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Indemnity clauses: why you think you need them (and when you probably don't)

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If you ask a lawyer why an indemnity clause is included in an agreement, the reflexive answer is usually some version of "risk allocation". That answer is true. It is also incomplete.

Indemnity clauses have become some of the most over-requested, under-examined and inconsistently understood provisions in commercial agreements. Everyone expects to see one, but few people stop to ask whether the clause accomplishes anything incremental in light of the rest of the deal mechanics.

Why indemnities?

At their core, indemnities are intended to allocate specific and identifiable risks to a particular party and provide a clear recovery mechanism if that risk materializes. They are also often designed to shift liability, allocate defence costs and prescribe the timing and process for recovery. In practical terms, indemnities are supposed to answer an important and simple question: If something unexpected happens, whose problem is it? When they work well, indemnities reduce uncertainty and post-closing friction, but "work well" is the key. Some do, but most don't.

Indemnities in the RWI world

Indemnities rarely operate in isolation in Canadian private equity transactions. Instead, they are usually one tool in the toolbox, along with:

- representation and warranty insurance (RWI), which now appears in the majority of sponsor-led deals;
- narrow fundamental representation frameworks and limited survival periods;
- tight caps and baskets that materially constrain seller exposure; and
- structuring choices driven by tax, financing and fund-level considerations.

In this environment, the practical value of an indemnity is often shaped less by its drafting and more by how it interacts with the rest of the deal structure (we share a few examples of this in our video, "Managing disputes in Canada and the U.S.: All about indemnity clauses").

Too much of an indemnified thing?

Indemnity clauses are often included out of habit rather than necessity, adding negotiation time (and cost) and bringing complexity into a document without meaningfully improving the buyer's economic outcome. In deals with meaningful RWI, indemnities are sometimes negotiated as if they were the primary recovery mechanism, even though that's not what either party contemplates. An indemnity is not needed to obtain damages for breaches of covenants or representations and warranties; the common law gives contracting parties the right to sue for breach of contract. In these cases, the primary utility of an indemnity clause is to limit (rather than enhance) the scope of liability with limitations, caps, baskets and time requirements.

Indemnity-to-imperilment

Most deals will still have indemnities, but they can't be the boilerplate clauses of yore. Instead, the best indemnities are designed to deal with the risks that are remaining once all the other mechanisms have been exhausted. You probably don't need suspenders and a belt, but you still want to make sure nothing remains unexposed.

RWI does not cover:

- known or identified risks that are excluded from insurance coverage;
- pre-closing tax matters or restructuring steps that insurers are unwilling to underwrite; or
- specific covenant breaches that fall outside the representation and warranty framework.

In other words, these risks exist. They need to be allocated. This is where the indemnity clause makes its money back.

What's a lot less worthwhile is turning contractual remedies into contractual breaches. Suing for a breach of representation and warranty and suing for a failure to indemnify for a breach of representation or warranty are essentially the same thing. The common law is strong and does much of the heavy lifting for you—unless you are intending to change its default rules (for example, by extending or limiting the recovery that would apply under ordinary remoteness principles), you don't need to haggle over yet another clause.

Instead of defaulting to the assumption that an indemnity is required, a better question is this: What risk is this indemnity intended to cover that is not already addressed by insurance or the broader deal structure? If you know the answer, you can draft to the risks (or indemnify to the imperilment). If you don't, the indemnity may be more decorative than functional.

Bottom line

Indemnities are neither obsolete nor universally necessary. They are tools. In a Canadian private equity market increasingly shaped by representation and warranty insurance, the value of an indemnity depends on whether it is targeted, intentional and aligned with the insurance framework. Knowing when an indemnity matters, and when it does not, is now a core part of sophisticated deal execution.

To discuss these issues, please contact the author(s).