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

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Purpose for Contracts

The main purpose of a contract is to formalize new relationships or projects and outline the various legal obligations each party owes to the other.

Most contracts are between businesses, not people.

Though individuals will sign contracts occasionally - to buy/sell a house, obtain a personal loan, or accept a job offer - businesses sign legal agreements in the masses, with partners, customers, vendors, and suppliers.

The truth is, contractual agreements form the backbone of every commercial relationship.

Purpose for Contracts

Another important aspect of contracts is to define risk.

Like any relationship, a contractual relationship has risks: risk of nonperformance or defective performance.

A contract can address these risks by allowing certain remedies or limiting certain remedies.

A contract can allow remedies (or making them easier to obtain), i.e., attorney's fees, injunctive relief, receivership relief, etc.

A contract can alter the forum or procedure for resolving disputes, i.e., arbitration, forum-selection, jury-waiver, venue-selection clauses.

A contract can also address risk by limiting liabilities.

Purpose of Limitation-of-Liability Clauses

There are many business relationships where the reward involved in the relationship does not outweigh the risk involved in the relationship.

One can imagine a technology vendor that stands to earn $100,000 for work on a program for a client, but it may have the risk of millions for intellectual property issues or security issues.

Without limiting liability, the vendor may not do the work.

In other words, if the client wants to have someone do the work, it may have to agree to limit the risk associated with the work.

Limiting Risk In A Contract

The following are some examples clauses used to limit a party's risk in a contract:

- Limit on overall liability or caps on different types of liabilities;
- Liquidated damages to set the amount of liability;
- Exclusion of certain types of losses – consequential or indirect losses, loss of profits, third party's responsibilities, punitive damages;
- Exclusion of certain implied terms, warranties or law – e.g. implied warranties or the duty of good faith and fair dealing;
- Exclusion of specific remedies - specific performance or set-off rights;
- Statute of limitation shortening clause for claims;
- Force majeure clause to exempt liability from an unforeseeable event; and
- Entire agreement clause to avoid alleged oral agreements;
- Exculpatory, release and indemnity clauses,
- Jurisdictional clauses (arbitration, forum-selection, jury waiver, venue),
- Contractual choice-of-law clause; and
- Non-reliance clause to avoid fraudulent inducement claims.

Enforcement of Limitation-of-Liability Clauses

Exclusion and limitation-of-liability clauses can be very effective in addressing and mitigating the parties' risks, but they can only do so if they are in fact enforceable.

The parties should be very careful in drafting such clauses to make sure that they are enforceable and effective.

For a clause to be effective, it generally must satisfy the following requirements:

- The clause should be incorporated into the contract;
- The clause should be clear and cover the liability in question;
- The clause should be reasonable and not constitute a penalty; and
- The clause should not be prohibited by law.

Incorporating the Clause in the Contract

One of the basic requirements for an enforceable contract is that the parties must have a meeting of the minds.

This requirement is easily enough met where there is a written contract, containing all terms, and signed by both parties.

However, exclusion and limitation-of-liability clauses may exist in other documents that are incorporated into the main contract.

There can be implied incorporation (where documents are executed at the same time and deal with the same transaction or purpose) and there can be express incorporation.

Incorporation is generally a valid way to include the terms of one document into the parties' contract.

However, depending on the jurisdiction, certain clauses may be required to be conspicuous.

Other Potential Theories To Apply Limitation-of-Liability Clauses

In addition to the express parties to a contract that contains an exclusion or limitation-of-liability clause, other theories can potentially bind nonsignatories.

- Third-party beneficiary theory (however, there may be a no-third party beneficiary clause).
- Defining parties to include employees and affiliates. *Quintillion Subsea Operations, LLC v. Maritech Project Servs., Ltd.*, 2023 U.S. Dist. LEXIS 3546 (S.D. Tex. Jan 06, 2023) (nonsignatory could use LOL clause because contract included it).
- Estoppel (direct-benefits estoppel). *Rohtstein Corp. v. KPMG, LLP*, 2007 Mass. Super. LEXIS 573, 2007 WL 4416840 (Mass. Super. Dec. 10, 2007) (nonsignatory was bound by LOL clause because his claim relied on contract).
- Other potential theories, look to arbitration precedent.

Clause Should Be Clear and Unambiguous

In many jurisdictions, courts apply a narrow construction of exclusion or limitation-of-liability clauses.

Parties should be very careful to draft these clauses as specifically as possible.

Instead of saying that a party will not be liable for damage "from any cause" it should list out the type of conduct: "party will not be liable for damage arising from or related to negligence, gross negligence or willful intent."

Clear terms reduce the probability of expensive litigation down the road.

Clause Should Be Reasonable

A limitation of liability or exclusion clause may be unenforceable if it is unreasonable – for example, if the liability caps are set too low or exclusions too broad in scope.

The more reasonable, narrow, and realistic the clause, the more likely it is to be upheld by a court.

The test for reasonableness may be different for the different types of clauses.

For example, for liquidated-damages clauses, the test is: (1) the harm caused by the breach is incapable or difficult of estimation, and (2) the amount of liquidated damages called for is a reasonable forecast of just compensation.

The downside of drafting an all-encompassing limitation or exclusion of liability clause is that it may run the risk of being struck down by the court.

If the entire limitation of liability clause is struck down, then the party may face unlimited liability, which is the exact opposite of what the parties want.

Clause Should Not Be Prohibited By Law

There are public policy concerns related to certain exclusion or limitation-of-liability clauses.

There are statutes in jurisdictions that address certain clauses.

- For example, in Texas, there is a statute that provides that statute-of-limitation-shortening clauses cannot shorten a limitations period by less than two years.
- Other statutes limit the use of clauses in consumer contracts.
- Other statutes limit the use of clauses in certain types of relationships, such as attorney/client or doctor/patient.

Otherwise, most jurisdictions will entertain a public policy argument depending on the facts and circumstances.

- When determining whether a limitation of liability provision violates public policy, courts will generally consider whether there was a disparity in bargaining power between the parties.
- Under that analysis, courts will consider the bargaining process (procedural unconscionability aspect) and the fairness of the contractual provision in controversy, by determining whether there are legitimate commercial reasons that justify its inclusion as part of the agreement (substantive unconscionability aspect).

Clause Should Not Be Prohibited By Law

Some jurisdictions do not enforce exclusion or limitation of liability clauses for gross negligence, reckless conduct, willful misconduct, and fraud.

For example, under § 1668 of the California Civil Code, contracts which "have for their object … to exempt any one from responsibility for his own fraud … are against the policy of the law."

Parties should consider whether to exclude these types of acts from the breadth of such a clause to avoid any public policy arguments that may void the entire clause in those jurisdictions.

Popular Limitation-of-Liability Clauses

A limitation of liability clause is technically a clause that limits the liability for a certain risk.

It does not mean that a party is not liable or does not breach the contract.

It may not limit other types of equitable relief.

This could include a cap on damages: “The vendor’s liability for any breach of contract is limited to the amount paid by the client.”

This could include a set amount: “The vendor’s liability for any breach of contract is limited to $20,000.”

This could include a formula.

This could include a provision that ties damages to insurance limits.

Popular Exclusion Clauses

An exclusion clause states that a party is not liable for any damages for a particular type of damage.

It may apply to direct damages; indirect, special or consequential damages, lost profits; incidental damages; punitive damages; attorney's fees and costs, etc.

"Direct damages," are those inherent in the nature of the breach of the obligation between the parties, and they compensate a plaintiff for a loss that is conclusively presumed to have been foreseen by the defendant as a usual and necessary consequence of the defendant's act.

Consequential damages, unlike direct damages, are not presumed to have been foreseen or to be the necessary and usual result of the wrong.

Lost profits may be in the form of direct damages, that is, profits lost on the contract itself, or in the form of consequential damages, such as profits lost on other contracts or relationships resulting from the breach.

Incidental damages are the costs and expenses the non-breaching party incurs to avoid other direct and consequential losses.

Drafting Tips

When drafting a contract, the parties should consider certain principals.

- Contracts are construed as a whole, so when drafting a limitation-of-liability or exclusion clause, the drafters should consider how those clauses will impact or be impacted by other provisions.
- Make sure that they are consistent with indemnity and insurance provisions.
- Make sure that the parties disclaim any adverse construction due to the party drafting the contract.
- Make provisions conspicuous (especially in consumer contracts) and express and specific.
- Make warranties that all parties signed the contract voluntarily and without duress.
- State that all parties are represented by counsel or have voluntarily and intentionally proceeded without counsel.
- Disclaim any prior oral agreements, integration clause, and no oral modification clauses.
- State that the contract price is directly impacted by the limitation on liability/exclusion clause and the other party had option to pay more in return modifying the limitation.
- Disclaimer-of-reliance clause.

Choice-of-Law Clause

Parties can mitigate against the risk of having an unexpected jurisdiction's law apply by using a contractual choice-of-law clause.

Absent a contractual choice-of-law clause, most jurisdictions require the court first to determine whether the applicable laws of the two jurisdictions conflict on any issue pertinent to the case.

If the states' laws do not conflict, the court simply applies the law of the forum state.

On the other hand, if a conflict does exist, the court determines which state has the most significant relationship to the occurrence and parties under the test outlined in the Restatement (Second) Of The Conflict Of Laws § 6 (Restatement), which lists factors to consider in resolving a conflict.

Contractual choice-of-law clauses are generally enforced if the law chosen by the parties has a reasonable relationship with the parties and the chosen state and the law of the chosen state is not contrary to the fundamental policy of the forum state.

Depending on the language of a choice-of-law clause, it may apply only to claims related to the contract or more broadly to claims arising from the parties' contractual relationship.

Choice-of-Law Clause

For example, in *Applied Bldg. Techs., Inc. v. Schneider Elec.*, the court applied the choice-of-law clause in the parties' agreement and construed a limitation-of-liability clause under California law. Case No. 09-11152, 2010 U.S. Dist. LEXIS 31943 (E. D. Mich. March 31, 2010).

"Michigan enforces choice of law clauses in contract actions unless certain exceptions are met."

The court enforced the clause, stating:

- [T]he contract states that "[i]n no event will Pelco be liable for any special, incidental, or consequential damages." This language clearly limits the scope of damages that can be sought by ABT. Second, the contract limits direct damages, whether based on breach of contract or negligence, to "the price paid by [ABT] to Pelco for such products." ABT has styled its compliant as one for breach of contract, but even if it were construed to include a claim of negligence, the clause would apply. The clause clearly limits Pelco's liability to the price that ABT paid for the goods.

Rescission Relief

Often when parties have contractual disputes, one party may seek to rescind the contract.

Certain claims allow for rescissionary relief, such as fraud and breach of fiduciary duty.

What impact does that have on the exclusion and limitation-of-liability clauses in the contract?

Do those clauses survive rescission and apply or are they washed away with the contract?

Rescission Relief

Some courts have held that where a party opts to rescind a contract, the limitation-of-liability clause does not apply. *Trinity Med. Servs., LLC v. Merge Healthcare Sols., Inc.*, No. 17-592, 2020 U.S. Dist. LEXIS 2424, 2020 WL 97162 (M.D. La. Jan. 8, 2020).

In *Bombardier Aero. Corp. v. Spep Aircraft Holdings*, a plaintiff who had purchased an aircraft sued the defendant for fraud associated with representations regarding whether the aircraft was new or used. 572 S.W.3d 213 (Tex. 2019).

The purchase agreement stated: "Flexjet will not be liable to either customer for any indirect, special, consequential damages or punitive damages arising out of any lack or loss of use of any aircraft, equipment, spare parts, maintenance, repair or services rendered or delivered under this purchase agreement." *Id.*

The plaintiff later found that parts of the aircraft were used, and sued for breach of contract and fraud.

The jury found for the plaintiff and awarded actual damages and punitive damages, and the defendant appealed.

Rescission Relief

The court of appeals affirmed the award of punitive damages notwithstanding the exemption claim that barred those damages.

The court stated:

- Following the Supreme Court's reasoning in Prudential and upholding the well-established principle that "fraud vitiates whatever touches it," we conclude a buyer cannot be bound by an agreement waiving exemplary damages if the seller commits fraud by nondisclosure. To conclude otherwise would allow a seller to deliberately fail to disclose material facts to entice a buyer to enter a contract and then shield himself from damages to which the buyer is entitled.

Rescission Relief

The Texas Supreme Court reversed the award of punitive damages because the plaintiff did not seek to rescind the purchase agreement, and instead sought damages while enforcing the purchasing agreement:

- As the plaintiffs point out, we have held that "fraud vitiates whatever it touches." … We have never held, however, that fraud vitiates a limitation-of-liability clause. We must respect and enforce terms of a contract that parties have freely and voluntarily entered. And the plaintiffs "cannot both have [the] contract and defeat it too." Rather than seeking rescission of the agreements based on Bombardier's fraudulent conduct, the plaintiffs have tried to enforce the agreements, seeking an award of actual damages, while at the same time seeking to strike the limitation-of-liability clauses to receive an exemplary damages award. … Bombardier and the purchasing parties—sophisticated entities represented by attorneys in an arms-length transaction—bargained for the limitation-of-liability clauses to bar punitive damages. In balancing the competing interests between protecting parties from "unintentionally waiving a claim for fraud" and "the ability of parties to fully and finally resolve disputes between them," we believe parties can bargain to limit exemplary damages. See id. We note that the purchasing parties did not waive a claim for fraud; they only waived the ability to recover punitive damages for any fraud. As such, the valid limitation-of-liability clauses must stand.

Rescission Relief

The plaintiff could have, but did not assert a breach of fiduciary duty claim because the parties' agreement gave the defendant power of attorney to inspect and accept the plane.

The Court noted that the fiduciary may be punished for breaching these duties by an award of exemplary damages.

The Court stated: "Because there is no breach of fiduciary duty claim and the plaintiffs did not seek exemplary damages on that basis, we decline to decide whether a breach of fiduciary duty for fraudulent conduct would affect the validity of a limitation-of-liability clause."

The Court noted that it allowed "forfeiture as an equitable remedy for breach of fiduciary duty in addition to actual damages for fraud and breach of contract, but declining to evaluate the award in light of rules applicable to punitive damages."

So, a court may potentially decide to make a defendant forfeit a limitation of liability clause in fiduciary relationship.

Rescission Relief

One potential way to avoid rescission relief is to avoid claims that allow for rescission.

Disclaimer of reliance clause states that a party does not rely on any statements or information provided by the other party and is solely relying on its own investigation.

Courts in some jurisdictions enforce disclaimer of reliance clauses to preclude fraud, fraudulent inducement, fraud by omission, and negligent misrepresentation claims.

The reasoning is based on the lack of reliance, which is a necessary element for those claims.

Parties can also state in a contract that they are not in a fiduciary relationship or that regarding the agreement that they are not relying on any fiduciary duties.

Some jurisdictions enforce contractual provisions defining a fiduciary relationship, and such provisions may preclude a breach of fiduciary duty claim.

Conclusion

Parties execute contracts to define duties and rewards and to limit risk.

There are many different types of clauses that parties can use to limit risk.

Limitation-of-liability and exclusion clauses are important tools to limit risk.

Parties should be aware of them, how to properly draft them, the issues involving enforceability, and risks involved with voiding them.

STOEL RIVES LLP

Limitation of Liability Clauses in Business Contracts

Presented by
Zachary S. Davis
January 31, 2023

My Perspective

- Construction and design lawyer
- Transactional work is mostly for owner clients
- Thus, my goal is usually to avoid or soften the blow of proposed liability limits
- Liability limiting provisions are by far where most of my negotiation time is spent
- LOLs are often a deal breaker for both sides

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)

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

- Is what I am being asked to agree to enforceable?
  - Some professions cannot limit liability (doctors/lawyers)
  - Courts often strike LOLs that are unconscionable (e.g., *Lucier v. Williams*, 366 N.J. Super. 485, 493, 841 A.2d 907, 912 (App. Div. 2004))
  - Courts may refuse to enforce LOLs that violate anti-indemnity statutes (*e.g. City of Dillingham v. CH2M Hill Nw., Inc.*, 873 P.2d 1271, 1278 (Alaska 1994))

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

- Is what I am being asked to agree to enforceable?
  - UCC 2-719 Contractual modification of limitation of remedy

(1) Subject to the provisions of subsections (2) and (3) of this section and of ORS 72.7180 on liquidation and limitation of damages:

(a) The agreement may provide for remedies in addition to or in substitution for those provided in this chapter and may limit or alter the measure of damages recoverable under this chapter, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of nonconforming 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 the Uniform Commercial Code.

(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.

EXAMPLE CONSEQUENTIAL DAMAGES WAIVER – AIA A201 GENERAL CONDITIONS FOR CONTRACT BETWEEN OWNER AND CONTRACTOR

§ 15.1.7 Waiver of Claims for Consequential Damages

The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes:

.1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

.2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit, except anticipated profit arising directly from the Work.

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:
  - Limit LOL application to appropriate circumstances only (e.g., ordinary negligence not gross negligence or intentional conduct)
  - Require other safeguards to ensure an adequate remedy even when an LOL applies (e.g., the contractually required insurance is placed by the provider)
  - Ensure that you don't inadvertently limit other remedies (such as rights against third 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
- LOL will not apply if notice not provided of claims that decrease or threaten to decrease available limits

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

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. or contractor's liability is limited for property damage other than to contractor's work)
- 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 third 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

What does this all look like? Here is one example:

Architect's liability to Owner under this Agreement is limited to the amount of {*insert $ amount that is a substantial amount higher than Architect's professional liability insurance limits, such as $1.5M if their limits are $1M*} per claim, provided that:

(1) this limitation of liability only limits amounts that Architect pays with its own funds or amounts paid by Architect's primary or excess insurer(s) (but not additional insurers):
(2) this limitation of liability does not limit the liability of subconsultants of Architect, and Architect's limit of liability is not reduced by amounts that Architect or Owner may collect from Subconsultants or their insurers;
(3) at the written request of Owner, Architect's contracts with and claims against its Subconsultants shall be assigned to Owner under such terms that Owner finds acceptable in its reasonable discretion; and
(4) this limitation of liability shall be entirely null and void if Architect at any time (a) fails to ensure that its subconsultant contracts and its claims against its subconsultants are fully assignable, (b) fails to give prompt written notice to Owner of any claims asserted against Architect that may reduce the available limits of Architect's insurance, (c) fails to give prompt written notice to Owner of any actual reduction in the available limits of Architect's insurance, or (d) fails to continuously maintain all insurance required under this Agreement, including all types, limits and durations specified herein.

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

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Zachary Davis is an experienced construction and design attorney who advises clients on a broad spectrum of legal matters, with specific emphasis on resolving complex construction and commercial disputes. He also has significant experience negotiating construction and design contracts.

Zachary employs a proactive approach in assisting clients whether in adversarial proceedings or contract negotiations. He has advocated on behalf of clients before a variety of adversarial tribunals including federal and state courts, arbitration panels and administrative bodies. Zachary's clients have included corporations, business owners and entrepreneurs in the construction, real estate, technology, hospitality, telecommunications, financial services, and insurance industries.

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