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Limitation of Liability Clauses in Business Contracts: Limiting Potential Damages and Avoiding Pitfalls

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Today's faculty features:

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Limitation of Liability Clauses in Business Contracts

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Contracts Involve Risk

Limitations on liability generally pertain to:

- The risk of non-performance
- The risk of flawed performance

That could harm the other party directly or result in third-party claims against the other party.

The limitation may apply to contract, tort, and other claims such as infringing on the rights of a third party.

(The risk of unforeseen events is generally dealt with in Force Majeure provisions or through doctrines of impossibility and/or frustration of performance, and through insurance).

Contracts Involve Risk

Three factors to consider in negotiating limitations on liability:

1. How likely is it that a party will not perform or perform poorly?

2. How severe will the impact be if a party fails to perform or performs poorly?

3. What risks can be addressed through insurance?

Limitations on Liability

A limitation on liability clause is a provision stating that if one party damages the other, it is not responsible for the **full amount** of the damage.

Limitations on Liability

A limitation on liability clause is generally enforceable unless prohibited by statute, unconscionable, or it violates public policy.

Statutes generally bar lawyers, doctors, and some other professionals from attempting to limit their liability.

Limitations on Liability

Agreeing on a ceiling for damages can be helpful so the parties know what their maximum exposure might be before entering into the agreement.

"This is particularly important in situations where the fees paid are relatively small compared to the potential liability of something goes wrong." Espenschied, *Contract Drafting*, 2nd Ed., p. 69.

Limitations on Liability versus Exculpatory and Hold Harmless Provisions

Limitation on liability clauses are sometimes called "**Exculpatory Clauses**," but conceptually it's best to think of an exculpatory clause as a provision stating that if one party injures the other, it is **not responsible at all**.

If the party causing the damage is not responsible for any damages, that is really a **"hold harmless" agreement**, e.g., a **release from all liability** rather than a **cap on liability**. *See, e.g., Rooz v. Kimmel*, 55 Cal.App.4th 573, 582 (1997)(Hold harmless provision prevented plaintiff from recovering damages resulting from defendant's negligence).

Limitations on Liability versus Indemnity and Force Majeure Provisions

Don't confuse a limitation on liability clause with an **indemnity provision**. **Indemnification** is the right of a party that is legally liable for a loss (the indemnitee) to shift that liability to another party (the indemnitor). *American Transtech, Inc. v. U.S. Trust Corp.*, 933 F.Supp. 1193, 1202 (S.D.N.Y. 1996). Indemnification generally involves claims by third-parties, not claims between parties to the agreement.

Don't confuse a limitation on liability clause with a **force majeure clause**. A force majeure clause is not a limitation on a party's liability – it is a provision that completely absolves a party from any liability.

Limitations on Liability versus Indemnity and Force Majeure Provisions

Don’t confuse “indemnify” and “hold harmless” even though many courts treat them as synonymous.

The inclusion of "hold harmless" has led to litigation over whether the indemnitor must advance defense costs to the indemnitee. *Majkowski v. American Imaging Management Service*s, 913 A. 2d 572 (Del. Ch. 2006).

"Hold harmless" language may also open the door to claims that one party agreed to release the other from responsibility for its own negligence. *Rooz v. Kimmel*, 55 Cal.App.4th 573, 582 (1997).

Limitations on Liability versus Liquidated Damages Provisions

Don't confuse a limitation on liability clause with a **liquidated damages** provision. A **liquidated damages** provision is a provision where the parties agree **in advance** on a dollar amount for damages regardless of the actual damages. Tina L. Stark, *Negotiating and Drafting Contract Boilerplate*, page 225.

A liquidated damages provision is enforceable if three conditions are satisfied: (1) the parties intended to agree in advance to the settlement of damages that might arise from a breach, (2) the amount provided as liquidated damages was reasonable at the time of contracting, bearing some relation to the damages which might be sustained, and (3) the actual damages would be uncertain in amount and difficult to prove. *John Hancock Life Insurance Company v. Abbott Laboratories*, 863 F.3d 23 (1st Cir. 2017); see also, UCC Section 2-718.

Contractual Provisions Relevant to Risk Allocation

Limitations on Liability;

Indemnity Provisions;

Insurance Provisions;

Force Majeure Provisions;

Attorney's Fees and Costs;

Liquidated Damages Provisions

Remedies; and (maybe)

Representations and Warranties (since these may give rise to a cause of action)

Types of Limitations on Liability

- Dollar caps

- Limitations on the types of damages, e.g., consequential, indirect, incidental, special, and punitive. (Damages where it is more difficult to foresee the dollar amount of damage).

Types of Damages

Careless drafting can cause problems if you don't understand the difference between various types of damages:

Direct damages – damages proximately caused by the breach that flow naturally from it.

Incidental damages – Costs and expenses the non-breaching party incurs to avoid other direct and consequential losses, e.g., finding a replacement or cover.

Consequential damages – Damages that are not direct or incidental.

"Indirect damages" and "Special damages" – Courts are not consistent. Some use these terms as synonyms for consequential and others use them to refer to both consequential and indirect damages.

Types of Damages

"The line between direct and consequential damages depends on the context, and it's not always clear." David W. Tollen, *The Tech Contracts Handbook*.

Ken Adams, an authority on contract drafting, points out that damages are never recoverable if not reasonably foreseeable. Given that courts don't always agree on whether a damage is direct, and given their sometimes inconsistent terminology, he argues against excluding consequential damages and suggests something like this:

Neither party will be liable for breach-of-contract damages that the breaching party could not reasonably have foreseen on entry into this agreement.

Adams, *Excluding Consequential Damages is a Bad Idea*.
https://www.adamsdrafting.com/excluding-consequential-damages-is-a-bad-idea/

Lost Profits

Be specific if you want to exclude lost profits.

"It is well established that damages that are consequential in one case might be direct in another." *Biovail Pharmaceuticals, Inc. v Eli Lilly and Co.,* United States District Court, E.D. North Carolina, Western Division, February 28, 2003, Not Reported in F.Supp.2d, 2003 WL 25901513.

Consider, "Lost profits, whether direct or consequential."

UCC Provisions

§ 2-710. Seller's Incidental Damages.

Incidental damages to an aggrieved seller include any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation, care and custody of goods after the buyer's breach, in connection with return or resale of the goods or otherwise resulting from the breach.

UCC Provisions

§ 2-715. Buyer's Incidental and Consequential Damages.

(1) Incidental damages resulting from the seller's breach include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

(2) Consequential damages resulting from the seller's breach include:
(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and
(b) injury to person or property proximately resulting from any breach of warranty.

UCC Provisions

§ 2-719. Contractual Modification or Limitation of Remedy.

(1)Subject to the provisions of subsections (2) and (3) of this section and of the preceding section on liquidation and limitation of damages, (a) the agreement may provide for remedies in addition to or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of non-conforming goods or parts; and (b) resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.

(2)Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act.

(3) Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not.

Frequently Used Exceptions

Drafters may want to exclude certain types of claims from otherwise applicable limitations on liability:

- Indemnity claims when a third-party sues
- Breach of confidentiality
- Gross negligence, willful misconduct, fraud

Avoid conflicts between limitations on liability and other provisions, such as indemnity provisions

Suppose a contract has an indemnity provision with no dollar limit on the duty to indemnify, but also has a limitation on liability that sets a dollar limit. Does the limitation on liability put a cap on the duty to indemnify? **Probably yes, unless you carve out an indemnity exception.**

A court should review a contract "in its entirety with the end in view of seeking to harmonize and to give effect to all provisions so that none will be rendered meaningless." *Copper Mountain, Inc. v. Industrial Systems, Inc.*, 208 P.3d 692 (Colo. 2009).

Avoid conflicts between limitations on liability and other provisions, such as insurance provisions

Be clear as to the interplay between limitations on liability and insurance requirements in the contract.

One common variation is to provide that a party's aggregate liability is limited to the coverage afforded by that party's insurer.

Enforceability Issues Simple Negligence

Parties are generally free to contract as they wish, and courts will enforce contracts according to their plain meaning, unless induced by fraud, duress, or undue influence. See, e.g, *Utility Service and Maintenance, Inc. v. Noranda Aluminum, Inc.*, 163 S.W.3d 910 (Mo. 2005).

As a general proposition, however, contractual provisions releasing a party from liability for its own negligent acts must be stated clearly, unequivocally, and conspicuously. Id.

Despite these general principles regarding contracts that eschew liability, this Court has drawn a distinction between contracts with consumers and contracts between businesses of equal power and sophistication. Id.

Enforceability Issues Gross Negligence

In states the recognize a distinction between negligence and gross negligence, provisions purporting to relieve a party of responsibility for gross negligence may be void. *Sommer v. Federal Signal Corp*., 79 N.Y.2d 540 (Court of Appeals of N.Y. 1992).

Enforceability Issues Reckless Conduct

Provisions purporting to relieve a party of responsibility for reckless conduct are probably unenforceable. *Tayar v. Camelback Ski Corp. Inc*., 47 A.3d 1190 (Pa. 2012).

Enforceability Issues Willful Misconduct

Limitations on liability as to willful misconduct are probably not enforceable. See, e.g., *Milligan v. Big Valley Corp*., 754 P.2d 1063 (Wyo. 1988).

Drafting Tips

- Make the limitation conspicuous, such as by using CAPS or **bold** letters. (Particularly important in consumer contracts).

- Exclude gross negligence, reckless conduct, willful misconduct, and fraud.

Drafting Tips

- Carve out exceptions for indemnification, breach of confidentiality, etc.

- Harmonize with insurance requirements.

Drafting Tips

- Include a provision that both parties participated in negotiating the contract.

- Include a provision that both parties had the opportunity to have counsel review the contract.

Drafting Tips

- If the intent is to limit liability for all claims," including negligence claims, specifically use the word "negligence." Though many states no longer require this in a commercial context, many still require it in a consumer contract.

Drafting Tips

Consider specifically stating the consideration for the limitation on liability and giving the other party the option to pay more in return modifying the limitation. This may make it more difficult for the other party to argue it was an adhesion contract. See, e.g., *Head v. U.S. Inspect DFW, Inc*., 159 S.W.3d 731, (Tex. App. 2005)(Furthermore, without the ability to limit liability, the costs of home inspection services would likely increase, which might make this service unaffordable for some).

About Mark

Mark has 36 years of experience as a lawyer. His practice focuses on drafting and reviewing legal documents and litigating disputes arising out of poorly drafted documents. He helps lawyer and organizations translate their legal documents into plain English. He is a Legal Advisor to **TermScout**, a company that reviews and rates contracts.

Mark earned a B.A.in Economics at Whitman College and earned his law degree at the University of Colorado in Boulder. He earned an LL.M. from the University of Arkansas, where he also taught advanced legal writing. His diverse legal career includes service as an Air Force JAG, a Special Assistant U.S. Attorney, a prosecutor, a municipal judge for Boulder, six years on the Advisory Board of The Colorado Lawyer (including one as chairperson), and service on the Executive Board of the Colorado Municipal League.

Mark wrote six articles in the Am.Jur. *Proof of Facts* series, including the seminal article on piercing the corporate veil.

Mark's article, *How to Draft a Bad Contract*, first published in *The Colorado Lawyer*, was praised by Harvard Prof. Steven Pinker as "simply brilliant" and has been republished in several journals including the *Scribes Journal of Legal Writing*.

Mark holds a black belt in karate and serves on the board of directors of Dart, Inc., a Boulder non-profit that offers training in personal safety, violence prevention, and appropriate dating relationships.

STOEL RIVES LLP

Creating Limitations of Liability That Both Parties Can Live With

Presented by
Zachary S. Davis
December 2019

Outline of Presentation

1. Should I Agree to an LOL in the First Place?
2. What Mechanisms Can I Use to Soften the Blow?
   a. Insurance Conditions
   b. Downstream Vendor Conditions
   c. Notice Conditions
   d. Performance Conditions
3. Other Negotiating Considerations
4. Conclusion

1. SHOULD I AGREE TO AN LOL IN THE FIRST PLACE?

- LOLs are a valuable negotiating point for vendors
- "Standard Form" documents attempt to set the trend
- LOLs should be limited to special circumstances
  - Results outside the reasonable control of the provider
  - The business model would not survive without LOL
  - Fee earned is disproportionate to risk
  - LOL is not a disincentive to good performance
- Some professions cannot limit liability (doctors/lawyers)

2. What Mechanisms Can I Use to Soften the Blow?

- The party that wants the LOL is typically the party that drafts it
- The party that responds to a proposed LOL usually considers negotiating:
  - Nothing and just blindly signs the form
  - All or nothing, because they see it as black or white
  - The LOL dollar amount
- What dictates whether conditions can be added to the enforceability of an LOL?
  - Leverage
  - The nature of the product or service
  - Creativity

2. What Mechanisms Can I Use to Soften the Blow?

- Adding conditions can serve many purposes:
  - Limits LOL application to appropriate circumstances only (e.g., ordinary negligence not gross negligence or intentional conduct)
  - Requires other safeguards to ensure an adequate remedy even when an LOL applies (e.g., the contractually required insurance is placed by the provider)
  - Ensures that you don't inadvertently limit other remedies (such as rights against 3rd parties not expressly subject to the LOL)

2. What Mechanisms Can I Use to Soften the Blow?

A. Insurance conditions

- LOL is limited to listed dollar limits of required vendor insurance
- LOL is limited to vendor's available insurance
- LOL is limited to actual proceeds from vendor's insurance
- LOL is limited to the greater of $1M or the amount of available insurance (or proceeds of insurance)
- LOL is limited to vendor's insurance limits + $500,000 (the "skin in the game" approach)

2. What Mechanisms Can I Use to Soften the Blow?

A. Insurance Conditions

- LOL will not apply unless all required insurance of vendor is purchased and maintained
- LOL will not apply if unacceptable exclusions are included in the insurance policy

2. What Mechanisms Can I Use to Soften the Blow?

B. Downstream Vendor Conditions

- LOL applies only to the prime vendor
- Preserve your right to make direct claims against downstream subs and suppliers of vendor
- Ensure subcontracts and supply contracts are assignable to you upon request
- Condition prime LOL enforceability on subcontracts maintaining proper insurance and assignment clauses

2. What Mechanisms Can I Use to Soften the Blow?

C. Notice Conditions

- LOL unenforceable unless prime vendor gives notice of mistake within X days of occurrence
- LOL unenforceable unless prime vendor gives notice of other claims made against insurance assets within X days of claim
- LOL unenforceable unless prime vendor gives notice of actual reduction in limits within X days of reduction

2. What Mechanisms Can I Use to Soften the Blow?

D. Performance of the Work Conditions

- LOL applies only to certain types of error (e.g., engineer's liability is limited only for professional negligence, not car wrecks, IP liability, etc.)
- LOL does not apply to failure to meet the standard of care; LOL applies only to other failures (e.g., guarantee of certain results)
- LOL unenforceable unless prime vendor first exhausts all remedies against insurance, subs and suppliers, or other responsible parties

3. Other Negotiating Considerations

- Make the LOL mutual
- Limit the LOL to certain types of damage
  - Direct damages – No LOL
  - Consequential/Punitive/Indirect – LOL applies
  - Indemnity from 3rd party claims – No LOL
  - Attorney Fees – LOL dollar amount does not include fees (separately collectible)
- Make the LOL a % of your damage (50/50) instead of an absolute dollar amount
- Make the LOL per claim (not per contract)

4. CONCLUSION

- Do not blindly agree to LOLs
- Negotiate more than yes/no or dollar amount
- Find exceptions that the vendor cares less about
- Consider the many alternatives and conditions that can help ensure better performance and a better remedy if there is a performance failure

THANK YOU

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