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REVISITING THE INDEMNITY V/S DAMAGES DEBATE

I. INTRODUCTION

Indemnity clauses are debated deeply and focused upon during negotiation of commercial contracts. Serious consequences can arise due to a poorly negotiated indemnity clause. But the question really is whether there is any reason to seek indemnity instead of resorting to claiming statutory damages under the Indian Contract Act, 1872 ("**Contract Act**") which is anyways available under law. What is there in an indemnity which is not covered under a remedy for damages? Is indemnity simply an agreement to cover damages suffered by a party? Can damages be contractually limited? How do liquidated damages differ from indemnity? What carve-outs and inclusions are necessary to have a water-tight indemnity or liability provision? This article focuses on answering few of such questions and outlining the negotiating strategies to be borne in mind for an indemnification clause to achieve its end.

II. SETTING THE FRAMEWORK

At the outset, it is important to understand whether common law principles apply for interpreting indemnity clauses or is the Contract Act self-sufficient and exhaustive? The Bombay High Court in *Gajanan Moreshwar Parelkar v. Moreshwar Madan Mantri*[1] while interpreting indemnity provisions clearly held that the Contract Act is not exhaustive and common law principles are to be relied upon. Hence, unless there is a conflict with the Contract Act or any judicial decisions rendered by the Courts in India, the common law principles pertaining to interpreting contracts will continue to be applicable to indemnity provisions.

The statutory framework and the relevant sections in the Contract Act relating to damages and indemnity are set out in **Annexure A**.

III. SPECIAL OBLIGATIONS THAT MAY ARISE PURSUANT TO AN INDEMNITY CLAUSE

This section intends to highlight the distinction between an indemnity claim and a claim for damages. Firstly, third party claims are covered under an indemnity whereas damages can only be claimed against the promisor or the party who has made a promise under the contract. Secondly, indemnity claims can be made even prior to the party having suffered any actual loss. Thirdly, consequential, indirect and remote losses can all be claimed under an indemnity clause whereas the same is not sustainable under a damage claim. Fourthly, indemnity can be claimed for losses without demonstrating that the loss has arisen on account of breach of contract event whereas for damages, a clear connection and sufficient nexus between the breach of contract event and damage suffered has to be demonstrated. All of the above distinctions have been elaborated below:

A) Third Party Claims

As per section 124 of the Contract Act, a claim for indemnity arises due to "*the conduct of the indemnifier or by the conduct of any other person*". This is a major benefit of an indemnity over damages. Indemnity clauses shifts the entire risk of future loss to the indemnifier.

B) When does the indemnification obligation kick in?

The courts in India have time and again taken the position that an indemnity holder is entitled to sue the indemnifier even before incurring any actual damage or loss and that an indemnity is not necessarily given by repayment after payment.[2] Hence, an indemnified party can call upon the indemnifier to make the payment once the liability has accrued. The concept of accrual of loss or liability and the attendant obligation to indemnify can be contractually agreed upon between the parties.

C) Are consequential or remote/ indirect losses covered? Does reasonability and foreseeability apply?

Under a claim for damages, the Contract Act only permits seeking compensation for any loss '*which the parties knew, when they made the contract, to be likely to result from the breach of it*' at the time of entering into the contract[3] which is commonly termed as the principle of contemplation of damages between the parties. Reasonable foreseeability is construed as the serious possibility of occurrence of loss and is often the test used for damages. Further, the damages claimed must be reasonable and hence damages may not be sustainable for loss of profit or opportunity costs ordinarily.[4] Section 73 specifically states that, "*Compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach.*" Hence, it specifically excludes any claim for remote or indirect losses.

No such restriction applies for an indemnity claim.[5] Section 124 of the Contract Act defines a contract of indemnity as "*a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person.*" A claim for damages is subject to the ordinary rules of remoteness discussed whereas a claim for indemnity is not subject to the same rules. Thus, consequential, remote, indirect, and

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third party losses can all be claimed by the indemnified party unless specifically excluded in the indemnity clause.

D) Does duty to mitigate losses or the principles of causation/ onus to prove actual loss apply?

In the context of damages, the concepts of foreseeability, reasonability and remoteness bring along an interlinked concept of duty to mitigate. It covers within its ambit two broad principles: a) The claimant must take all reasonable steps to reduce or contain his loss; and b) The claimant must not act unreasonably so as to increase his loss.[6] Section 73 of the Contract Act itself embodies such a concept. It states that, "*In estimating the loss or damage arising from a breach of contract, the means which existed of remedying the inconvenience caused by the non-performance of the contract must be taken into account.*"[7]

However, such an obligation may not arise in an indemnity unless specifically stated so in the indemnity clause. There exists no clear Indian jurisprudence on this point. However, the courts in United States have taken this position.[8] The rationale behind it appears to be that in case of a claim under damages, there is an obligation to mitigate damages following the breach of contract event. However, in the instance of indemnity, a contract to indemnify is a separate contract in itself and hence the breach is refusal to indemnify itself rather than the specific event which led the indemnified party to seek the indemnity. The indemnity clause may therefore be construed as a claim for debt and not as a claim for damages and hence the duty to mitigate does not apply.

Similarly, unlike a claim for damages, where a clear connection and sufficient nexus has to be demonstrated between the breach of contract event and the damage suffered, the threshold to establish is much lower in case of an indemnity and there is no onus to prove actual loss before claiming indemnity. There is no direct case law on this point, however, this inference is drawn from the fact that an indemnity holder in India is entitled to sue the indemnifier even before incurring any actual damage or loss and that an indemnity is not necessarily given by repayment after payment.[9]

IV. LIQUIDATED DAMAGES V. CAPPED INDEMNITY CLAUSE

Section 74 of the Contract Act deals with the concept of liquidated damages and states that, "*If a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for"* In such a case, there may not be any necessity of leading evidence for proving damages, unless the Court arrives at the conclusion that no loss is likely to occur because of such breach or the happening of such an event. In *Fateh Chand v. Balkishan Das*[10], the Supreme Court held that in all cases where there is a stipulation in the nature of penalty, the court has jurisdiction to award such sum only as it considers reasonable, *but not exceeding the amount specified in the contract*.

However, a capped indemnity clause operates on a different footing as the concept of reasonability, foreseeability and remoteness applicable to a damage claim is not applicable to the adjudication of an indemnity claim. Hence, parties are likely to be able to claim far more through a capped indemnity clause compared to a liquidated damage clause.

V. EXCLUSIVE REMEDY INDEMNIFICATION CLAUSE WITH LIMITATION OF LIABILITY: EXCLUDES CLAIM FOR DAMAGES UNDER INDIAN LAW

In order to contractually determine the extent of liability, parties may agree to limit their exposure to a well drafted and substantially limited indemnity provision largely immune from the discretion of the courts. An illustration for such a clause is set out below:

(a) Exclusive Remedy Clause: The clause should state that, "*indemnity provided under this clause shall be its sole remedy in relation to the transactions contemplated under this agreement to the exclusion of all other rights and remedies (including those in tort or arising under statute)*"; and

(b) Limitation of Liability: Limitation of liability clause which states that the total liability under the agreement shall be limited to the amount and conditions stipulated for the indemnity.

Currently there appears to be no clear jurisprudence that exists on the interpretation of exclusive remedy clauses. In the above construct, damages as a statutory remedy may not be completely ruled out, but since damages hinge on the principle of foreseeability, the courts may be inclined to rule that indemnity be used as the benchmark while determining the extent of damages.

VI. NEGOTIATING AN INDEMNITY CLAUSE

a) From an indemnified party's perspective

1. **Usage of phrase "Hold Harmless" and "protect from liability":** It is important to avoid usage of terms "make good" or "compensate" as the courts may interpret it as covering claims only due to actual loss suffered by the indemnified party and not cover instances where the liability has accrued but no payment has been made.

   Hence, it is advisable to use the notion "Hold Harmless" instead to cover both the situations.[11] Further, usage of phrase "protect from liability" ensures that the indemnifier has an added obligation of duty to defend cast upon him which requires the indemnifying party to defend the indemnified against covered third-party claims and potentially first party claims depending on the language included in the provision.

2. **Obligation to defend begins from the moment any claim is made**: Indemnification is an equitable remedy and is not to be merely used as a sword but also includes the obligation to shield the indemnified party. Therefore, the clause may provide that the right to defend the indemnified party by the indemnifying party shall kick in the moment any claim is made by any third party (whether the liability has accrued or not accrued). Sometimes, the indemnified party may want the claim to be settled instead of pursuing/prolonging the dispute as it may cause a reputational loss. In such an instance, the duty to defend may be interpreted as taking within its ambit an obligation to settle such claim and provide complete release to the indemnified party.

3. **Give inclusive definition to phrases such as Losses or Liability:** Since consequential, indirect and remote losses can be claimed under the indemnity clause, it is important to not give an exhaustive definition to Losses. Avoid usage of "*Losses means*" and rather use "*Losses includes*".

September 26, 2024

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September 22, 2024

4. **Use "arising out of" instead of "result of" or "connection of":** Terms such as "a result of" or "connection of" require close nexus to be established. Hence, arising out of should be used which is given a broad interpretation by the courts and mere occurrence of the event would suffice.[12]

5. **Tax Gross up:** Since the indemnity payments are made due to breach of representations and warranties or breach of covenants in an agreement, it may be argued and stated that the indemnifying party absorbs the tax consequences of any indemnifiable loss. Indemnity payments may qualify as other income and may be subject to a 30% tax. Hence, the indemnity payments are to be made in such a manner that the actual payment is equal to the payment due under the indemnity claim plus the amount of taxes payable with respect to its receipt. However, a counter argument may be made that where actual loss is suffered by the indemnified party, then it actually reduces the amount to which the indemnified party would have been liable to be taxed, and hence the indemnifying party cannot be held liable for such an amount.

6. **Claim Notice:** Since an indemnity works very differently than a claim for damages, it is important to draft an indemnity clause in such a manner that the indemnity payment obligation triggers on issue of a claim notice. The clause should clearly state that upon the indemnified party giving a notice to the indemnifying party of any claim that may arise out of an indemnity clause, the obligation of the indemnifying party to make the payment shall become due and payable upon receipt of the notice or within a period of X days of receipt of such notice. Further, it may be stated that any delay in making any claims or giving a notice does not relieve the indemnifying party of such obligation.

7. **Depositing the claim amount with the arbitrator**: It may be stated that in case the claim amount is disputed by the indemnifying party and arbitration or any other mode of resolving dispute as provided in the agreement is invoked by the indemnifying party, then the claim amount shall be upfront deposited with the arbitrator. This is to be done in order to ensure that the indemnifying party has the capacity to pay if a successful award is decided in favor of the indemnified party.

8. **Fraud and wilful negligence exclusion from any indemnity cap**: Any wilful negligence, breach or fraud committed by the indemnifying party may be considered to be excluded from the indemnity cap, if any, agreed upon.

b) From an indemnifying party's perspective

1. **Setting out clearly the basket or deductible:** Baskets and deductibles are designed to provide an indemnifying party with an assurance that it will not be bothered for frivolous claims. It is a common negotiating point between the parties to agree upon a basket or deductible. In the case of a deductible, the indemnifying party is only liable for the amount over and excess the deductible threshold whereas in case of a basket, the indemnifying party is liable for the entire amount once the basket threshold is hit.

2. **Ensure that specific limitations/ exclusions are expressly put in a LOL clause:** A limitation of liability clause is given an extremely strict interpretation since it is an exculpatory clause. Hence, any exclusions that are to be made from an indemnity clause are to be expressly set forth. Some of the exclusions that can be considered by the parties have been enlisted below:

   - *Actual or Constructive knowledge qualifier*: The indemnifying party may consider excluding claims for breach of the agreement to the extent the facts, matters, information or circumstances relating to the relevant claim is known to the indemnified party and hence, an *actual or constructive knowledge qualifier may be added.*
   - *Net Financial Benefit:* The indemnifying party may consider carving out a specific exclusion that it will not be liable for any net quantifiable financial benefit that could arise to the indemnified party from any loss suffered. For instance, where the amount for which indemnified party would otherwise have been accountable to be assessed for taxation is actually reduced or extinguished as a result of the matter giving rise to such Loss, then the indemnifying party should not be liable for such amount.
   - *Contingent Liability exclusion*: It is advisable to clearly state that the indemnifying party shall not be liable in respect of any liability which is contingent unless and until such contingent liability becomes due and payable.
   - *Recovery only once for the same matter and Recovery covered under insurance policy*: Since indemnity is a continuity obligation, it must be clearly stated that the indemnified party is not entitled to recover more than once in respect of the same matter or the same event which has occasioned the loss. Similarly, it may be clearly stated that the indemnifying party shall not be liable in respect of any claim to the extent such losses are covered by a policy of insurance or can be recoverable from a third person.
   - *Exclusion where provisions have already been made*: It can be stated that the indemnifying party shall not be held liable in respect of any claim if proper allowance, provisions or reserve is made in the accounts.

3. **Duty to Mitigate:** Unless specifically stated in the indemnity clause**,** there may not be any specific obligation cast upon the indemnified party to mitigate losses. Hence, the indemnifying party may negotiate and provide for a duty to mitigate in the indemnity clause.

4. **Going for Limitation of Remedy clause:** As mentioned earlier, contracts have limitation of liability clauses which simply limit the liability of the indemnifier but does not rule out other contractual remedies to be pursued against the indemnifier. However, if one is representing the indemnifier, it is advisable to go in for a 'limitation of remedy' clause which takes into its ambit both the limitation of liability and exclusive remedy clause and leaves no room for any ambiguity in interpretation.

5. **Survival of Indemnity clause:** While, parties may state that the indemnity clause will survive the termination of the agreement. However, from an indemnified party's perspective, it is important that the survival clause is tailor made. For instance, it may be stated any indemnity claim arising out of breach of representations may be valid for a limited period of three years post the closing of the agreement.

VII. REMITTANCE OF MONETARY DAMAGES FROM A RESIDENT TO A NON-RESIDENT: CAPITAL ACCOUNT OR CURRENT ACCOUNT TRANSACTION

Quite often in instances of the indemnified party being a foreign entity, this question arises in India. Upon a review of

the definition of capital account and current account transaction, no clear answer emerges. We briefly set out herein below the legal framework and our thoughts on this point.

Section 2 (e) of FEMA states that capital account transaction means:

"*a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions specified in sub-section (3) of section 6.*"

Section 2(j) of FEMA states that a current account transaction ***means a transaction other than a capital account transaction.***

All current account transactions are permitted, unless specifically restricted by Central Government whereas all capital account transactions are specifically prohibited unless specifically permitted. As permitted transactions, current account transactions require no prior regulatory approval.

Remittance of monetary damages/ payment of indemnity to a person resident outside India would not amount to alteration of resident Indian's capital assets outside India. Therefore, it may not be construed as a capital account transaction.

At this stage, it is pertinent to look at the Articles of Agreement of the International Monetary Fund ("**IMF**") ("**IMF Regulations**") which has been adopted by India and forms the basis of adoption of partial convertibility of Indian rupee by Reserve Bank of India ("**RBI**"). India joined the IMF in 1945, as one of the IMF's original members. In 1994, India accepted the obligations of Article VIII of the IMF Articles of Agreement on current account convertibility. Article VIII of the IMF Regulations states that no member shall impose restrictions on the making of payments and transfers for current international transactions.

The Balance of Payments Manual published by IMF ("**BOPM**") provides conceptual guidelines for compiling balance of payments statistics according to international standards, and importantly, includes detailed definitions for current and capital accounts and transactions. Indian authorities should place no restrictions if a transaction in question is considered a current account transaction under applicable IMF definitions.

BOPM identifies certain special characteristics of capital transfers to distinguish them from current transfers. A transfer in kind without a charge is a capital transfer when it consists of (i) the transfer of ownership of a nonfinancial asset (other than inventories, i.e., fixed assets, valuables, or non-produced assets) or (ii) the forgiveness of a liability by a creditor when no corresponding value is received in return. Also, a transfer of cash is a capital transfer when it is linked to, or conditional on, the acquisition or disposal of a fixed asset (for example, an investment grant) by one or both parties to the transaction. Current transfers are all transfers which cannot be stated to be capital transfers.

"*Payment of compensation*" is included within the definition of current transfers in the BOPM. Paragraphs 12.55 and 12.56 of the BOPM state that "*payments of compensation*" are current transfers. Included within the definition of "*payment of compensation*" are settlements agreed out of court or compensation for nonfulfillment of contracts not covered by insurance policies. Hence, an argument or view can be taken that the indemnity payments and payments of compensation pursuant to a court order or arbitral award are to be construed as current account transaction and not capital account transaction. However, in practice, banks during remittance of money prefer to seek clarification/ approval of RBI which is generally not denied.

– Satish Padhi, Ruchir Sinha & Vyapak Desai
You can direct your queries or comments to the authors

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[1] (1942) 44 BomLR 704.

[2] See *Jet Airways (India) Limited v. Sahara Airlines Limited and Ors*, 2011 (113) Bom LR 1725, *Khetarpal v. Madhukur Pictures*, AIR 1956 Bom 106. See also *Osman Jamal and Sons Limited v. Gopal Purshattam*, (1928) ILR Cal 262. "*Equity has always recognized the existence of a larger and wider right in the person entitled to indemnity. He was entitled, in a Court of Equity, if he was a surety whose liability to pay had become absolute to maintain an action against the principal debtor and to abtain an order that he should pay off the creditor and relieve the surety (…) Indemnity is not necessarily given by repayment after payment. Indemnity requires that the party to be indemnified shall never be called upon to pay*".

[3] *See* Section 73 of the Indian Contract Act, 1872. See also *Hadley v. Baxendale*, [1854] EWHC J70 which forms the basis of unliquidated damages under the Contract Act. The observations of the court are as follows: "*Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.*"

[4] Ruxley Electronics and Construction Limited v. Forsyth, [1996] AC 344.

[5] Total Transport Corporation v. Arcadia Petroleum Limited, [1998] 1 Lloyd's Rep. 351. See observations of Lord Justice Staughton wherein it is stated that, "*Indemnity" may refer to all loss suffered which is attributable to a specified cause, whether or not it was in the reasonable contemplation of the parties."*

[6] See Law of Contract (Lexis Nexis) 3rd Edition (2007).

[7] *See* Explanation to Section 73.

[8] See Am. States Ins. Co v. Glover, 960 F. 2D (6th Circuit 1992) ("*Failure to mitigate is not a defense to indemnity action*"); See also Napier Elec. & Constr. Co.; 571 S.W.2.D 644 ("*Indemnity Agreement terms determine nature of indemnitors which terms allow reimbursement of all payments made in good faith*").

[9] See *Jet Airways (India) Limited v. Sahara Airlines Limited and Ors*, 2011 (113) Bom LR 1725, *Khetarpal v. Madhukur Pictures*, AIR 1956 Bom 106. See also *Osman Jamal and Sons Limited v. Gopal Purshattam*, (1928) ILR Cal 262. "*Equity has always recognized the existence of a larger and wider right in the person entitled to indemnity. He was entitled, in a Court of Equity, if he was a surety whose liability to pay had become absolute to maintain an action against the principal debtor and to abtain an order that he should pay off the creditor and relieve the surety (…) Indemnity is not necessarily given by repayment after payment. Indemnity requires that the party to be indemnified shall never be called upon to pay*".

[10] AIR 1963 SC 1405

[11] See *Queen Villas Homeowners Association v. TCB Property Management*, 2007 Cal. App. Lexis 470 wherein it has been observed that, "*The words "indemnify" and "hold harmless" are not synonymous. One is offensive and the other is defensive – even though both contemplate third-party liability situations. "Indemnify" is an offensive right, a sword which allowes an indemnitee to seek indemnification. Hold harmless" on the other hand is defensive which simply provides for a right not to be bothered by the other party itself seeking indemnification."*

[12] *See Samways v. WorkCover Queensland and Ors*. [2010] QSC 127. The relevant observations made by Applegarth J are enlisted as follows: "*The words "arising out of" are wide. The relevant relationship should not be remote, but one of substance albeit less than required by words such as "caused by" or "as a result of"*.

Annexure A

The law governing claim for damages is set out in Sections 73 and Section 74 of the Contract Act.

Section 73 of the Contract Act deals with unliquidated damages and reads as follows:

"*When a contract has been broken, the party who suffers by such breach is entitled to receive, form the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.*

Such compensation is not to be given for any remote and indirect loss of damage sustained by reason of the breach.

Compensation for failure to discharge obligation resembling those created by contract: When an obligation resembling those created by contract has been incurred and has not been discharged, any person injured by the failure to discharge it is entitled to receive the same compensation from the party in default, as if such person had contracted to discharge it and had broken his contract.

Explanation: In estimating the loss or damage arising from a breach of contract, the means which existed of remedying the inconvenience caused by non-performance of the contract must be taken into account."

Section 74 deals with liquidated damages and reads as follows:

"*When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.*

Explanation: A stipulation for increased interest from the date of default may be a stipulation by way of penalty."

Similarly, the law governing indemnity is set out in Sections 124 and 125 of the Contract Act.

Section 124 of the Contract Act defines a contract of indemnity as follows:

"*A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person, is called a "contract of indemnity".*

Section 125 of the Contract Act gives the right of indemnity holder when sued and states that,

"*The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor (1) all damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies; (2) all costs which he may be compelled to pay in any such suit, if in bringing of defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit; and (3) all sums which he may have paid under the terms of any compromise of any such suit, if the compromise was not contract to the orders of the promisor, and was one which it would have been prudent for the promise to make in the absence of any contract of indemnity, or if the promisor authorized him to compromise the suit.*"