LEGAL TAKE

INDEMNITY FOR THE PAST

SECURITY FOR THE FUTURE

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Parties to any transaction always feel the need to be protected from risks, either legal or financial. Parties to a contract in particular want to feel secure in the fact that the transaction will proceed to their benefit. **Indemnity clauses** are included in contracts to provide that feeling of safety and security. Such clauses ensure that parties are comfortable with the level of risk they are willing to take in any transaction. Risks are everywhere when it comes to entering contracts, and indemnity clauses give parties a fall back if these risks occur.

What are indemnity clauses?

Indemnity clauses are provisions included in contracts that protect either party to the transaction from incurring extra costs as a result of the other party's action or inaction. They provide that one party, say Party A, shall pay back any amounts incurred by the other party, say Party B, as a result of Party A's action or failure to act. Through these clauses, a party is compelled to repay any amounts paid up by the other party.

Simply put, indemnity clauses are a legal way of mitigating financial risk.

Indemnity clauses are anticipatory in nature, they only operate in the event of breach of a party's obligations under the contract. If Party A fails to fulfill its obligation under the contract, then any costs as a result of that breach shall be repaid by Party A to Party B. The potential costs that a party can incur as a result of breach include any costs at termination of the agreement, damages as a result of the breach, costs relating to legal proceedings or all costs that a party would not have otherwise incurred if the breach had not occurred.

Indemnity clauses generally serve two purposes:

a) first, they prevent a party in the contract from failing to fulfill their obligations under the contract. By placing a punishment on the breaching party, parties are more likely to ensure they fulfill their obligations.

b) Second, they protect parties from potential expenses as a result of the breach.

Indemnification of the Seller

In a sale transaction, sellers of goods or property include clauses in the sale agreement requiring the buyer to indemnify the seller for any costs incurred by the seller as a result of the buyer's default in obligations.

Why is this necessary?

a) Sellers usually incur certain extra costs in relation to the property being sold. These costs include marketing costs, costs for processes such as change of user or subdivision of property where the sale is only of a portion of the entire property or legal costs such as where the money used to purchase the property was obtained fraudulently. Where the buyer defaults on their obligations, the seller will have expended these amounts for nothing, and will likely have to repeat some of the processes such as marketing for another buyer. Under the indemnity clauses, buyers must reimburse sellers for such costs.

b) Generally, sale agreements are drafted in a way that protects buyers financially. As the party paying a purchase price, buyers are given ample protection in contracts. These include clauses on refund of sums paid to the seller by the buyer. In certain transactions, the sellers may not have that kind of a safety net, other than through indemnity clauses. Indemnification of the seller recognizes the financial risks incurred by the seller and protects them.

Indemnification of the Buyer

Indemnification of the buyer is a common clause included in agreements. The buyer bears more financial and legal risk in any sale transaction. The buyer faces legal risks such as:

a) Does the seller actually own the property?

b) Is the property in the state that the seller says it's in?

c) Have all approvals required by government agencies been obtained to allow a sale?

The buyer faces financial risks mainly through payment of the purchase price. Consequently, indemnity clauses work in favour of the buyer. Indemnification of the buyer requires the seller to repay all costs incurred by the buyer in relation to the breach by the seller.

Why is this necessary?

In a sale transaction, the buyer holds a weaker position as compared to the seller. This explains the heavy reliance on due diligence by the buyer as an attempt to strengthen their position. Buyers face more risks, and they require clauses that mitigate the potential risks as a result of breach by the seller. This includes payment of any costs that the buyer will incur to terminate the contract, or the costs for suing the buyer for remedies like specific performance.

Are there ways to limit a party's indemnification obligation?

Yes. Parties tend to employ certain techniques in the agreements that would limit the extent to which they would be liable to indemnify the other party. These include:

1. **Reducing obligations in the agreement**: seeing as indemnification is pegged on fulfilment of obligations under the agreement, parties take steps to ensure they limit their obligations as much as possible. Ideally, a party would prefer to have their obligations stripped down to the bare minimum necessary to make the contract possible. Any warranties and conditions beyond that, parties tend to refuse to be bound by them.

2. **Excluding claims for consequential loss**: consequential loss/damages are indirect losses suffered as a result of the breach. They may include loss of rent, or potential profits from agricultural proceeds on a piece of land. Consequential damages are quite difficult to quantify, and if considered, may require a party to indemnify the other large sums of money. Therefore, parties exclude claims for consequential loss from indemnity clauses.

3. **Indemnity thresholds/baskets**: indemnity thresholds limit the amounts payable as indemnity. Parties negotiate a fixed amount as the threshold/basket, say K.Shs. 300,000/=. In the event of breach, a party will only be entitled to indemnity if the claimed costs as a result of the breach exceed

the basket, and the other party is only liable for the excess. Therefore, if the claimed losses or damages is K.Shs. 600,000/=, the other party shall only pay K.Shs. 300,000/= as the excess.

4. **Survival period**: parties usually put a limitation on how long the indemnity clause will survive after execution and completion of the agreement. The timeline of the agreement is governed by the limitations of actions placed under law, but parties are at liberty to reduce the time in which the indemnity clause survives the contract.

Conclusion

Indemnity clauses serve both a punitive and preventive purpose. Parties to a contract can be rest assured that with indemnity clauses in place, their financial risks are mitigated. In the same way, parties also do their best to limit their obligation under the indemnity clauses as highlighted above. Each party faces some form of risk, and each party is entitled to some form of protection.

Indemnity clauses give that safety and certainty. After all, what could be better?

In case you require further information on Indemnity clauses, please get in touch with our lawyers, **Lewis Ndonga** ndonga@fidelmwaki.com or **Fidel Mwaki** legal@fidelmwaki.com

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