# INDEMNITY (COMPENSATION FOR LOSSES) AND LIQUIDATED DAMAGES: THE DIFFERENCE OF INSTITUTIONS IN ENGLISH CONTRACT LAW

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**Abstract**
The article analyzes a new institution of contract law for the Russian law — indemnity, which is a more flexible legal mechanism for restoring the property status of a creditor, in some cases has become an alternative to such a measure of civil liability as damages. The provisions of English law make it possible to secure indemnity as an exclusive sanction to replace damages. The article concludes that there are significant differences in the nature of the institutes under consideration, the presence or absence of the obligation to reduce damage, the statute of limitations on claims for the appropriate type of compensation. In addition, the institute of indemnity, unlike liquidated damages, does not represent a measure of civil liability (this is a debt obligation, the period for filing claims for which is established directly in the contract); in the absence of limitations of the subject composition provides for a substitution of parties in the obligation; it is not of a nature of assignment, it is a "self" insurance that affects the formation of the contract price; it is not a way to determine the size of losses; unlike liquidated damages as a reasonable estimate of foreseeable losses, indemnity may act as a legal mechanism for limiting liability.

**Keywords**: indemnity, contractual damages, liquidated damages, damage, civil liability.

The obvious similarity of the institute of indemnity with insurance provides serious grounds for identifying contractual indemnity with subrogation, thus giving rise to corresponding disputes in practice[1]. One of the most accredited publications, the *Black's Law Dictionary*, defines subrogation as "the substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or

[1] *Phoenix Ins. Co. v. United States Fire Ins. Co*. [1987] 189 Cal. App. 3d 1511.

securities that would otherwise belong to the debtor"[2]. The indemnity contract, in turn, is succinctly defined as "a contract that repays the insurer losses back to them"[3]. Thus, we can conclude that compensation for losses is a special case of subrogation. In this regard, A.G. Karapetov rightly classifies indemnity as the so-called "**self insurance**", i.e. the cases "when the risk of occurrence of losses associated with a concluded contract is insured by one of the parties by the other party", while the "premium for taking the risk is included in the contract price"[4]. In other words, the author identifies the key difference between indemnity and insurance — the obligation to compensate for the losses lies not with a third party, but with one of the parties to the contract. In this case, the choice in favor of indemnity is rightly connected by the author with two factors: difficulties in finding an insurer who is ready to insure the risk of the occurrence of such circumstances for less than a self insurance premium, and also because it is often easier for the debtor as a specialist in the relevant field to assess the risks of the occurrence of such losses than it would be for an external insurer[5].

Lack of a unified approach to the interrelation between indemnity and insurance is, we believe, based on the fact that the rights transferred to the debtor through indemnity to claim against the party liable for damage are treated by the Anglo-Saxon doctrine as subrogation[6]. In addition, this position is reflected in the two well-known precedents of *Darrell v. Tibbitts* and *Castellain v. Preston*, where the contract of insurance in relation to resolving the issue of the amount of compensation was qualified by the Royal Bench Branch of the High Court of England and Wales as a contractual indemnity[7]. It should be specified, however, that by the time these cases are considered (1880 and 1883, respectively), the institute of indemnity, we believe, has not yet fully budded off the parent branch of insurance law, which explains the use of some of its rules and terminology.

In turn, liquidated damages which are also a legal mechanism for accounting for the risks of the parties to the agreement cannot be categorized as self insurance for

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[2] Black's Law Dictionary. 6th ed. / J.R. Nolan, ed. St. Paul: West Publishing Co., 1990. P. 1427.

[3] Ibid. P. 769. *See also*: *Dawson v. Fidelity & Deposit Co.* of Md [1961] 189 F. Supp. 854.

[4] *See*: Karapetov A.G. Zavereniia ob obstoiatel'stvakh i usloviia o vozmeshchenii poter' v novoj redaktsii GK RF [Assurances and Conditions for Compensation of Losses in the New Version of the RF Civil Code] // Zakon, 2015, No. 6.

[5] Ibid.

[6] Courtney W. The Nature of Contractual Indemnities // Journal of Contract Law, 2011. Vol. 27, No. 1; Sydney Law School Research Paper, 2011. No. 11/41. P. 15.

[7] *Darrell v. Tibbitts* [1880] L.R. 5; *Castellain v. Preston* [1883] L.R. 11 QBD

the following reasons. **Firstly**, the risk is not redistributed, since the general rule applies when compensating for liquidated damages — the agreed sum of compensation is payable by the person who violated the terms of the contract and there is no replacement of the lender. **Secondly**, the "insured event" in case of compensation for liquidated damages is a violation of the terms of the contract, and not the occurrence of a certain event. Consequently, the risk of breach of contract is insured, and not the onset of some event. **Thirdly**, agreeing on liquidated damages does not imply an increase in the contract price, since an alternative method is developed for determining the size of damages that are mandatory for compensation, and there is also no "insurance premium" of the party to the agreement.

It should be noted that the concept of contractual indemnity, as well as of liquidated damages, has been shaped by judicial practice and clarified by doctrine over several centuries. Its content was specified, the scope of its application was narrowed, the interrelation of the said measure with compensation for losses was adjusted, and the degree of autonomy of the parties when agreeing on such conditions grew. In this regard, foreign literature indicates that the relevant judicial practice in interpreting contractual terms on indemnity is not established, but is in constant development[8].

The lack of a unified approach to understanding contractual indemnity is visible to this day. Thus, Penny L. Parker and John Slavich define indemnity as "a contract between two parties whereby one agrees to cover any liability, loss or damage sustained by the other from some contemplated act or condition, or damage resulting from a claim or demand of a third person"[9]. Guenter Heinz Treitel, in turn, specifies that the indemnitor is obliged to cover only those losses of the indemnitee that were expressly stipulated in the indemnity agreement, even if there was a real possibility to foresee other losses[10].

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[8] *See*: Loveman J.A. Understanding Contractual Indemnity and Defense Obligations under California Construction Law // Building & Bonding: The Construction Group News letter. Fall, 2011. URL: http:// www.lexology.com/ library/ detail.aspx?g=6fded1d1-55b9-4b6c-a558-64ac4fd79d36; Davies E. What does hold harmless mean? What is an indemnity anyway? // PLC Construction, 2011. 19 July. URL: http:// constructionblog. practicallaw.com/what-does-hold-harmless-mean-what-is-an-indemnity-anyway; Courtney W. Op. cit. P. 3.

[9] Parker. P.L., Slavich J. Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On // Southwestern Law Journal, 1991. P. 1351.

[10] Treitel G.H. The Law of Contract. 11th ed. London: Sweet & Maxwell, 2003.

The variety of definitions of contractual indemnity is attributable to the fact that its content, like the content of liquidated damages, is largely determined by the agreement itself. That is why English law makes the legal agreement on compensation for losses dependent on the "clarity" and "maximum accuracy" of its wording[11]. Note that, otherwise, the courts, as a rule, refuse to satisfy claims for the reimbursement of a contractual indemnity[12].

At the same time, the common feature of all types (forms) of the institute of indemnity, that is inherent also in the liquidated damages, is the exclusively restorative nature of the former. It is reflected, in particular, in three aspects of the principle of "exact protection". The first aspect concerns the **"effectiveness" of protection**: depending on the terms of the agreement, the debtor undertakes to prevent losses and/or compensate for the losses already incurred. The second is the "**accuracy**" **of protection**: the compensation must correspond to the losses incurred on the pound-for-pound basis. The third aspect is related to the **"volume" of protection**: either all losses are to be indemnified, or, as a rule, only those expressly stipulated in the indemnity agreement[13]. In addition, the restorative nature of indemnity is manifested in the prohibition on seeking compensation for indemnity as unjust enrichment, in particular, the inadmissibility of the so-called "double indemnity": a creditor does not have the right to claim compensation for those losses that were covered by other sources than the debtor or its affiliates (for example, insurance coverage)[14].

It should also be noted that, despite the fact that the type of indemnity under consideration represents a contractual mechanism for restoring the property status of a creditor, English law **prohibits reducing its size**. Of course, the impossibility of reduction of the amount of compensable losses by the court carries with it the risk of depriving the weaker party of the defense mechanism against accepting the extremely disadvantageous terms of the transaction imposed by the stronger party to the agreement. In this case, in general law, there is a rule similar to the rule on the

[11] *See*: Sweigart R.L. English Indemnity Law-Parsing the Promise: Words Are Important, But So Are Actions // Pillsbury Winthrop Shaw Pittman, 2011 (March). P. 1.

[12] *See*: *Weaver-Bailey Contractors, Inc. v. Fiske-Carter Construction Company* [1983] 657 S.W.2d 209; *Arkansas Kraft Corp. v. Boyed Sanders Construction Co.* [1989] 764 S.W.2d 452.

[13] *See*: Courtney W. The Nature of Contractual Indemnities. Oxford, Portland: Hart Publishing, 2014.

[14] *See*: Segalova E.A. Ogranicheniia zaverenij, garantij i obiazatel'stv po vozmeshcheniiu poter' v dogovore kupli-prodazhi aktsij (dolej) po anglijskomu pravu // Grazhdanskoe Pravo [Limitations of Pledges, Guarantees and Obligations in Compensating Losses in Shares (Interest) Purchase Contract under English Law // Civil Law], 2015. No. 6.

distinction between liquidated damages and penalties: if the conditions for compensation for losses become punitive, the creditor is deprived of the right to judicial protection.

Taking into account that the content of the contractual indemnity constitutes the obligation of the debtor to compensate for the losses of the creditor, to make good, it is important to single out the characteristics sufficient for the formulation of the concept. **Firstly**, contractual indemnity represents legal relations of inter-assignment, the assumption of another's debt, the contractual redistribution of risks. **Secondly**, only losses that are not related to the violation of obligations of the contract, but caused by the presentation of the legal claims of third parties or public authorities, are subject to compensation. **Thirdly**, the agreement of terms on indemnity is taken into account when forming the contract price. As additional features of the institute under consideration, it is worth highlighting the possibility of limiting liability[15] by defining a specific list or nature of the grounds for compensation. In addition, the parties have the right to limit compensation to a previously agreed amount or to provide with a number of restrictions the possibility of eliminating losses by the forces and means of the debtor.

We will separately consider the characteristics of contractual indemnity in a comparative aspect. **First of all**, it is worth noting that the contractual terms of the liquidated damages do not imply a substitution of parties in the obligation, and therefore do not constitute legal relations of inter-assignment. The application of this liability measure does not authorize the transfer of obligations from the original creditor to a new one, but, on the contrary, in contrast to contractual indemnity, constitutes relative legal relations. **Further**, since the liquidated damages are one of the types of (methods of calculating) losses, the fact of breach of contract is the basis for their compensation, and not the performance of actions of third parties or public authorities specified in the agreement. And, **finally**, as it has been noted earlier liquidated damages are an alternative contractual way to compensate for losses, the agreement on which does not entail a change in the contract price. The costs of their agreement, as a rule, are part of the cost of negotiating an agreement. Thus, based on the analysis of sufficient characteristics of contractual indemnity, we can conclude that the nature of the compared contractual mechanisms is different.

[15] Application of the term "liability" is conditional as violation does not serve as the basis for compensation of losses.

Considering the additional characteristics of contractual indemnity, we can note the following. It should be recalled that the payment of contractual indemnity is not a measure of civil liability, since the offense (violation of the terms of the contract) cannot be the basis for its payment. Moreover, as the experience of Great Britain, Germany and France shows, the reason for the emergence of the institute of indemnity appears to be in the difficulties that arose during the application of measures of liability for violating warranty and guarantees. For example, in case of the conclusion and performance of a contract when the buyer is aware of the risks of the occurrence of circumstances, responsibility is either completely impossible (in English law), or its size can be significantly changed (as in Germany and France).

The nature of the contractual indemnity in this connection appears to be a monetary claim, the basis of which is the occurrence of circumstances determined in the agreement that are not related to the breach of the contract. However, the practical meaning of the use of contractual indemnity, as A.V. Tomsinov rightly notes, is "limiting liability compared to conventional measures of common law (which cannot be changed)"[16].

This kind of restriction can be expressed as follows. **First**, the debtor has the right to control the creditor's legal expenses related to the settlement of disputes regarding the occurred circumstances with which the agreement associates the compensation for losses. This manifests in securing the debtor's obligation to accompany the court proceedings concerning the claims of third parties related to the subject matter of the main contract. It should be noted that this kind of obligation arises, as a rule, from the moment such claims are filed. In relevant literature, it is noted that such conditions are fixed in the majority of agreements on indemnity, since it precludes unreasonable expenses of the creditor connected with the removal of the burden from the subject of the main contract[17]. The demand for such restrictions can be

[16] Tomsinov A.V. Zavereniia ob obstoiatel'stvakh i vozmeshchenie poter' v rossijskom prave v sravnenii s representations, warranties i indemnity v prave Anglii i SSHA // Vestnik ehkonomicheskogo pravosudiia Rossijskoj Federatsii [Assurances of Circumstances and Compensation of Losses in the Russian Law in Comparison with Representations, Warranties and Indemnity in the Law of England and USA // Bulletin of Economic Justice of the Russian Federation] 2015. No. 11.

[17] Steinberg J., McCord L. Indemnity Procedures and Liability in IT Contracts // Daily Report (January 22, 2016). URL: http://www.kilpatricktownsend.com/en/ Knowledge_Center/ Publications/ Articles/2016/01/ Indemnity_Procedures_ and_Liability_in_IT_Contracts.aspx

explained by the fact that the creditor, being "insured" against such losses, actually loses interest in the results of the proceedings.

**Secondly**, in the agreement it is permissible to condition the compensation for losses by exceeding their certain amount or to establish the limit of liability, limiting either the amount of potential compensation to a predetermined amount, or make clear the list of circumstances, the losses occurring from which are undertaken to be compensated. Otherwise, the debtor undertakes to indemnify any creditor's losses related to the subject matter of the contract. It is worth noting that such an obligation of a debtor, as a rule, arises after the creditor has actually suffered such losses: has satisfied the claims of third parties, settled the tax arrears, etc.

Thus, the Supreme Court of the US state of Colorado obliged the lessee (indemnity debtor) to indemnify the lessor's losses related to compensation for injury to a woman who slipped in the lessor's parking lot[18]. The court arguing its decision indicated that according to the terms of the contract, the flower shop (lessee) undertook to indemnify the business center (lessor) for losses related to claims for compensation for damage to someone on the rented area or another lessor's territory. And, since the indemnity agreement had a broad indemnity clause, the lessee, despite the absence of guilt, was awarded to indemnify the loss of the lessor. In another case, a broad indemnity clause was the basis for imposing the obligation to compensate for losses caused by injury to an organization that was not related to construction work, during which the plaintiff suffered[19].

**Thirdly**, by providing compensation for losses of "any and all claims", the debtor may limit the grounds for compensation to those that were not caused by culpa of the creditor (limited indemnity). However, such a clause should also be explicitly reflected in the indemnity agreement. Otherwise, as evidenced by the relevant court practice, the debtor will be obliged to compensate for any property losses of the creditor arising in the event of circumstances specified in the indemnity agreement, regardless of the degree of the creditor's fault[20]. In this regard, A.G. Arkhipova further notes that, unlike English law, where enforcement of contractual terms on compensation for losses caused by the creditor's negligence (intent) is allowed, "the US law and court practice combine different — sometimes directly opposite —

[18] *Constable v. Northglenn LLC* [2011] 248 P.3d 714.
[19] *Bernotas v. Super Fresh. Food Markets* [2004] 863 A.2d 478.
[20] *Polozola v. Garlock, Inc.* [1977] 343 So. 2d 1000; *Mills v. Fidelity & Casualty Co.* [1964] Civ. A. No. 8007.

approaches to the question of acceptability of conditions of compensation for losses caused by negligence or intention of the creditor"[21].

In turn, liquidated damages, incorrectly interpreted by identifying them with penalty, can be considered as a legal mechanism for limiting civil liability. To look at liquidated damages through the prism of foreseeability of losses also leads to the conclusion about the limited nature of compensation. However, in this regard, it is worth clarifying that establishing liquidated damages, the parties do not set a limit to their liability, they do not knowingly reduce the level of protection of civil rights, but make a reasonable estimate of foreseeable losses from violation of specific terms of the agreement, thereby agreeing on the amount of full, unlimited indemnification. In other words, the very nature of liquidated damages as a compensatory measure of civil liability is in conflict with the phenomenon of its limitation, and does not allow contrasting the compared measures on this basis. In this regard, it is worth noting that with compensation for both losses and damages, the proof of their size is based on the principle of foreseeability. Accordingly, the amount of compensation in both cases may be limited by this criterion. Therefore, on the one hand, the equivalence of the size of liquidated damage or indemnity to the foreseeable amount of damages confirms the reasonableness of their assessment by the parties when concluding such agreements. On the other hand, foreseeability also serves as a criterion for distinguishing the compared categories from punitive measures of liability: in the case of a substantial, as a rule, manifold, inconsistency of the sizes of the first ones and the foreseeable damages, the court accordingly limits the corresponding amount of compensation.

It should be noted that **the broad indemnity clause** allows fixing the obligation of the debtor to compensate not only for the losses, but also for the losses incurred by the creditor as a result of the circumstances specified in the agreement[22]. At the same time, this does not mean that indemnity can act as a way to calculate such damages — in this case, the institute in question only plays the role of a legal basis for changing parties in the obligation to pay damages. The difference between indemnity and compensation for losses as such should be considered in this regard.

[21] Arkhipova A.G. Vozmeshchenie poter' v novom GK RF: "za" ili "protiv"? // Vestnik grazhdanskogo prava [Compensation of Losses in the New RF Civil Code: For or Against? //Bulletin of Civil Law], 2012. No. 4.

[22] *See*: Parker. P.L., Slavich J. Op. cit.

First of all, it is worth noting that the nature of indemnity is a debt obligation: the party to the agreement undertakes to compensate the losses of the other party related to the conclusion or performance of the contract, but not its violation[23]. So, A.G. Arkhipova reasonably defines the nature of indemnity as a "claim for execution specifically in the form of paying the debt claim"[24]. In turn, damages, on the contrary, is a measure of civil liability, the basis of which is a violation, but not the occurrence of circumstances related to the conclusion or performance of the contract.

Further, it should be noted that as a general rule, a creditor under an indemnity agreement is not obliged to reduce the amount of the corresponding losses[25]. At the same time, according to the generally accepted approach, the creditor should not contribute to an increase in losses under the pain of a proportionate decrease in the amount of compensation by the court.

In addition, different limitation periods apply to the cases in question. As it is known, the general limitation period applies to claims for damages. However, for claims for damages, this rule is not general, since the corresponding obligation of the debtor is dispositive in nature and varies in different areas. For example, E.A. Senegalov points to the one-and-a-half-year period for transactions on the acquisition of shares and the 6-7-year period for the provision of compensation related to tax disputes[26].

The subject composition of legal relations arising in connection with the use of compared structures is also different. Recall that the use of liquidated damages is limited to the scope of business relations. In turn, indemnity has no such restrictions.

Until recently, the distinction of the institute in question from damages was the recognition by the courts of the validity of the conditions of the agreement on indemnity, according to which the debtor pledged to compensate for any losses associated with a third-party action or an occurrence of some event[27]. However, in

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[23] *See*: *Royscott Commercial Leasing Ltd v. Ismail Independent* [1993] CA (93/0266/C); *Codemasters Software v. Automobile Club de L'Quest* [2009] EWHC 2361; *BN AMRO Commercial Finance plc v. Ambrose McGinn, Ross Lawrance Beattie, Marcus Leek* [2014] EWHC 1674.

[24] Arkhipova A.G. Op. cit.

[25] *BN AMRO Commercial Finance plc v. Ambrose McGinn, Ross Lawrance Beattie, Marcus Leek* [2014] EWHC 1674.

[26] *See*: Segalova E.A. Op. cit.

[27] Let us remind that according to English law only those losses which the party could expect reasonably at signing of the contract are subject to compensation (*See*: *Hadley v. Baxendale* [1854] EWHC J70).

1996, the Court of Appeal in England and Wales acknowledged that even in the presence of an agreement on indemnity, a clause on covering all the consequences, only those losses that were **foreseeable at the conclusion of the agreement** are subject to compensation[28]. In other words, the amount of compensation ceased to serve as a characteristic differentiating indemnity and damages.

It should be noted that as the concept of liquidated damages was derived from their comparison with punitive damages, and so the indemnity was formed due to the comparison of the latter with the losses and classical insurance. As a result, indemnity, which is a more flexible legal mechanism for restoring the property status of a creditor, in some cases has become an alternative to such a measure of civil liability as damages: the provisions of English law make it possible to secure indemnity as an exclusive sanction to replace damages[29].

**Thus**, there are significant differences in the nature of the institutes under consideration, the presence/absence of the obligation to reduce damage, the statute of limitations on claims for the appropriate type of compensation. In addition, the institute of indemnity, unlike liquidated damages, **firstly** does not represent a measure of civil liability (this is a debt obligation, the period for filing claims for which is established directly in the contract); **secondly**, in the absence of limitations of the subject composition provides for a substitution of parties in the obligation; **thirdly**, it is not of a nature of assignment, it is a "self" insurance that affects the formation of the contract price; **fourth**, it is not a way to determine the size of losses; **fifth**, unlike liquidated damages as a reasonable estimate of foreseeable losses, indemnity may act as a legal mechanism for limiting liability.

[28] *Total Transport Corp v. Arcadia Petroleum Ltd (The Eurus)* [1996] QBD.
[29] *See*: Tomsinov A.V. Op. cit.