
BALANCING FREEDOM OF CONTRACT AND JUDICIAL CONTROL: A CRITICAL ANALYSIS OF INDEMNITY, LIMITATION OF LIABILITY, AND LIQUIDATED DAMAGES UNDER THE INDIAN CONTRACT ACT, 1872

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ABSTRACT

Freedom of contract is the fundamental principle of trade and commerce as it enables the parties to freely negotiate their legal relations by agreement.¹ Nevertheless, this freedom of contract should not be unconditional because there is a need to exercise judicial control over contracts in order to avoid any forms of wrongdoings.² Therefore, the main purpose of this research paper is to analyse the relationship between the freedom of contract and judicial review in relation to indemnity clauses, limitation of liability clauses, and liquidated damages as defined in the Indian Contract Act, 1872.³ In order to achieve such an aim, the paper employs the method of statutory interpretation, the analysis of case laws, as well as comparative analysis of relevant laws and case studies.

Keywords: Freedom of Contract, Judicial Control, Indemnity Clause, Limitation of Liability, Liquidated Damages, Indian Contract Act, Section 73, Section 74, Reasonable Compensation, Public Policy.

¹ Sir George Jessel, *Printing and Numerical Registering Co. v. Sampson*, (1875) LR 19 Eq 462.

² *Central Inland Water Transport Corp. Ltd. v. Brojo Nath Ganguly*, (1986) 3 SCC 156.

³ Indian Contract Act, 1872.

1. INTRODUCTION

Freedom of contract underlies the very foundation of contract law.⁴ It gives individuals the discretion to enter into agreements as per their own wishes. Contracting parties have the right to negotiate terms of engagement that would be more appropriate for their respective businesses.⁵ Especially in today's commercial transactions, the freedom of contract principle is evident through the use of indemnity provisions, limitation of liability clauses, and liquidated damages clauses within contracts.⁶ These clauses ensure certainty, eliminate any uncertainty, and help to manage risks among individuals who participate in economic activities.⁷

But the concept of absolute freedom of contract does not seem to be practical at all.⁸ In a number of contractual relationships, where the parties to the contract use standard form contracts, the dominant party may force upon the weaker party conditions that are too harsh or oppressive.⁹ This may result in violating the essence of contractual justice. Thus, there are certain limitations imposed by law on contractual freedom.¹⁰

This precarious balance is achieved by the Indian Contract Act of 1872.¹¹ Although the law allows for a considerable degree of freedom for parties, it does not allow them to act arbitrarily.¹² In particular, as per Section 23, certain agreements that are against public policy and those involving illegal consideration shall be void, which means that certain terms and conditions can be prohibited under the law.¹³ Also, as per Section 28, any agreement that is an absolute restraint against legal proceedings shall be void, as parties will have to remain accessible to courts through such agreements.¹⁴

The interpretation by judges has been instrumental in giving shape to the contours of such statutory provisions.¹⁵ Indian courts have been keen to ensure that, on the one hand, there is no violation of the sanctity of contracts and, on the other hand, there should not be any oppression

⁴ Pollock & Mulla, *Indian Contract and Specific Relief Acts* (15th ed., LexisNexis)

⁵ Anson's *Law of Contract* (29th ed., Oxford University Press).

⁶ McKendrick, *Contract Law: Text, Cases, and Materials* (OUP).

⁷ Ewan McKendrick, *Contract Law* (Palgrave).

⁸ Atiyah, *Introduction to the Law of Contract* (Clarendon Press).

⁹ *Central Inland Water Transport Corp. case*, supra note 2.

¹⁰ P.S. Atiyah, *The Rise and Fall of Freedom of Contract*.

¹¹ *Indian Contract Act, 1872*.

¹² *Niranjan Shankar Golikari v. Century Spinning*, AIR 1967 SC 1098.

¹³ *Indian Contract Act, 1872*, § 23

¹⁴ *Indian Contract Act, 1872*, § 28.

¹⁵ *Gherulal Parakh v. Mahadeodas Maiya*, AIR 1959 SC 781.

or unjust enrichment.¹⁶ By adopting a balanced approach to judicial reasoning, courts have looked into the reasonableness, proportionality, and fairness of contractual provisions such as indemnity clauses, limitation clauses, and liquidated damages clauses.

In this regard, this study will attempt to analyse critically the manner in which the Indian contract law resolves the issue of freedom of contract versus judicial control. Using a discussion on some of the main statutes related to contracts, along with pertinent judicial pronouncements, this study will look at the issues of indemnity clause, limitation of liability provision, and liquidated damages clause in the light of their enforceability and meaning. The study attempts to show that contractual freedom cannot be absolute and has to be constrained by certain rules of law.

2. Conceptual Framework

2.1 Freedom of Contract

Make contracts freely: Parties have the freedom of choosing whether to make a contract or not without any coercion or compulsion.

Set the terms of the contract: The parties enjoy the freedom to fix the terms and conditions of their agreement.¹⁷

Assigning risks and liabilities: Parties have the freedom to divide risks and liabilities.

Business certainty: This is assured by the freedom of contract.

Economic efficiency: This is guaranteed by the freedom of contract.

Transaction predictability: This is made possible through the freedom of contract.¹⁸

2.2 Judicial Control

Preventing any oppression and unconscionability of a contract: The judiciary will control contracts that are oppressive and unconscionable.

¹⁶ Fateh Chand v. Balkishan Das, AIR 1963 SC 1405.

¹⁷ Cheshire, Fifoot & Furmston, Law of Contract.

¹⁸ Richard Posner, Economic Analysis of Law.

Ensuring statutory provisions are met: Contracts must meet all the legal provisions as per the statutory laws.¹⁹

- Protecting weaker parties: Weaker parties who are vulnerable are protected from any exploitation.
- Public policy (s. 23): If any contract goes against the policy of society, then the courts can strike down such an agreement.²⁰
- Reasonableness: The courts determine the reasonableness of a contract.
- Equity: This is justice.²¹

3. Indemnity Clauses: Scope and Role of Courts in Interpreting Them

3.1 Concept and Meaning

Third-party claim liability: Indemnity clauses help safeguard a person from any losses that he faces on account of a claim by some third party against him.²²

Risk associated with certain events stipulated in the agreement: They deal with those events specified in the agreement.

Not necessary to breach: Liability to indemnify is not necessarily based on a breach but may be contingent on an event.²³

3.2 Law

Indemnity clause as defined in sections 124 and 125 of the Indian Contract Act: Sections 124 and 125 provide for indemnity and the rights of the indemnity holder.²⁴

Great latitude is enjoyed by parties in formulating their indemnity terms: There is great freedom

¹⁹ Central Inland Water Transport Corp., supra note 2.

²⁰ Indian Contract Act, 1872, § 23.

²¹ LIC of India v. Consumer Education & Research Centre, (1995) 5 SCC 482.

²² Adamson v. Jarvis, (1827) 4 Bing 66.

²³ Gajanan Moreshwar v. Moreshwar Madan, AIR 1942 Bom 302

²⁴ Indian Contract Act, 1872, §§ 124–125.

in drafting indemnity clauses according to one's business necessities.²⁵

3.3 Approach of the Judiciary

Extent of the Indemnity: The scope of the indemnity, as determined by courts, is based on the wording of the contract.

Intentions of the Parties: The approach of the courts with regard to indemnity involves determining the actual intentions of the parties during contract formation.²⁶

Too One-Sided: The court's review of the contract might reveal whether the clause is too lopsided against one party.

Avoid Liability of Wrongdoing: The use of an indemnity clause cannot help one to evade liability for his or her wrongdoings.²⁷

Defeat Statutory Rights: The judiciary helps in preventing indemnity provisions from conflicting with statutory rights.²⁸

4. Limitation of Liability Clauses: Restricting Contractual Freedom 4.1

Definition and Purpose

Limit financial responsibility: This is a clause that limits the extent to which an individual can be responsible for any harm caused by breach of contract.²⁹

Prevent the recovery of certain categories of damage (such as consequential damages): It prevents compensation for damages arising out of the breach of contract.

They are common in business transactions to hedge risks: It enables the parties to regulate their financial risk beforehand.³⁰

²⁵ Pollock & Mulla, *supra* note 4.

²⁶ *New India Assurance Co. v. Kusumanchi Kameshwara Rao*, (1996) 2 SCC 217.

²⁷ *Oil & Natural Gas Corp. v. Saw Pipes Ltd.*, (2003) 5 SCC 705.

²⁸ *Economic Transport Organization v. Charan Spinning Mills*, (2010) 4 SCC 114.

²⁹ *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] AC 827 (HL).

³⁰ McKendrick, *supra* note 6.

4.2 Legal Restrictions

Section 23 (public policy): A clause that is contrary to law or public policy is considered void.³¹

Section 28 (legal process): A clause that prohibits legal action is null and void.³²

4.3 Judicial Interpretation

They are reasonable: Courts will apply limitation provisions provided that they are reasonable and fair.³³

They are not exempt from liability for acts of fraud or reckless disregard. It is forbidden to use a contract provision to escape liability for an act of fraud or reckless disregard.³⁴

They do not frustrate the object of the agreement: The clause should not work against the very reason for agreeing.

Unreasonable clauses may be disregarded by courts: Courts may strike such clauses if they are unreasonable or against the principles of justice and equity.³⁵

5. Liquidated Damages: Compensation vs Punishment

5.1 Meaning

The term liquidated damages implies a pre-estimated sum that is payable in the event of any breach. It denotes the effort made by both parties to calculate their loss before any disagreement arises.³⁶

5.2 Legal Provisions

Section 74 of the Indian Contract Act states: This section determines the validity of prearranged sums in case of breach and prevents undue demands.³⁷

³¹ Indian Contract Act, 1872, sec 23, 28.

³² *Superintendence Co. v. Krishan Murgai*, (1981) 2 SCC 246.

³³ *A.B.C. Laminart Pvt. Ltd. v. A.P. Agencies*, (1989) 2 SCC 163.

³⁴ *HIH Casualty v. Chase Manhattan Bank*, [2003] UKHL 6.

³⁵ *Central Inland Water Transport Corp.*, supra note 2.

³⁶ *Dunlop Pneumatic Tyre Co. v. New Garage*, [1915] AC 79.

³⁷ Indian Contract Act, 1872, sec-74.

The maximum amount of compensation is not more than the stipulated sum: The party suffering the loss cannot claim more than the amount fixed in the contract.

Focus on “reasonable compensation”: The courts will provide only reasonable compensation, irrespective of the figure fixed in the contract.³⁸

5.3 Judicial Development

Reasonable Compensation: Courts make sure that the amount fixed is commensurate with the loss suffered.

Exact Loss Not Required to be Proved: In some cases, particularly those wherein loss is hard to prove, stringent rules on this matter are liberalized.

Loss Should Be Proved: For one thing, no loss implies no compensation, which is why courts usually demand at least some kind of loss or injury.

Good Faith Estimate Binding: Where there is reason to believe that the amount stipulated is merely an estimate of likely loss, courts uphold it.

Punitive Amount Struck Out: If the amount stipulated is in any way punitive in nature, courts strike out its enforcement.

6. Relationship Between the Three Clauses

Clause	Function	Judicial Concern
Indemnity	Risk transfer	Over-broad liability
Limitation	Risk restriction	Unfair exclusion

Liquidated Damages Pre-estimated loss Reasonableness

The interaction between these clauses is quite complicated:

³⁸ Fateh Chand v. Balkishan Das, supra note 16

- Indemnity – Risk shifting – Excessive liability: The indemnity clause has a high risk of causing excessive liability.
- Limitation – Risk restricting – Unjustifiable exclusion: The limitation clause has a great risk of becoming unjust to claims.
- Liquidated damages – Loss estimation – Reasonableness: This type of clause should always be based on true loss estimation.

Issues Involved:

Whether the indemnity clause supersedes the limitation clause: It is for the court to decide whether an indemnity clause supersedes a limitation clause.

Whether the pre-estimated loss can escape liability limits set by the clause: The court will determine if the clause will cover all pre-estimated losses.

Misuse for purposes of evading Section 74: The court will ensure that no clause is used for the purpose of evading Section 74.

Court's Approach:

Holistic interpretation to achieve equilibrium: The court will interpret the contract as a whole, taking into account the interaction between the various clauses.³⁹

7. Comparative and International Perspective

English common law (reasonableness doctrine): The Indian legal system borrows heavily from the traditions of the English system, where fairness and reasonableness have always been the key elements in the formulation of contract terms.

American drafting techniques (detailed risk distribution): The contract provisions also reflect the impact of American drafting, which usually includes extensive distribution of risks within contracts.⁴⁰

³⁹ Oil & Nat. Gas Corp. Ltd. v. Saw Pipes Ltd., (2003) 5 S.C.C. 705 (India).

⁴⁰ Int'l Inst. for the Unification of Private Law (UNIDROIT), Principles of International Commercial Contracts (2016).

- CISG: The convention creates international uniformity in sale-of-goods contract provisions.
- UNIDROIT Principles: The internationally recognized standards on formation and performance of a contract are adopted in the Indian context.
- UNCITRAL Model Law: Arbitration and dispute resolution conventions affect contract formation and enforcement.
- Codified framework: Indian contract law relies on the Indian Contract Act, 1872.
- Courts' interpretation discretion: Judicial decisions play an important role in the formulation of fair contract terms.
- Best international practices: Global standards are integrated into the Indian framework of contract legislation.
- Hybrid approach: Therefore, contract law in India combines domestic regulations and international considerations to provide a flexible yet controlled contractual framework.

8. New Developments

8.1 Contracting in Technology

Indemnification for IP and data breaches: Indemnification is now standard practice in contracts to mitigate IP and data breach issues.

Sophisticated liability provisions: Liability clauses are getting increasingly complex with several caps, exemptions, and risk-specific limitations.

Liability issues with AI: With the advent of AI, there is an issue of assigning fault in liability cases.

8.2 Transactions Across Borders

Uniformity in clauses: Cross-border transactions now have standardized clauses to ensure uniformity and efficiency in the contract.

Arbitration for dispute resolution: Arbitration is the preferred mode of dispute resolution in international contracts.

Risk allocation in cross-border transactions: Risks are allocated across borders through crossborder contracts.

8.3 Risk Management Integration

Insurance-related contracts: The liabilities in the contracts match the insurance policies available.

Flexible clauses (review and escalation): There are flexible clauses in the contracts that can be revised due to changes over time.

Risk management contracts: Contracts are prepared depending on the risk analysis of the enterprise.

9. Challenges in the Existing Law

While there are detailed provisions in the Indian Contract Act, 1872, regarding certain contractual terms, some problems still exist in the law's ability to regulate modern contracts. First, there are no statutory guidelines to interpret and apply limitations of liability clauses. Even though they are commonly applied in modern commerce, their interpretation is left at the discretion of courts without clear rules laid out by the Indian Contract Act of 1872.

Another challenge in interpreting the Indian Contract Act, 1872, lies in the determination of "reasonable compensation" in Section 74. It is challenging to find an objective definition that could serve as a guide to the amount of reasonable compensation. Thus, the process of calculating damages is quite subjective and unpredictable.

Moreover, inconsistency in judicial interpretation is another problem associated with contract law in India. Courts might apply different ways when interpreting provisions for indemnities, limitations, and liquidated damages according to their judicial discretion and facts of the particular case, which will cause legal uncertainty and may provoke litigation.

Furthermore, modern contracts are too complicated due to the increased technical nature of contractual relationships. The high complexity of contracts makes them challenging to interpret

and enforce. Such an aspect makes them prone to legal disputes since courts might have problems understanding the intentions of the parties to the contract.

In general, such challenges make it necessary for India to have a clear legislative regulation and judicial practice in place.⁴¹

10. Suggestions

Drafting Clarity: Define terms and duties clearly so that there can be no confusion and minimize room for disagreements.

Reasonable Clause Drafting: Draft clauses keeping risks in mind and do not make any unnecessary obligations.

Clause Conformity with Statute: All the clauses need to conform to sections 23, 28, 73, and 74 of the Indian Contract Act.

Exceptions: Mention exceptions to such an agreement in cases like fraud, gross negligence, and wilful misconduct to keep things balanced.

Dispute Resolution Techniques: Arbitration and mediation should also be included in the contract for easy dispute resolution.

Industry Specific Clauses: Customize the contract clauses according to industry-specific requirements.

11. Conclusion

Freedom of contract and judicial regulation are both critical principles in the law of contract in India. The use of indemnity, limitation of liability, and liquidated damages provisions is an essential part of business planning. But all this relies on judicial evaluation based on principles of fairness, reasonableness, and sound public policy.

India's legal regime achieves balance through:

- Protection of contractual freedom

⁴¹ Fateh Chand, A.I.R. 1963 S.C. 1405.

- Avoidance of abuse of position
- Favouring just results

After all, good contract drafting is not simply about legal expertise; it also involves practical business sense.

Therefore, the Indian legal system follows an equitable approach. While on one hand, the system recognizes the autonomy of contractual negotiations and drafting, it ensures that such autonomy is not misused in any form. It makes sure that clauses in contracts that are unjust, unreasonable, and against public policy are voided or modified. Moreover, it ensures that while interpreting the terms and conditions laid down in a contract, the courts ensure fairness, and justice prevails.⁴²

It goes without saying that in today's scenario, where globalization, technological development, and changes in business models are taking place, effective drafting of contract clauses is essential. Contractual clauses should reflect practical considerations apart from legal considerations alone. This implies that lawyers should have a clear understanding of business realities. They must understand the risks involved in the contract and lay down clauses accordingly.

Overall, the interrelationship of the freedom of contracting and judicial intervention in India portrays an intricate and ever-changing legal process where commercial efficiency and fairness are equally considered to create harmony. The freedom of contracting allows for a certain level of flexibility on the part of the involved individuals, as long as there is judicial intervention to guarantee that the elements of reasonableness, fairness, and interest of the general population are taken into consideration.

⁴² Cent. Inland Water Transp. Corp., (1986) 3 S.C.C. 156.