RISK ALLOCATION CLAUSES IN MODERN COMMERCIAL CONTRACTS

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ABSTRACT

Now commercial contracts are no longer limited to dealing with disputes after a breach has occurred. Instead, they are drafted to manage risk in advance by clearly allocating responsibility for loss, liability, and enforcement. Clauses such as indemnity, limitation of liability, liquidated damages and de minimis play an important role in this process by deciding who bears the risk, how much can be claimed and when a claim may arise. These clauses are unavoidable in sectors such as technology licensing, infrastructure and construction, mergers & acquisitions, joint ventures, and service agreements, where contracts involve substantial financial exposure, performance obligations, regulatory scrutiny, and commercial uncertainty. In such transactions, parties depend of these clauses to allocate risk in advance, contain liability, and ensure that potential breaches do not undermine the commercial viability of the arrangement. This paper provides the importance and relevance of these clauses and explains their role in shaping risk allocation in commercial contracts under Indian law.

MAIN BODY:

Indemnity:

An indemnity clause is a central risk allocation clause in commercial contracts. One party gives a contractual guarantee that it will compensate the other party for losses arising due to its acts, or breaches in accordance with the agreed terms. Indemnity generally covers a wide range of consequences including intellectual property infringement, loss, damage, penalties, costs, claims, and legal proceedings. Basically, indemnity reflects a guarantee that if one party suffers loss due to the indemnifier's wrongful conduct, the indemnifier will make that loss good.

Indian courts have consistently recognised that a contract of indemnity is independent of the principal contract. In [1]*Deepak Bhandari v. HPSIDC*, the Supreme Court held that indemnity obligations are separate and enforceable irrespective of disputes under the main agreement.

Indemnity is especially relevant in modern commercial contracts because several risks cannot be effectively addressed through ordinary damages alone. For example, in a technology licensing agreement between Company A and Company B, Company B is contractually obligated to not copy, reverse engineer, or develop any derivative technology based on Company A's licensed technology. The agreement further contains an indemnity clause requiring Company B to indemnify and hold harmless Company A against all losses, damages, costs, and liabilities arising from any breach of these obligations. If company B subsequently develops a substantially similar technology by making minor modifications to Company A's model, resulting in infringement of Company A's intellectual property or unauthorised use of confidential information, the indemnity clause would require Company B to compensate company A for the losses suffered. In this manner, indemnity functions as a risk-allocation mechanism between the contracting parties by ensuring that the financial consequences of the wrongful act are borne by the party responsible for it.

Indian courts have further strengthened the utility of indemnity by recognising that it may be invoked once liability becomes certain, as provided in the case [2]*Gajanan Moreshwar v. Moreshwar Madan Mantri,* Bombay High Court held that an indemnity holder does not need

[1] *Deepak Bhandari v. Himachal Pradesh State Industrial Dev. Corp. Ltd.*, Civil Appeal No. 1019/2014 (S.C. India 2014)

[2] *Gajanan Moreshwar Parelkar v. Moreshwar Madan Mantri*, AIR 1942 Bom. 302, (1942) 44 BomLR 703

to wait for actual loss to occur and can enforce the indemnity once the liability becomes absolute or legally certain.

In practice indemnity clauses are commonly placed along with boilerplate clauses. This drafting approach may cause parties to underestimate their scope and impact at the negotiation stage. In real world operation, indemnity functions as a protective shield as once liability is established, the indemnifier must step in to cover legal costs or damages as agreed through legal options.

Limitation of Liability:

A limitation of liability clause sets a defined upper limit on the amount a party may be held liable for in the event of breach or related claims. Its primary function is to introduce commercial certainty by enabling parties to assess risk, price their obligations and obtain insurance based on a known exposure threshold. In the absence of such a clause, even minor breaches may result in disproportionate and unpredictable liability.

Indian courts have generally upheld contractual caps on liability where they are clear and mutually agreed. These clauses are particularly significant in long term or high value contracts where potential losses may far exceed the contract value itself. In practice, limitation clauses are often located along with boilerplate clauses and may be overlooked during negotiations despite their far-reaching consequences.

A limitation of liability clause generally becomes operative once a breach or indemnity claim arises. Indian courts assess their enforceability under *Section 73 and 74 of the Indian Contract Act*, with reference to fairness, reasonableness, and public policy. Courts have also consistently enforced exclusion and limitation clauses. Decisions such as [3]*ONGC v. Wig Bros*, reinforce the principle that clear contractual exclusions must be respected, however the freedom is not absolute in [4]*Central Inland Water Transport Corporation v. Brojo Nath*, the Supreme Court struck down unconscionable contractual terms imposed in situations of unequal bargaining power. Further, in [5]*Texco Marketing v. TATA AIG*, court restricted the operation of exclusion clauses where consumer protection principles applied and provided that certain liabilities,

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[3] *Oil & Natural Gas Corp. Ltd. v. Wig Brothers Builders & Engineers (P) Ltd.*, (2010) 13 SCC 377
[4] *Central Inland Water Transport Corp. Ltd. v. Brojo Nath Ganguly*, AIR 1986 SC 1571, (1986) 3 SCC 156
[5] *Texco Marketing Pvt. Ltd. v. TATA AIG General Insurance Co. Ltd. & Ors.*, (2023) 1 SCC 428, Civil Appeal No. 8249/2022 (S.C. India 2022)

including death, statutory obligations or breaches that defeat the fundamental purpose of the contract cannot be excluded.

limitation of liability operates as a financial safety limit. For example, where a software services contract caps liability at the contract value, the service providers exposure remains limited even if the clients' losses are substantially higher, unless the claim falls within a non-excludable category. This illustrates how such clauses balance risk allocation while preventing commercially unworkable outcomes.

Liquidated Damages:

Liquidated damages clauses allow parties to pre determine the monetary consequence of specified breaches. Their principal objective is to provide certainty and avoid post breach disputes over the quantification of loss. In commercial contracts, this enables businesses to manage timelines, plan cash flow and reduce litigation risk.

Under *section 74 of Indian Contract Act*, liquidated damages operate as the maximum recoverable amount for the relevant breach, subject to the requirement of reasonableness. In [6]*Fateh Chand v. Balkishan Das*, the Supreme Court held that only reasonable compensation can be awarded and that the stipulated sum does not automatically become payable, and courts retain the power to reduce the stipulated sum if it is found to be excessive or unrelated to the anticipated harm.

This position was expanded in [7]*ONGC v. Saw Pipes*, where the court adopted a more commercial approach, holding that liquidated damages may be enforced even without strict proof of actual loss, provided the amount represents a genuine pre-estimate. However, subsequent decision by Supreme Court have reintroduced judicial scrutiny, in [8]*Kailash Nath v. DDA,* clarified that liquidated damages cannot be awarded arbitrarily where no loss has occurred.

Therefore, reflecting a balance between contractual certainty and judicial control. While parties seek predictability through pre-estimated damages, court retain discretion to ensure that the

[6] *Fateh Chand v. Balkishan Das*, AIR 1963 SC 1405, (1964) 1 SCR 515
[7] *Oil & Natural Gas Corp. Ltd. v. Saw Pipes Ltd.*, AIR 2003 SC 2629, (2003) 5 SCC 705
[8] *Kailash Nath Associates v. Delhi Development Authority*, (2015) 4 SCC 136

stipulated amount remains reasonable and connected to anticipated loss.

In practice, liquidated damages clauses are often embedded within technical schedules or service level agreements rather than appearing as standalone clauses, which may cause parties to underestimate their financial impact.

For example, where a construction contract stipulates liquidated damages of 1 lakh for delay beyond the completion date, the employer may claim that amount without proving precise loss, unless the court considers it unreasonable. The contractor's exposure is known in advance even if the actual loss is higher or lower.

De Minimis:

A de minimis clause sets a minimum threshold below which claims or liabilities cannot be enforced, ensuring that trivial breaches do not trigger legal action. Its purpose is to prevent contractual enforcement from being invoked for minor or technical deviations, thereby saving time, cost, and administrative effort of the Parties. It sets a minimum level of enforceability. So that contractual consequences arise only when a breach is material and not trivial.

In practice, de minimis clauses are commonly applied to small warranty, indemnity or operational claims and are often embedded discreetly within liability related clauses as a single line threshold. For example, if a contracts threat claims below 50000 rupees as de minimis, losses below that amount are disregarded, while claims exceeding the threshold become actionable.

The clause reflects the principle of *de minimis non curat lex* meaning the law does not concern itself with trivial matters and is supported by *section 95 of IPC*. In [9]*Comcare v. Sahu Khan*, court held that for the de minimis principle to not apply, the harm must be material in nature. In [10]*India TV v. Yashraj Films*, Delhi High Court applied the principle to hold that copying an insignificant portion of a work did not warrant legal intervention as trivial in nature.

Courts decline the application of de minimis in matters involving public safety, repeated misconduct, or public interest, as provided in *State v. Puran Mal (1985)*, the Supreme court

[9] *Comcare v. Sahu Khan*, [2007] FCA 243 (Austl.) (persuasive authority)
[10] *India TV Independent News Service Pvt. Ltd. v. Yashraj Films Pvt. Ltd.*, FAO(OS) 583 & 584/2011 (Del. H.C. Aug. 21, 2012), 2013 (53) PTC 586 (Del.)

declined to apply de minimis in cases involving public health and held that public health considerations override triviality.

Suggestions:

Indemnity, limitation of liability, liquidated damages, and de minimis clauses are independent clauses, each serving a distinct function. While they do not depend on each other for their operation, careful drafting ensures that they work harmoniously.

For drafting these clauses, parties should clearly define the scope of indemnity, specify the types of losses covered, and expressly state whether indemnity obligations are capped or excluded from liability limits. Limitation of liability clauses should reflect a commercially reasonable balance and clearly identify non-excludable risks. Liquidated damages should be based on a genuine pre-estimate of loss, and de minimis thresholds should be realistic to filter trivial claims without denying meaningful remedies.

These clauses are not mandatory, but when included thoughtfully and applied equally, they benefit both parties by reducing uncertainty, minimising disputes, and protecting against unexpected financial exposure. Their true value lies not in avoiding liability altogether but in ensuring that liability is predictable, proportionate, and commercially workable.

Conclusion:

The primary objective of parties entering a commercial contract is to conduct business while safeguarding themselves against foreseeable risks. Indemnity, limitation of liability, liquidated damages, and de minimis clauses assist in achieving this balance by allowing parties to allocate risk in advance and reduce certainty if disputes arise. In practice these clauses are not drafted to eliminate liability but to make liability manageable. Parties accept that disputes may arise, but seek clarity on exposure, timing, and responsibility. Risk allocation clauses therefore reflect commercial realism rather than an attempt to avoid accountability. When drafted carefully and fairly, these clauses protect both parties and promote stable commercial relationship. While they are not compulsory, their inclusion based on mutual understanding and commercial equality, plays a significant role in minimising risk and ensuring contractual certainty in modern commercial transactions.