THE PRACTICALITIES OF INDEMNITY IN COMMERCIAL CONTRACTS

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ABSTRACT

This paper examines the role and purpose of indemnity clauses in contracts, in light of the provisions of the Indian Contract Act, 1872 and relevant case laws. It also focuses on the practicality of including an indemnity clause in a commercial contract. Several key points have been highlighted which should be considered from the perspective of an indemnifying party (e.g.: promoters of a company receiving investment by way of subscription to shares are indemnifying parties with respect to the investor).

In light of the foregoing and as a conclusion to this research, an appropriate way to draft an indemnity clause in an investment agreement (e.g. for subscription of shares by an investor into a target company), keeping in mind the concerns of the indemnifying party have been summarized.

Keywords**:** Indemnity; Commercial Contract; Contract Drafting, Reviewing and Negotiating; Investment Agreement; Share Purchase Agreement; Share Subscription Agreement; Indian Contract Act; Indemnity holder; Indemnifier; Indemnifying Party; Qualifiers; Representation; Warranties; Breach of Contract; Enforcement of Indemnity; Law Commission of India;

INTRODUCTION

Risk allocation and mitigation is a crucial aspect of contract drafting and negotiation. The most significant tools for risk allocation are representation and warranties, positive and negative covenants, conditions precedent and subsequent, and indemnity. Out of all these tools, indemnity is a risk allocation clause and hence, most intensely negotiated between the parties.[i]

The Key Elements and Scope of Indemnity under the Indian Contract Act, 1872

Section 124 of the Indian Contract Act[ii] defines a 'contract of indemnity'. According to this section, the essential elements of a contract of indemnity are :- a) there must be two parties- the indemnifier and the indemnified; b) a promise by the indemnifier to save the indemnified party from loss; c) and the loss suffered by the indemnified party should be due to the conduct of the indemnifier or any a third party.

The scope of indemnity under section 124[iii] is narrower than English Law.[iv] The latter also allows a party to be legally indemnified on the occurrence of some event or accident. However, under the Indian Contract Act, scope of indemnity is limited to losses incurred from the conduct of humans.[v] Moreover, several judicial decisions have held that indemnity can be express as well as implied[vi] but section 124 does not expressly include an implied indemnity.[vii]

Therefore, the Law Commission of India in its thirteenth report[viii] recommended that section 124 should expressly include the words- 'expressly or impliedly' and also losses incurred by acts or events other than those arising out of human conduct.

Rights of an Indemnity-holder

Section 125[ix] further elaborates on the rights of an indemnity-holder. However, it is restricted to recovery of damages, costs and sums arising out of loss suffered by suits and compromises.[x] Moreover, these rights are only conferred on the condition that the suit or compromise are brought about prudently like in the absence of an indemnity and not in contravention of the orders of the promisor. While the condition of acting prudently is justified, the requirement of not contravening with the orders of the promisor creates an unnecessary burden on the promisee and might even be disadvantageous. Therefore, this section can be reconsidered for a more comprehensive and efficient protection of an indemnity-holder.

UNEQUITABLE ENFORCEMENT OF INDEMNITY IN INDIAN COURTS

Indemnity in India suffers from the lack of equitable enforcement. The Supreme Court[xi] has held that the cause of action to enforce indemnity only arises when the promisee is damnified. The loss suffered must be proved to claim recovery.[xii] This stance on indemnity is unequitable because in many cases indemnity is incorporated to provide the indemnified party with a recourse to save itself from incurring losses which are incurable. For example, loss due to seizure of assets and property, closing of business, losing market share etc. In such circumstances the requirement to suffer loss leaves the indemnity-holder in a detrimental position even after being indemnified because the loss becomes irreparable. Hence, the conceptual idea of indemnity of restoring to the position when no harm had occurred becomes futile. Furthermore, identifying the crystallization point of accrued loss into actual loss can also be problematic in many circumstances.

Though, some High Courts have held that section 124 and 125 are not exhaustive and have accepted cause of action for enforcing indemnity on certainty of incurring losses[xiii], the Supreme Court has not departed from its stance of claiming indemnity only on evidence of loss suffered since 2002.[xiv] It also eliminated the idea of 'hold harmless' from indemnity and stated that indemnification shall only occur to the extent of loss suffered. [xv]

The English Courts are also moving towards an equitable enforcement of indemnity.[xvi] Consequently, the Law commission also suggested the insertion of Article 125A to permit enforcement of indemnity irrespective of whether actual loss has occurred or not.[xvii] The proposed section also allows the indemnity-holder to obtain a decree compelling the promisor to set aside a fund which can be used to discharge his liability to indemnity. [xviii] Unfortunately, the legislature has shown no plan of implementing this recommendation since the past few decades. The legislature should consider that the notion of indemnity suggests that an indemnity-holder should never be called upon to pay.[xix] Thus, indemnifier should be liable to pay the moment there is certainty of the indemnified loss to occur.

THEORETICAL AND PRACTICAL APPROACH TO INDEMNITY IN CONTRAST WITH DAMAGES FOR BREACH OF CONTRACT

Theoretically, the scope of risk events and protection covered under indemnity is broader than breach of contract.[xx] Under breach of contract, only the party liable for the damage is liable to compensate, however indemnity can also cover for losses caused by third parties. Ideally, causality, foreseeability and closeness of the risk event with the incurred losses can be done away with under Indemnity.[xxi] Moreover, indemnity can also be linked to the breach of any contractual obligation, representations and conditions made by the indemnifying party.[xxii] Thus it attempts to save the party from the lengthy, cumbersome, and costly litigation process involved in recovering damages for breach of contract.

However, practically, it is highly unlikely that the parties mutually agree on non-causal, unforeseeable, or remote losses.[xxiii] Even if agreed upon, usually, the indemnifying party either abstains from replying to an indemnity notice or does not agree to indemnify the promisee. This is because conditions of enforcing indemnity (e.g. Misrepresentations or breach of contractual obligations) are mostly 'legal conclusions' that involves defenses and evidence.[xxiv] As a result, the matter always reaches the courts, where the trend is of an inequitable enforcement approach as reflected in the *Bank of Saurashtra Case*[xxv]. Moreover, section 124[xxvi] identifies indemnity for losses incurred only from the conduct of the promisor or a third party.

Therefore, a pragmatic analysis of the current legal position of indemnity in India reflects that the consequences of enforcing indemnity under section 124 and a breach of contract under section 73 and 74 are essentially the same. The differences between the two are more from a conceptual perspective rather from a practical stance. Nevertheless, unlike breach of contract, the fact that indemnity can protect an indemnity-holder against damaging conduct of third parties and fix the amount of liability of the indemnifier still subsists.[xxvii]

USE OF INDEMNITY IN COMMERCIAL CONTRACTS

A party in a contract cannot control all aspects of the performance of a contract. Most commercial contracts involve a certain level of risk and consider indemnity as a crucial risk allocation tool.[xxviii] Regardless of the intricacies involved in the practical legal stance of

indemnity, from a commercial logic, indemnity provides a considerable sense of security to the parties, particularly in cases of breach of contractual obligations and high incurable risks. For instance, an investor in the course of due diligence discovers that a company has not attained a very crucial license to conduct its business, or has not complied with a significant legal compliance or has a or has a financially risky litigation going on but because of the foreseeable flourishing profits the investor wants to invest in the company. In such a scenario, indemnity gives reasonable confidence to the investor to proceed with the investment.[xxix] Therefore, it is reasonable to have an indemnity clause in cases of commercial contracts.[xxx] However, the parties must be aware of the practical implications of it and should not develop high expectations from merely the theoretical benefits of such a clause.

KEY POINTS TO CONSIDER FROM THE PERSPECTIVE OF AN INDEMNIFYING PARTY

Indian Contract Act does not specifically grant any rights to an indemnifying party. The concept of indemnity entails a wide scope of protection to the indemnity-holder.[xxxi] It can also account for indemnification of unforeseeable and remote losses.[xxxii] Hence, in case there is lack of clarity on what the triggering event is or if the scope of the triggering event is extremely wide, or , if the indemnity clause does not limit to definite types and amount of loss, then the liability of the indemnifier extends to pay for almost any or all losses incurred by the indemnity-holder.[xxxiii] An indemnity-holder can also take indemnity for granted and not be cautious towards the already known risks or not mitigate reasonably avoidable losses.[xxxiv]

Furthermore, when the indemnity clause does not limit its enforceability within a time period of the occurrence of the risk event, the indemnifier can be liable to indemnify at any time after such occurrence and maybe even without having the knowledge of that occurrence. Likewise, if the contract of indemnity extends to the conduct of third parties, then in case the third parties are not clearly specified, the liability of an indemnifier can extend to cover for losses incurred by the conduct of parties which he did not even intend to indemnify for.

Therefore, indemnity amount, scope of losses and risk events, parties, time limits, notice requirements and reasonable duties of the indemnity-holder are some key points of

consideration from an indemnifier's perspective, to avoid an unlimited liability. The usage of words must be precise and clear with no scope of extending the liability of the indemnifier.[xxxv]

The Contract Act[xxxvi] itself limits the causation of losses incurred to the conduct of the promisor or the third party. Section 125[xxxvii] also imposes a duty on the indemnified party to act reasonably or as he would have acted in the absence of a contract of indemnity. Nevertheless, a purpose of indemnity is also to avoid the lengthy and time-consuming litigation process and to have an efficient and effective remedy against certain risk events that the indemnified party does not want to be burdened with while performing the transaction. Therefore, drafting an unambiguous and equitable indemnity clause builds a possibility of an effective dispute prevention mechanism between the indemnified and the indemnifying party.

DRAFTING AN INDEMNITY CLAUSE IN INVESTMENT AGREEMENTS

Expressing the Burden of Indemnity

An indemnity clause in an investment agreement is usually linked to a breach of any representation, condition, covenant, or any contractual obligation by the indemnifying party.[xxxviii] In case through due diligence, the investor finds out that the transaction involves a high risk, that risk is specifically made a triggering event in the indemnity clause. For instance, a highly detrimental pending litigation should be specifically added as triggering event for invoking the indemnity clause. Additionally, a tax indemnity is commonly incorporated in investment agreements.[xxxix] It imposes a liability on the Target Company to indemnify the investor for all losses it might have to incur because of paying taxes, which were payable by the Target Company before the investor subscribed to the shares of the company.[xl]

Tackling the concerns of the Indemnifying Party (i.e. Target Company)

It is evident that indemnity creates a heavy burden on the promisor to indemnify the promisee when the risk event occurs. Hence, while the indemnity-holder will always insist on expanding the scope of an indemnity clause by making it inclusive, the indemnifier must ensure that the indemnity clause is limited, clear and exhaustive.

a) Clear and Limited Scope of Indemnity Clause

In a Share Subscription Agreement, the target company should aim towards agreeing upon an unambiguous and limited liability so that the indemnity provided by it is not taken for granted by the investor. The amount of indemnity should be fixed and limited to cover foreseeable losses incurred by the direct causation of the risk events specifically agreed to be indemnified for**.** Qualifiers like 'reasonable', 'foreseeable', 'directly incurred' losses should be explicitly used to limit the liability of the target company. Phrases like '*any* loss directly or *indirectly arising out of/ in connection with*', should be avoided to make the clause unambiguous. Furthermore, de-minimums or minimum threshold, tipping baskets or deductibles, and cap-in liability are some tools to avoid frivolous claims for insignificant losses and to fix the amount of liability of the target company.[xli] A cap on indemnity limiting the indemnity to the investment amount can also be considered.

An indemnity clause involving indemnification for the conduct of a third party, (e.g. a subsidiary, agent, sub-contractors etc.) should specify such third parties along with the triggering events of these third parties for which indemnity can be claimed.[xlii] All necessary information regarding the claims against those third parties shall be provided to the seller while invoking indemnity.[xliii]

Qualifiers of 'material breach'[xliv] can also be added when the indemnity is linked to the breach of contractual obligations by the target company. The investor usually does a due diligence of the company and the indemnity clause should be free of the risks discoverable through a reasonable due diligence unless those risks are specified in the indemnity clause. This can be achieved through 'actual or constructive knowledge' qualifiers. The target company can also include a 'Disclosure Schedule' in the agreement to disclose any existing fact contradicting the representations, warranties, covenants, conditions, and other contractual obligations arising out the agreement. The investor will be presumed to have knowledge of all those contradictions and shall not be allowed to claim indemnity for it.

The target Company should negotiate for the payment of only actual losses suffered or only on a definite certainty of the occurrence of risk events. The indemnifier shall specify that the indemnity clause cannot be invoked in case of a contingent liability and it shall only be applicable when the contingent liability becomes due and payable.[xlv] Any loss which the

indemnifier has paid for but does not occur due to change of circumstances, should be reimbursed to the target company.[xlvi]

b) Conditional Enforcement of Indemnity

It is a common practice in Share Subscription Agreements to have a survival clause for indemnity (usually 6 years) which prohibits the enforceability of the indemnity clause after a particular time period.[xlvii] There can also be a time limit on the applicability of the indemnity clause from the occurrence of that risk event. The Target Company must always be notified within a reasonable time on the occurrence of the triggering events.

The investor should always be imposed with **a duty to mitigate the losses**[xlviii] for which it intends to seek indemnity, and all reasonably avoidable losses must be barred from the enforcement of indemnity. The Target Company might create an escrow arrangement which might withhold the indemnity amount till the investor discharges its duty to mitigate the losses. Any loss for which the investor is partially or completely liable or arising out of an illegal or negligent act of the investor shall be barred from the enforcement of indemnity.[xlix] The investor should be specifically refrained from invoking indemnity for the same triggering event more than once and shall be indemnified for the losses claimed only at the first time of invocation of the indemnity clause.[l]

Lastly, a Share Subscription Agreement also imposes certain representations, covenants, conditions, and other contractual obligations on the investor for the breach of which the Target Company can include a separate or a mutual indemnity clause.[li] In such a case the investor should use the same limitation strategies as explained in the context of the Target Company.

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