Indemnification Clauses in Commercial Contracts (OH)

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A Practice Note discussing indemnification and defense provisions in commercial contracts under Ohio law. This Note defines indemnification and explains how parties often use indemnification to allocate risk. It discusses key issues including statutory and common law barriers to enforcement, defining the scope of the indemnity, limiting liability, and alternatives to indemnification. This resource includes drafting and negotiating tips.

Nearly every commercial contract has an indemnification provision. Parties include these provisions for a variety of reasons. For example, the parties to an equipment lease might include an indemnification provision to:

- Allocate risk between the parties that:
  - defects in the equipment injure the lessee or third parties like sublessees;
  - the lessee's use of the equipment infringes third-party intellectual property rights;
  - the lessor fails to timely deliver the equipment;
  - the equipment does not adhere to specifications; or
  - the lessor does not obtain all of the tax benefits associated with being the tax owner of the equipment.
- Allow an aggrieved party to pursue certain rights, like the right to attorneys' fees, which may otherwise not be available in a common law cause of action.
- Provide predictability and certainty of recourse.
- Show a court the parties' intent regarding risk allocation.
- Increase the odds of settlement based on the parties' intent.

If the contract does not contain a properly drafted indemnification provision:

- The **non-breaching party** may:
  - have to rely on uncertain common law causes of action; and
  - not be able to obtain certain types of reimbursement, for example, attorneys' fees.
- The **breaching party** may not be able to adequately:
  - cap its liability;
  - reduce its liability by incorporating materiality qualifiers; or
  - reduce its liability by incorporating liability caps or deductibles like thresholds or baskets.

Although commonly used, indemnity provisions can be complex. If used improperly, an indemnification provision can subject a party to continuing liability for circumstances outside of its control. If used correctly, an indemnification provision can shield a party from lawsuits and damages. This Note discusses the meaning and benefits of indemnity under Ohio law, and helps parties to correctly draft and negotiate an indemnification provision that effectively manages risk.

DEFINITION OF INDEMNIFICATION

Generally, indemnification (or indemnity) is an undertaking by one party to compensate the other party for certain costs and expenses. Indemnity is imposed either by law or contract in Ohio.

INDEMNITY IMPLIED BY STATE LAW

State law indemnity is a remedy implied under common law or statute and arises out of obligations imposed through a preexisting relationship (see, for example, R.C. 1302.25(C) (imposing a statutory obligation on buyers of goods to hold sellers harmless against certain claims of infringement)). The extent to which this obligation is imposed depends on:

- Applicable state law.
- The nature of the transaction.
- The nature of the relationship (for example, wholesaler/ retailer, abutting property owner/ municipality, independent contractor/employer, and master/servant (*Mosser Constr., Inc. v. W. Waterproofing Co.*, 6th Dist. Lucas No. L-05-1164, 2006 WL 1944934, at *4).

Generally, courts impose an implied indemnity on a contractual relationship only in the absence of an indemnification provision. For example, a court may find implied indemnification where a party is secondarily liable and passively negligent (*Whitney v. Horrigan*, 679 N.E.2d 315, 317 (Ohio 10th Dist.1996)). Parties relying on implied contractual indemnity generally face unpredictable outcomes and may not be able to obtain certain types of reimbursement, for example, attorneys' fees. To avoid any uncertainty, the parties to an express indemnity provision may choose to include a disclaimer of the right to implied indemnity.

CONTRACTUAL INDEMNITY

Parties to a contract use a contractual indemnity provision to customize risk allocation. Under Ohio law, the nature of an indemnity relationship is determined by the intent of the parties as expressed by the language used (*Worth v. Aetna Cas. & Sur. Co.*, 513 N.E. 2d 253, 256 (1987)).

Indemnification clauses vary widely, but in a typical indemnification provision, the obligor (indemnifying party) promises to reimburse the obligee (indemnified party) from and against any and all "losses, liabilities, claims, and causes of action" (recoverable damages) incurred by the indemnified party that "cause," "arise from," or are "related to" (nexus phrase) the specified events giving rise to the indemnity (covered events).

For more information on recoverable damages, nexus phrases, and covered events, see Defining the Recoverable Damages, Choosing the Right Nexus Phrase, and Defining the Covered Events of the Indemnity, respectively.

The insurance policy is a classic example of a contractual indemnity. For another example of an indemnification provision, see Standard Clauses, General Contract Clauses: Indemnification (OH) (w-000-1141).

In many cases, parties negotiating an indemnity clause also negotiate a defense clause (see Obligation to Defend). In a defense clause, the indemnifying party promises to defend the indemnified party against third-party claims, for example, litigation or arbitration, caused by or arising from:

- The indemnifying party's breach of contract.
- The indemnifying party's acts or omissions, even if the acts or omissions are not breaches.

OBLIGATION TO INDEMNIFY DISTINGUISHED FROM OBLIGATION TO DEFEND

In Ohio, the duty to defend is separate and distinct from the duty to indemnify (*W. Lyman Case & Co. v. Natl. City Corp.*, 667 N.E.2d 978, 979 (Ohio 1996); see also *Ohio Govt. Risk Mgt. Plan v. Harrison,* 874 N.E.2d 1155, ¶ 19 (Ohio 2007)). While a duty to defend arises if the allegations in the pleadings state a claim "potentially and arguably" within the coverage of the indemnification provision, the duty to indemnify arises only if liability actually exists under the indemnification language (*Elevators Mut. Ins. Co. v. Scassa*, 9th Dist. Wayne No. 03CA0045, 2004 WL 1463040, ¶ 12).

Obligation to Indemnify

Under an indemnity provision, the indemnifying party agrees to compensate the indemnified party for direct claims (by the indemnified party against the indemnifying party), third-party claims, or both. For a more detailed discussion of indemnity for direct versus third-party claims, see Direct Versus Third-Party Claims.

Indemnification requires the indemnifying party to:

- Reimburse for covered **paid costs and expenses** (losses).
- Advance payment for covered **unpaid costs and expenses** (like liabilities) as they are incurred but only if the recoverable damages under the indemnity include liabilities, claims, or causes of action. For more information on losses versus liabilities, see Defining the Recoverable Damages.

Obligation to Defend

The obligation to defend is also usually broader than the obligation to indemnify because it may apply whether or not the third-party claim has merit (*Ward v. United Foundries, Inc.*, 951 N.E.2d 770, ¶ 19 (Ohio 2011)). The obligation to defend is both:

- **An obligation.** The indemnifying party must:
  - reimburse for covered **paid costs and expenses** (losses) comprised of defense costs and expenses, which may include the cost and expense of appeals and counterclaims and losses on resolution of the dispute; and
  - advance payment for covered **unpaid costs and expenses** (like liabilities) comprised of defense costs and expenses.
- **A right.** The indemnifying party has the right to assume and control the defense, subject to applicable agreements (such as control of defense provisions (see Control of Defense Provisions)) and the law.

An indemnified party always wants the indemnification provision to expressly include the duty to defend because they otherwise risk having the indemnifying party only offer to pay for actual damages or judgments resulting from the claims made.

An indemnification provision must expressly include any obligation to defend as Ohio courts do not otherwise assume this obligation. For example, even where an agreement requires one party to reimburse another party for legal expenses incurred in defending itself as part of its indemnification obligation, Ohio courts do not require that party to also assume the burden of providing a defense unless the language of the agreement imposes an express duty to defend (see *Rayco Mfg., Inc. v. Beard Equip. Co.*, 9th Dist. Wayne No. 11CA0057, 2014 WL 1350808, ¶ 22).

The allegations asserted in the suit, not the ultimate merits of the action, give rise to the obligation to defend. For an example, see Defense is Often Broader than Indemnification: An Example. Therefore, a party may have to defend the other party even if the court ultimately finds the underlying claim to be without merit.

For a detailed discussion of the triggers to and scope of the obligation to defend, see Practice Note, Commercial General Liability Insurance Policies: Property Damage and Bodily Injury Coverage (Coverage A) (9-507-2539).

Defense is Often Broader than Indemnification: An Example

Consider an indemnification provision that requires the indemnifying party to:

- Indemnify against third-party claims for damages and losses arising out of the indemnifying party's negligence.

- Defend against third-party suits raising claims covered by the indemnity.

The indemnified party sues the indemnifying party under the provision for losses and damages suffered. The court absolves the indemnifying party of negligence. In this case, the court:

- Also absolves the indemnifying party of any indemnity liability. Because the indemnifying party is absolved of negligence, the indemnifying party has no obligation to indemnify for its own negligence.
- May require the indemnifying party to defend the indemnified party. The indemnifying party's defense obligation is triggered by suits raising claims covered by the indemnity, not whether the conditions of indemnity were, or were not, later established. In this case, some courts have upheld the defense obligation, regardless of the underlying obligation to indemnify (see *Beaverdam Contr. v. Erie Ins. Co.,* 3rd Dist. Allen No. 1-08-17, 2008 WL 4378153, ¶ 20 (citing *Motorists Mut. Ins. Co. v. Trainor*, 294 N.E.2d 874 (Ohio 1973)).

For information about the scope of defense obligations under insurance contracts, see Practice Note, Commercial General Liability Insurance Policies: Property Damage and Bodily Injury Coverage (Coverage A): The Duty to Defend Is Broader than the Duty to Indemnify (9-507-2539).

INDEMNIFICATION VERSUS HOLD HARMLESS PROVISIONS

Most indemnification provisions require the indemnifying party to "indemnify and hold harmless" the indemnified party for specified liabilities or losses. In practice, these terms are typically paired and interpreted as a unit to mean "indemnity." However, some commentators have drawn a distinction between the two. For example, they construe "hold harmless" to protect another against the risk of loss as well as actual loss and define "indemnify" to mean "reimburse for any damage," a narrower meaning than that of "hold harmless" (see Mellinkoff's Dictionary of American Legal Usage 286 (1992); see also discussion in Bryan A. Garner, U, 15 Green Bag 2d 17, 22-24 (2011)). However, in Ohio, the term "hold harmless" is used interchangeably with the term "indemnification" (see Office of Attorney General, State of Ohio, Opinion No. 96-060, 1996 Ohio Op. Atty. Gen. 2-233 (Ohio A.G.), 1996 Ohio Op. Atty. Gen. No. 96-060, 1996 WL 708356)).

Obligation to Hold Harmless

Similar to the obligation to indemnify (see Obligation to Indemnify), in states or courts that recognize a distinction, under the obligation to hold harmless, the indemnifying party must:

- Reimburse for covered **paid costs and expenses** (losses).
- Advance payment for covered **unpaid costs and expenses** (like liabilities) as they are incurred.

However, unlike the indemnity obligation, the hold harmless obligation in states or courts that recognize a distinction may require the indemnifying party to advance payment for covered unpaid costs and expenses even when the defined recoverable damages are limited to losses and do not include liabilities, claims, and causes of action (see Obligation to Indemnify and Defining the Recoverable Damages). Additionally, "hold harmless" may release the indemnified party from any related claim or cause of action by the indemnifying party.

To avoid "hold harmless" being given meaning above and beyond indemnification or otherwise causing confusion, the indemnifying party should consider:

- Excluding "hold harmless" from the indemnification provision. However, if the contract includes the obligation to defend, the indemnifying party will likely in any event have to compensate the indemnified party for both paid and unpaid costs and expenses (see Obligation to Defend).
- Clarifying that payments will be made only for actual losses and in the form of reimbursement.

For more information, see Standard Clauses, General Contract Clauses: Indemnification (OH): Drafting Note: Hold Harmless (w-000-1141).

STATUTORY AND COMMON LAW BARRIERS TO ENFORCEMENT

Statutory or common law restrictions may limit the enforceability of an indemnity. While there is no specific statute that generally governs the enforceability of all indemnification provisions in Ohio, parties should review any applicable Ohio law specific to their circumstances that may restrict or establish rules regarding aspects of the indemnity provision. For example, certain types of indemnities are vulnerable to challenge under state law or public policy that:

- Require a party to indemnify another for all claims, regardless of who is at fault (see *Glaspell v. Ohio Edison Co.*, 505 N.E.2d 264, 267 (1987)). In *Glaspell*, the court refused to strictly construe against the drafter the phrase "any loss" to exclude claims arising from a party's own alleged negligence, where the parties were commercial enterprises of sufficient size and quality as to presumably possess high degree of sophistication in matters of contract. In other situations, however, courts apply a heightened level of scrutiny whenever a party attempts to indemnify against its own negligence (*Toth v. Toledo Speedway*, 583 N.E.2d 357, 358 (6th Dist.1989)). In either case, the best practice is to expressly mention negligence.
- Provide for tort-based damages like punitive damages. Ohio law generally disfavors insurance against punitive damages resulting from the insured's own torts, but has carved out exceptions (see, for example, *The Corinthian v. Hartford Fire Ins. Co.*, 758 N.E.2d 218, 223 (8th Dist.2001)).
- Are not conspicuously set out in the contract (see Legal Update, Tenth Circuit: Inconspicuous Indemnification Clause is Unenforceable (2-591-9145)).
- Are given by protected classes like those involved in or relating to:
  - construction-related contracts (see R.C. 2305.31);
  - workers' compensation benefits (see R.C. 4123.82); and
  - consumers (see the Consumer Sales Practices Act, R.C. 1345.01 et seq., where Ohio courts have adopted a liberal approach to ensure protection for consumers) (*Price v. KNL Custom Homes, Inc.*, 28 N.E.3d 640, ¶ 15 (Ohio 9th Dist.2015)).

Outside of the above-listed contexts, Ohio courts generally uphold indemnification provisions absent a public policy exception (see *Worth*, 513 N.E.2d at 257 (Ohio 1987)).

IDENTIFYING THE INDEMNIFIED PARTIES

Either or both parties to the agreement may be indemnified parties, depending on whether the indemnification clause is structured as a unilateral indemnification or a mutual indemnification (for more on mutual indemnification, see Mutual Indemnities). Some contracts include officers, directors, managers, members, employees, agents, sub-contractors, and affiliates as indemnified parties.

When identifying the indemnified parties, parties should consider the impact of other provisions in the agreement:

- **Third-party beneficiaries provisions.** The parties can use a third-party beneficiaries provision to give a third-party indemnified party the ability to enforce its rights under the agreement. For a sample third-party beneficiaries provision, see Standard Clauses, General Contract Clauses: Third-Party Beneficiaries (6-519-7630).
- **Assignment provisions.** An assignment provision can change or expand the list of future indemnified parties (see Assignment Rights).

For more information, see Standard Clauses, General Contract Clauses: Indemnification (OH): Drafting Note: Who is the Indemnifying Party? (w-000-1141).

DEFINING THE SCOPE OF THE INDEMNITY

Parties can manage risk expectations and avoid interpretation, enforceability, and other disputes if the covered events and related damages under the indemnity are appropriate in nature and scope. To do this, a party should:

- Carefully consider its needs and negotiating position within the given context.
- Assess transaction-related risk in terms of events and consequences, and the likelihood that those events or consequences will occur.

In defining the scope of the indemnity, the parties should consider how broadly or narrowly they will:

- Define the recoverable damages (see Defining the Recoverable Damages).
- Define the nexus phrase (see Choosing the Right Nexus Phrase).
- Define the covered events of the indemnity (see Defining the Covered Events of the Indemnity).
- Limit the scope of the indemnity (see Limitation of Liability Approaches).

DEFINING THE RECOVERABLE DAMAGES

Although seemingly redundant, each word in the phrase "losses, liabilities, claims, and causes of action" has an individual meaning and serves a specific purpose. Since Ohio courts have indicated that they strictly construe indemnification provisions (*Palmer v. David R. Pheils, Jr. & Assoc.*, 6th Dist. Wood No. WD-01-010, 2002 WL 1436030, ¶ 39), it is important that parties include language covering all types of damages intended to be covered. The terms are listed below in order of increasing breadth:

- **Losses.** This generally includes any covered judgments, settlements, fees, costs, and expenses. The indemnifying party becomes responsible for a loss only after the indemnified party pays.
- **Liabilities.** This generally includes debts and other legal obligations. The indemnifying party becomes responsible for a liability when the liability is legally imposed, but before the money is paid. (See *Enterprises Group Planning, Inc. v. Savin*, 8th Dist. Cuyahoga No. 65693, 1994 WL 43877, *2).
- **Claims.** This generally includes damages resulting from a third-party lawsuit. The indemnifying party becomes responsible for a claim at the moment when a party, including any third party, files a lawsuit.
- **Causes of action.** This generally includes damages resulting from a right to seek relief. The indemnifying party becomes responsible for a cause of action when the indemnified party's or a third party's right to seek relief, as the case may be, accrues.

The above list of standard covered items is not exhaustive. Additionally, "losses, liabilities, claims, or causes of action" can be narrowly tailored, for example, to cover one or more of the following:

- Personal injury and death.
- Real and personal property damage.
- Infringement of intellectual property.
- Breach of confidentiality.
- Violation of law.

Direct Versus Third-Party Claims

The obligation to compensate an indemnified party may apply to:

- **Direct claims.** These are claims that an indemnified party has against an indemnifying party. Commercial contract indemnification provisions typically do not cover direct claims. A federal court applying Ohio law, however, held that an indemnity provision applies to both third-party and direct claims unless otherwise limited in the contract (*Battelle Mem. Institute v. Nowsco Pipeline Services, Inc.*, 56 F.Supp.2d 944, 951-52 (S.D.Ohio 1999)). While parties often expressly exclude direct claims, they may be subject to increased risk of liability or dispute if they overlook or fail to address them (see Indemnification: Avoiding Common Pitfalls: Overlooking or Failing to Adequately Address Direct Claims (6-538-5805)). An indemnification provision for direct claims typically covers damages relating to the indemnifying party's acts, omissions, or breach of the agreement.
- **Third-party claims.** These are claims that a third party has against the indemnified party, which parties most commonly use indemnification to cover.

In many commercial transactions, parties limit indemnification to cover only third-party claims and address liability for direct damages elsewhere in the agreement, for example, in the limitation of liability clause. If the indemnification clause covers direct claims and breach of the agreement, the parties should consider whether the indemnification obligation should be included in the limitation of liability. For a sample limitation of liability clause, see Standard Clauses, General Contract Clauses: Limitation of Liability (OH) (w-000-1253).

Attorneys' Fees

Ohio courts may not award the indemnified party's attorneys' fees without an express statement of intent (see *Nour v. Shawar*, 10th

Dist. Franklin No. 13AP-1070, 2014 WL 3058296, ¶ 9). Therefore, parties should address attorneys' fees in the indemnity provision, and if relevant, identify whether they are limited to reasonable or out-of-pocket expenses. Attorneys' fees are implicitly included in an obligation to defend.

CHOOSING THE RIGHT NEXUS PHRASE

This Note uses the term **nexus phrase** to describe the series of words that link the list of recoverable damages (for example, losses or liabilities) to the covered events (for example, breach of the agreement or the indemnifying party's negligence). Nexus phrases dictate the degree to which the event giving rise to the indemnity and the indemnified party's damages need to be related for the event to qualify for recovery. The nexus phrase therefore helps shape the scope of indemnity and directly impacts the amount of recoverable damages.

Usually, the **indemnified party** wants the indemnity to include a broad nexus phrase, for example, "related to." A broad nexus phrase helps to expand the indemnity's scope of coverage.

Usually, the **indemnifying party** wants the indemnity to include a narrow nexus phrase. A narrow nexus phrase excludes damages unrelated to the indemnifying party's own acts or omissions. To narrow indemnity coverage, parties can use:

- "Caused by."
- "Result from."
- "Solely result from."
- "To the extent they arise out of."

DEFINING THE COVERED EVENTS OF THE INDEMNITY

Covered events generally arise from or relate to:

- The indemnifying party's breach of the agreement (see Indemnities for Breach of the Agreement).
- The indemnifying party's acts or omissions, even if the acts or omissions are not breaches (see Occurrence-Based Indemnities).

Covered events include two broad categories, as follows:

- Direct claims.
- Third-party claims.

Indemnities for Breach of the Agreement

An indemnity for breach of some or all of the agreement may appear unnecessary because a breaching party can almost always be sued for the direct loss under contract theory. However, parties commonly include an indemnity for breach as a way to:

- Change (usually extend) the indemnified party's right to recover damages, particularly regarding legal costs and expenses.
- Recover loss suffered resulting from third-party claims.

Indemnity based on breach of the agreement can be limited by:

- **Common law.** Common law rules relating to breach of the agreement, such as the foreseeability rule in *Hadley v. Baxendale*, may similarly modify indemnity coverage of breach ((1854) 156 Eng. Rep. 145). Under *Hadley*, a plaintiff may not recover damages that are improbable and unforeseeable unless the defendant had special knowledge of the circumstance. Courts have not definitively determined whether *Hadley*'s foreseeability rule would apply to an indemnity claim based on breach of the agreement. However, Ohio courts have, in certain circumstances, referred to the foreseeability of the risks being indemnified against to support enforcing an indemnification clause (see, for example, *Brookridge Party Ctr., Inc. v. Fisher Foods, Inc.*, 468 N.E.2d 63, 68-69 (Ohio 8th Dist.1983)). Therefore, if appropriate, parties should include reasonably foreseeable language in the indemnity provision to ensure that the common law rule of reasonableness applies.
- **Limitations in the underlying contract language.** The scope, depth, and duration of the indemnifying party's representations, warranties, and covenants impact the indemnified party's indemnification rights for breach of the agreement. For example, the seller of a business often makes a series of representations about its business and the enforceability of the agreement to induce the buyer to enter into the transaction. If a statement is untrue when made, then the seller has breached the agreement, and the buyer may have an indemnification claim on this basis. If the statement is true when made, but becomes untrue some time later, then the seller has not breached the agreement, and the buyer does not have an indemnification claim (unless the seller breaches a corresponding covenant). To the extent that a representation is qualified, the indemnification for breach of that representation will also be correspondingly limited. For sample representations and warranties, see Standard Clauses, General Contract Clauses: Representations and Warranties (2-519-9438).

For more information on indemnity for breach of the agreement, see Standard Clauses, General Contract Clauses: Indemnification (OH) (w-000-1141).

Occurrence-Based Indemnities

Indemnity clauses frequently cover liabilities based on specific occurrences. A broad occurrence-based indemnity obligation may, for example, cover all negligent acts or omissions of the indemnifying party. Occurrence-based indemnities can be narrowed, including by:

- Limiting coverage to specific claims or liabilities. The claims may be known or unknown, contingent or non-contingent, or cover a specific subject matter, such as:
  - environmental harms;
  - claims arising in a specific jurisdiction; or
  - losses associated with specific pending litigation.
- Limiting the scope of activities and qualifying the standard of care, for example, by replacing "negligent acts or omissions" with "negligent work" or limiting the indemnification obligation to apply only when the indemnifying party is solely negligent.

LIMITATION OF LIABILITY APPROACHES

Parties should customize indemnity coverage to be reasonably consistent with the transaction-related risk and the parties' negotiating posture. Parties can control the impact of the indemnity by:

- Carefully tailoring the language, by negotiating, for example:
  - exceptions to the indemnifying party's obligation to indemnify (see Exceptions to Indemnification);

- the degree to which either party has the right or the obligation to control the defense of an indemnified claim (see Control of Defense Provisions);
- the degree to which the indemnified party has the obligation to notify the indemnifying party of third-party claims (see Notice of Third-Party Claims);
- indemnification deductibles (see Liability Baskets);
- an indemnification cap (see Maximum Liability (Limitation of Liability)); and
- materiality and other indemnification qualifiers (see Materiality and Other Qualifiers).

- Integrating the language with the agreement's other risk allocation provisions, for example:
  - waiver of consequential damages (see Waiver of Incidental and Consequential Damages);
  - sole remedy provisions (see Sole Remedy Provisions); and
  - assignment rights (see Assignment Rights).

EXCEPTIONS TO INDEMNIFICATION

Indemnity coverage commonly excludes circumstances where the indemnified party's own actions cause or contribute to, in whole or in part, the harm triggering indemnification. For example, an indemnification provision may exclude the indemnified party's:

- Negligent or grossly negligent acts or omissions, or willful misconduct.
- Use or alteration of the products that does not conform with the specifications.
- Bad faith failure to comply with the agreement.

In Ohio, indemnification clauses in construction contracts are statutorily prohibited from indemnifying a party for its own negligence (R.C. 2305.31). Outside of the construction context, courts have generally held that indemnification agreements purporting to relieve a party from the consequences of its own negligence must be expressed in terms which are "clear and unequivocal" or they are unenforceable (*Tanker v. N. Crest Equestrian Ctr.,* 621 N.E.2d 589, 590 (Ohio 9th Dist.1993) (citing *Kay v. Pennsylvania R. Co.*, 103 N.E.2d 751, 753 (Ohio 1952)).

For an example of an exceptions clause in an indemnity provision, see Standard Clauses, General Contract Clauses: Indemnification (OH): Section 2.1 (w-000-1141). For common indemnity exclusions found in the loan agreement context, see Practice Note, Loan Agreement: Expenses and Indemnification: Exceptions to Expense Reimbursement Obligation (4-502-0802).

WAIVER OF INCIDENTAL AND CONSEQUENTIAL DAMAGES

This waiver, which often disclaims a host of non-direct damages including indirect, consequential, incidental, punitive, and special, limits the indemnifying party's liability to certain actual and direct damages and reduces the amount the party may otherwise be liable to pay. For definitions of certain of these damages, see Practice Note, Loan Agreement: Expenses and Indemnification: Waiver of Consequential Damages, Etc. (4-502-0802). For a sample waiver of incidental and consequential damages, see Standard Clauses, General Contract Clauses: Limitation of Liability (OH) (w-000-1253).

Note, however, that Ohio courts in some cases review these provisions for substantive and procedural unconscionability (see, for example, *Askenazi v. Gen. Elec. Co.*, 2nd Dist. Montgomery No. 16085, 1997 WL 447355, *3).

When drafting and negotiating an indemnification provision, parties should understand whether and how this type of waiver impacts the indemnification provision. For example, if the indemnity for third-party claims is not excluded from the waiver, the indemnifying party is not required to pay for indirect and consequential damages stemming from third-party claims even though these damages are caused by its own bad acts. If parties intended for the indemnity to cover **all** liabilities stemming from third-party claims (including consequential and so on), then the parties should exclude indemnification from the waiver, at least to the extent that it relates to third-party claims.

CONTROL OF DEFENSE PROVISIONS

With the obligation to defend, the indemnifying party has the right to control the defense, unless the agreement states otherwise. As the paying party, the indemnifying party wants to control the defense to better regulate its expenses and liabilities. However, the indemnified party, as defendant, may want to control the defense to protect its own legal status, reputation, and liability.

If representation by the same counsel presents a genuine conflict of interest between the parties, Ohio law may grant the indemnified party the right to select counsel (see *Star Rent-A-Car, Inc. v. Campbell*, 2nd Dist. Montgomery No. 20083, 2004 WL 541140, ¶¶ 13, 14). However, for more certain protection and control over its liabilities, an indemnified party can seek contractual rights, such as the right to:

- Assume the defense, either outright or based on certain contingencies (for example, conflict of interest or inaction of the indemnifying party).
- Consent to settling the claim or entry of a judgment, either outright or based on certain contingencies (for example, if the judgment will negatively impact the indemnified party's financial interest or reputation).
- Consent to counsel selection.
- Participate in the defense (possibly at its own expense).

For an example of a Control of Defense Provision, see Standard Clauses, General Contract Clauses: Indemnification (OH): Section 3 (w-000-1141).

NOTICE OF THIRD-PARTY CLAIMS

The indemnifying party is usually better able to limit its liability if:

- It has prompt notice of a covered third-party claim.
- The indemnified party agrees to cooperate throughout the disposition of the claim.

Ohio courts generally agree that "prompt, written notice" is a condition precedent to indemnification rights (see *Bank One, NA. v. Echo Acceptance Corp.*, 522 F.Supp.2d 959, 966 (S.D.Ohio 2007)).

The main point of contention regarding notice typically relates to whether the indemnified party's late or defective notice excuses or limits the indemnifying party's obligation to indemnify. To avoid this potential conflict, the parties should specify whether indemnification:

- Is conditioned on notice.
- Covers litigation expenses that were incurred before notice.

LIABILITY BASKETS

Liability baskets are common in corporate transactions like asset and stock purchase transactions, but uncommon in commercial transactions like the sale of goods and services. However, sellers that engage in multiple transactions with individual buyers should consider including this provision, as the cost of indemnifying a relatively small third-party claim could greatly exceed the value of the commercial agreement.

Generally, a basket shields the indemnifying party from having to indemnify an otherwise covered claim unless and until the amount of losses resulting from covered claims exceeds a defined amount. The parties can structure the basket as either a:

- Threshold, so that once the agreed amount is reached, the indemnifying party is liable for the total amount of losses (sometimes referred to as a "tipping" or "dollar one" basket).
- Deductible, so that once the agreed amount is reached, the indemnifying party is only liable for the amount of losses in excess of the agreed amount (sometimes referred to as an "excess liability" basket).

For an example of a liability basket provision, see Standard Clauses, General Contract Clauses: Indemnification (OH): Section 2.2 (w-000-1141) and the accompanying Drafting Note, which also discusses the possibility of structuring the liability basket as hybrid threshold/deductible basket or a mini-basket.

The Implications of a Liability Basket on the Obligation to Defend

Parties may choose to limit an obligation to defend using a liability basket. In this case, the obligation to defend may arise before the liability basket threshold has been reached. Parties should consider clarifying the parties' rights and responsibilities by obligating the indemnified party to reimburse the indemnifying party for all non-covered amounts in this event.

MAXIMUM LIABILITY (LIMITATION OF LIABILITY)

An indemnifying party with negotiating leverage may insist on a monetary cap on indemnity. As with other types of liability caps, the indemnifying party should ensure that this provision:

- Caps its potential liability to a fixed amount.
- Limits the maximum aggregate liability for all potential claims that may arise under the agreement, not just for individual claims.

The indemnification cap may appear in a general limitation of liability clause covering all contract liabilities (including indemnity) or as part of the indemnification provision. A limitation of liability covering all contract liabilities will impact the indemnity provision, unless indemnification is explicitly excluded from the cap.

For an example of a maximum liability clause, see Standard Clauses, General Contract Clauses: Indemnification (OH): Section 2.3 (w-000-1141).

Implications of Maximum Liability on the Obligation to Defend

Parties may choose to limit an obligation to defend using a liability cap. In this case, the obligation to defend may continue after the liability cap has been reached. Parties should consider clarifying the parties' rights and responsibilities by obligating:

- The indemnifying party to continue the defense.
- The indemnified party to reimburse the indemnifying party for all non-covered amounts in this event.

SOLE REMEDY PROVISIONS

A sole remedy provision prohibits the indemnified party from recovering damages for covered claims beyond the terms set out in the indemnification provision. With a sole remedy provision, the indemnified party can look only to the indemnification provision for recourse on covered claims. Without a sole remedy provision, the indemnified party may be able to use a non-indemnity related contractual remedy or remedy at law to recover more than what the indemnifying party thought the parties had originally bargained for.

In addition, the indemnifying party should ensure that the agreement does not contain a cumulative remedies clause that could conflict with this provision and, as a result, provide the aggrieved party an opportunity to seek damages or remedies beyond the scope of what is provided in the indemnification clause. Parties should, if appropriate, exclude the indemnification clause from the cumulative remedies provision.

For an example of a sole remedy provision, see Standard Clauses, General Contract Clauses: Indemnification (OH): Section 2.6 (w-000-1141).

MUTUAL INDEMNITIES

Commercial contracts often include mutual indemnification provisions. Under a mutual indemnification provision, each party indemnifies the other. While mutual, each indemnity obligation is not necessarily identical or proportional to the other. The extent to which the provision is balanced depends on the allocation of risk and negotiating power between the parties. Each indemnifying party should strive to tailor the indemnity to cover only the risk it has agreed to shoulder.

The mutuality of an indemnity can serve to mitigate risk for either or both parties by:

- Reducing the likelihood of litigation between the parties.
- Strengthening the contractual relationship.
- Establishing certainty regarding future potential liability.

MATERIALITY AND OTHER QUALIFIERS

Often, the representations and warranties in the agreement are subject to materiality or other qualifiers. For example, a warranty may state: "Seller represents and warrants that products are free from **material** defects in material and workmanship."

These qualifiers prohibit the non-breaching party from recovering damages for the breach unless it can prove that the nature or the subject matter of the breach, as the case may be, was material. Indemnity for breach of a contract provision does not negate the qualification placed on that provision, and so to this extent the unqualified indemnification is similarly diluted, unless the contract has an express statement to the contrary.

Typically , a "material breach" of contract is a party's failure to perform an element of the contract that is so fundamental to the contract that the single failure to perform either:

- Defeats the essential purpose of the contract.
- Makes it impossible for the other party to perform.

(*O'Brien v. Ohio State Univ.*, 10th Dist. Franklin No. 06AP-946, 2007 WL 2729077, ¶ 56 (citing Williston on Contracts, Section 63:3)).

Sometimes, the parties agree to qualify the indemnification provision with materiality. The parties should consider the consequences of qualifying the indemnification provision with materiality because:

- It introduces a second layer of materiality if the underlying representation is already qualified by materiality. In this case the indemnifying party indemnifies only if it materially breaches a provision that may already be qualified by materiality. This is sometimes called double materiality.
- It introduces a new layer of materiality to representations that the indemnifying party may have negotiated without qualification. This is sometimes called back-door materiality.
- The indemnifying party may already have negotiated protective qualifiers like indemnification baskets, which act as a kind of materiality qualifier (see Liability Baskets).

REPRESENTATION AND WARRANTY INSURANCE AND ESCROW

Like most other contractual obligations, indemnification is only valuable if the indemnifying party stands behind its promise. If an indemnifying party is a significant credit risk, then the indemnified party should consider requiring the indemnifying party to obtain a minimum amount of representation and warranty insurance. Parties commonly use insurance contracts to:

- Supplement, or even substitute, indemnity obligations.
- Induce counterparties to enter into the transaction.

The insurance policy can usually be tailored to correspond to the transaction at hand.

Similarly, an indemnified party may seek a portion of the purchase price to be held in escrow to satisfy the seller's indemnification obligations. These funds are often held in escrow for the duration of the indemnity survival period.

Both insurance and escrow for indemnification obligations are more commonly used in M&A transactions but less frequently relied on in commercial contracts.

ASSIGNMENT RIGHTS

Assignment of the agreement could unexpectedly alter the risk allocation in the transaction. For example, the indemnifying party may assign the contract to a third party that cannot honor the indemnity obligations. Ohio common law applies and permits assignment if:

- There is no language prohibiting assignment.
- The assignment does not materially alter the duty, risk, or benefit of the obligor.
- There is no public policy reason to prevent assignment.

(*See Pilkington N. Am., Inc. v. Travelers Cas. & Sur. Co.*, 861 N.E.2d 121, ¶ 36 (Ohio 2006).)

Parties should therefore consider seeking assignment limitations, such as consent requirements, if appropriate.

For more information on assignment limitations in Ohio, see Standard Clauses, General Contract Clauses: Assignment and Delegation (OH) (w-000-1042). For information on assignability of commercial contracts, see Practice Note, Assignability of Commercial Contracts (1-525-3176).

DURATION OF INDEMNITY

Indemnifying parties often impose time limitations on indemnity and related provisions to control liability. Absent an agreement to the contrary, Ohio law statutes of limitations dictate the length of time that a party has to raise a claim, including an indemnity claim (State Q & A, Statutes of Limitations: Ohio). Time limitations on indemnity claims vary depending on the type of claim (for example, a tort claim may have a different time limitation than a breach of contract claim), and whether the claim is a:

Direct claim. The statute of limitations clock starts once the indemnified party has suffered a loss (see *Firemen's Ins. Co. of Newark, N.J. v. Antol*, 471 N.E.2d 831, 834 (Ohio 10th Dist.1984)). The length of time the indemnified party has to file the claim depends on the type of claim. Parties often limit the duration and survivability of contract terms, for example, to have the representations survive the deal closing but expire 30 days after the contract effective date. For an example of a survival provision, see Standard Clause, General Contract Clauses: Survival (OH) (w-003-9085). For a direct claim such as this, the contractual time limitations supersede the statute of limitations if:

  - the modification is reasonable; and
  - the language explicitly references the terms "action," "lawsuit," or "demand."
- (See *Escue v. Sequent, Inc.*, 568 Fed. Appx. 357, 363 (2014).)
- **Third-party claim.** Absent an agreement to the contrary, the statute of limitations limits:
  - the amount of time the third party has to bring a claim against the indemnified party (the statute of limitations clock starts from the time the claim accrues); and
  - the amount of time the indemnified party has to bring an indemnity claim against the indemnifying party. A typical statute of limitation clock for an indemnity claim starts when the indemnified party has been served with process in the underlying lawsuit, or when the party knew or should have known of any act or omission giving rise to the cause of action for indemnity, whichever period expires later.

Ideally, the duration of the indemnity gives the indemnified party a reasonable amount of time to discover any covered breach or third-party claim. Parties should consider customizing indemnity duration in the agreement after:

- Analyzing each potential claim and its related statute of limitations.

- Coordinating the time limitations of each of the covered claims and the term and survival period of the contractual indemnity.

For a sample contractual statute of limitations clause, see Standard Clauses, General Contract Clauses: Contractual Statute of Limitations (OH) (w-000-1142). For a discussion of indemnity duration in the context of acquisition agreements, see Practice Note, What's Market: Indemnification Provisions in Acquisition Agreements (3-504-8533).

ALTERNATIVES TO INDEMNIFICATION

Indemnification is often a highly negotiated provision, and sometimes the benefits are not worth the battle. With this in mind, parties should consider alternatives to indemnity, including:

- Relying on Ohio common law or statute for recourse (for example, bringing a lawsuit for breach of warranty, breach of contract, or fraud).
- Conditioning the purchase price on fulfillment of certain conditions.
- Using a right of offset by escrowing a part of the consideration with a third party.
- Deferring payment so that the indemnified party can deduct potential indemnity payments from future payments.
- If you are the buyer, using your own subsidiary to purchase the seller or the seller's assets to confine the transaction-related risk to that subsidiary.
- Providing contractual work-arounds for anticipated problems (for example, requiring the infringing party to provide a non-infringing replacement in the event of intellectual property infringement).
- Using other risk allocation provisions to limit overall risk (see Practice Notes, Risk Allocation in Commercial Contracts (4-519-5496) and Remedies: Adequate Liability Coverage (0-553-7425)).

Excluding an indemnification provision may increase the likelihood of dispute. Therefore, parties should consider including a strong dispute resolution provision, especially absent an indemnity clause. For a sample dispute resolution clause, see Standard Clauses, General Contract Clauses, Alternative Dispute Resolution (Multi-Tiered) (9-555-5330).