"Do You Know" Series

"Indemnity" and "Liquidated Damages" in India

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"Indemnity" and "liquidated damages" are frequently used by parties in commercial contracts as means to manage contractual risks. The two concepts may generally sound more familiar to the legal fraternity in the common law world, since they are not recognised in certain civil law jurisdictions (although functionally similar concepts may exist).

In this "do you know" article, the Asian Business Law Institute (ABLI) takes a closer look at "indemnity" and "liquidated damages" under Indian law.

Indemnity

The concept of indemnity is recognised under Section 124 of the Indian Contract Act, 1872 ("ICA"). It is defined as a promise to save the *promisee*, i.e., the indemnitee, from loss, caused by the *promisor*, i.e., indemnitor or a third party. Indemnity clauses are commonly seen, among others, in commercial contracts on acquisition or investment deals, commercial arrangements involving intellectual property and confidentiality agreements (to compensate loss due to disclosure).

Apart from the general principles of contract law that are applicable to the validity of a contract, a few essential elements must be met for an indemnity clause to be valid and enforceable under Section 124 of the ICA. These elements include: (1) The indemnitor must promise to save the indemnitee from loss and (2) The indemnitee must have incurred a liability and that liability must be absolute. In addition, case law has also established that an indemnity clause need not be explicit; it may also be implied from the circumstances of a case.

Compared to other statutory remedies for breach of contract, having an indemnity clause has its advantages. For example, unlike damages which can only be claimed when loss has occurred, case laws have established that indemnity may be claimed from the indemnitor even when loss has not occurred but when there is accrual of liability and such liability has become absolute. In addition, having the ability to invoke an indemnity clause in the case of a contractual breach simplifies the dispute resolution process. This is because the party relying on the indemnity does not have to establish the elements of its claim to the extent it would otherwise be required for claiming damages for the same breach.

The Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 provide that where equity instruments are transferred between an Indian resident and a non-resident, the seller may furnish an indemnity for an amount not exceeding 25% of the total consideration (paid in full) and that such indemnity obligation cannot be extended beyond 18 months from the date of payment of the full consideration. Furnishing of indemnities in excess of the said thresholds would require prior permission of the Central Bank. Except for the foregoing circumstance, indemnity clauses contractually agreed between the parties do not require any Central Bank approval when they are entered into, although any remittance of money covered in those clauses to a non-resident to fulfill any such indemnity obligations may require Central Bank approval.

Liquidated damages

The concept of liquidated damages is recognised under Section 74 of the ICA which provides that when the amount to be paid for breach of contract is provided in the contract, or if the contract stipulates any sort of penalty, then the party in breach is not liable to pay any sum more than what is defined in the contract. Having a liquidated damages clause in a contract increases certainty as contractual parties are aware of the consequence of a breach of the contract in advance.

Under Indian law, for a liquidated damages clause to be valid and enforceable, the following requirements must be met: (1) Case law has established that the stipulated sum of damages must be a genuine pre-estimate of losses suffered by the party; (2) The stipulated damages should be an effort to restore the affected party to the same position as if the contract had been properly performed; (3) Compensation may be stipulated for any loss reasonably foreseeable to the parties when they enter into the contract. However, such stipulation should not relate to losses that are remote or only indirectly related to the contract; and (4) The claim for damages must be fair and reasonable. In addition, the sum of damages agreed under the contract cannot be penal or punitive in nature.

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The experts are contributors to ABLI's latest project that aims at harmonising contractual clauses in Asia, covering 12 key contracting jurisdictions that include Australia, China, England, India, Indonesia, Japan, Malaysia, New York State, the Philippines, Singapore, Thailand, and Vietnam.

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