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CONTRACTUAL INDEMNITIES: PUBLIC & PRIVATE SECTOR IMPLICATIONS

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Indemnities are part of the overall risk allocation matrix and should not be considered in isolation from broader liability and limitation of liability issues. We'll deal with public and private sector indemnity issues. This paper supplements our paper *Limitation of Liability & Related Issues - February 2005 Update*: http://www.wigleylaw.com/LimitationOfLiabilityAndRelatedIssues.html.

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1 Executive Summary

1.1 This paper supplements our paper *Limitation of Liability & Related Issues - February 2005 Update: http://www.wigleylaw.com/LimitationOfLiabilityAndRelatedIssues.html*. Indemnities are part of the overall risk allocation matrix and should not be considered in isolation from broader liability and limitation of liability issues. Key points to watch out for are set out at the end of the paper.

1.2 Indemnities can cover a wide array of transactions such as a stand-alone guarantee and indemnity in a mortgage context. Here, we are dealing with indemnities in commercial contracts (typically between suppliers and purchasers).

1.3 Indemnities in commercial contracts come in a wide array of forms and so their effect depends on their wording, which can be freely chosen by the parties (the main exception being Crown indemnities). An indemnity (which creates a *primary* obligation on a party (typically to pay money if certain events happen) often overlaps with *damages* remedies (which kick in when a primary obligation such as a warranty is breached). We get the impression that often there is a big focus on indemnities without regard to those other issues. Additionally, because indemnities overlap with other contractual solutions, there are often other ways of skinning the cat.

1.4 For similar reasons, there can be a risk that an indemnity can create unlimited liability, overriding carefully crafted limitation of liability clauses.

1.5 An important use of contractual indemnities is to create liability where the party indemnifying is in fact not at fault. A good example: an indemnifying party perhaps should be largely or fully liable for breach of IP rights, even where that breach is outside the control of that party.

1.6 This brings us to the question of indemnities and the public sector. There are special rules under the Public Finance Act and the Crown Entities Act. We deal with these below.

2 What is an Indemnity?

2.1 An indemnity is:

> *"a contract by which one person agrees with another to make good all loss which that other person may suffer by doing some act, exercising some forbearance, or assuming some liability at the request of the person by whom the indemnity is given or of some third party."*[1]

2.2 A key purpose of indemnities in a commercial contract is to provide another avenue for making the supplier liable in addition to or instead of the remedies (such as termination, damages, etc.), which flow from breach of contract. Normal breach of contract principles involve the breach of a *primary* commitment (namely the failure to meet a contractual commitment such as a warranty), with *secondary* rights flowing from that breach (which are analysed in terms of causation, remoteness and quantum). These remedies are typically damages.[2] Very often, even a highly complex commercial agreement does not specify how the *secondary* rights are determined. Frequently these issues (made up mainly of causation, remoteness and quantum) are left to the common law to determine.[3]

2.3 Often *boundaries* are placed around these *secondary* rights. So, for example, a typical *boundary* is a limitation of liability clause such as a cap on liability or a statement that consequential loss can't be claimed. Within those *boundaries* however, common law damages rights generally apply.

2.4 Indemnities on the other hand are *primary* obligations. An indemnity can, for example, require the supplier to pay money to the customer on the happening of certain events (typically, by reimbursing the customer for loss incurred because the supplier has failed to meet another primary contractual obligation). They are conceptually different but often cover the same territory. Importantly, they

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[1] New Zealand Forms and Precedents (Title 26, Guarantees and Indemnity, para 2649). See further the New Zealand Law Society Seminar Paper, *Drafting Commercial Contracts*, presented by Fraser Goldsmith and Duncan Webb, April 2004 at page 36.
[2] There may also be Contractual Remedies Act rights.
[3] And maybe, to the Contractual Remedies Act as well.

involve payment (or that certain steps be taken) as a *primary* step, not as a *secondary* step. An indemnity is a contractual obligation, generally to pay money if certain events happen. On the other hand, damages flow from a breach of a contractual obligation (such as a warranty).

2.5 One of the few good summaries on indemnities, in a commercial contract context, is in McGuiness, *The Law of Guarantee* (2nd ed.) at pages 615-631). At page 618:

> *"Although there is a similarity in their respective practical consequence, a right to be indemnified is not the same as a right to recover damages. A right to recover damages is a legal right in favour of a plaintiff to be compensated by the defendant for injuries recognised at law which were suffered by the plaintiff as a result of the wrongful conduct of the defendant. A right of indemnity may exist where the plaintiff has suffered no injury at the hands of the person who is obliged to indemnify, and even where the wrong giving rise to the claim for indemnity was arising from some natural or other impersonal hazard committed by some third party, or where no wrong has been committed by any person but the indemnifier is nonetheless obliged to make good a loss which has been suffered by the claimant. Thus a right to recover the damages occasioned by breach of contract is the converse of a contractual right to an indemnity. Where a contractual right of indemnity exists, the right to indemnity constitutes a term of the contract and forms part of the contract between the parties. A right to damages for breach of contract, on the other hand, arises as a consequence of the breach of the original bargain which the parties made. A right to recover damages for breach of contract is not part of a contract; it is an incident which the law attaches to a breach of contract, rather than a provision of the contract itself."*

3 Drafting Indemnities

3.1 Depending on how an indemnity is drafted (after all, the parties can choose its overall structure and effect), both the breach of contract and the indemnity approaches often lead to the same result. For example, to succeed under an indemnity clause, the customer will still often have to establish causation and quantum to the same level of proof, and follow broadly the same tests, as they would have to do when relying upon secondary common law rights.[4] There are remarkably few reported cases on contractual indemnities and therefore little material on whether the same sort of approach to causation would be followed under indemnity as applies under the common law in relation to damages. However, in practice, very often the same types of causation issues will arise

[4] We've not found authority to that effect but it follows basic remedies principles. So this point is subject to the possibility that there will be authority contrary to "basic principles" analysis. Note that Hughes and Sharp in their Computer Contracts text at para 1.520 consider, without giving reasons, that sums recoverable under an indemnity clause won't necessarily be limited by common law remoteness and other principles.

and there will be little scope for difference. But it would be prudent to check this out in each case, particularly as the scope for indemnity liability is driven by its wording and the surrounding specific circumstances.

3.2 But that all depends upon how the parties choose to frame their indemnity. This is all a matter of contract. The indemnity clause could be widely framed to cover all sorts of loss including loss which has not been caused, or contributed to, by the supplier. On the other hand it could be much more restricted. Additionally the rights may well be subject to the cap in the limitation of liability clause. Without that, the cap may be largely ineffective in limiting a party's liability in the way intended, although this again depends on the scope of the indemnity. In practice, a common problem is that suppliers get nice limitation of liability clauses put in contracts but overlook including the indemnity within the limitation clause (bearing in mind that a typical limitation of liability clause applies only to *damages* liability (the *secondary* step, not the *primary* liability of an indemnity clause).

3.3 Customers often fight hard to have indemnities included and yet they may already have the same rights by way of breach of contract remedies. It is not always clear how fighting for those rights advances the customer's interests. Sometimes, it seems the focus is on indemnities, ignoring much more important issues. A supplier might think a lot about minimising indemnities and overlook much greater risk issues (such as liability for breach of warranties, liability under the Fair Trading Act, and so on). A purchaser may push hard for indemnities and yet could get a similar outcome in a less contentious way by taking a different route. We find it surprising that in negotiations there can be so much focus on indemnities when either there is a different solution or in fact providing the indemnity doesn't make a great deal of difference, compared to the existing obligations in the agreement. Frequently we end up saying to supply clients that they might as well run with the indemnity because really it doesn't make any difference to what are their existing obligations anyway. But again it all depends on the circumstances and type of indemnity sought.

3.4 The rights to indemnity can include entitlement to full reimbursement of legal costs although it would be prudent for the customer to set this out explicitly rather than leaving it for the courts to construe from less specific indemnity wording.[5]

3.5 It's fairly easy to trip up on the wording of indemnities. There are few examples in the cases, although this seems to have happened in *Micron Systems*

[5] There can be liability for full reimbursement of legal costs even though that is not expressly stated. In *Tower Ltd v. McConnell Dowell* [2002] 3 NZLR 280, McConnell Dowell was liable for full legal costs of fighting tax litigation under a clause by which McConnell Dowell said it would "*keep the plaintiff fully and effectively indemnified from and against any taxation or claim for taxation*".

v. Wilkinson[6] when the party relying on the indemnity couldn't succeed because of its wording.[7]

4 Indemnities in Relation to "No Fault" Events or against Liability to Third Parties

4.1 One of the real benefits of indemnity clauses is to protect the indemnified party against the consequences of "*no fault*" events or against liability to third parties. This is an area where standard damages remedies of course don't generally apply. However, it is a big ask for a party to agree to be liable for circumstances outside its control. Obviously the party should take care to enter that commitment having considered its implications, or perhaps have limited the responsibility in some way, such as taking on liability which is reasonably within its knowledge and control.

5 Intellectual Property Indemnities

5.1 One of the classic examples of a "*no fault* " indemnity, where there is protection in relation to third parties for actions outside the indemnifier's control, is the intellectual property indemnity. Typically, the parties to a contract agree that indemnities should be limited to the scope of the limitation of liability provision. Some types of liability however are often excluded from that cap. This includes, particularly, intellectual property and – often – breach of a confidentiality commitment. It is generally accepted that if a party breaches a third party IP owner's rights or the other party's confidentiality, it should fully protect the other contracting party against any claims that arise as a result. This is because of the potentially colossal implications of such breaches on the business operations of the affected party. It is recognised that the enforcement of IP rights and protection of confidential information is uniquely within the hands of the party with the closest connection with it. Therefore it is often appropriate for there to be unlimited liability in those areas. But care is still needed. Many multi-national IT vendors for example push back on unlimited IP indemnities, particularly in light of litigation such as IBM v SCO.

6 Indemnities and The Public Sector

6.1 There have been statutory restrictions on public sector guarantees and indemnities for some time. The landscape changed as from this year in view of changes to the Public Finance Act (by way of the Public Finance Amendment Act 2004), the Crown Entities Act 2004, and the Crown Entities (Financial Powers) Regulations 2005.

6.2 The Public Finance Act deals with indemnities by the Crown (that is, Ministries and Departments). We will deal with that first, followed by the position as to Crown entities.

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[6] Unreported 16 April 2002, High Court, Chambers J.
[7] For a fuller description see the New Zealand Law Society Paper, Drafting Commercial Contracts, referred to above.

7 Indemnities and Ministries/Departments

7.1 Previously the Public Finance Act contained a limited ability for the Crown to give guarantees and indemnities. Currently, they are not possible except where the Minister of Finance has approved them. The list of exceptions that was scheduled to the Public Finance Act (as the 3rd Schedule) has been deleted. Ministries and Departments can't give guarantees or indemnities (without Ministerial approval) until Regulations are introduced to enable this.[8] While there are similar Regulations for Crown entities, this has not happened yet for Ministries and Departments. In the meantime there is a short-term solution as we now note.

7.2 Treasury has indicated (in Treasury Circular 2005/05 (http://www.treasury.govt.nz/circulars/tc-2005-5.pdf)) that Regulations will come out. Until that happens, the Minister has delegated his approval powers, via the Secretary of the Treasury, to Departmental Chief Executives. The Treasury Circular outlines how this works, including as to transitional issues as from January 2005, and the scope of indemnities that can be approved. This scope is based around maintaining the status quo until the new Regulations are promulgated. So the starting point is the 3rd schedule of the Public Finance Act before it was repealed. That includes IP indemnities: a frequent issue in IT contracts.

7.3 Treasury is going through a consultative process, but indications are that the Regulations will be similar in effect to those applying to Crown entities, as noted below.

7.4 There may, in practice, be little point in providing an indemnity given that there could be other ways to achieve the same outcome (such as relying on the *primary* and *secondary* damages mechanism noted above). Additionally, often the Crown is the customer. So its indemnity is less important than the supplier's.

7.5 An area where there might be difficulty is where it's important for the supplier to have the public sector agency's protection against claims by third parties (eg: the agency's "clients" utilising the supplier's services). There may be other ways to reduce this risk, however.

7.6 For helpful guidance on public sector guidelines see the Australian guidelines at http://www.finance.gov.au/finframework/docs/contingent%5Fliability%5Fguidelines%5Frtf.rtf.

8 Crown Entities and Indemnities

[8] Section 65ZC-65ZE.

8.1 A wide array of organisations are Crown entities[9]. A Crown entity cannot give an indemnity[10] unless:

8.1.1 The indemnified party is a person such as a board member, employee, etc;[11]

8.1.2 It is permitted under the Act under which the Crown entity was created;[12]

8.1.3 Ministerial approval is granted;[13]

8.1.4 The Crown entity is within the categories of Crown entities in Schedules 1 and 2 of the Crown Entities Act.[14] Those organisations are the Government Superannuation Fund Authority, the Public Trust, the CRIs, New Zealand Venture Investment Fund Limited, and Television New Zealand; or

8.1.5 The Crown Entities (Financial Powers) Regulations 2005 (or any subsequent Regulations) permit it.[15]

8.2 Clause 14(2) of those Regulations give Crown entities relatively wide powers to grant indemnities in 8 situations, ranging from loan and lease agreements through to:

8.2.1 contracts *"…for the procurement of services entered into by the Crown entity in the ordinary course of its operations"*[16]*;* and

8.2.2 contracts *"…for the purchase of an intangible (including intellectual property or a licence of intellectual property) entered into the Crown entity in the ordinary course of its operations"*.[17]

8.3 This is wide enough to cover many day to day requirements.

8.4 Clause 14(3), unusually, notes that an indemnity can be given, in those situations (and 3 other situations) in an *"ancillary"* contract or instrument *"…relating to that class of contract, but only if that indemnity is contained in … standard printed terms and conditions …"* The idea is to make it clear that indemnities are acceptable in routine standard-form situations (the regime after all is particularly aimed at reducing substantial or material Crown indemnity exposure rather than isolated and relatively small day-to-day risk).

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[9] See Section 7 Crown Entities Act 2004.
[10] Section 163(1).
[11] Section 163(2).
[12] Section 160(1)(c).
[13] Section 160(1)(b).
[14] Section 160(1)(d).
[15] Section 160(1)(a).
[16] Clause 14(2)(g).
[17] Clause 14(2)(h).

8.5 The two examples given above (procurement of services, and IP in the ordinary course of operations) seem wide enough to cover indemnities in most practical procurement and IP situations (including permitting unlimited indemnities by the Crown entity, which is common in IT contracts generally).

9 Key Points[18]

9.1 Think about indemnities in the overall context of the contract, other terms such as warranties, liability for damages, and underlying liabilities such as in the Fair Trading Act[19]. Too often there is a big focus by the supplier and/or the purchaser on indemnities when:

9.1.1 there are other ways of achieving the same outcomes; and/or

9.1.2 on full analysis, it may turn out that giving the indemnity doesn't make too much difference anyway. There is no point in having an argument about indemnities when it really doesn't matter, and, from a tactical point of view, giving away to the other party an indemnity can be a trade-off for another benefit.

9.2 Often other types of contract terms (such as warranties and other contractual commitments), coupled with damages remedies, or remedies requiring the party to fix the problem, are just as good or better than indemnities.

9.3 An indemnity clause is not inherently a limitation of liability clause. Make sure that the indemnity meshes appropriately with the limitation of liability clause which will generally only apply to damages liability yet can be extended to cover limitation of the indemnity liability as well.

9.4 While it is common to have unlimited liability for intellectual property or confidentiality breach, consider in each case whether that is appropriate. Very often the IP risk for a *customer* is low and so it may be acceptable from a risk perspective to have a relatively wide and unlimited indemnity given by the *customer* (yet some customers automatically rule this out: it is all a matter of assessing risk).

9.5 Whether supplier or purchaser, look carefully at the drafting to make sure desired outcomes are achieved (and whether the indemnity should be limited in some way, such as to apply to matters about which the indemnifying party should have knowledge but does not).

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[18] We acknowledge, in the compilation of this list, the very useful material in the excellent paper by Fraser Goldsmith and Duncan Webb, *Drafting Commercial Contracts* (New Zealand Law Society Seminar Paper April 2004).

[19] For more detail see our paper Limitation of Liability & Related Issues – February 2005 Update: http://www.wigleylaw.com/LimitationOfLiabilityAndRelatedIssues.html and our 2005 Update of our Tenders, RFPs and Competitive Purchasing Article: http://www.wigleylaw.com/TendersRFSCompetitivePurchasing.html.

9.6 Particularly where the indemnity covers "*no fault*" events or liability to third parties, the indemnified party should look at whether the force majeure clause might exonerate the indemnifier.

9.7 Clients sometimes seem to think that indemnity clauses state the extent of their obligations to each other, in place of other obligations such as performance obligations, warranties, etc. This may be one reason why there seems to be such undue focus on indemnities ahead of other core risk areas. Care is needed to ensure a realistic approach.

9.8 Ministries and Departments can't give indemnities except in limited situations (the most relevant being the IP indemnity). Very often however, a supplier will understandably want some reassurance from the Ministry or Department in the area which might otherwise be covered by the indemnity. Commonly there will be another way of doing this, outside the indemnity regime.