

# IT BYTES

## ANSWERING YOUR COMMON IT CONTRACT LAW QUESTIONS

# WHAT ADDITIONAL PROTECTION DOES AN INDEMNITY PROVIDE?



## WHEN DOES THIS QUESTION TEND TO ARISE?

**Indemnities are often included in IT contracts as a way of allocating liability between the customer and the supplier. Depending on how it is drafted, an indemnity can offer broader protection and certainty to the indemnified party compared to simply relying on a claim for damages under a breach of contract. For example, an indemnity claim may not be limited by principles of causation, remoteness, and mitigation in the same way as a breach of contract claim would. Indemnities may also be used to allocate liability where there would be no underlying breach of contract (i.e. where there would otherwise be no basis to bring a claim to be compensated for loss or damage that has been incurred).**

## WHAT DOES THE LAW SAY?

An indemnity provision may be characterised in two different ways:

<b>1</b>	As an obligation to prevent loss or to 'hold harmless'	<b>2</b>	As an obligation to 'make good' or compensate for loss or harm that is suffered
	If construed in this way, if a loss does occur then the indemnity will give rise to a right to claim for damages for a breach of contract. The usual rules for contractual damages would then apply, including as to requirements of causation, remoteness, and mitigation.		If construed in this way, if a loss does occur then the indemnity will give rise to an obligation to pay the amount of that loss. In this case, the indemnity is analogous to a debt claim and is not subject to limiting principles relevant to contractual damages.

The way that a particular indemnity is characterised may depend on the way that it is drafted (see below for drafting tips). If drafted as an obligation to compensate then the indemnity may offer a number of advantages over a breach of contract claim, principally in the form of greater certainty as to the scope of loss that will be recoverable:

	BREACH OF CONTRACT	INDEMNITY
<b>Definition and scope</b>	<p>A breach of contract entitles an innocent party to seek compensation for loss or damage arising from the breach.</p> <p>Contractual damages seek to restore the plaintiff to the same situation as if the contract had been performed.</p>	<p>An indemnity is a contractual promise from one party to compensate another party in respect of a specific type of loss or from loss that arises from a specific trigger event.</p> <p>The scope of the obligation to compensate will depend on how the indemnity is drafted, but may extend to loss that would not be recoverable as contractual damages.</p>
<b>Supporting evidence</b>	The claimant will need to establish that the defendant committed a breach of contract.	<p>The claimant will need to establish that the relevant trigger event has occurred.</p> <p>The trigger event could be a breach of contract, but could also be an event that would not necessarily involve a breach, such as a claim brought by a third party.</p>
<b>Causation</b>	The claimant will need to establish that the loss they are claiming was caused by the breach that has been established.	<p>The claimant will likely need to establish some link between the trigger event and the loss is being claimed.</p> <p>However, depending on how the indemnity is drafted it may be less onerous than the legal standard of causation that will apply for a breach of contract claim.</p>
<b>Remoteness</b>	Loss will only recoverable if it was foreseeable at the time of contract.	<p>Remote losses will be recoverable if within scope of the indemnity, as the ordinary rules relating to recovery of damages will not apply.</p> <p>However, in some circumstances courts may still read limitations into broadly drafted indemnities. For example, in some cases broad indemnities that purported to cover 'all loss' have been read down so as to only apply to losses that were proximate to the trigger event.</p>
<b>Mitigation</b>	The claimant will not be able to recover for loss or damage if they had knowledge of the breach but failed to mitigate the loss.	<p>The claimant may be able to recover under the indemnity even where it has failed to mitigate its loss.</p> <p>However, there may still be some limitations where the claimant has been recklessly indifferent as to the loss – in that case, the loss may be attributed to the failure to take mitigating action rather than to the underlying trigger event. In addition, sometimes the indemnity will be drafted so that it only applies to loss that could not have been avoided by taking mitigating action (effectively incorporating a duty to mitigate as part of the scope of the indemnity).</p>
<b>Limitation period</b>	Six years from the date of the breach.	Six years from the time of loss.



## WHAT ARE THE IMPLICATIONS FOR YOUR CONTRACT?

When drafting an indemnity clause, it is important to use express and clear language. The courts will not rewrite a clearly drafted indemnity cause even if it is unfair. However, in a case of ambiguity, the court will usually construe the indemnity in favour of the indemnifier.

An indemnity construed as an obligation to compensate may provide greater protection for the indemnified party than an ordinary claim in damages for a breach of contract. Use of terms such as “reimburse” or “pay” is more likely to support the characterisation of the indemnity provision as an obligation to compensate. In contrast, use of terms, such as “hold harmless” or promising to “indemnify”, is likely to support a characterisation as an obligation to prevent loss. A claim under this type of indemnity will likely be treated much like a claim for damages breach of contract.

A customer under an IT contract may want to push on the inclusion of an indemnity when there are known foreseeable risks to the subject matter of the contract, and the supplier has better control over these risks. For example, if the supplier will contribute materials to a project, then the customer's position will typically be that the supplier should bear all risk that those materials may infringe a third party's IP rights as the supplier will be the one creating or sourcing the materials and so will clearly be best placed to control those risks. As such, it is typical in this scenario for the customer to expect the supplier to provide an indemnity against third party IP claims.

The drafting of indemnities needs to be carefully considered, with particular care taken to clearly specify the relevant trigger events, the scope of loss intended to be covered (including whether it should extend to loss incurred by related entities), whether there should be a contractual obligation for the indemnified party to mitigate their loss, and whether any exclusions or limitations of liability that apply under the contract should apply to indemnity claims. When drafting, always consider whether you would be comfortable giving an indemnity in the same terms, as counterparties will often ask that indemnities be reciprocal where there are similar risks to both parties.

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