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Factors To Consider In Negotiating Indemnification Provisions

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One of the most negotiated and fundamental provisions in any contract is the manner in which the parties will allocate risk. Also known as an “indemnity” or an “indemnification provision,” these provisions are not commonly included in a business term sheet or letter of intent. While indemnification provisions can be technically challenging and easy to gloss over, it is essential to understand what they mean so they can be appropriately and clearly drafted, the correct insurance can be purchased, and, if an incident does arise, the liable party can be easily determined.

Indemnities show up in a wide variety of contracts, and there are various reasons why a party may be willing to indemnify another — among them is in exchange for a right, good or service (*e.g.*, to be permitted to use another’s property), as consideration for a loan or mortgage, or as a settlement of an existing dispute. This article outlines the main factors that should be considered in reviewing an indemnification provision.

Building Blocks of an Indemnification Clause

Typical indemnification provisions will be long sentences with many clauses, legal-sounding words, and long lists of specific details. The best manner to review a long-winded indemnification provision is to break it down into its component parts, which are generally as follows:

- *The Indemnitor*: This is the person or entity taking on the risk or obligation. Typically, the indemnitor must be a party to the agreement but may be a guarantor or a related party. When considering the party taking on the obligation, attention should be given to whether that party has sufficient financial resources to cover the losses imposed and, if the indemnitor is an entity, whether it will continue in existence for the period of the obligation. If the indemnitor may not be able to cover the indemnity obligation, a third-party guarantor may be brought in or provisions can be added to require the indemnitor to carry insurance to cover the indemnified risk. If a third party will be taking on an indemnification obligation or guaranty, that party will have to sign on to the contract to acknowledge the obligation or sign and deliver a separate guaranty document.

- *The Indemnitee*: The indemnitee is the beneficiary of the indemnification. It is important to include related parties within the definition of the indemnitee, including employees, members, partners, agents and any other party that may be related to the indemnitee and involved with the performance of the contract and all such

parties' successors and assigns.

- *Covered Damages*: The damages covered by an indemnification provision should be tailored for the circumstance. In some cases, indemnification provisions will only cover claims for damages to third parties. In other cases, damages directly to the indemnitee will also be covered. Often damages must "arise out of" or "relate to" a specific place, occurrence or action, such as "all damages arising out of a breach of this agreement, or the negligence of the indemnitor."

- *Standard of Care:* Indemnification provisions can vary with regard to the standard of care exercised by the parties before an indemnification obligation will arise.

  - *No Standard*: In some cases, the indemnification obligation will be absolute. This often happens in a leasing situation, where the tenant is obligated to indemnify the landlord for all damages occurring within the premises, regardless of the cause or the negligence of the landlord.

  - *Negligence Standard:* This will mean that the indemnitor is not obligated to take on the obligation unless it has been negligent. Some contracts will also negate the indemnification language if the indemnitee is found to have been negligent as well.

  - *Gross Negligence or Willful Misconduct:* This is a higher bar to the indemnitor's obligation, requiring indemnification only when the indemnitor has been grossly negligent or willfully caused a harm. Conversely, the gross negligence or willful misconduct of the indemnitee will generally relieve the indemnitor of its obligation. Depending on the state, indemnification clauses where the indemnitor takes on responsibility for the indemnitee's gross negligence or willful misconduct may be void as a matter of law. In addition, many states do not differentiate between gross negligence and negligence, so it is important to follow state law when making these distinctions.

- *Specific Circumstances*. Depending on the nature of the contract, indemnity provisions may include specific indemnifications related to the use of intellectual property, hazardous materials and other matters related to the circumstances of the transaction.

Insurance Implications and Other Contractual Matters

When a risk is shifted from one party to another, it is essential to determine whether the burdens are consistent with the insurance being purchased by that party and whether it makes economic sense. It can therefore be extremely helpful to have the insurance agents for both sides involved from the beginning of the negotiations, so that both parties understand whether they have sufficient coverage and the cost of that coverage. This can also help to shift the conversation away from a more emotionally charged one about who may be "in the wrong" to one about the economics of making sure that a casualty event is properly covered regardless of the cause.

For example, in a lease setting, landlords often require tenants to cover all of the risk of loss for injuries occurring within the leased premises and for damages to their personal property, even if those injuries or damages are caused by the landlord's negligence. While at first glance this may seem draconian, the provision accomplishes

two things. First, it places the burden of insuring everything within the leased premises on the tenant and relieves this burden from the landlord. Second, it means that there should not be a dispute over liability if damages or injuries occur within the leased premises; the tenant's insurance should simply pay the claim regardless of whose negligence caused the damage. In these situations, the tenant should require the landlord to indemnify it for injuries and damages occurring in the remainder of the building (exclusive of the leased premises) and the surrounding property. In this way, the tenant should not have to insure the rest of the property that it does not control.

If the goal is to divide the insurance responsibilities between the parties regardless of the negligent party in the matter, it is also essential to obtain waivers of subrogation so that the insurer does not then try to collect from the indemnified party that may have been negligent.

In addition to the insurance provisions, special attention should be paid to any other contract provisions that shift liability or otherwise handle risk allocation. This will include provisions addressing fire or other casualty damages. These provisions should follow the indemnification and insurance obligations by not focusing on fault and instead focusing on insuring the loss and obtaining the appropriate coverage.

Other Technical Elements of an Indemnification Provision

Indemnification provisions can include additional details that will structure what will happen if an event triggers the indemnification obligations. Some examples are as follows:

- *Baskets and caps:* These provisions will require a dollar threshold before an indemnification obligation is triggered and a cap on the amount of damages. These are most often seen in corporate transactions, where the purchasing party is expected to take on some risk and the selling party is not willing to retain an unlimited risk.

- *Survival periods:* In many situations, the indemnification provision will last longer than the contracting period because certain damages may not be known before the expiration of the contract. However, the indemnitor may want to close the door to its obligations before the expiration of the applicable statute of limitations, so a shorter survival period for the indemnification obligations can be specified.

- *Limitation on types of damages*: Indemnification provisions may limit the types of damages covered. For example, they may exclude consequential and punitive damages.

- *Choice of attorneys:* Some indemnification provisions will detail which party controls the choice of counsel and the manner in which the litigation is handled. In these cases, it is essential that the party paying the claim have control over the ultimate settlement.

Takeaway

Indemnification provisions can often be a last-minute, back-and-forth item pushed by counsel for both parties and often not fully understood by clients. It is therefore vital to break down the component parts of the provisions to understand and explain the burdens and benefits early on in the process. Bringing in the insurance carrier will also quickly clarify the coverage obligations and associated costs related to any additional liability taken on in an

indemnification clause. The outcome of these negotiations often rests on the relative bargaining power of the parties. If obtaining an indemnification will be vital to a particular contract, negotiating the terms upfront with the other business conditions will go a long way toward achieving the desired result.

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