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# Indemnification Clauses in Commercial Contracts (TN)

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

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

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

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

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

Although commonly used, indemnity provisions can be complex. If drafted:

- Improperly, an indemnification provision can subject a party to continuing liability for circumstances outside of its control.
- Correctly, an indemnification provision can shield a party from lawsuits and damages.

This Note discusses the meaning and benefits of indemnity under Tennessee law to help parties correctly draft and negotiate an indemnification provision that effectively manages risk.

## Definition of Indemnification

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

## Indemnity Implied by Tennessee Law

State law indemnity is a remedy implied under common law or statute and arises out of obligations imposed through a preexisting relationship (see, for example, T.C.A. § 47-2-312(3)). The extent to which this obligation is imposed depends on:

- Applicable state law.
- The nature of the transaction.
- The nature of the relationship.

Tennessee courts recognize a common law cause of action for indemnity based on the principle that a person should bear responsibility for his own wrongdoing. Tennessee courts will impose an implied obligation to indemnify when either:

- The obligation is a necessary element of the parties' relationship.
- Justice and fairness demand shifting the burden of paying for a loss to the party whose fault or responsibility is qualitatively different from the other parties' fault.

(*Memphis-Shelby Cnty. Airport Auth. v. Ill. Valley Paving Co.*, 2006 WL 3041586, *3 (W.D. Tenn. Oct. 26, 2006).)

Generally, courts impose an implied indemnity on a contractual relationship only in the absence of an indemnification provision. Parties relying on implied contractual indemnity generally face unpredictable outcomes and may not be able to obtain certain types of reimbursement.

For example, the recovery of attorneys' fees under an implied indemnity theory may be uncertain (see *Pullman Standard, Inc. v. Abex Corp.*, 693 S.W.2d 336, 338-39 (Tenn. 1985) (recognizing that indemnity arising by operation of law based on the parties' relationship may include the indemnitee's recovery of attorney's fees and other costs for third-party litigation); see also *Electric Controls v. Ponderosa Fibres of America*, 19 S.W.3d 222, 229-30 (Tenn. Ct. App. 1999) (the indemnitee's right to recover attorneys' fees under an implied indemnity theory depends not only on the indemnitee's being required to defend itself but also on the indemnitee's being required to defend itself because of indemnitor fault or wrongdoing)).

To avoid any uncertainty, the parties to an express indemnity provision may choose to include a disclaimer of the right to implied indemnity.

## Contractual Indemnity

Parties to a contract use a contractual indemnity provision to customize risk allocation. Tennessee courts interpret indemnification agreements in the same manner as other contracts by:

- Determining the parties' intention.
- Interpreting the language in a plain, ordinary, and popular sense.
- Construing the agreement as a whole.

(*Pitt v. Tyree Org. Ltd.*, 90 S.W.3d 244, 252-53 (Tenn. Ct. App. 2002).)

If the language of the indemnity agreement is unambiguous, courts must interpret it as written (*Pitt*, 90 S.W.3d at 252-53). In order for an indemnification agreement to indemnify the indemnified party against its own negligence, the agreement must express this intention in clear and unequivocal terms (*Kellogg Co. v. Sanitors*, 496 S.W.2d 472, 473 (Tenn. 1973); see also *Wells ex rel. Baker v. State*, 435 S.W.3d 734, 747-49 (Tenn. Ct. App. 2013), appeal denied (Apr. 9, 2014)).

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

For more information on recoverable damages, nexus phrases, and covered events, see:

- Defining the Recoverable Damages.
- Choosing the Right Nexus Phrase.
- Defining the Covered Events of the Indemnity.

For an example of an indemnification provision for use in a broader commercial contract, see Standard Clauses, General Contract Clauses: Indemnification (TN).

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

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

## Obligation to Indemnify Distinguished from Obligation to Defend

The obligation to indemnify for damages and the obligation to defend against third-party suits are separate and distinct. It is possible that an indemnifying party may have a duty to defend but no subsequent duty to indemnify. (See *Travelers Indem. Co. of Am. v. Moore & Assoc., Inc.*, 216 S.W.3d 302, 305 (Tenn. 2007) (insurer duty to defend).)

### Obligation to Indemnify

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

Indemnification requires the indemnifying party to:

- Reimburse for covered **paid costs and expenses** (losses). Indemnity against loss:
  - does not accrue until after the indemnified party actually pays the obligation for which it is liable; and
  - limits the indemnifying party's liability to the amount the indemnified party was actually required to pay.
- Advance payment for covered **unpaid costs and expenses** (like liabilities) as they are incurred, but only if the recoverable damages under the indemnity include liabilities, claims, or causes of action in addition to losses actually paid.

(See *Long v. McAllister-Long*, 221 S.W.3d 1, 11 (Tenn. Ct. App. 2006).)

For more information on losses versus liabilities, see Defining the Recoverable Damages.

Tennessee courts construe the language of the agreement as a whole and consider the posture of the parties and circumstances existing when the parties made the agreement, to determine whether a particular agreement provides for indemnity against loss or indemnity against liability (*Long*, 221 S.W.3d at 11).

### Obligation to Defend

The obligation to defend is broader than the obligation to indemnify because it may apply whether or not the third-party claim has merit (see *Travelers Indem. Co. of Am.*, 216 S.W.3d at 305 (insurance)).

The obligation to defend is both:

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

An indemnified party normally wants the indemnification provision to expressly include the duty to defend because it otherwise risks having the indemnifying party assert that its obligation is limited to only actual damages or judgments resulting from the claims made.

The allegations asserted in the suit, not the ultimate merits of the action, give rise to the obligation to defend. For an example, see Defense is Often Broader than Indemnification: An Example. Therefore, a party may have to defend the other party even if the court ultimately finds the underlying claim to be without merit (see *Jackson Hous. Auth. v. Auto-Owners Ins. Co.*, 686 S.W.2d 917, 922 (Tenn. Ct. App. 1984) (insurance)).

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

### Defense is Often Broader than Indemnification: An Example

Consider an indemnification provision that requires the indemnifying party to:

- Indemnify against third-party claims for damages and losses arising out of the indemnifying party's negligence.
- Defend against third-party suits raising claims covered by the indemnity.

The indemnified party sues the indemnifying party under the provision for losses and damages suffered. The court

absolves the indemnifying party of negligence. In this case, the court:

- Also absolves the indemnifying party of any indemnity liability. Because the indemnifying party is absolved of negligence, the indemnifying party has no obligation to indemnify for its own negligence.
- May require the indemnifying party to defend the indemnified party. The indemnifying party's defense obligation is triggered by suits raising claims covered by the indemnity, not whether the conditions of indemnity were, or were not, later established.

## Indemnification Versus Hold Harmless Provisions

Most indemnification provisions require the indemnifying party to "indemnify and hold harmless" the indemnified party for specified liabilities or losses. In practice, these terms are typically paired and interpreted as a unit to mean "indemnity." However, some courts and commentators have drawn a distinction between the two. For example, they may construe "hold harmless" to protect another against the risk of loss as well as actual loss and define "indemnify" to mean "reimburse for any damage," a narrower meaning than that of "hold harmless" (see discussion in Bryan A. Garner, U, 15 Green Bag 2d 17, 22-24 (2011)).

Tennessee courts have interpreted "hold harmless" as synonymous with indemnification (*Long v. McAllister-Long*, 221 S.W.3d at 10; see also *Pinney v. Tarpley*, 686 S.W.2d 574, 579 (Tenn. Ct. App. 1984) (a "hold harmless" agreement is an indemnity contract to prevent or reimburse for indemnitee loss)).

### Obligation to Hold Harmless

Similar to the obligation to indemnify against liability (see Obligation to Indemnify), under the obligation to hold harmless, the indemnifying party must:

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

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

Additionally, although unlikely in Tennessee, "hold harmless" may release the indemnified party from any related claim or cause of action by the indemnifying party.

Because Tennessee courts treat the terms "indemnify" and "hold harmless" as synonymous, they are unlikely to draw this distinction between the terms (*Long v. McAllister-Long*, 221 S.W.3d at 10).

However, "hold harmless" may be too general and broad to be construed as indemnifying against indemnitee negligence (*HMC Techs. Corp. v. Siebe, Inc.-Robertshaw Tennessee Div.*, 2000 WL 1738860, at *3 (Tenn. Ct. App. Nov. 27, 2000); see also *Wajtasiak v. Morgan Cnty.*, 633 S.W.2d 488, 490 (Tenn. Ct. App. 1982)).

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

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

For more information, see Standard Clauses, General Contract Clauses: Indemnification (TN): Drafting Note: Hold Harmless.

## Statutory and Common Law Barriers to Enforcement

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

- Require a party to indemnify another for all claims, regardless of who is at fault. In Tennessee, indemnification for a party's own negligence is not against public policy, but the parties must expressly state that intent in clear and unequivocal terms (see *Kellogg*, 496 S.W.2d at 473 and *Wells*, 435 S.W.3d at 747-49; see also *Summers Hardware & Supply Co. v. Steele*, 794 S.W.2d 358, 361 (Tenn. Ct. App. 1990)).

Tennessee courts, however, find indemnity clauses invalid as to damages caused by gross negligence or willful conduct on the part of an indemnified party (see *Planters Gin Co. v. Fed. Compress & Warehouse Co.*, 78 S.W.3d 885, 893 (Tenn. 2002)).

- Are not conspicuously set out in the contract (see *Jones Exp., Inc. v. Watson*, 2011 WL 1842853, at *7 (M.D. Tenn. May 16, 2011) ("[t]he indemnification provision is not buried in the agreement, nor is it worded in such a way as to be confusing")). While Tennessee does not require an indemnification provision to be conspicuous, courts may disfavor provisions buried in an agreement, especially where the provision might be disfavored for other reasons or otherwise merit greater conspicuousness (for example, protecting an indemnitee against its own negligence).
- Are given by protected classes like:
  - parties to certain construction-related contracts (T.C.A. § 62-6-123; see also *Caroum v. Dover Elevator Co.*, 806 S.W.2d 777, 779-80 (Tenn. Ct. App. 1990));
  - tenants under certain residential rental agreements (T.C.A. § 66-28-102(a) and T.C.A. § 66-28-203; see also *Crawford v. Buckner*, 839 S.W.2d 754, 760 (Tenn. 1992));
  - parties to certain motor carrier transportation contracts (T.C.A. § 65-15-108); or
  - consumers.

However, Tennessee courts generally respect the parties' rights to allocate liability for future damages through indemnity clauses (*Planters*, 78 S.W.3d at 892).

## Identifying the Indemnified Parties

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

If parties include certain covered entities, such as affiliates, they should add temporal modifiers to expressly indicate if they intend the term to include both existing and future affiliates. In the absence of defining or modifying the term, some courts have concluded that the term "affiliate" includes only existing affiliates (see, for example, *Ellington v. EMI Music, Inc.*, 997 N.Y.S.2d 339, 343-44 (2014) (under New York law, use of the term "affiliates" in a contract includes only those affiliates in existence at the time the contract was executed, absent clear and unambiguous language indicating that the parties intended to bind other affiliated parties to the underlying contractual obligations)).

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

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

For more information, see Standard Clauses, General Contract Clauses: Indemnification (TN): Drafting Note: Who is the Indemnifying Party?.

## Defining the Scope of the Indemnity

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

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

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

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

When an indemnity clause is unambiguous, the plain language of the agreement will control the breadth of the indemnity clause (see *Planters*, 78 S.W.3d at 892).

## Defining the Recoverable Damages

Although seemingly redundant, each word in the phrase "losses, liabilities, claims, and causes of action" has an individual meaning and serves a specific purpose. The terms are listed below in order of increasing breadth:

- **Losses.** This includes any covered judgments, settlements, fees, costs, and expenses. The indemnifying party becomes responsible for a loss only after the indemnified party pays (see, for example, *Long*, 221 S.W.3d at *11).
- **Liabilities.** This includes debts and other legal obligations. The indemnifying party becomes responsible for a liability when the liability is legally imposed, but before the money is paid (see, for example, *Ford Motor Co. v. W.F. Holt & Sons, Inc.*, 453 F.2d 116, 118 (6th Cir. 1971) (applying Tennessee law)).
- **Claims.** This includes damages resulting from a third-party lawsuit. The indemnifying party becomes responsible for a claim at the moment when a party, including any third party, files a lawsuit.
- **Causes of action.** This includes damages resulting from a right to seek relief. The indemnifying party becomes responsible for a cause of action when the indemnified party's or a third party's right to seek relief, as the case may be, accrues.

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

- Personal injury and death.
- Real and personal property damage. Parties may specify "tangible property damage" if they want to distinguish the term from indemnification for claims relating to intangible property (such as claims for intellectual property infringement).
- Infringement of intellectual property. However, intellectual property claims are often covered in a separate provision because intellectual property indemnification generally has different:
  - remedies; and
  - limitations of liability.
- For an example of an intellectual property indemnification provision, see Standard Document, Professional Services Agreement: Section 11.2.
- Breach of confidentiality.
- Violation of law.

### Direct Versus Third-Party Claims

The obligation to compensate an indemnified party may apply to:

- **Direct claims.** These are claims that the indemnified party has against the indemnifying party. Commercial contract indemnification provisions typically do not cover direct claims. Tennessee courts have held that:
  - standard indemnity provisions apply only to suits brought by third-parties, not to direct claims (see *Colonial Pipeline Co. v. Nashville & E. R.R. Corp.*, 253 S.W.3d 616, 624 (Tenn. Ct. App. 2007) and *Bowen v. Paisley*, 2014 WL 2708499, at *2 (M.D. Tenn. June 16, 2014)); and
  - parties seeking to include direct claims must adopt contractual language clearly and unequivocally doing so in their indemnity agreement (see *Eatherly Const. Co. v. HTI Mem. Hosp.*, 2005 WL 2217078, at *10-11 (Tenn. Ct. App. Sept. 12, 2005)).
- Parties may be subject to increased risk of liability or dispute if they overlook or fail to address direct claims (see Practice Note, Indemnification: Avoiding Common Pitfalls: Direct Claims). An indemnification provision for direct claims typically covers damages relating to the indemnifying party's acts, omissions, or breach of the agreement.
- **Third-party claims.** These are claims that a third party has against the indemnified party, which parties most commonly use indemnification to cover.

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

### Attorneys' Fees

Under Tennessee law, costs and attorneys' fees are recoverable under an indemnity contract if the language of the agreement is broad enough to cover the expenditures (*N. Am. Specialty Ins. Co. v. Heritage Glass, LLC*, 2017 WL 440000, at *2 (E.D. Tenn. Jan. 9, 2017)). However, an indemnified party cannot recover attorneys' fees incurred in a dispute with the indemnifying party unless the indemnity provision specifically applies to disputes (direct claims) between the parties (*Individual Healthcare*

*Specialists, Inc. v. BlueCross BlueShield of Tennessee, Inc.*, 566 S.W.3d 671, 705 (Tenn. 2019);see also *Pinney*, 686 S.W.2d 574 at 581 (attorney's fees not recoverable in proceeding to enforce indemnity agreement)).

To avoid a potential construction issue, the indemnity provision should reflect the intent of the parties and specifically address whether attorneys' fees are:

- Excluded from or included in the indemnity obligation.
- Limited to reasonable or out-of-pocket expenses.

## Choosing the Right Nexus Phrase

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

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

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

- "Caused by."
- "Resulting from."
- "Solely resulting from."
- "To the extent they arise out of." Under Tennessee law, a court may construe the words "arising from" as broadly as "related to" (*Wright Med. Tech., Inc. v. Spineology, Inc.*, 747 Fed. Appx. 335, 338 (6th Cir. 2018)).

## Defining the Covered Events of the Indemnity

Covered events generally arise from or relate to:

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

Covered events include two broad categories:

- Direct claims.
- Third-party claims.

### Indemnities for Breach of the Agreement

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

- Change (in most cases, extend) the indemnified party's right to recover damages, particularly regarding legal costs and expenses.
- Recover loss suffered as a result of third-party claims that result from the breach.

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

- **Common law.** Common law rules relating to breach of the agreement, such as the foreseeability rule in *Hadley v. Baxendale*, may similarly modify indemnity coverage of breach ((1854) 156 Eng. Rep. 145). Under *Hadley*, a plaintiff may not recover damages that are improbable and unforeseeable unless the defendant had special knowledge of the circumstance. Tennessee courts follow the *Hadley* rule in breach of contract claims (see *Pankey v. S. Pioneer Prop.*, 2014 WL 11514533, at *2 n.2 (W.D. Tenn. Aug. 12, 2014) (insurance)). However, if appropriate, parties should include "reasonably foreseeable" language in the indemnity provision to ensure that the common law rule of reasonableness applies.
- **Limitations in the underlying contract language.** The scope, depth, and duration of the indemnifying party's representations, warranties, and covenants impact the indemnified party's indemnification rights for breach of the agreement. For example, the seller of a business often makes a series of representations about its business and the enforceability of the agreement to induce the buyer to enter into the transaction. If a statement is untrue when made, then the seller has breached the agreement, and the buyer may have an indemnification claim on this basis. If the statement is true when made, but becomes untrue later, then the seller has not breached the agreement, and the buyer does not have an indemnification claim (unless the seller breaches a corresponding covenant). To the extent that a representation is qualified, indemnification for breach of that representation will also be correspondingly limited. For sample representations and warranties, see Standard Clauses, General Contract Clauses: Representations and Warranties.

For more information on indemnity for breach of the agreement, see Standard Clauses, General Contract Clauses: Indemnification (TN).

### Occurrence-Based Indemnities

Indemnity clauses frequently cover liabilities based on specific occurrences. A broad occurrence-based indemnity obligation may, for example, cover all negligent acts or omissions of the indemnifying party. In some instances, parties may agree to forgo a non-infringement representation and warranty, but protect the indemnified party with an indemnity obligation covering third-party intellectual property infringement claims. In this case, the third-party claim does not arise from a breach, but is indemnified regardless.

Occurrence-based indemnities can be narrowed, including by:

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

## Limitation of Liability Approaches

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

- Carefully tailoring the language, by negotiating, for example:
  - exceptions to the indemnifying party's obligation to indemnify (see Exceptions to Indemnification);
  - the degree to which either party has the right or the obligation to control the defense of an indemnified claim (see Control of Defense Provisions);
  - the degree to which the indemnified party has the obligation to notify the indemnifying party of third-party claims (see Notice of Third-Party Claims);
  - indemnification deductibles (see Liability Baskets);
  - an indemnification cap (see Maximum Liability (Limitation of Liability)); and
  - materiality and other indemnification qualifiers (see Materiality and Other Qualifiers).
- Integrating the language with the agreement's other risk allocation provisions, for example:
  - waiver of consequential damages (see Waiver of Incidental and Consequential Damages);
  - sole remedy provisions (see Sole Remedy Provisions); and
  - assignment rights (see Assignment Rights).

### Exceptions to Indemnification

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

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

A party with significant negotiating leverage may request indemnification for its own plain negligence, including only gross negligence as an exception to indemnification. Public policy generally does not prohibit indemnifying a party for its own negligence (see *Kellogg*, 496 S.W.2d at 473). However, it is unusual, typically associated with specific industries, and may be subject to statutory restrictions.

Such requests are uncommon in the broad commercial context. A party seeking indemnification for its own negligence should consider:

- Whether such requests are accepted practice in the relevant industry.
- Whether applicable state laws or industry-specific regulations allow or prohibit such indemnification.
- Whether the nature and scope of the risk sufficiently outweigh the bargained-for consideration in the transaction.
- The potential negative effect of the request on negotiations of the overall transaction.

For a party to receive indemnity for its own negligence under Tennessee law:

- The parties must state that intent in expressly clear and unequivocal terms (see *Kellogg*, 496 S.W.2d at 473; see also *Wells*, 435 S.W.3d at 747-49).
- General, broad, and seemingly all-inclusive language in the indemnity agreement is not sufficient (see *Summers Hardware*, 794 S.W.2d at 361).

Also, an indemnity agreement may not indemnify a party from damages caused by gross negligence or willful conduct on the part of the indemnified party (*Planters*, 78 S.W.3d at 893).

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

## Waiver of Incidental and Consequential Damages

This waiver, which often disclaims a host of non-direct damages including indirect, consequential, incidental, punitive, and special, limits the indemnifying party's liability to certain actual and direct damages and reduces the amount the party may otherwise be liable to pay. For definitions of certain of these damages, see Practice Note, Damages for Breach of Commercial Contracts. For a sample waiver of incidental and consequential damages, see Standard Clauses, General Contract Clauses: Limitation of Liability (TN).

When drafting and negotiating an indemnification provision, parties should understand whether and how this type of waiver impacts the indemnification provision. For example, if the indemnity for third-party claims is not excluded from the waiver, the indemnifying party is not required to pay for indirect and consequential damages stemming from third-party claims even though these damages are caused by its own bad acts.

If parties intend for the indemnity to cover **all** liabilities (including indirect and consequential damages) arising from third-party claims, then the parties should exclude indemnification for third-party claims from the waiver.

## Control of Defense Provisions

As the paying party, the indemnifying party wants to control the defense to better regulate its expenses and liabilities. However, the indemnified party, as defendant, may want to control the defense to protect its own legal status, reputation, and liability.

For more certain protection and control over its liabilities, an indemnified party can seek contractual rights, such as the right to:

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

For an example of a Control of Defense Provision, see Standard Clauses, General Contract Clauses: Indemnification (TN): Section 3.

## Notice of Third-Party Claims

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

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

However, under common law, even if the indemnified party does not give the indemnifying party notice of covered claims, the indemnified party may still have an action for indemnity (see *Sears Roebuck and Co. v. Strey*, 512 F. Supp. 540, 542 (E.D. Tenn. 1981)). Therefore, an indemnifying party may want to insist in the contract on prompt notice of a third-party claim.

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

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

The parties may agree that an indemnified party's failure to provide proper notice will excuse the indemnity obligation only to the extent the indemnifying party's ability to defend is adversely affected, such as if the lack of notice causes the indemnifying party to miss a filing deadline.

## Liability Baskets

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

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

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

For an example of a liability basket provision, see Standard Clauses, General Contract Clauses: Indemnification (TN): Section 2.2.

### The Implications of a Liability Basket on the Obligation to Defend

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

## Maximum Liability (Limitation of Liability)

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

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

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

For an example of a maximum liability clause, see Standard Clauses, General Contract Clauses: Indemnification (TN): Section 2.3.

If the agreement includes a cap on the maximum liability for indemnification, parties should ensure that the agreement does not contain any other provisions that could potentially conflict with the stated limit.

### Implications of Maximum Liability on the Obligation to Defend

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

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

## Sole Remedy Provisions

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

With a sole remedy provision, the indemnified party can look only to the indemnification provision for recourse on covered claims.

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

For an example of a sole remedy provision, see Standard Clauses, General Contract Clauses: Indemnification (TN): Section 2.6.

## Mutual Indemnities

Commercial contracts often include mutual indemnification provisions. Under a mutual indemnification provision, each party indemnifies the other (see, for example, *Cascade Ohio, Inc. v. Modern Machine Corp.*, 2010 WL 4629467, at *5 (Tenn. Ct. App. Nov. 15, 2010) (mutual indemnification obligations of seller and buyer)).

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

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

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

## Materiality and Other Qualifiers

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

These qualifiers prohibit the non-breaching party from recovering damages for the breach unless it can prove that either the nature or the subject matter of the breach was material. Indemnity for breach of a contract provision does not negate a materiality qualification placed on that provision, so the indemnification is subject to the same materiality qualification unless the contract expressly says otherwise.

In Tennessee, to determine whether a breach is material, courts consider:

- The extent to which the injured party will be deprived of the benefit which he reasonably expected.
- The extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived.
- The extent to which the party failing to perform or to offer to perform will suffer forfeiture.
- The likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances.
- The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

(*Forrest Const. Co., LLC v. Laughlin*, 337 S.W.3d 211, 225–26 (Tenn. Ct. App. 2009) (citing Restatement (Second) of Contracts § 241).)

While courts typically will not infer a materiality requirement when analyzing an indemnification provision (see, for example, *Franklin Am. Mortgage Co. v. Univ. Nat'l Bank of Lawrence*, 910 F.3d 270, 282 (6th Cir. 2018)), sometimes, the parties agree to qualify the indemnification provision with materiality. The parties should consider the consequences of qualifying the indemnification provision with materiality because:

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

## Insurance and Escrow

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

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

The insurance policy can usually be tailored to correspond to the transaction at hand. Different kinds of coverage may apply to different aspects of the agreement, such as representation and warranty insurance; but the parties should carefully consider whether the types and amounts of insurance required are adequate to cover all indemnification obligations.

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

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

## Assignment Rights

Assignment of the agreement could unexpectedly alter the risk allocation in the transaction. For example, a party may assign the contract to a third party that cannot honor the assigning party's indemnity obligations.

Tennessee recognizes the general assignability of contract rights (*Dick Broad. Co., Inc. of Tennessee v. Oak Ridge FM, Inc.*, 395 S.W.3d 653, 671 (Tenn. 2013); see also *Price's Collision Ctr., LLC v. Progressive Hawaii Ins. Corp.*, 2013 WL 5782926, at *1 (M.D. Tenn. Oct. 28, 2013)).

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

For more information on assignment limitations in Tennessee, see Standard Clauses, General Contract Clauses: Assignment and Delegation (TN). For information on assignability of commercial contracts, see Practice Note, Assignability of Commercial Contracts.

## Duration of Indemnity

Indemnifying parties often impose time limitations on indemnity and related provisions to control liability. Absent an agreement to the contrary, Tennessee law statutes of limitations dictate the length of time that a party has to raise a claim, including an indemnity claim (State Q&A, Statutes of Limitations: Tennessee).

There is no statute that expressly provides a statute of limitations for indemnity claims. However, Tennessee courts have applied Tennessee's six-year statute of limitation period for contract claims to claims of indemnification based on an indemnification provision in a contract (T.C.A. § 28-3-109(a)(3); see also *Nissan N. Am., Inc. v. Schrader Elecs., Ltd.*, 2013 WL 3778729, at *4–5 (M.D. Tenn. July 18, 2013)). However, the parties can expressly contract for a shorter limitations period (see *Town of Crossville Housing Authority v. Murphy*, 465 S.W.3d 574, 581 (Tenn. Ct. App. 2014)).

In some states, time limitations on indemnity claims vary depending on the type of claim. For example, a tort claim may have a different time limitation than a breach of contract claim. Time limitations also depend on whether the claim is:

- **A direct claim.** In some states, the statute of limitations clock starts once the claim underlying the indemnity accrues. The length of time the indemnified party has to file the claim depends on the type of claim. Parties often limit the duration and survivability of contract terms. For example, in an acquisition agreement, the representations may survive the deal closing but expire 30 days after the contract's effective date. For an example of a survival provision, see Standard Clause, General Contract Clauses: Survival (TN). For a direct claim such as this, the contractual time limitations supersede the statute of limitations.
- **A third-party claim.** Absent an agreement to the contrary, the statute of limitations limits:
  - the amount of time the third party has to bring a claim against the indemnified party (the statute of limitations clock starts from the time the claim accrues); and
  - the amount of time the indemnified party has to bring an indemnity claim against the indemnifying party. The duty to indemnify arises when there is a decision on the factual merits of the dispute, while the duty to defend may arise earlier, and the time when either of these duties is breached may differ accordingly (see *Nissan*, 2013 WL 3778729, at *5–6 and Obligation to Indemnify Distinguished from Obligation to Defend).

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

- Analyzing each potential claim and its related statute of limitations.
- Coordinating the time limitations of each of the covered claims and the term and survival period of the contractual indemnity.

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

## Alternatives to Indemnification

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

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

Excluding an indemnification provision may increase the likelihood of dispute. Therefore, parties should ensure the agreement contains a strong dispute resolution provision if they choose not to include an indemnity clause. For a sample dispute resolution clause, see Standard Clause, General Contract Clauses, Alternative Dispute Resolution (Multi-Tiered) (TN).