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Why indemnification provisions are too important to leave to the lawyers

By Mark L. Boos*

Indemnification provisions are part of virtually every commercial contract. Ironically, they're also among the contract elements most likely to be overlooked by the parties. Indemnification language tends to be dense, convoluted legalese, so leaving it for the lawyers to work out is often the default approach.

But when it comes to indemnification, deferring to the lawyers may not be the best tack to take. Indemnification is about risk allocation, and the particular language of an indemnification provision can make a dramatic difference in the nature and extent of exposure each of the parties assumes. In other words, indemnification arrangements are as much a business decision as they are a legal mechanism. As such, determining whether the indemnification language in a prospective contract distributes the risk of the transaction appropriately is really a call the parties should make.

Understanding Indemnification

The idea is simple enough: an indemnity is one party's promise to do something if certain events occur. Usually, that "something" is to cover the other party's losses related to the occurrence of a covered event. For example, in leases it's common for the tenant to be responsible for losses incurred by the landlord due to the tenant contaminating the leased premises. In contractual language, the tenant agrees to indemnify the landlord for losses resulting from the tenant contaminating the leased premises.

So far, so good. But arriving at the specific language for the indemnification provisions can be a challenge.

First, although many contracts impose potential indemnity obligations on both parties, the nature of the underlying transaction usually makes one party more likely than the other to have to make good on those obligations. Second, the particular language of an indemnity provision can fall anywhere along a continuum from very narrow to very broad. And, as reflected in Figure 1, whether the language of an indemnification provision leans more toward the narrow or more toward the broad can make a significant difference with respect to who and what is covered, how strictly the indemnified party must comply with the terms of the pertinent provision, what limitations might apply to the indemnification obligation, and more.

In short: (i) in most cases one party has much more at risk than the other, and (ii) how narrow or broad the specific language of the indemnification provisions ends up being determines how much potential exposure each party is assuming. Consequently, there's an inherent tension in negotiating the terms of a "fair" indemnity. Namely, the party which believes it is more likely to have occasion to indemnify the other wants the narrowest, most limited indemnity language it can get. The other party, predictably, wants the broadest, least restrictive possible wording. Consequently, coming up with mutually acceptable indemnification language often requires protracted negotiation.

Evaluating Indemnification Provisions

To illustrate why the specific language of a particular indemnification provision really matters (and why the parties to the contract should weigh in on that language rather than leaving it to the lawyers), recall the scenario mentioned above–a tenant has contaminated the leased premises. A summary of the analysis below is provided in Figure 2.

Who does the indemnity protect? Suppose the contamination migrates off the leased premises and both the state environmental agency and the owner of the neighboring property assert claims against not only the tenant, but against the landlord and its president as well. Whether the indemnification provision in the lease is drafted narrowly or broadly, the tenant's indemnification obligation will almost certainly apply to protect the landlord from losses resulting from both claims. Whether the landlord's president is covered is not so clear. A narrowly drafted indemnification provision might extend only to indemnitees who are parties to the contract. In that case, the landlord's president would be out of luck.

Does the landlord have a claim for direct damages? Now assume that the contamination causes damage to the leased premises themselves and/or to personal property that belongs to the landlord. If the indemnification provision is broadly drafted, the landlord will have an indemnification claim against the tenant for the resulting losses. If, on the other hand, the

indemnification provision is narrowly drafted, only third-party claims may be covered. In that case, to recover for damage to its property (a "first-party" claim), the landlord would be forced to bring a claim for breach of contract or the like. Such claims are often less advantageous than pursuing indemnification.

What about defending the landlord against the claims it faces? With a broadly worded indemnification clause, the tenant likely would have to not only indemnify the landlord against covered losses, but also provide a legal defense against claims made against the landlord. A narrowly worded indemnification clause, in contrast, would not require the tenant to provide a defense.

Are unadjudicated claims covered? If the indemnification clause in the lease is narrowly drawn, the landlord might not have an indemnifiable claim unless and until the suits against it have been resolved. Then, only to the extent those suits were proven to have merit would the landlord be entitled to indemnification. With a more broadly drafted indemnification provision, however, the landlord would be covered against legitimate losses even if the underlying claims were later determined to be legally insufficient.

What if the landlord fails to timely provide notice or doesn't follow the exact procedures outlined in the lease? With a narrow indemnity provision, the landlord would lose its right to indemnification altogether. With a broad indemnity, on the other hand, the landlord would lose its right to indemnification only to the extent the losses for which indemnification is requested resulted from that failure.

What limitations apply to the tenant's indemnification obligation? Broadly drafted indemnification provisions are commonly subject to baskets (deductibles), caps, exclusions, and truncated survival periods, all of which limit the landlord's right to indemnification to one degree or another. Narrowly drafted indemnification provisions typically include few, if any, such limitations.

And so on . . . . The analysis could go on. The type of occurrences which qualify as a "claim," and what constitutes a compensable "loss" are just two of many other points that tend to be heavily negotiated. Additionally, it's important to keep in mind that, for purposes of this article, only clauses at the respective ends of the "broad-versus-narrow" continuum have been considered in the examples. Most indemnification provisions end up somewhere between those two extremes; the options for the actual language are myriad.

In short, there is ample reason the process of arriving at an indemnification provision satisfactory to both parties can seem to go on forever. The takeaway that matters, though, is that the parties are in the best position to decide the scope of liability they are willing to accept. Leaving it entirely to the lawyers may result in an allocation of risk other than what the parties had in mind.

Figure 1

	Very Narrow Indemnity	**Very Broad Indemnity**
Who is covered by the indemnity?	Primary party to contract only (the "*Indemnitee*")	Indemnitee, plus its affiliates, directors, officers, employees, contractors, and agents
What is being indemnified against?	Only those *Covered Claims* for *Qualified Losses* that are suffered by third parties	*Covered Claims* for *Qualified Losses*, whether suffered by third parties or by the Indemnitee or its affiliates, directors, officers, employees, contractors, or agents
What is a Covered Claim?	Only a claim that has been fully adjudicated, brought to final judgment, and is non-appealable	Any claim, whether alleged, adjudicated, or otherwise
What is a Qualified Loss?	Only those damages, liabilities, and expenses that result solely from an inaccurate representation made by the party providing the indemnity (the "*Indemnitor*")	Damages, liabilities, and expenses resulting from, related to, or connected with an inaccurate representation, breach of the contract, or other act or omission of the Indemnitor or any of its affiliates, officers, directors, employees, contractors or agents
What if Indemnified Party fails to follow contractual procedures in making its indemnity claim?	Indemnitor relieved of its indemnity obligations	Indemnitor relieved of its indemnity obligations only to the extent *Qualified Losses* are exacerbated by the failure
What limits the indemnity?	May be subject to cap, basket, exclusions, and/or specific claim periods	Few or no limitations
Must Indemnitor defend Indemnitee against *Covered Claims* brought by third parties?	No	Yes

Figure 2

	Very Narrow Indemnity	**Very Broad Indemnity**
Does Tenant's indemnity extend to Landlord?	Yes	Yes
Does Tenant's indemnity extend to Landlord's president individually?	No. President likely not the Indemnitee.	Yes
Does Tenant's indemnity extend to the neighbor's claim against Landlord?	Yes	Yes
Does Tenant's indemnity extend to Landlord's claim for damage to its equipment?	No. Landlord is not a third party.	Yes
Does it matter that the claims have not been adjudicated?	Yes. Narrow indemnities exclude unadjudicated claims.	No. Broad indemnities generally define "claim" liberally, so the claims in this situation would qualify for indemnification.
Can Tenant avoid its indemnification obligations if Landlord fails to follow the procedures for making a claim as set forth in the lease?	Yes. Strict compliance required.	Only to the extent Landlord's losses were made worse by its failure
Must Tenant defend Landlord against the neighbor's claim?	No. Narrow indemnities do not include legal defense against claims.	Yes
Is Tenant's liability under its indemnity limited?	Yes. Narrow indemnities often impose caps, baskets, exclusions, and/or time limitations.	No, broad indemnities usually have few or no limitations

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