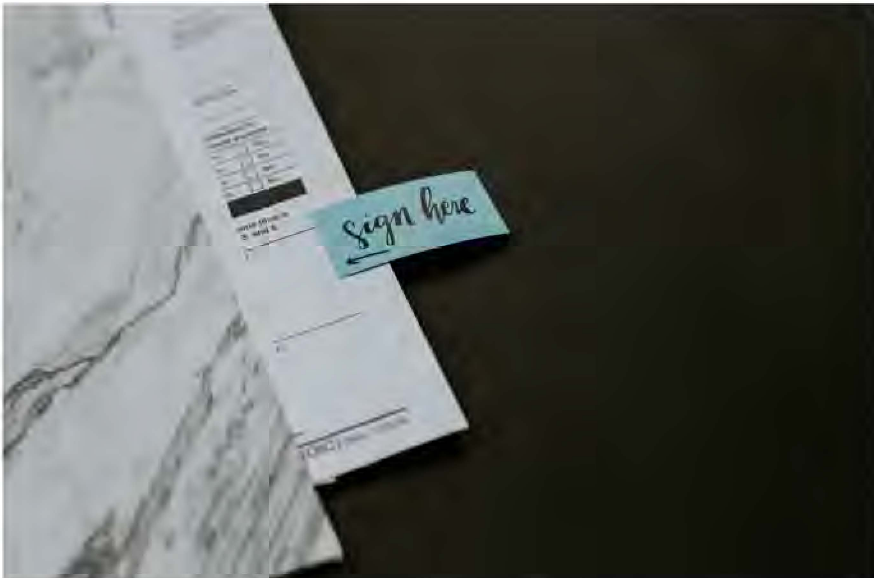
Specific indemnities, on the other hand, are not uncommon in construction contracts and can typically be found to cover the likes of:

- third party claims for infringements of the IP licence;
- loss or damage to third party property or persons in carrying out the works;
- breaches under the Bribery Act;
- breaches of confidentiality undertakings or data protection;
- liability caused as a result of actionable nuisance and trespass claims; and/or
- infringements of environmental law.

The best starting point is always to adopt a narrower and more tailored approach in considering which risks should be covered by indemnities given the nature of the project.

Professional indemnity insurance

A practical concern in construction contracts littered with indemnities or containing blanket indemnities is that they risk invalidating the cover of the professional indemnity insurance and, in



turn, putting the company's balance sheet in the firing line. Any indemnity should be viewed with caution if the intention is for it to be backed up by an insurance policy. Ideally, the insurer should be made aware of the indemnity being requested to ensure that the policy will respond.

Standard form contracts

The standard form construction contracts contain indemnities.

JCT. The JCT Design and Build 2016 edition contains the usual Contractor-specific indemnities for:

- intellectual property infringement (clause 2.19); and
- injury or damage to property or persons in carrying out the Works due to negligence, breach of statutory duty omission or default of the Contractor or Contractor's Persons (clause 6.2).

NEC. The position under the NEC contracts has not always been clear for contractors. Clause 83.1 of the NEC3 contained a reciprocal indemnity whereby: "*Each party indemnifies the other against claims, proceedings, compensation and costs due to an event which is at his risk.*" The problem was that Contractor's risks were very widely defined as all "*risks which are not carried by the Employer*".

On a plain reading of clause 83.1 the indemnity appears to be extremely wide and commentators have noted that an "uncommercial" reading could suggest that "*because not all compensation events are Employer's risks some of them may be Contractor's risks with the result that there may be an increase in the prices under clause 60 which the Employer then recovers under his indemnity under clause 83.1*".[7]

Fortunately, this ambiguity has been clarified under the new NEC4 editions where Contractor's liabilities (previously called *Contractor's risks*) are now listed in clause 81, rather than being defined by exception as done in the NEC3. These indemnified liabilities now relate to specific risks for which the Contractor is responsible:

- claims from Others in connection with providing the works;
- loss or damage to the works, Plant, Materials,

- loss or damage to property owned or occupied by the Client other than the works which arise in connection to the works; and

- death or bodily injury to the employees of the Contractor.

FIDIC. FIDIC has recently had to revisit its approach to indemnities. The early pre-release of the Yellow Book Second Edition 2017 created a stir amongst contractors when the new clause 17 (now called "Care of the Works and Indemnites") contained an indemnity from the Contractor to the Employer in relation to any breach of its design obligations that results in the Works not being fit for the purpose identified. This indemnity was drafted to sit outside of the limitation of liability.

Although the design-related fitness for purpose indemnity remains in the new edition, it is now included within the reciprocal limitation of liability at clause 1.15.

The usual FIDIC indemnities remain in the new 2017 editions in relation to intellectual and industrial property infringement; bodily injury, sickness, disease or death; and damage or loss to any property (other than the Works).

When negotiating any standard form contract parties should look out for bespoke amendments seeking to incorporate additional and/or enhanced indemnities.

A way forward?

Indemnites should remain a red flag on the page. That said, they are likely to be one of the most misunderstood terms used in construction contracts. Without doubt indemnities can be a powerful tool to allocate risk and recover loss – this, however, requires careful thought, negotiation and drafting. Any hope that the word "indemnity" provides for a straightforward and easy case is wrong as the case may well focus on what the indemnity actually means.

End Notes

1.Total Transport Corporation v Arcadia Petroleum Ltd, ("the Eurus") [1998] Lloyds Rep 351

2.Church Commissioners v Ibrahim [1997] 1 EGLR 13.

3.Woodford v AIG Europe Ltd [2018] EWHC 358 (QB).

4.CPR 44.4.

5.Housing Grants, Construction and Regeneration Act 1996 (as amended).

6.Section 108A(2).

7.David Thomas QC, Keating on NEC3: Clause by Clause Commentary on the Engineering and Construction Contract, Sweet & Maxwell, 2012, 9-003.

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