Effects of Indemnity and Limitation of Liability Clauses in Contracts

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A key clause to be aware of is an indemnity clause. This is designed to allocate a greater share of the risk when liabilities arise. While a useful clause to consider including is a limitation of liability clause, to put a cap on the amount of liability you may be responsible for.

Indemnity Clauses
In the case of an indemnity clause, if one party breaches the terms of the contract or is at

fault due to negligence or for other reasons, and the breach or fault causes loss to the other party, the clause protects the other party (an indemnified party) from the legal or financial liability arising from that breach or fault. An indemnifier usually agrees to be responsible for all costs, damages and losses that flow from their breach or fault. Indemnity clauses are often imposed on parties when they sign “standard” form agreements.

On the surface indemnity clauses seem clear and straightforward, and for some types of loss may seem fair. However, if an indemnity clause is not written properly or limited sufficiently, it can significantly increase the risk for the indemnifier (party giving the indemnity or promising to hold the other party harmless from the loss). They are often drafted broadly encompassing all losses or damages flowing from the act or omission and all costs of any kind. They also make it much simpler for a party suing the indemnifier to claim for these amounts through the Courts.

An indemnity clause usually alters the standard legal approach to liability. The standard position in the event of a breach or fault is that the party who causes the loss is liable for the foreseeable consequences that arise from that breach or fault. However, an indemnity clause can make that party liable for losses and costs that are not foreseeable from the breach or fault (i.e. something you would not normally expect to become responsible for) and for costs that extend far beyond what might be considered reasonable. This far surpasses the liability under a standard breach of contract.

We consider best practice is to carefully check contract terms you are asked to sign, and request that the indemnity clause is removed, unless you consider its terms are fair and reasonable. For example, these clauses are often one-sided and only apply if one of the parties breaches the contract, but not the other party. While this may be appropriate in some circumstances, you should always consider if they should be mutual and apply to both parties.

If an indemnity clause is included, check it is clear, consider whether it should be mutual and confirm that it only applies to a limited extent. Even better is if there is a limitation of liability clause. This will limit the potential sum the indemnifying party may be liable for. So, if for example, you are providing services, and there is a limitation of liability clause in the contract, you might want it to limit your liability to the value of the services provided.

If you have no choice but to agree to providing some form of indemnity, consider:

- Limiting the types of losses that the indemnity includes.
- Remove the reference to all costs (as that means all costs incurred by the other party even if unreasonably high) and maybe limit to reasonable costs arising from the loss.
- Define whether the indemnity will extend past the duration of the contract or be extinguished upon completion, i.e. make sure it only applies during the term of the contract.
- Ensure that consideration has been given to any potential risks that may emerge, resulting in unforeseeable consequences which you could be liable for under an indemnity. For example, if the goods you sold might have an unknown defect in them – what could happen even if you don't expect it to happen – because you could be liable for all of that loss or damage if it does occur.
- Outline where liability will lie for third party claims, so if you sell goods to a merchant and the merchant sells them to a third-party customer, exclude liability to that third-party customer. (Note, if you supply consumer goods, you will still have responsibilities under the Consumer Guarantees Act.)

Ensuring that these five aspects have been considered (and addressed) will help to reduce the risk/liability the indemnifier agrees to and will reduce the range of potential claims it may be liable for. In conjunction with ensuring the clarity of the indemnity clause, considering the inclusion of a limitation of liability clause is also advised (even when there isn't an indemnity clause).

Limitation of Liability Clause

A limitation of liability clause has the effect of setting a maximum sum that a party may be liable for, or it can just limit the type of loss a party is liable for. It can be a good idea to make it clear that the limit applies to any losses, not just breach of contract, otherwise liability in instances where the event causing the harm or loss arose from negligence, misconduct, fraud, or misrepresentation by a party, can still arise. Additionally, to be enforceable the limitation of liability must be reasonable and transparent. It is good practice to include a clause that excludes a party from consequential losses, which are again, in simple terms, losses outside the normal foreseeable loss one might anticipate from a breach. The purpose of this type of clause is to protect the party where the loss/harm could be far more than the value of goods or services provided and may be outside that party's control. It helps prevent an aggrieved party seeking an unreasonably excessive sum in damages.

Key Takeaways

The key takeaway from this article is to beware when signing a contract that contains an indemnity clause. An indemnity clause means the indemnifier (the party saying they will indemnify the other party and/or hold the other party harmless from liability) will be at risk for liability for everything falling within the scope of the clause, even if it is far more than they would normally be liable for at law.

If the indemnity cannot be removed, the scope of the clause should be reasonably reduced, to ensure you only provide limited indemnities. In addition, ensuring a limitation of liability clause is present in the contract is recommended to ensure that if there is a claim, there is a maximum sum of liability that can be claimed by the aggrieved party to avoid the possibility of excessive liability or costs.

This article is designed as an overview of indemnity clauses and limitation of liability clauses. It is not intended to provide an exhaustive list of risks or considerations that need to be contemplated when drafting, reviewing, or entering a contract. If you would like further advice or contract review/drafting, please contact Carolyn Culliney or Claudia Riddle.