Limiting Exposure: Limitation of Liability Clauses in Commercial Contracts

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Occasionally considered part of the legal "boilerplate", the "limitation of liability" clause is an important provision in any commercial contract, and companies should carefully consider several issues when drafting and negotiating this provision.

Limitation of Liability

When companies enter a commercial contract, they rarely expect any disputes or claims for damages to arise. To avoid souring the relationship, parties may avoid discussing terms relating to damages or liability or inviting attorneys (who focus on "worst-case scenarios") to participate in direct negotiations.

However, "worst-case scenarios" may become reality. If a contract contains a limitation of liability clause, it may determine both whether the breaching party owes any money and the amount owed, regardless of the damages incurred by the other party.

Negotiating a good limitation of liability clause is less costly and less risky than waiting until a dispute arises to determine what the clause should have said. This article describes a few key components of limitation of liability clauses in commercial contracts. As always, it's strongly recommended that a party engage counsel to advise on potential contract clauses.

Conflicts with other Contract Clauses

The limitation of liability can conflict with other clauses. For example, a contract for the sale of goods may require the goods to meet certain standards and for the seller to replace or repair nonconforming goods or reimburse the buyer the cost of obtaining conforming goods elsewhere. The limitation of liability, however, may cap the seller's liability at less than the amount needed to replace or repair the goods or reimburse the buyer for such cost. Parties often prefer to specify which clause should govern in such a conflict. The party with the most potential for monetary liability may prefer to have the limitation of liability govern, perhaps by stating that the limitation of liability will apply "notwithstanding anything in the [Agreement] to the contrary."

Exclusion of Certain Types of Damages

Most limitations of liability have two "substantive" components. The first is the exclusion of certain damages. Damages often excluded include (1) "consequential" damages (often including "lost profit or revenue"), generally defined as damages arising as a consequence of a party's breach, and (2) "punitive" damages assessed against a breaching party as punishment for wrongdoing. Punitive damages generally cannot be recovered for breach of contract but may be recoverable if the breaching party committed a tort. The foregoing damages can be hard to predict or quantify and may be disproportionate to the value of the contract. "Direct" damages generally cannot be excluded but are addressed by the cap noted below.

Cap on Total Damages

The second "substantive" component of many limitations of liability is a cap on the damages that a party can recover. The cap amount is generally a negotiation point and may be tied to the contract value. Damage caps may be stated as "the amount of the defective goods", "the amount of fees paid [or

payable] during the prior 12 months", or "the total amount payable" under the contract, or may be a fixed dollar value.

Carveouts

Finally, parties may exclude certain conduct or contract clauses (or breaches of certain clauses) from the limitation of liability. A party may argue that such conduct or breaches of such clauses are too egregious (or the clause is too fundamental) to limit liability, or that any resulting damages are inevitably consequential. Damages from willful misconduct, fraud, or even gross negligence may be excluded. Breaches of confidentiality and perhaps intellectual property are sometimes excluded, and a party's third-party indemnity obligations may be excluded (although a party should consider the scope of its indemnity before agreeing to its exclusion).

Takeaways

All components of a limitation of liability can be negotiated heavily, particularly when the parties realize the benefits and risks of the provision. The presence of a good limitation of liability can allow the protected party to better quantify and assess its risk, which can aid with pricing and investment decisions. The absence of a good limitation of liability can leave a party exposed to uncapped liability. The significant power of this clause is a good reason to obtain input of experienced counsel when drafting and negotiating commercial contracts.

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