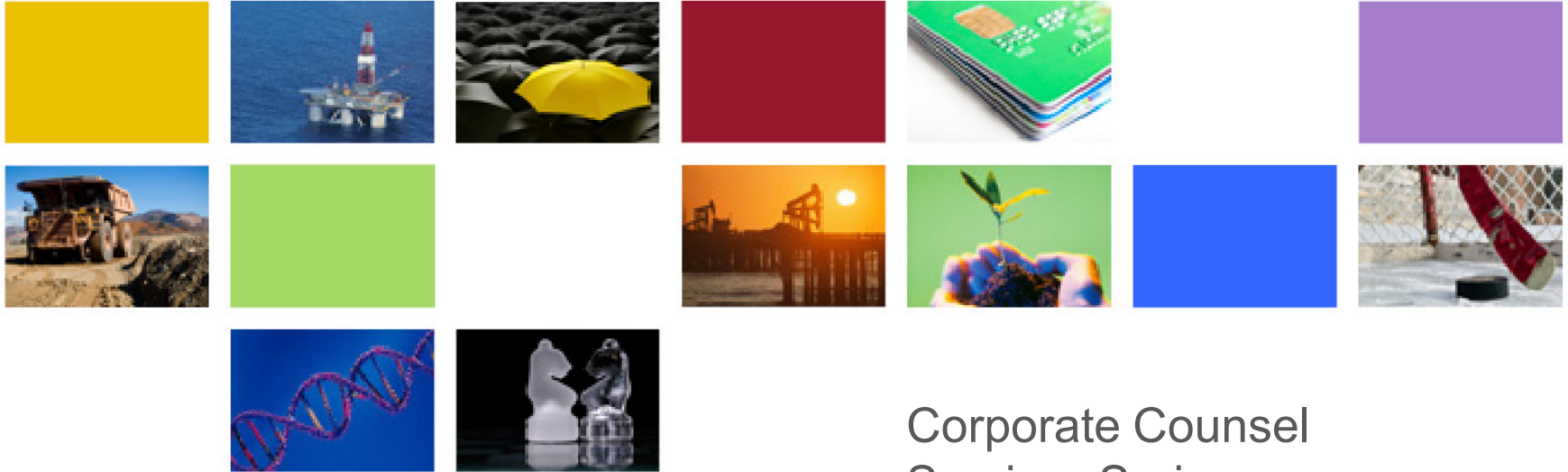


# Indemnities and Limitations of Liability: Beyond the Basics



Corporate Counsel  
Seminar Series  
November 10, 2011

# Indemnities – Beyond the Basics



Bruce McNeely  
November 2011



# Principle #1

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- An indemnity is a contract
- Takeaway:
  - First, consider the plain language of the indemnity to determine the intention of the parties. If the indemnity applies to the circumstances in question, apply Principle #2



## Principle #2

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- The language of the indemnity will be narrowly construed
- Takeaway:
  - Indemnity language in any agreement should be as complete as possible – see list on handout pages 1 and 2



## Principle #3

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- Actionable contract damage claims must be either (a) fair and reasonable and be foreseeable or (b) arise out of special circumstances of the Yied Person which were highlighted, and agreed to, at time contract entered, and be foreseeable
- Takeaway:
  - Draft from the perspective of what is indemnified: “The Ying Party shall indemnify the Yied Party against any reasonably foreseeable losses and reasonably foreseeable liabilities arising out of a breach by the Ying Party of any [representation, warranty or covenant] made or given by it in favour of the Yied Party in this agreement.”



## Principle #3

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- Takeaway:
  - Buyers should specify what damages are to be indemnified and include specific reference to an indemnity for business interruption damage claims arising from a breach of the contract by the Ying Person. Exclude everything else



## Principle #4

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- Indemnities generally lessen the common law rights of the Yied Person in return for agreed-upon mechanics to aid the claim and recovery process
- Takeaway:
  - Direct claims between the parties are claims for breach of contract, not true indemnity claims
  - Indirect claims, that is, those made by a third party against the Yied Party are indemnity claims



## Principle #5

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- Referring to tort-based damages in a contractual context for the purpose of exclusion may create confusion in the mind of an adjudicator and limit recovery
  - Takeaway:
  - Yied Party runs the risk of confusion if the indemnity excludes, for example, “punitive damages” or “exemplary damages”



## Principle #6

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- Subject to applicable statutory provisions and narrow public policy restrictions, clearly worded, unambiguous contracts are enforceable
  - Takeaway:
  - The parties to a contract should be keenly aware of the statutory provisions that apply in the circumstances in question



## Principle #6

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- A party who can demonstrate that unequal bargaining power has resulted in either (a) an unfair bargain or (b) a transaction sufficiently divergent from community standards of commercial morality may defend enforcement of the contract against such party and have it rescinded as unconscionable
  - Takeaway:
  - Where the circumstances in question raise a concern regarding enforcement of a contract on the basis that it is an unconscionable contract, require that the opposing party obtain independent legal advice



## Principle #6

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- Takeaway:
  - For contracts of adhesion, if practical, require evidence that the party in the weaker position obtained independent legal advice



## Principle #7

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- Courts have a bias against third party beneficiary contract claims (i.e. privity of contract is required) and courts will only lift the corporate veil and impose contractual liability on a parent, subsidiary or person in control of the defendant corporation based on the 4 matters set out on handout page 6
- Takeaway:
  - In the best of circumstances (although often not practical) have each Yied Person execute the agreement, even if only by way of counterparty endorsement at the end of the agreement



## Principle #8

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- Contribution and subrogation rights may increase the risk to the Ying Party arising from unanticipated third party (contribution and subrogated) claims
- Takeaway:
  - Where appropriate and available, seek and obtain waivers of subrogation:
    - (a) from the insurer at the time any insurance policy is taken out; and
    - (b) from Yied Party guarantors and other relevant third parties as part of any settlement



## Principle #9

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- Courts apply the unconscionable contract analysis set out in Principle #6 in determining whether limitation of liability exculpatory language in a contract is enforceable
  - Takeaway:
  - The dominant party should (a) draw the limitation of liability language and its intended effect to the weaker party at the time they enter into the contract and (b) require evidence of independent legal advice



## Principle #10

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- See extracts from legislation which underpin the law of indemnity in Ontario set out on handout pages 7 to 10



# Drafting

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- Takeaway:
- Drop the “save harmless” in “indemnify and save harmless”
- Takeaway:
- An agreement to protect a person “from liability” includes a duty to defend; an agreement to protect a person “from damages” does not. The first is likely to be more expensive for the Ying Person than the second
- Takeaway:
- Do not list incidental damages in the indemnity exclusions – they are foreseeable and reasonable expenses incurred by the Yied Party should be re-imbursed



# Drafting

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- Takeaway:
- “exclusive remedies” – choose one of the two alternatives set on handout page 13
  
- Takeaway:
- “entire agreement” – if it is, expand the usual language as set on handout pages 13 and 14



# Drafting

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- Takeway:
- “survival” – parties to a “business agreement” which is governed by the laws of Ontario can vary (either extend or reduce), exclude or suspend the running of the basic period by agreement, effectively, for up to 15 years (the ultimate limitation period) from the date on which the agreement was made – see commentaries on *the Limitations Act, 2002* (Ontario) on handout pages 8 and 14



# Drafting

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- “Sandbagging” concern that indemnity obligation of the Ying Party by the terms of the agreement will not be affected by Yied Party’s knowledge of a breach at or prior to closing – see handout page 15
  - Takeway:
  - Balance of convenience lies with the Yied Party – if a concern, include a covenant of the buyer in a purchase agreement to disclose such knowledge as soon as it knows of a breach to permit the seller to take steps to cure the breach prior to closing or to lessen the resulting damages



# Drafting

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- Tax adjustment clause – Consider whether the amount to be paid by the Ying Party should be the “after tax” amount to avoid a windfall to the Yied Person arising out of the reduction in tax costs resulting from the indemnified losses – see handout pages 15 and 16



# Drafting

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- Takeway:
- Confidentiality agreement indemnity language – see handout page 16
- Takeway:
- Release or settlement agreement indemnity language – see handout pages 16 and 17



# Drafting

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- Takeway:
- Purchase and sale agreement blue sample sky representations – see handout pages 17 and 18



# Drafting

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- Takeway:
- In appropriate circumstances, integrate the provisions of any contribution agreement among a group of Ying Parties with the terms of the principal contract's escrow agreement
- Takeway:
- Indemnity distinguished from guarantee – see handout pages 18, 19 and 20



# Drafting

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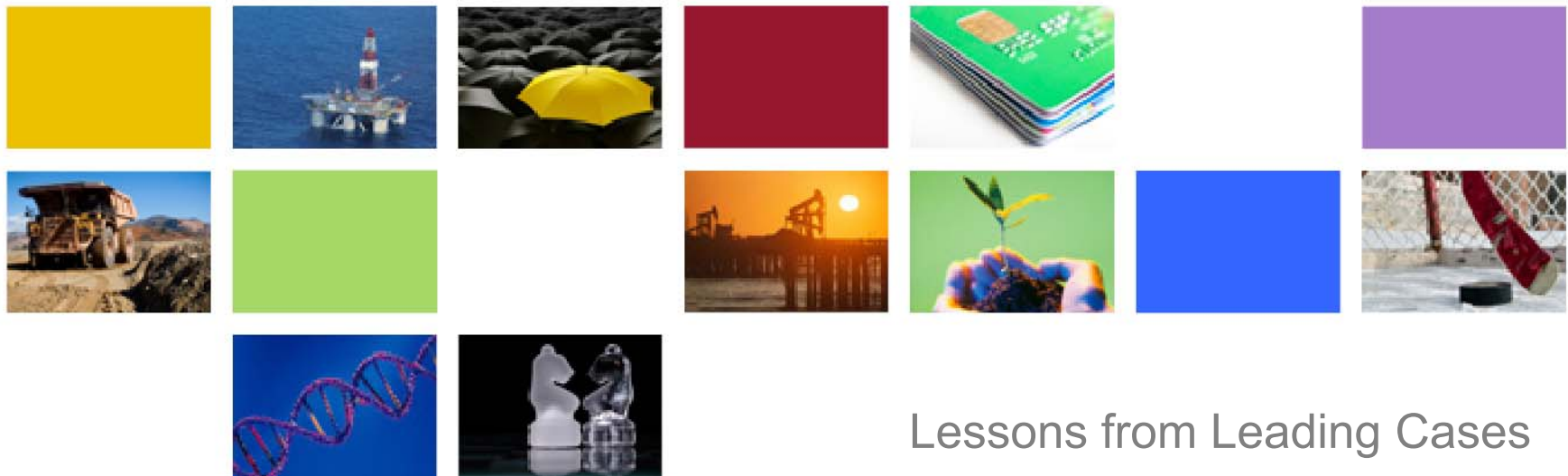


- Takeway:
- “as is” conveyances - – see handout page 20
- Takeway:
- *Canada Business Corporations Act* hybrid joint and several director and officer liability regime – see handout pages 20 and 21



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# Limitations of Liability and Indemnities



Lessons from Leading Cases

Peter J. Henein



# Lessons from Leading Cases

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- Limitation of Liability Clauses: Overview
  - Key elements
  - A quick history
  - The modern test for enforcement
  - Lessons
- Indemnity Clauses: Overview
  - Definition
  - The courts' approach
  - Lessons



# Limitations of Liability Clauses

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- Key Elements of a Limitation of Liability Clause
  - Party receiving the benefit of the limitation
  - Party agreeing to be limited
  - Liabilities to which the limitation applies
    - Causes of action
  - Categories of damages which are excluded or limited
  - Amount of any limitation



# Limitation of Liability Clauses

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- A quick history
  - Long history of judicial resistance to exclusion clauses
  - Formerly, limitation clauses were ineffective if the claim went to the root of the contract: *Karsales (Harrow) Ltd v Wallis*, [1956] 2 All ER 866 (CA)
  - In *Karsales*, Lord Denning invented doctrine of fundamental breach for limitation of liability clauses



# Limitation of Liability Clauses

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- A quick history (continued)
  - According to the doctrine of fundamental breach, a party could not rely on a limitation clause where its breach of contract deprived the non-breaching party of the main benefit for which it bargained
  - While this doctrine helped to protect consumers, it produced absurd consequences in commercial transactions
  - Fair, reasonable limitation clauses struck down because court characterized the breach as “fundamental”



# Limitation of Liability Clauses

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- A quick history (continued)
  - For example, in *Hunter Engineering Co v Syncrude Canada Ltd*, the parties agreed to a contract to supply gearboxes. The parties agreed that, in the event of breach, the seller's liability would be limited to the purchase price
  - This was a perfectly fair and reasonable agreement between two sophisticated businesses with equal bargaining power and the benefit of counsel
  - If the buyer wanted to guard itself against further loss, it could have purchased insurance, which may have been the parties' intentions all along



# Limitation of Liability Clauses

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- A quick history (continued)
  - Despite that, the British Columbia Supreme Court found the clause unenforceable because the seller's breach in providing defective gearboxes was "fundamental"
  - The Supreme Court of Canada overturned this decision and rejected the doctrine of fundamental breach: *Hunter Engineering Co v Syncrude Canada Ltd*, [1989] 1 SCR 426
  - However, some judicial hostility remains. Courts will sometimes adopt tortured interpretations of clauses to avoid harsh results



# Limitation of Liability Clauses

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- The modern test for enforcement
  - From recent Supreme Court of Canada case: *Tercon Contractors Ltd v British Columbia (Transportation and Highways)*, [2010] 1 SCR 69
  - Limitation clauses are enforceable according to their terms, unless they are unconscionable or overriding public policy militates against enforcement
  - The two exceptions are narrow: the key question is the correct interpretation of the clause



# Limitation of Liability Clauses

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- Lesson #1: think ahead
  - Recent Supreme Court of Canada case: *Tercon*
  - BC solicited bids from contractors for a public works project
  - BC established a tendering process, set out the qualifications for bidders to participate
  - Included limitation clause, stating:
    - “No proponent shall have any claim for compensation of any kind whatsoever, as a result of participating in this request for proposals.”



# Limitation of Liability Clauses

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- Lesson #1: think ahead (continued)
  - Tercon submitted a compliant bid to the tendering process
  - A joint venture submitted a non-compliant bid
  - BC awarded the contract to the joint venture, despite the non-compliance of its bid
  - Tercon sued BC for breach of contract
  - BC sought to rely on the limitation of liability clause



# Limitation of Liability Clause

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- Lesson #1: think ahead (continued)
  - The British Columbia Supreme Court found BC liable. The Court refused to apply the clause, finding that it did not apply to liability arising from BC's acceptance of a non-compliant bid
  - The British Columbia Court of Appeal disagreed. That Court unanimously found that the clause was clearly drafted and applied to limit BC's liability
  - Tercon appealed to the Supreme Court of Canada



# Limitation of Liability Clauses

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- Lesson #1: think ahead (continued)
  - A 5-4 majority of the Supreme Court of Canada found that the clause did not cover liability from BC accepting a non-compliant bid
  - The majority reasoned that a process in which BC accepted non-compliant bids was not the process that the contract contemplated. Therefore, the claim did not arise “as a result of participating in *this* request for proposals.”



# Limitation of Liability Clauses

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- Lesson #1: think ahead (continued)
  - BC could have anticipated that accepting a non-compliant bid would lead to liability
  - BC had complete control over drafting the clause – there were no negotiations over the wording of the provision
  - BC should have simply said “no claim arising from BC accepting a non-compliant bid”



# Limitation of Liability Clauses

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- Lesson #2: use plain language
  - Jargon terms like “**consequential damages**” or “**indirect damages**” have no clear meaning in Canada
  - Ken Adams defines “**direct damages**” as “damages that one would reasonably expect to arise from the breach in question, without taking into account any special circumstances of the non-breaching party”



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - Adams defines “**incidental damages**” as “expenses incurred by a buyer in connection with rejection of non-conforming goods delivered by the seller in breach of contract, or by the seller in connection with wrongful rejection by a buyer of conforming goods delivered by the seller to the buyer”
  - Adams defines “**consequential damages** all losses sustained by the non-breaching party that ” as “are attributable to any special circumstances of the non-breaching party that the parties were aware of when they entered into the contract; in other words...all contractually recoverable damages that aren’t either direct or incidental damages”



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - These terms are confusing and unclear
  - Better practice: identify specific types of damages to be either included or excluded
    - For example, “lost revenues, lost profits, loss of business value, or loss of business opportunity”
  - Avoid linkage to traditional language or jargon



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - *Hunter Engineering* case
  - Hunter Engineering sold gearboxes to Syncrude
  - The gearboxes were defective
  - Syncrude sued Hunter Engineering for the cost of repairs, which was more than double the purchase price
  - Limitation clause:
    - “In no event shall the liability of the seller exceed the unit purchase price of the defective product”



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - The Supreme Court of Canada unanimously applied the clause
  - Clause clearly defined the limit for both contractual and tortious damages



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - Address the types of claims to be limited using their usual legal names
  - This is especially important when excluding negligence
  - If the clause does not specifically mention negligence and it could apply to other types of claims, negligence will **not** be excluded



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - Leading case is *ITO – International Terminal Operators Ltd v Miida Electronics Inc*, [1986] 1 SCR 752
  - Stevedore company held Miida’s electronic goods in temporary storage before shipping. Stevedores negligently failed to guard the goods, which were stolen. Miida sued for negligence
  - Limitation clause:
    - The stevedore company “shall not be liable in any capacity whatsoever for any loss of the goods occurring before loading.”



# Limitation of Liability Clauses

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- Lesson #2: use plain language (continued)
  - Clause did not expressly mention negligence
  - However, given the facts of the case, negligence was the only possible claim that could have arisen
  - The Supreme Court of Canada enforced the clause
  - If the parties wish to exclude negligence **and other claims**, they must explicitly mention negligence



# Limitation of Liability Clauses

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- Lesson #3: no clause in invincible
  - In egregious enough circumstances, courts will refuse to enforce the clause
  - These will be cases involving risks to safety or fraudulent conduct
  - Leading example is *Plas-Tex Canada Ltd v Dow Chemical of Canada Ltd* (2004), 357 AR 139 (CA)



# Limitation of Liability Clause

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- Lesson #3: no clause is invincible (continued)
  - Dow sold polyethylene resin to Plas-Tex for use in building natural gas pipelines
  - Parties had a limitation clause:
    - “Plas-Tex accepts all liability for loss or damage resulting from use of the resin.”
  - The resin was defective, causing the pipes to crack and spew natural gas. This posed life-threatening danger to Plas-Tex’s employees and customers



# Limitation of Liability Clause

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- Lesson #3: no clause in invincible (continued)
  - Dow knew that the resin was defective when it made the sale. Dow also understood the threat to health that these defects posed.
  - Instead of warning Plas-Tex of the danger, Dow made the sale in the expectation that it could rely on the limitation clause
  - Plas-Tex sued for negligence and breach of contract



# Limitation of Liability Clauses

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- Lesson #3: no clause in invincible (continued)
  - Dow's conduct scandalized the Alberta Court of Appeal
  - The Court acknowledged that the clause was clear enough to encompass this type of claim
  - Despite that, the Court refused to enforce the clause, finding it unconscionable and against public policy in the facts of the case
  - Even with a clear clause, evidence of good faith and reasonableness will help to ensure enforcement



# Limitation of Liability Clauses

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- Case Study #1: *Pro-clean International Ltd v Patisserie Monaco Inc*, 2011 ONSC 1498
  - Pro-clean supplied cleaning services to Patisserie Monaco
  - Limitation clause in the contract:
    - “the Service Provider will have no liability to the Customer or any other party for any loss or damage (whether direct, indirect or consequential) which may arise from the provision of the Services”



# Limitation of Liability Clauses

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- Case Study #1: *Pro-clean International* (continued)
  - Pro-clean's staff damaged Patisserie Monaco's sponge cake slicer
  - Patisserie Monaco sued Pro-clean for negligence
  - The Ontario Superior Court of Justice held that the limitation clause covered Patisserie Monaco's claim
  - Pro-clean was not liable



# Limitation of Liability Clauses

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- Case Study #2: *Timminco Ltd v ABB Industrial Systems Inc*, 2010 ONSC 6971
  - Timminco purchased blast furnaces from ABB
  - Parties included limitation clause:
    - “Seller’s liability for any clam whether in contract, warrant, negligence, tort, strict liability or otherwise loss...arising out of, connected with, or resulting from this contract or the performance of breach thereof, of from the design, manufacture, sale, delivery, resale, repair, replacement, installation, inspection, operation of use of any equipment covered by or furnished under this contract, or from any services rendered in connection therewith, shall in no case...exceed the purchase price allocable to the Equipment or Services”



# Limitation of Liability Clauses

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- Case Study #2: *Timminco Ltd* (continued)
  - ABB moved on summary judgment for a declaration that its damages be limited to the purchase price of the furnaces, US\$2,075,000.00
  - The Ontario Superior Court of Justice granted the motion
  - The Court found that the clause was clear enough to limit ABB's liability to the purchase price of the furnaces



# Limitation of Liability Clauses

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- Case Study #3: *Dennis v Ontario Lottery and Gaming Corp* (2010), 101 OR (3d) 23 (SCJ)
  - Dennis was addicted to gambling
  - He entered into a “self-exclusion” contract with OLG
  - Contract had a limitation clause:
    - “OLG denies any responsibility in the event that you fail to comply with the ban...you hereby acknowledge that OLG has no responsibility or obligation to keep you or prevent you from entering an OLG facility, to remove you if you enter, or stop you from gambling”



# Limitation of Liability Clauses

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- Case Study #3: *Dennis* (continued)
  - Dennis continued to gamble, suffering further losses
  - Dennis sued OLG for negligence and moved for certification to proceed as a class
  - Based on the limitation clause, OLG argued that it was “plain and obvious” that Dennis’ action was contractually excluded and, therefore, could not succeed



# Limitation of Liability Clauses

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- Case Study #3: *Dennis* (continued)
  - The Ontario Superior Court of Justice found that gambling losses was the only type of damage that the clause could have been intended to exclude. Therefore, the clause was clear enough and applied to Dennis' claim
  - Despite that, the Court rejected OLG's argument
  - Given Dennis' addiction and vulnerability, and the inequality or bargaining power between Dennis and OLG, the Court found that Dennis could argue that the limitation clause was unconscionable or contrary to public policy



# Limitation of Liability Clauses

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- Case Study #4: *Wrighton v Integrity Inspections Inc* (2007), 418 AR 222 (QB)
  - Wrighton hired Integrity to inspect a home he was thinking of buying
  - Inspection contract included a limitation clause:
    - “The Company’s liability for any Client claims, beyond the Guarantee, is limited to the maximum of the home inspection fee paid. The limitations in liability herein apply to all claims, whatsoever their nature and whether arising in negligence or other tort, in contract or from any other source of cause”



# Limitation of Liability Clauses

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- Case Study #4: *Wrighton* (continued)
  - Integrity's employees made gratuitous oral representations about estimated costs to repair the home
  - Wrighton bought the home, and discovered that the actual repair costs far exceeded Integrity's estimate
  - Wrighton sued Integrity for negligent misrepresentation
  - Integrity sought to rely on the limitation clause to limit to the damages to the price of the inspection (\$10,000.00)



# Limitation of Liability Clauses

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- Case Study #4: *Wrighton* (continued)
  - The Alberta Court of Queen's Bench found the clause ambiguous
  - Court interpreted the clause to exclude liability for breach of contract or negligence relating to the performance of the contract
  - However, Integrity's representations were gratuitous and unrelated to the contract; therefore, the clause did not cover them
  - Integrity was liable



# Limitation of Liability Clauses

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- Case Study #5: *Garrett v Quality Engineered Homes Ltd* (2006), 30 CLR (3d) 129 (Ont. SCJ)
  - Quality agreed to construct a pre-fabricated home for Garrett
  - The contract included a limitation clause:
    - “The Purchaser shall be responsible for the siting of the requisite foundation”



# Limitation of Liability Clauses

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- Case Study #5: *Garrett* (continued)
  - Quality constructed the home with a badly misaligned foundation, requiring expensive repairs
  - Garrett sued Quality for breach of contract
  - Quality sought to rely on limitation clause
  - The Ontario Superior Court of Justice found the clause ambiguous
  - The Court interpreted the clause to exclude liability only where Quality followed the site plan
  - As quality failed to follow plan, the clause did not apply



# Indemnity Clauses

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- Definition of Indemnity
  - 1. To reimburse another for a loss suffered because of a third party's or one's own act or default.
  - 2. To promise to reimburse another for such a loss.
  - 3. To give another security against such a loss.
    - » Black's Law Dictionary



# Indemnity Clauses

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- The Court's Approach
  - Courts less hostile to indemnity clauses than to limitation clauses
  - Ordinary rules of contractual interpretation apply
  - Courts will construe an indemnity clause according to the likely expectations of the business parties who drafted it
  - Technical, hairsplitting interpretations less common in this area than with limitation clauses



# Indemnity Clauses

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- Lesson #1: be specific
  - Specifically mention the types of claims subject to indemnity, using their ordinary legal names
  - Example is *Smith v Global Plastics Ltd*, 2001 BCSC 1336
  - In an agreement of purchase and sale, the seller agreed to indemnify the buyer for:
    - “any incorrectness in or breach of any representation of warranty of the Vendors contained in this Agreement or under any other agreement, certificate or instrument executed and delivered pursuant to this agreement.”



# Indemnity Clauses

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- Lesson #1: be specific (continued)
  - After buying the business, the buyer terminated the contract of one of the sales agents
  - The buyer claimed that the seller had verbally represented that the sales agent was an independent contractor
  - The sales agent sued the buyer for wrongful dismissal, claiming he was an employee



# Indemnity Clauses

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- Lesson #1: be specific (continued)
  - The buyer made a third party claim for indemnity against the seller
  - The buyer claimed that the wrongful dismissal damages flowed from an “incorrectness” of “any representation” in “any other agreement” under the indemnity clause
  - The seller moved for summary judgment to dismiss the third party claim



# Indemnity Clauses

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- Lesson #1: be specific (continued)
  - The Court rejected the buyer's argument and granted the seller's summary judgment motion
  - Normally, the buyer assumes responsibility for wrongfully dismissing employees
  - The contract did not specifically extend the indemnity to wrongful dismissal damages
  - The contract made no reference to any representation about the status of the sales agent



# Indemnity Clauses

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- Lesson #2: be reasonable
  - Unless the contract specifically says otherwise, the indemnified party will only be entitled to reasonable costs spent in discharging the liability
  - Evidence of good faith and prudent conduct will establish the reasonableness of costs on a *prima facie* basis: *Guarantee Co of North America v Beasse* (1992), 124 AR 161 (QB)
  - In *Beasse*, the indemnified party's attempts to communicate and cooperate with the indemnifier were critical to collecting on the indemnity



# Indemnity Clauses

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- Lesson #2: be reasonable (continued)
  - Unless the contract says otherwise, legal fees spent hopelessly resisting a valid claim will not be recoverable through an indemnity clause: Kevin P. McGuinness, *The Law of Guarantee*, 2<sup>nd</sup> ed. (Scarborough: Carswell, 1996)
  - While the parties can agree on the scale of costs to be indemnified in a dispute, the court retains discretion to award different costs to sanction unreasonable conduct: *Berg v Elkousy Construction Co*, 2005 BCSC 1012



# Indemnity Clauses

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- Case Study #6: *SDMA Insurance Corp v Manning Mercury Sales Ltd* (1995), 139 Sask R 161 (QB)
  - Manning asked SDMA to post a \$20,000.00 bond for it in favour of the Saskatchewan government, as required under the *Motor Dealers Act*
  - Manning promised to indemnify SDMA:
    - “from and against any and all loss, costs, charges, suits, damages, counsel fees and expenses of whatever kind and nature, which the Plaintiff shall or may, for any cause, at any time, sustain or incur or be put to, by reason or in consequence of the Plaintiff having...the bond applied for, or any renewal, extension, continuation or increase of the bond”



# Indemnity Clauses

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- Case Study #6: *SDMA Insurance* (continued)
  - Saskatchewan demanded payment of the bond from SDMA. SDMA complied.
  - SDMA then claimed the amount from Manning under the indemnity
  - The Court held Manning liable under the indemnity



# Indemnity Clauses

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- Case Study #7: *Edmonton (City)Library Board v Morrill* (1989), 96 AR 128 (QB)
  - Morrill agreed to accept responsibility for her teenage son's library card
  - Morrill agreed to indemnify the library for:
    - “any fines, loss or damage by the use of the Library Card”
  - Morrill's son lost his card, which a rogue then used to steal 30 books from the library



# Indemnity Clauses

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- Case Study #8: *Morrill* (continued)
  - The library sued Morrill under the indemnity
  - Morrill's counsel argued that "use of the Library Card" included only the son's use, not the rogue's
  - The Alberta Court of Queen's Bench rejected that argument, finding that the indemnity covered any use
  - Morrill was liable under the indemnity



# Indemnity Clauses

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- Case Study #9: *GMAC Leasco Ltd v 1348259 Ontario Inc (cob Midtown Motors)*, [2005] OJ No 540 (SCJ)
  - As part of a settlement, GMAC agreed to indemnify Midtown Motors against any liability, costs or losses:
    - “imposed, assessed or incurred by reason of the commencement of any action or proceeding, judicial or extra-judicial, against Midtown”
  - Midtown then sued GMAC on the indemnity for a proceeding in which it was already involved at the time the parties executed the indemnity agreement



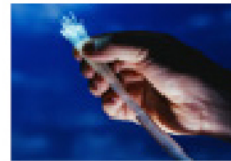
# Indemnity Clauses

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- Case Study #9: *GMAC* (continued)
  - Midtown moved for summary judgment on the indemnity
  - The Ontario Superior Court of Justice dismissed the motion, finding the clause ambiguous
  - The clause was unclear on whether the indemnity applied to proceedings that were already underway at the time of execution
  - The Court could not resolve the ambiguity based on the factual record on the motion, stating that a trial was necessary

# Limitations of Liability and Indemnities: Lessons from Leading Cases

Peter J. Henein



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## Indemnities – Beyond the Basics

*Bruce T. McNeely*

### Principle #1

An indemnity is, firstly, a contract. As a result, the general rules for the interpretation of contracts apply.

Takeaway: First, consider the plain language of the indemnity to determine the intention of the parties. If the indemnity applies to the circumstances in question, apply Principle #2.

### Principle #2

Once the intention of the parties is determined, the language of the indemnity will be narrowly construed by the courts - there is an interpretation bias in favour of the indemnifying party (Ying Person). The courts will only compel the Ying Person to do exactly what the Ying Person agreed to do – nothing more.

Takeaway: Indemnity language in any agreement should be as unambiguous and explicit as possible regarding:

- (a) the identity of the Ying Person(s),
- (b) the identity of the indemnified person(s) (Yied Person(s)),
- (c) a list of the claims indemnified,
- (d) a list of the types of damages indemnified,
- (e) the aggregate amount (cap) for which the Ying Person is to be exposed (if there is to be one),
- (f) a threshold amount for liability purposes (basket), and possibly a de minimus amount for inclusion in the basket itself,
- (g) lists of the excluded claims and damages,
- (h) consider listing excluded remedies that would otherwise have been available to the Yied Person, but exercise caution – avoid ambiguous language which could limit the intended recoveries,
- (i) a list of additional remedies not otherwise available to the Yied Person for the nature of the claims indemnified,

- (j) details of funded escrow arrangements, if any, and
- (k) the extent to which legal costs are recoverable by the “successful” party.

Finally, the indemnity should include a complete set of dispute resolution procedures. We recommend rules that impose an obligation on senior management of each party to attempt to resolve or limit the matters in dispute, a restriction on the extent of the matters in dispute to those set out in the notice of claim, written submissions and mandatory production to be provided with the notice of claim and with the notice of dispute, fixed periods should be specified for argument and for each other step in the process with an obligation on the adjudicator to issue a written decision with reasons by the end of a specified period.

Takeaway: If the parties have selected the *Arbitration Act, 1991* (Ontario) as the source for the applicable dispute resolution rules, we recommend that the agreement exclude the application of section 7(2) of the Act and also provide that the arbitral award is intended by the parties to be final and binding and not subject to appeal. Failure to exclude section 7(2) will leave it open to the party that is unhappy with the arbitral award to argue that there were two conflicting provisions in the rules governing the arbitration and such party should not be denied its right to appeal a question of law to the courts. If the application of section 7(2) of the Act is excluded this argument will not be available, the award will truly be final and binding on the parties in accordance with the agreed-upon term of the contract.

Takeaway: If the parties have agreed not to include indemnity provisions where an indemnity would commonly be included in like contracts, add a provision confirming that the parties specifically agree that nothing in the contract shall be construed as an agreement by either party to indemnify.

### Principle #3

Under contract law, if the Ying Person breaches a representation, warranty or covenant, then the Ying Person would be obligated to compensate the Yied Person for the damages suffered by it that are either (i) fair and reasonable and naturally arising from the breach of the type of contract in question (are by their nature foreseeable) or (ii) arise out of special circumstances of the Yied Person (that would not naturally arise from the type of contract) that have been brought to the attention of the Ying Person at the time the contract was entered into (which must be shown to have been foreseeable) and for which the Ying Person has agreed to provide indemnity.

Clause (ii) above is the key to determining the extent to which “lost profits” may be recovered under the terms of an indemnity. Frequently, “lost profits” are specifically excluded from the matters indemnified on the basis that they represent consequential damages that are not foreseeable. The term “consequential damages” has a broad and, as a result, an uncertain meaning. Those damages that come within the term have to meet one of the two remoteness tests in clauses (i) and (ii) in the preceding paragraph and the lost profits must be foreseeable. You should express in clear language what

the parties intend, both in the circumstances where consequential damages come within the indemnity obligation and when they are outside it.

Takeaway: In the context of an acquisition agreement, it could be that the only damages that an Yied Person may suffer are (a) lost profits and (b) diminution in the value of the purchased business, for example, as a result of the termination of a key customer contract arising from the past conduct of the seller. These would be damages caused by the seller's breach. Direct damages under Canadian law have been characterized as those that flow directly and immediately from the breach. The foregoing may be narrower in scope than in other common law jurisdictions. In the circumstances in this example, to categorize lost profits as "excluded consequential damages" would not make sense from the buyer's perspective and could leave the buyer with no recovery at all. Buyers should specify what damages are to be indemnified and include specific reference to indemnity for business interruption damage claims arising from a breach of the contract by the Ying Person. See and apply Principle #2.

Takeaway: Generally, the outright exclusion of all consequential damages in an indemnity provision is wrong and may result in the loss by the Yied Person of a remedy it ought to have had. Examples of consequential damages that might, however, be excluded are loss of reputation or mental distress.

#### Principle #4

Indemnity language allocates risk as between the Ying Person and the Yied Person and generally has the effect of lessening the common contract law rights of the Yied Person.

It is commonplace for the Yied Person to surrender its right under contract law to damages for breach without an agreed-upon dollar limit, provided an action is initiated in the courts within the applicable limitation period (in Ontario, 2 years from the date when the buyer knew or ought to have known that all the elements of a claim within the meaning of the *Limitations Act, 2002* (Ontario) exist) by agreeing to (a) a cap on damages for breach of contract, and (b) a reduction in the time during which it can make a claim against the Ying Person, say, 18 months from the date of the agreement, in exchange for greater certainty of timely payment of damages incurred by the Yied Person up to the agreed upon cap.

#### Principle #5

The parties to a contract should not, as a result of inexact drafting, adversely affect the rights of either party to the contract, for example, by referring in the excluded matters provisions of the contract to terms that are commonly used in the context of tortious conduct, such as "punitive" or "exemplary" damages. These damages are intended to punish the wrongdoer for their harmful conduct, not to compensate a party to a contract for damages arising as a result of the failure of the other party to perform the contract. Of course, a party could agree to waive tort claims, but this should only be done with clear, unambiguous language in the contract; it should not arise by implication out of a laundry list of excluded damages.

## Principle #6

Sophisticated contracting parties are free to make whatever bargain they wish, subject only to applicable *statutory provisions* and *public policy*.

Applicable *statutory provisions* include consumer protection legislation which often reverses the onus of proof, for example, to require a supplier to prove that it did not engage in an unconscionable act and Sale of Goods Act (and UN Convention on the International Sale of Goods) implied warranties and conditions. Ensure *Competition Act* (Canada) compliance in applicable business agreements and conduct.

Mandatory dispute resolution provisions, even in contracts of adhesion (“this is our standard form agreement and no changes are permitted”), are enforceable. See the Supreme Court of Canada decision in *Seidel v. Telus Communications Inc.* (Seidel). Mandatory waiver of class action rights may be enforceable.

Takeaway: A dominant party should be keenly aware of the statutory provisions that apply in the circumstances in question. For example, in response to the Seidel decision, Ontario amended its *Consumer Protection Act* (OCPA) (see OCPA extracts below) to render invalid mandatory arbitration and class action waiver provisions of contracts to which the OCPA applies.

For other commercial contracts, there are two possible *public policy* bases on which one of the contracting parties may be successful in having the agreement in question rescinded as an unconscionable contract. The plaintiff must demonstrate unequal bargaining power between the parties (lack of business knowledge or financial distress by the weaker party) that resulted in either (a) an unfair bargain or (b) a transaction sufficiently divergent from community standards of commercial morality that it should be rescinded. To successfully defend such a claim for rescission, the dominant party must show that the contract is fair and reasonable and does not offend community standards (that is, it is not “unconscionable”).

There are other public policy issues (but only a few) which may prevent the enforcement of an indemnity, for example, where the indemnity payment is construed by a court as “interest” that contravenes the criminal rate of interest provisions of the *Criminal Code* (Canada) or to the extent that enforcement of the indemnity would constitute the indirect enforcement of a foreign revenue or penal law.

Takeaway: Where the circumstances in question raise a concern regarding enforcement of a contract on the basis that it is an unconscionable contract, require that the opposing party obtain independent legal advice.

Takeaway: Provided no public policy is breached, it is possible for one of the parties to an indemnity to contract out of its own negligence. The Ying Person agrees to pay, even if, and to the extent, the damages arise out of the negligent conduct of the Yied Person. The excluding language has to be clear and unambiguous and we recommend in those circumstances that the Yied Person specifically exclude the application of the provisions of the *Negligence Act* (see extract below) which might

otherwise allocate responsibility for both contract and negligence damage claims between the parties.

Applying the foregoing six principles:

Takeaway: In purchase agreements, use “to my knowledge, information and belief” to modify those matters in respect of which there is an unknown element (e.g. whether a regulatory body has initiated an investigation of conduct of the target corporation). Do not use “to the best of my knowledge ...”. These words are redundant and could create ambiguity. Do not use the foregoing phrase or any like modifier if the Ying Person is to assume the risk of the unknown or unknowable. In the latter case, the litmus test is not whether the person making the representation or warranty in question knew, ought to have known, or even could have known, the veracity of the statement. The indemnity can provide that if the event occurs, the Ying Person pays.

Takeaway: The indemnity language may augment the rescission rights of either party by providing for the right to rescind the contract upon the happening of a specified default, notwithstanding such event of default would not have been sufficient at common law to support the right of such party to rescind the agreement.

Takeaway: The indemnity language may provide for off-set rights against cash or other collateral deposited by the Ying Person with an escrow agent, or in the context of a purchase and sale agreement, against the Yied Person’s promissory note delivered at closing in partial satisfaction of the purchase price, for a specified period of time set out in the purchase agreement. The foregoing arrangement would eliminate most of the risk to the Yied Person that the Ying Person will fail to honour its indemnity obligations following a covenant or representation breach.

Takeaway: Claims based on fraud or wilful misconduct are usually specifically excluded from the indemnity damages cap or exclusions. However, with sufficiently clear language and provided the contract is not unconscionable, the party in the wrong could exclude damages arising from its own fraudulent and wilful misconduct and exclude all such claims in the “exclusive remedies” section in the contract.

If public policy is breached, the indemnity cannot be enforced against the Ying Person.

Takeaway: The foregoing forms the basis for the following standard qualifications in enforceability opinions:

“We express no opinion as to the enforceability of any provision of the [transaction documents] to the extent it purports to exculpate, or provide indemnity to, the [corporation, its employees, shareholders, directors, officers and/or affiliates], its agents or any receiver, manager, or receiver-manager appointed by it, from liability in connection with acts or omissions that may be illegal, fraudulent, or involve wilful misconduct.”

“The enforceability of any indemnity may be limited by applicable law to the extent that it directly or indirectly relates to liabilities imposed on the [purchaser] by law which would be contrary to public policy.”

### Principle #7

Claims by and against third parties:

- (a) the principle of privity of contract is respected by the courts; and
- (b) in a corporate law context, the courts will only lift the corporate veil and impose contractual liability on a parent, subsidiary or person in control of the defendant corporation based on the following considerations: (i) legal identity of a corporation should not be disregarded lightly; (ii) each decision is fact specific; (iii) typically, the corporate veil is lifted when the corporation has been constituted for a purpose that is illegal, fraudulent or improper; and (iv) personal liability may be imposed on a person who controls a corporation and uses it as a shield for fraudulent or wrongful conduct, provided such conduct is the reason for the plaintiff’s injury or loss.

Takeaway: Apply the comments under Principle #2. Consider providing that each Yied Person who has not signed the agreement shall be excluded from the application of the provisions of the commonplace boilerplate “no third party beneficiaries” clause of the agreement.

Takeaway: In the best of circumstances (although often not practical) have each Yied Person sign the agreement, even if only by way of counterparty endorsement at the end of the agreement, for the purpose of being a party to the agreement and avoiding a defence to a claim by the Ying Person based on the absence of privity of contract.

### Principle #8

Section 6 of the Ontario *Mercantile Law Amendment Act* (OMLAA), the *Negligence Act* (Ontario) and provisions of policies of insurance may result in contribution rights among multiple same-side contracting parties or an insurer (or other third parties) having the right to subrogate, and step into the shoes of the Ying Person.

Takeaway: Where appropriate and available, seek and obtain waivers of subrogation: (a) from the insurer at the time any insurance policy is taken out; and (b) from the counterparty (and relevant third parties) as part of any settlement agreement.

Takeaway: In the context of an acquisition agreement, as part of any due diligence with the foregoing principle in mind, review any settlement agreement to which the target entity is a party to identify any open-ended potential liability as a result, for example, of a covenant by the entity in the settlement agreement to indemnify a counterpart against future claims.

### Principle #9

Limitation of liability clauses often form part of standard form commercial agreements. The courts apply the unconscionable contract analysis set out in Principle #6 in determining whether such exculpatory language should be enforced.

Takeaway: The dominant party should draw the limitation of liability language and its intended effect to the weaker party at the time they enter into the contract. Where practical, the dominant party should have the weaker party obtain independent legal advice.

### Principle #10

To the extent that the claims advanced by a plaintiff include one for damages arising as a result of the *wrongful* or *negligent* conduct of the plaintiff, the *Negligence Act* (Ontario) sets out the principles on which the liability as among the joint tortfeasors, including the plaintiff (on the basis of contributory negligence), are to be allocated.

Takeaway: See comment following the extracts from the *Limitations Act, 2002* (Ontario) below.

### **Certain Applicable Statutory Provisions**

The following is a partial list of federal and Ontario statutes which have provisions that affect one or more of the above principles. This material does not include a full analysis of consumer protection legislation or any analysis of insurance law, including the provisions of the *Insurance Act* (Ontario).

*Consumer Protection Act (Ontario) (OPCA)* – Overrides common law principles regarding the enforceability of mandatory arbitration and waiver of class act proceeding rights of contracting parties under a “consumer agreements”.

Section 7(2) of the OCPA provides that any term or acknowledgment in a consumer agreement or a related agreement that requires, or has the effect of requiring, that disputes arising out of the consumer agreement be submitted to arbitration is invalid insofar as it prevents a consumer from exercising a right to commence an action in the Superior Court of Justice given under the OCPA.

Section 8(1) of the OCPA provides that a consumer may commence a proceeding on behalf of members of a class under the *Class Proceedings Act, 1992* (Ontario) or may become a member of a class in such a proceeding in respect of a dispute arising out of a consumer agreement despite any term or acknowledgment in the consumer agreement or a related agreement that purports to prevent, or has the effect of preventing, the consumer from commencing or becoming a member of a class proceeding.

*Limitations Act, 2002 (Ontario) (OLA)* – Creates a presumption that a defendant “discovered” all the elements of all claims for contribution and indemnity against any

potential third party (based in tort, contract or otherwise) on the day on which the defendant was first served with a notice of claim in the action.

Section 18(1) of the OLA provides that for the purposes of:

- (a) subsection 5(2) of the OLA (a person with a claim shall be presumed to have known of the elements of a claim on the day the act or omission on which the claim is based took place, unless the contrary is proved); and
- (b) section 15 of the OLA (no proceeding shall be commenced in respect of any claim after the 15th anniversary of the day on which the act or omission on which the claim is based took place),

in respect of a claim by one alleged wrongdoer against another for contribution and indemnity, the day on which the first alleged wrongdoer was served with the claim in respect of which contribution and indemnity is sought shall be deemed to be the day the act or omission on which that alleged wrongdoer's claim is based took place.

Takeaway: The defendant to a court proceeding should, immediately upon being served with the claim, develop a plan regarding each potential person that the defendant may wish to add as a party defendant to the action and either (a) issue and serve the requisite third party notice or (b) settle and sign an appropriate standstill agreement under section 22(3) of the OLA with each such prospective third party within the 2-year period from the date on which the defendant was served with the claim. If the defendant fails to complete one of the foregoing alternate steps with each prospective third party, any claim by the defendant against such person will be statute-barred, even if the issue of the defendant's own liability had not been established as at such second anniversary date of service. For Ontario "business agreements", if the running of the basic limitation period is suspended under the terms of a standstill agreement by the defendant and a prospective third party to the greatest extent permitted by law, the effective limitation period would be extended from 2 to 15 years.

Mercantile Law Amendment Act (Ontario) (OMLAA) – Imposes contribution obligations and codifies rights of subrogation in the circumstances described below.

Section 2 of the OMLAA, in effect, confers subrogation rights on certain classes of persons by providing that:

- (a) every person who, being (i) a surety for the debt or duty of another or (ii) liable with another for any debt or duty, pays the debt or performs the duty is entitled to have assigned to him/her/it every judgment or security that is held by the creditor in respect of the debt or duty, whether the judgment or security is (or is not) deemed at law to have been satisfied by the payment of the debt or the performance of the duty; and
- (b) such person is entitled to stand in the place of the creditor, and to use all the remedies to obtain from the principal debtor, or any co-surety, co-

contractor or co-debtor, just proportionate indemnification for the advances made and loss sustained by such person. Payment or performance made by the person is not a defence to such action or other proceeding by the person.

Takeaway: The right of subrogation will be subject to the equities that exist between the debtor and the creditor at the time the subrogating party pays the debt, and the rights of the subrogating party may be adversely affected by bankruptcy law.

Section 6 of the OMLAA, in effect, imposes contribution obligations between certain classes of persons by providing that:

- (a) any covenant, whether express or implied, or agreement entered into by a person with that person and one or more other persons shall be construed and be capable of being enforced in like manner as if the covenant or agreement had been entered into with the other person or persons alone; and
- (b) the foregoing applies to covenants or agreements heretofore or hereafter entered into and to covenants implied by statute in the case of a person who conveys or is expressed to convey to that person and one or more other persons.

Negligence Act (Ontario) – Sets out the contribution obligations among joint tortfeasors, contract parties and persons otherwise subject to an obligation of contribution or indemnity.

Section 1: Where damages have been caused or contributed to by the *fault* or *neglect* (emphasis added) of two or more persons, the court shall determine the degree in which each of such persons is at fault or negligent, and, where two or more persons are found at fault or negligent, they are jointly and severally liable to the person suffering loss or damage for such fault or negligence, but as between themselves, in the absence of any contract express or implied, each is liable to make contribution and indemnify each other in the degree in which they are respectively found to be at fault or negligent.

Section 2: A tortfeasor may recover contribution or indemnity from any other tortfeasor who is, or would if sued have been, liable in respect of the damage to any person suffering damage as a result of a tort by settling with the person suffering such damage, and thereafter commencing or continuing action against such other tortfeasor, in which event the tortfeasor settling the damage shall satisfy the court that the amount of the settlement was reasonable, and in the event that the court finds the amount of the settlement was excessive it may fix the amount at which the claim should have been settled.

Section 3: In any action for damages that is founded upon the fault or negligence of the defendant if fault or negligence is found on the part of the plaintiff that contributed to the damages, the court shall apportion the damages in proportion to the degree of fault or negligence found against the parties respectively.

Section 4: If it is not practicable to determine the respective degree of fault or negligence as between any parties to an action, such parties shall be deemed to be equally at fault or negligent.

Takeaway: See comments regarding the CBCA below.

Statute of Frauds (Ontario) – Provides that certain contracts must be in writing; indemnities are not one of them.

Section 4: No action shall be brought to charge any executor or administrator upon any special promise to answer damages out of the executor's or administrator's own estate, or to charge any person upon any special promise to answer for the debt, default or miscarriage of any other person, or to charge any person upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them, unless the agreement upon which the action is brought, or some memorandum or note thereof is in writing and signed by the party to be charged therewith or some person thereunto lawfully authorized by the party.

Takeaway: Case law establishes that guarantees must be in writing. Indemnities may be either written or oral on the basis that where a party has been induced to enter into a contract on a person's agreement to indemnify such party for doing so, there should be no requirement that the indemnity be in writing. Guarantees must be in writing. Indemnities may be either written or oral.

Bills of Exchange Act (Canada) – Regarding bills of exchange:

Section 132: In the absence of evidence of an authorized contrary intention, a person endorsing a bill of exchange will be liable to indemnify the holder or a subsequent endorser compelled to pay the bill where proceeds on dishonour are duly taken.

Canada Business Corporations Act (CBCA) – Sets out modified contribution obligations among CBCA directors and officers for breach of CBCA financial disclosure requirements.

CBCA sections 237.1 to 237.9 create a regime of modified joint and several liability for directors, officers and other persons found liable for an error, omission or misstatement contained in financial information mandated by the CBCA. Each defendant is liable based on the portion of damages corresponding to the defendant's degree of responsibility for any proved loss. Full joint and several responsibility continues for losses based on fraud. A court may apportion up to 50% of an absent or insolvent defendant's liability on a proportionate basis among the available and solvent defendants. This regime does not apply to claims by the Crown, charities, small investors (under \$20,000) and unsecured goods and services trade creditors of the subject corporation, all of which remain joint and several obligations of the directors, officers and other persons who are found liable.

There are no similar provisions in the *Business Corporations Act (Ontario)* (OBCA). Under the OBCA, directors and officers may be jointly and severally liable for an error,

omission or misstatement contained in financial information required by the OBCA, meaning that a person with a claim may make the claim against one or more defendants and recover the full amount of the proved claim against any one or more of such defendant(s). The paying defendant(s) is/are then left to seek contribution from others under an applicable contract or pursuant to the rights and obligations set out in the *Negligence Act* (Ontario).

Both the CBCA and the OBCA provide for a due diligence defence for directors and officers for statutory claims against them.

### **Drafting of the Indemnity Provisions of Common Forms of Contract**

#### “Indemnify and Save Harmless”

Ambiguity (what does “save harmless” mean?) and redundancy (if it means “indemnify”, what’s the point?). Save harmless or hold harmless have uncertain meanings and they are open to abuse by a litigious party. Delete “and save harmless” and “delete “and hold harmless”.

#### “Duty to Defend” Indemnities

The language of an indemnity could be broadly cast, as discussed under the heading “Director and Officer Indemnities” below. In this circumstance, the Ying Person has agreed to protect the Yied Person from liability. As a result the Ying Person will have an obligation to take carriage of the defence, the right to select defence counsel, and the authority to settle claims and the obligation to pay settled claims. The Yied Person must be satisfied that the Ying Person has the financial ability to see the matter to completion, and to pay the settlement.

Takeaway: The duty to defend indemnity is open-ended; it is much broader than the duty to pay. There is no limit on the potential cost to the Ying Person. The result of the covenant is masked by the words “from liability”. An indemnity described in this way is a serious trap for the unwary.

Takeaway: The indemnity provision should include a right in favour of the Yied Person to information on a timely basis, a right to approve all settlements (reputation risk) and a right to assume carriage of a defence (including the selection of new defence counsel) in appropriate circumstances. Escrow of funds by the Ying Person to evidence its ability to pay a proved claim and costs should be considered.

#### “Duty to Pay” Indemnities

In this circumstance, the Ying Person has only agreed to protect the Yied Person from damages. The only obligation of the Ying Person is to pay the fine or settlement amount and costs at the end of the claim process. Obviously, the Yied Person will face the costs incurred to defend the governmental action or other third party claim. The Ying Person is at risk that the Yied Person will not pursue a defence to the claim in good faith, for example, where the Yied Person has other business interests that override

consideration of its obligation to the Ying Person, as payor, to seek and obtain the lowest settlement at the least cost.

Takeaway: Duty to pay indemnities are narrower in scope than duty to defend indemnities and, on balance, benefit the Ying Person.

### “Incidental Damages”

Incidental damages are costs incurred by the Yied Person to lessen or avoid direct damages. They are not costs personal to the Yied Person or outside the indemnity.

Takeaway: The parties to a contract should not exclude “incidental damages” from those damages for which the indemnity applies but should use the term and clarify its application through a list of examples.

### “Material” Qualifiers

In the context of acquisition agreements, the parties must determine whether to disregard the qualifier “materially” or “material alone and in the aggregate” or “in all material respects” or to a “material adverse effect” where it appears in the body of the agreement (regarding representations and warranties) (a) for all indemnification purposes or (b) for indemnity threshold or cap calculation purposes. The issue is whether recognizing the qualifier represents a “double dip” in that damages within the material qualifier are ignored for breach purposes and ignored a second time in calculating any indemnity threshold and with respect to payment obligations up to the cap.

Takeaway: My current view: Regarding both (a) and (b), there is no breach of an individual representation if the materiality test for that representation is not exceeded. As a result, a loss arising from such a representation breach is not a loss for purposes of the agreement, including indemnification, until (and only to the extent that) it exceeds the materiality qualifier. The parties should consider and settle their agreed-upon approach to the issue.

Takeaway: Where materiality modifiers are used extensively in the agreement, the foregoing would support a bid by the buyer that there should be no de minimus threshold for indemnification purposes.

Takeaway: If there is to be a de minimus threshold, and if losses within the individual materiality qualifications are to be excluded for indemnification purposes, then there is support for the position that there should be fewer rather than more representation materiality qualifiers in the agreement.

### “Liquidated Damages”

In appropriate circumstances, for the purpose of avoiding the costs and risk inherent in having claims adjudicated, contracting parties may identify the damages that are reasonably foreseeable should a breach occur and estimate the quantum or fix a formula to determine the quantum of such anticipated damages. If a court determines

that such pre-estimate of such damages is genuine, it will enforce the contract. If a court determines that the pre-estimate is not genuine, but a penalty inserted in the contract to compel performance by one of the parties, then the liquidated damages clause will not be enforced.

Takeaway: The parties to a contract should consider, and where appropriate, include a genuine pre-estimate of damages that would arise on a breach of their contract. The provision should explain the basis of the pre-estimate and provide that the estimate represents a fair and reasonable estimate of actual damages and is not intended as a penalty. The amount stipulated should accord with what an innocent party would be entitled to recover under current contract law. The clause should provide that payment of the liquidated damages would constitute full and final settlement of the payor's liability for all losses incurred by the payee.

#### "Exclusive Remedies" Provision

The need for boilerplate provisions in contracts is obvious, however, such provisions should be reviewed with care.

Takeaway: Each contract where specific remedies are provided for or excluded should determine whether the special terms are intended to settle all of the remedies as between the parties. If that is the intent, then ensure that the boilerplate includes an "exclusive" remedies provision such as: "The parties intend that the remedies set out in section ● are the exclusive remedies of the parties with respect to the subject matter of this agreement. No party shall be able to avoid the limitations set out in this section or in section ● by electing to pursue any remedy not specifically provided for in this agreement."

Takeaway: If the special remedies are not intended to be the only remedies available to the parties, then amend the boilerplate to the effect that "... subject only to giving effect to [specific remedy provision], it is not the intent of the parties to exclude any remedies available to such parties at law. Remedies under the contract are cumulative, and the exercise of any other remedy under the contract or otherwise available at law does not prevent any party from exercising any other remedy available to it under the contract or otherwise available at law."

Takeaway: Avoid redundancy – use "exclusive" and neither "sole and exclusive" nor "sole" by itself.

#### "Entire Agreement" Provision

This is another boilerplate provision which should be included where there is a concern that a party will seek a remedy outside the four corners of the contract to circumvent the original intent of the parties.

Takeaway: Where the parties intend that only the terms of the contract govern, include language such as the following in the contract with such additional language as may be appropriate to support a reasoned conclusion that the term is not mere

boilerplate; that it captures the true intent of the parties after due consideration of the circumstances relevant to the contract. Consider:

“This agreement [together with the Transaction Documents] constitutes the entire agreement between the parties relating to the subject matter of this agreement; it supersedes any previous agreements and discussions between the parties, whether written or oral, including any representations or warranties relating to the subject matter of this agreement made by either party or their respective agents. None of us is relying on any representations, covenants or other terms other than those set forth in this agreement [and the Transaction Documents] and each of us is relying on our own judgment in entering into this agreement. This agreement may only be amended by a written document executed by each of the parties.”

### “Non-Merger” Provision

This provision negates any possible application of the doctrine of merger under which representations and warranties with respect to property "merge in the deed", or are extinguished when the transaction closes and the subject property is conveyed.

Takeaway: Consider including the following provision:

“All provisions contained in any transaction document, certificate or instrument executed and delivered pursuant to any transaction document (other than the conditions of closing set out in article ●) shall not merge on closing but shall survive the execution, delivery and performance of this agreement, closing and the execution and delivery of any transfer documents or other documents of title to the [Purchased Assets] [Purchased Shares] and all other agreements, certificates and instruments executed and delivered hereunder and the payment of the consideration for the [Purchased Assets] [Purchased Shares].”

### Period of Enforcement

Generally, an indemnity may be enforced by the Yied Person at any time (subject to the following comments) during the period fixed by the agreement. If no period is fixed, the ability to enforce the indemnity is subject for Ontario governed contracts, to the 2-year basic limitation period set out in the *Limitations Act, 2002* (Ontario). As noted earlier, parties to a “business agreement” which is governed by the laws of Ontario can vary (either extend or reduce), exclude or suspend the running of the basic period by agreement, effectively, for up to 15 years (the ultimate limitation period) from the date on which the agreement was made. The running of the ultimate limitation period may be suspended or extended, but only after the relevant claim has been discovered.

In acquisition agreements, it is common to impose different limitation periods based on the nature of the provision of the agreement that is breached. Representations as to title to shares or assets, failure by the seller to comply with the *Bulk Sales Act* (Ontario), corporate existence, corporate authority to enter into and perform obligations imposed by the agreement, validity of transaction documents and environmental liability are enforceable without limitation as to time (other than those imposed by law – see above).

Tax representations are enforceable for a period, usually 30 days after the relevant regulatory authorities shall no longer be entitled to assess liability for taxes against any of the target entity, the seller or the buyer for the particular period. Indemnification arising under third party claims is often extended for a period longer than direct claims between the parties themselves.

### Seller's Sandbagging Concerns in Acquisition Agreements

In acquisition agreements, the buyer may require a provision to the effect that no information or knowledge of the buyer, nor the results of any due diligence or investigation by the buyer shall affect, waive, modify, limited or diminish the right to indemnification or other remedy by any party to this agreement based on the representations, warranties, covenants and obligations contained in this agreement or any transaction document notwithstanding (i) the Closing or (ii) any investigation or knowledge of the buyer acquired prior to the Closing.

Concern for the seller that shortly following closing, the buyer will make a claim for a breach regarding a breach of a representation that the buyer knew prior to closing.

Takeaway: In a sign and close transaction, have the buyer acknowledge that it does not have any such knowledge of an existing breach.

Takeaway: In other transactions, although the buyer has a right to seek indemnification regarding a breach known to it at or prior to closing, include a covenant of the buyer to disclose such knowledge as soon as it knows of a breach to permit the seller to take steps to cure the breach prior to closing or to lessen the resulting damages.

### Reducing Indemnity Payment to Reflect Tax Effect on the Yied Party

Consider whether the amount to be paid should be the "after tax" amount to avoid a windfall to the Yied Person arising out of the reduction in tax obligations resulting from the indemnified losses.

Takeaway: Include the following provision in the indemnity:

"If the amount of [Indemnifiable Damages] incurred by an [Indemnified Party] at any time subsequent to the making of an indemnity payment is reduced by:

- (a) the amount of any insurance or other reimbursement actually received by the [Indemnified Party] in relation to the breach or other event giving rise to the claim;
- (b) the amount recovered under any counterclaim against [Third Parties] in relation to the breach or other event giving rise to the claim; and
- (c) any readily identified tax benefit actually received by the [Indemnified Party] with respect to such [Indemnifiable Damages],

and the amount of such reduction (less any costs, expenses (including taxes) or premiums incurred in connection therewith, together with interest thereon from the date of payment thereof at the prime rate, shall promptly be repaid by the [Indemnified Party] to the [Indemnifying Party]. Upon making a full indemnity payment, the [Indemnified Party] shall, to the extent of such indemnity payment, be subrogated to all rights of the [Indemnified Party] against any third party in respect of the [Indemnifiable Damages] to which the indemnity payment relates. Until the [Indemnified Party] recovers full payment of its [Indemnifiable Damages], any and all claims of the [Indemnifying Party] against any such third party on account of such indemnity payment shall be postponed in right of payment to the [Indemnified Party]'s rights against such third party.”

Takeaway: The indemnity provision should include an obligation of the Yied Person to maintain records, and, in the case of a potential tax matter claim, an agreement (a) to file for the tax period of the corporation arising on closing (triggered by the resulting change in control), (b) not to re-file tax returns of the corporation in respect of a completed taxation period and (c) not to agree with Canada Revenue Agency to extend an assessment period beyond that fixed in the *Income Tax Act* (Canada).

Takeaway: Review the case of Nova Petrochemicals Ltd. v. Bayer Aktiengesellschaft, 204 A.C.W.S. (3d) 790 in which a seller sought to recover tax refunds to the credit of the target corporation in respect of a taxation year that ended prior to closing of the purchase agreement based on the language of the agreement, as money paid back to the target on account of taxes. The court found that in the circumstances, for the corporation to have an obligation to pay such tax refund received by it to the seller, the corporation would have had to have paid the tax in question prior to closing.

### Confidentiality Agreements

Confidentiality agreements usually include an agreement by the party receiving the subject confidential information to compensate for damages suffered by the party providing such information as a result of an unauthorized disclosure of the confidential information to third parties by the recipient or by any representative of the recipient.

Takeaway: Ken Adams believes that there are people who take the position that the rules which apply to confidential agreement indemnities for the acts of representatives of the recipient party are different from those that apply generally to indemnities, and he proposes that a sentence such as the following be included in confidentiality agreements to refute this concern:

“The [Recipient] shall indemnify the [Disclosing Party] against any reasonably foreseeable losses and reasonably foreseeable liabilities arising out of disclosure or use of any [Confidential Information] by any representative of the [Recipient], other than as authorized in this agreement, subject to the same defences that the [Recipient] would be entitled to assert in an action for breach of contract.”

### Settlement Agreements and Releases

A release will often form part of, or be ancillary to, a settlement agreement. A release extinguishes rights. An indemnity may limit or exclude rights, but it also creates substitute rights and obligations.

Takeaway: Consider adding the following language to the release: "... and the Releasor covenants and agrees not to make any claim or to commence or maintain any action or proceedings against any person or corporation in which any claim could arise against the Releasee for contribution or indemnity in respect of the aforesaid matters, save only as may arise in respect of this settlement agreement between the Releasor and the Releasee."

### Asset and Share Purchase and Sale Agreements

Often in the indemnity provisions of purchase agreements the parties differentiate between "direct claims" (being claims by the buyer against the seller for a breach of the seller's representations, warranties and covenants under the agreement) and "third party claims" (claims by a third party against the corporation or the buyer based on circumstances in respect of which the seller gave a representation), and the agreement applies the indemnity language and dispute resolution mechanics to both types of claim. Strictly speaking, a "direct claim" is not a claim for indemnity; it is a claim for a breach of the contract.

Takeaway: When the above arrangement is coupled with an "exclusive" remedies provision in the boilerplate of an agreement, the buyer will have relinquished the common law contract remedy of rescission otherwise available to it as a result of the seller's breach. In most cases, rescission is not a practical remedy from the buyer's perspective. However, if it is, the buyer could (a) limit the indemnity provision in the purchase agreement to third party claims based on breaches of representations and warranties; (b) specifically retain its right to all contractual remedies available at law without a cap on damages for any "direct breach" by the seller of a covenant or any representation or warranty; and (c) ensure that the "exclusive" remedies provision in the boilerplate language does not take away any of those rights and remedies.

The boilerplate "entire agreement" provision of a purchase agreement may also have the effect of removing rights that might otherwise accrue to the buyer. If the seller or any of its representatives, in answering due diligence enquiries or otherwise, provides comfort or information to the buyer (by email, in writing or in other written or oral form) which through inadvertence or otherwise fails to be reflected in the purchase agreement, the buyer would lose the right to indemnification for losses arising from a breach of any such representation.

Takeaway: If this is a concern, either (a) settle on appropriate language in the representations and warranties or (b) attempt to incorporate by reference in the agreement representations included in reports or material provided by the seller

during the due diligence process. Finally, you might attempt to open the door to such claims by adding one or more of the following representation(s):

“The vendors are not aware of any matter which has not been disclosed by the vendor to the buyer which, if known by the buyer, would reasonably be expected to affect the buyer’s decision to agree to purchase the purchased [shares] [assets] or to pay the Purchase Price or complete the purchase and sale transaction substantially on the terms and conditions of this agreement.”

or

“Neither this agreement nor any form of agreement, certificate, acknowledgment or other document provided to the buyer pursuant to this agreement contains any untrue statement of a material fact in respect of the Corporation or the vendors, the affairs, prospects, operations or condition of the Corporation or the vendors, their assets or business, or omits any statement of a material fact necessary in order to make such statements not misleading.”

or

“There is no fact known to the vendors which materially and adversely affects the affairs, prospects, operations or condition of the Corporation, its assets or business which has not been set forth in this agreement or in a documents provided pursuant to this agreement or otherwise disclosed to the buyer.”

### Contribution Agreements

Where one set of parties to an agreement is made up of a number of persons (e.g. sellers of shares of a corporation), the purchase and sale agreement would usually provide for indemnification by each seller on a joint and several basis with each of the other sellers with respect to the accuracy of the representations and warranties and compliance with covenants in the agreement. It is common for the agreement to provide for a holdback of part of the purchase price as security for performance by the sellers of their agreement to indemnify the buyer for any breach of covenant or representation or warranty within the indemnity period fixed in the purchase agreement. The consideration held back is usually governed by the terms of an escrow agreement under which an independent escrow agent holds the collateral and releases it in accordance with the terms of the escrow agreement. Frequently, the sellers will enter into a separate contribution agreement among themselves pursuant to which they will provide for a pro rata (or other appropriate) sharing of the indemnity claims paid by one or more of the sellers pursuant to the purchase agreement.

Takeaway: The escrow agreement should obligate the escrow agent to establish and maintain segregated accounts in the name of each seller, and the set-off and other rights of the buyer under the purchase agreement should be referenced in, and integrated into, the payment obligations of the sellers as among themselves under the contribution agreement. A designated seller could be identified in the contribution

agreement as having authority to irrevocably direct the escrow agent to transfer balances among the escrow agreement segregated accounts to reflect, to the extent possible, contribution settlement payments.

### Guarantees

(a) Under Ontario law a guarantee is a secondary obligation, not a primary one. Indemnities, in contrast, are primary obligations. As a result, for guarantees:

- If the principal obligor guaranteed obligation is void, illegal, ultra vires or otherwise unenforceable, the guarantor is relieved of its obligations under the guarantee.
- If the nature of the guaranteed obligation materially changes by agreement between the principal obligor and the guarantee beneficiary without the consent of the guarantor, the guarantee would generally be unenforceable.
- The discharge of a bankrupt principal obligor automatically discharges such principal obligor's guarantors.

Takeaway: In an attempt to raise the status of a guarantee agreement to that of a primary obligation and to avoid the extinguishment of rights of the beneficiary of the guarantee arising in the circumstances such as those described above, consider:

- i. Adding indemnify language to the guarantee under which the guarantor agrees to "indemnify the beneficiary for all losses, costs, demands, actions, or causes of action arising out of the guaranteed obligations notwithstanding that the guarantee itself is or becomes void, voidable, invalid or otherwise unenforceable at law or is released or discharged by operation of law. This agreement to indemnify is absolute and unconditional and shall not be discharged or in any way affected by any of the foregoing circumstances." An indemnity is a primary independent obligation, in essence, an agreement by the Ying Person to "make whole" the Yied Part in the circumstances.
- ii. Adding language to the effect that the guarantee is "a guarantee of payment and not of collection" to support the position that the arrangement is intended by the parties to be a primary obligation – an agreement to pay on demand – and not a secondary obligation, that is, an agreement to pay after remedies against the principal obligor are exhausted. Likewise, add a covenant to the effect that the guarantor is to pay "as principal obligor and not as a surety". Each of the foregoing may provide the beneficiary with some comfort, but they do not necessarily address all the issues relating to guarantees that arise from the secondary nature of the obligation.

- iii. Adding a covenant by the guarantor to pay as “as principal debtor and not as a surety” – again, an attempt to make the obligations of the guarantor primary. It appears that in the entire context of the guarantee language, this phrase will not be sufficient to avoid a guarantee’s secondary obligation limitation.

(b) The expiry of a limitation period (more common in Ontario now that the basic limitation period is 2 years) for claims against the principal obligor does not relieve the guarantor of its obligations under the guarantee. The foregoing result arises from the fact that on the expiration of a limitation period, the obligation is not extinguished, the principal obligor remains liable, but the creditor or covenant beneficiary is without a remedy – it is statute-barred as against the principal obligor from initiating legal proceedings to collect the debt or enforce the obligation. The limitation period applicable to the guarantee runs from the date notice is given under the guarantee whether or not the guarantee itself is framed as a demand obligation (entered into on or after October 18, 2006) or one arising following notice.

Takeaway: Include in the primary contract a provision to the effect that the principal obligor agrees that “the running of the basic limitation period under the *Limitations Act, 2002* (Ontario) is suspended to the greatest extent permitted by law”. This language gives the Yied Person 15 years from the date on which circumstances exist that give rise to a claim to enforce its rights.

Takeaway: Include the above language in the guarantee to extend the rights of the Yied Person beyond the basic 2-year period from the date of demand or other date on which the guarantee limitation period begins to run.

Takeaway: From the guarantor’s perspective, attempt to have the Yied Person agree that should its ability to initiate legal proceedings against the principal obligor be statute-barred, the guarantee shall automatically terminate.

### “As is” Conveyances

It is possible for a buyer to agree to purchase an asset from a seller on an “as is – where is” basis, subject only to meeting the unconscionable contract tests described in Principle #6. It may even be possible for a party to exclude its own negligence or certain acts of wilful misconduct without breaching public policy and categorizing the agreement as unconscionable.

### Director and Officer Indemnities

OBCA and CBCA corporations may, if authorized by their by-laws, indemnify their own directors and officers and persons acting in a like capacity for other entities at the request of the corporation. The Acts permit such corporations to advance litigation costs to directors and officers, and former directors and officers, in any proceeding to which they are parties. These rights of indemnity and advancement do not vest until an action is commenced against the person in question. If the corporation’s by-laws are amended

to eliminate or modify the power to indemnify or to make litigation cost advances, the affected persons may be without a claim for indemnification against the corporation.

The same analysis applies to corporations governed by the *Canada Not-for-profit Corporations Act* (which came into force on October 17, 2011). Similar provisions are in the pending *Not-for-profit Corporations Act, 2010* (Ontario). When it comes into force (projected for January 2012), corporations governed by the Ontario Act will have like powers to indemnify current and past directors and officers and to make litigation cost advances.

Takeaway: If it is intended that the rights of directors and officers and such other persons be vested and enforceable against the corporation, each of them should enter into a written agreement with the corporation under which the corporation agrees:

- (a) to indemnify the director/officer in question to the full extent permitted by law (or otherwise); and
- (b) to advance to the officer/director monies on account of litigation costs on an “as incurred” basis, subject to the qualification that if it is shown that the director or officer so indemnified did not act honestly and in good faith with a view to the best interests of the corporation in respect of the matter in question or, in appropriate circumstances, did not have reasonable grounds for believing his/her conduct was lawful, failing which there would be an obligation on the director or officer to repay any such advances with interest. Such a written agreement, unlike a corporate by-law, cannot be amended without the consent of all contracting parties.

Takeaway: Where the solvency of the corporation is in question, the indemnity agreement should be credit-enhanced with a creditworthy parent guarantee (or in extreme cases, security against cash collateral that is under the control of a third party – usually the law firm representing the affected directors, officers and other indemnified persons).

Takeaway: The corporation’s D&O insurance policy should be carefully reviewed in the context of the permitted indemnities and coverage qualifications. Each director and officer who is so indemnified should be a named insured under the policy.

## BRUCE MCNEELY

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**Education:** LL.B., University of Ottawa, 1972; B.A., Queen's University, 1967

**Call to the Bar:** Ontario, 1974

**Associations:** American Bar Association; Canadian Bar Association; The Canadian Counsel for Public-Private Partnerships; International Bar Association; Ontario Bar Association

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### Expertise

Bruce McNeely's initial professional training was as an economist and mathematician at Queen's University. This led to a short career as an economist with the federal public service followed by law school at the University of Ottawa and over 37 years of practice as a corporate-commercial lawyer in downtown Toronto. Bruce enjoys the practice of law.

Bruce has had extensive experience throughout his career in negotiating and closing merger and acquisition transactions. Transactions include:

- Developing a unique contractual approach to settle a complex parallel interest investment in a commercial arrangement between two sophisticated business parties
- Acting as principal client lawyer in successfully effecting a public auction in the face of a highly restrictive controlling shareholders agreement, which resulted in a significant Ontario Court of Appeal judgement

Bruce has acted for all levels of government. Transactions include:

- Acting for the Ontario Ministry of Finance in drafting the trust agreement and other arrangements under which Ontario's principal nuclear power generator will meet its nuclear fuel management and decommissioning obligations set out in licences issued under the *Nuclear Fuel Waste Act* (Canada)
- Acting for the Ontario Attorney General in completing the organization of the Ontario Power Authority and constitution of its board
- Successfully acting for a limited partner in defending an attempt by a U.K. Utility to include the Ontario assets of an Ontario limited partnership in the Utility's restructuring

As a lending lawyer, Bruce has acted for a broad range of senior lenders and borrowers with particular emphasis on credit and priority agreements, personal property security issues, securities transfer issues, limitations issues and opinions. Transactions include:

- Acting for a major Canadian Banks in respect of bridge loans made to private equity entities for acquisitions in a variety of industries with conventional credit facilities to the operating businesses on closing

- Advice to independent board members in various circumstances

Bruce is actively involved in knowledge management at Cassels. He is leading the development of not-for-profit materials for the firm arising out of the modernization of not-for-profit corporate law by the recent coming into force of the *Canada Not-for-profit Corporations Act* and the anticipated coming into force of the *Not-for-profit Corporations Act, 2010* by Ontario.

Bruce has always been an active legal writer. Recent publications include the firm's *Carrying on Business in Canada* publication, and commentaries on the implications to business arising from the *Limitations Act, 2002* (Ontario), *Securities Transfer Act, 2006* (Ontario) and changes to the obligations of consumer product supply chain participants under the *Canada Consumer Product Safety Act* and the not-for-profit legislation referenced above.

## PETER HENEIN

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**Education:** LL.B., University of Western Ontario, 2003; B.A. (with Distinction), University of Toronto, 1994

**Call to the Bar:** Ontario, 2004

**Associations:** Advocates' Society (nominated Vice-Chair to the Young Advocates' Standing Committee; sits on the Collegiality, Mentoring and Membership Committee); Alliance of Canadian Cinema, Television and Radio Artists (ACTRA); Canadian Actors' Equity Association; Canadian Bar Association; Canadian Defence Lawyers; DRI (Defence Research Institute); Ontario Bar Association



### Expertise

Peter practises complex commercial litigation in the areas of class actions, intellectual property, and product liability and securities litigation. He has worked with international auto, drug manufacturers, and national and international franchisors, among others.

Some of Peter's most recent work includes:

- Working on numerous class actions involving a wide range of issues for a variety of clients, including specifically auto manufacturers
- Handling a multi-million dollar arbitration of a franchise dispute for an international client
- Handling product liability files for automobile manufacturers and distributors
- Working with copyright collectives on tariff enforcement and copyright infringement issues
- Assisting corporate clients with risk management issues and shareholder disputes
- Defending an oppression remedy application for a multinational corporation
- Enforcing letters rogatory (i.e. letters of request) from foreign jurisdiction

Peter is a tutorial leader and guest lecturer for the Osgoode Hall law school civil procedure class. He is a contributing writer to the Watson & McGowan "*Annual Survey of Recent Developments in Civil Procedure.*" Peter is an active member of the Advocates' Society, is nominated secretary to the Young Advocates' Standing Committee, and sits on the Collegiality, Mentoring and Membership Committee. In 2009, Peter sat on the *Principals of Professionalism Committee* of the Advocates' Society Symposium on Professionalism.

Peter attended the University of Western Ontario Law School, where he received the Blake, Cassels & Graydon LLP Company Law Award. At Western, he represented his law school in the Jessup International Law Moot, winning second prize in Canada for factum writing.