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The distinction between indemnity and liability clauses in commercial contracts

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One of the most frequent points of confusion for businesses when they are reviewing and considering contracts is the ‘indemnity’ and ‘liability’ clauses of the contract. In fact, these are clauses that are most frequently raised with lawyers by their clients, saying that they are unsure what the contract is saying.

This blog is for all business owners, contract officers or anyone reading a contract to better understand those clauses.

What is a liability clause?

Liability is a concept that applies through almost all areas of law. Another word that could be used to summarise the concept of liability is ‘responsibility’. For example, where someone causes an injury to another person, then that person will likely be liable (i.e responsible) to compensate the injured person for those injuries.

When liability is governed by a contract, the responsibility that certain parties may have for certain actions could change in accordance with the terms of the contract. An example of this could be clarifying that a principal contractor is liable for the actions of its sub-contractors.

Liability may also be amended through contracts to limit or exclude certain liability. For example, parties may agree in a contract that they are not permitted to pursue claims of liability against each other unless the compensation claimed is greater than a certain amount. Alternatively, they could limit any potential claims for liability to be a maximum monetary amount (often this is linked to the value of the contract in some way).

What is an indemnity clause?

Unlike liability, which is determined by a party's responsibility for certain losses, indemnity is a purely contractual concept. It is a promise from one party (indemnifying party) to another/other party/ies to cover losses suffered by those other parties, even if the indemnifying party would not necessarily have been liable. An indemnity goes further than liability and can make the indemnifying party responsible for certain events or losses, regardless of fault.

Indemnity clauses may also extend the types of losses that a party is responsible for to those that would otherwise not generally be recoverable through the general concepts of liability.

Let's look at an example of an indemnity clause and consider how Party A's requirement to provide financial compensation to Party B may change if the indemnity clause were in place, compared to the general concepts of liability.

Example clause

> *"Party A indemnifies and must keep indemnified Party B against all loss, damage, liability, costs (including legal costs on a full indemnity basis) and expenses arising out of or in connection with any claim, demand, action or proceeding by any person in respect of personal injury, death, or property damage caused by Party A in performing the Services."*

Under the general laws (i.e., without this indemnity clause), Party A would only be responsible to compensate Party B if they were directly at fault for the loss. However, because of this indemnity clause, this responsibility to compensate extends even further to include any loss that is in connection with Party A's services, even if Party A was not necessarily at fault.

Understanding the distinction between a liability and an indemnity when drafting and reviewing contracts?

The distinction between a liability and indemnity can significantly change a contracting party's responsibility and financial exposure in respect of a contract. Therefore, ensuring that you carefully review, understand and negotiate the liability and indemnity clauses of contracts that you are entering into is crucially important.

Without understanding these concepts and the practical implications of clauses in contracts that are being considered, many businesses risk agreeing to be responsible for things that they didn't originally intend. When reviewing these terms, it can be helpful to think about a practical example of where the clauses could apply and what practical differences the clauses could make to each of the parties' positions.

It may also help to consider the level of control that the parties each have to try to reduce the likelihood of loss being suffered. If you do not have any control over a certain activity but are agreeing to indemnify another party for losses that could be caused by the activity, then your exposure may be greater than if that activity were directly in your control, and you could better manage the activity to ensure that loss doesn't occur.

Business owners and representatives may also need to consider whether the liability or indemnity clause could change whether their insurance coverage would apply, or if their responsibility may extend beyond their insurance coverage (making that business

more exposed financially to the risks of the contract).

Get help from a commercial lawyer

Getting these clauses right in your contracts is of the utmost importance, and that is why it is crucial to have an experienced commercial lawyer review and advise about your contracts before you enter into them. An expert commercial contract lawyer can help you to understand the impacts of the clauses and, if necessary, propose solutions, amendments or negotiations that may protect you and your business more appropriately.

Good legal advice could make the world of difference to your position if the liability and indemnity clauses have to be relied upon one day.

If you have a contract that you would like assistance reviewing, be sure to contact the IM Lawyers team for an obligation-free initial consultation to see if we can help.

This article is of a general nature and should not be relied upon as legal advice. If you require further information, advice or assistance for your specific circumstances, please contact us.