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TO INDEMNIFY OR NOT? WHAT IS THE BIG DEAL?

An indemnity provision can be found in almost any standard form commercial lease. It typically states that one party to the lease will "indemnify and hold harmless" the other party from a laundry list of risks including damages, claims, expenses and more. Although these provisions are fairly standard, it is not uncommon for a party to dig in its heels during lease negotiations and refuse to indemnify. This begs the question, if indemnities are standard terms, what is there to be concerned about?

WHAT IS AN INDEMNITY?

All commercial entities, including landlords and tenants, are exposed to various forms of liability, both at common law and under statutes. Indemnity clauses in contracts are intended to be terms by which one party transfers the risk of liability for death, injury, damage, loss, expenses, claims and so on ("Claims"), to the other party (who may or may not have otherwise been liable.)

Most commonly, but not exclusively, an indemnity clause in a commercial lease will provide that the tenant will indemnify the landlord (or vice-versa) from any liability arising from a breach or issues arising out of use, occupancy, behaviour or events caused or suffered by third parties such as lenders or other occupants. In other words, an indemnity is simply a reallocation of risk.

The risks range from small Claims for small incidents (like modest water damage or a basic slip and fall), to large Claims resulting from catastrophes like destruction due to negligence, casualty, an environmental spill or terrorism. Regardless of the significance of the matter, the indemnifying party is liable for ALL Claims associated with the incident. This is a blanket form of protection.

WHAT ARE THE RISKS?

First, the party granting the indemnity is exposing itself to greater liability than it would be exposed to if it did not agree to indemnify. (Not only is it responsible for its own liabilities, but it is taking on the liabilities of another.)

The exposure is infinite. For example, the indemnifying party may be called upon to pay for Claims resulting from the action of an outsider to the contract (e.g. an employee, a customer or a service provider). The indemnifying party may have no right to sue that outsider for a variety of reasons, yet the promise to indemnify will be unqualified.

Second, the indemnified party is not required to mitigate its damages. (When someone else is footing the bill, there is less of an incentive to minimize costs.)

Third, the indemnified party is not required to include the indemnifier in any settlement of the Claim. The indemnifier can end up having no say in a negotiated settlement, yet it will be called upon to pay.

Fourth, ….drum roll, please. Legal fees can run amok. The indemnified party can spend an unlimited amount of time and money on legal representation. The indemnifier must pay the fees.

Knowing these major risks, it is not surprising that some Crown corporations are statutorily barred from granting indemnities in their contracts. To avoid the costs and responsibilities associated with indemnification, some legislation strictly limits when and if a Crown corporation can indemnify a contracting party.

HOW DOES ANYONE MITIGATE THE RISK OF INDEMNIFICATION?

Some of these risks are mitigated by insurance. Most liability insurance, including contract and liability insurance, is intended to backstop obligations to indemnify. But, as we all know, insurance typically has limits and is subject to exceptions.

The most effective way to mitigate the risks of indemnification is to spell out limitations. The indemnifying party can diminish its exposure by express statements along the following lines:

- The indemnity is limited to reasonably foreseeable damage (and does not extend to remote damages or indirect losses).

- The indemnity is limited to a certain monetary amount or timeframe.
- The indemnified party will mitigate its damages.
- The indemnified party will include the indemnifier in settlement discussions.
- The indemnifier's counsel will have carriage of any legal proceedings.
- The indemnifier will subrogate to the rights of the indemnified party against any third party to the extent such third party caused or contributed to the Claim.

MUTUAL INDEMNITIES

A mutual indemnification is an agreement whereby each party assumes the same or similar liability for Claims against the other party. Similarly, sometimes contracting parties express a mutual release (whereby each of the parties releases the other from Claims that are or should be covered by insurance), directing each party to their respective insurers in the event of a Claim. The insurance community likes to call this "knock for knock".

In the cases of Crown corporations who are prohibited from granting indemnities, an alternative to mutual releases and indemnities is to provide for mutual releases, but no indemnities (neither mutual nor one-way).

Whether or not these statements should be included in a lease will depend on the factual matrix of the relationship and the negotiating strength of each party. There is no risk management regime that applies to every scenario, although we do find that when asked, insurance brokers and risk managers reviewing lease clauses tend to like reciprocity.

WHAT IF A PARTY ABSOLUTELY REFUSES TO INDEMNIFY?

Even though there are ways in which a party can minimize the risk of indemnification, some parties may still refuse to indemnify. It is possible to live without a covenant to indemnify in a contract. In the absence of indemnities, the parties simply look to the covenants in the lease, including the insurance obligations. Breached covenants and failed obligations still give rise to Claims (which, at law, must be mitigated), and the courts have interpreted the covenant to insure as a *de facto* release (with respect to property damage Claims). If we can fairly assume that no indemnified party ever expected to be protected from unmitigated losses and liabilities, it's easy to conclude that the primary missing element that results from omitting an indemnity clause is coverage for legal fees. An unindemnified party will have to absorb its own legal fees to defend a Claim.

CONCLUSION

Parties have ample reason to fear an obligation to indemnify the other contracting party. There's a lot of exposure embedded in the covenant to indemnify. However, a carefully drafted indemnification clause can serve a valid purpose, by functioning to appropriately allocate risk between contracting parties. If not, fear not. Living without an indemnification clause is not fatal if the other covenants are clear and enforceable.

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