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Limitation-of-Liability Clauses in Commercial Contracting: Ironclad or Leaky Sieve?

Commercial and Contracts

CHEAT SHEET

- ***Be explicit.*** If there are specific fact patterns or conduct that you want to subject to the LoL clause, even post-termination, you should spell them out explicitly.
- ***When in California.*** An LoL clause, subject to California law, that disclaims liability for "consequential, incidental, special or indirect damages" and/or caps damages for direct damages should add the phrase "including, but not limited to, negligence claims."
- ***Choice of law.*** If you want your LoL clause to be effective in limiting the damages recoverable for gross-negligence claims, in your governing law clause use the law of a state with a reasonable relationship to the parties or transaction where LoL clauses may permissibly limit damages for gross-negligence claims.
- ***Caps your clause.*** Parties should ensure that the LoL clause appears in a conspicuous manner to better avoid claims of procedural unconscionability.

Do these in-house scenarios sound familiar?

A business executive sends you a form contract for some consulting services. You scan the clauses. Everything seems fair and balanced until you stop suddenly at the limitation of liability (LoL) clause. The consulting company limits liability for all damages except direct damages capped at the amount of payments made to the consultant in the preceding 12-month period. Your blood begins to boil; you redline the LoL clause and send it back to the consultant. That triggers a three-week drafting struggle before the “simple” consulting agreement is finalized and signed.

Your company is entering into the cloud business, providing platform-as-a-service (PaaS) offerings to the marketplace. Mindful of the potentially catastrophic liability exposure of your company for handling the key data and IT systems of your customers, you draft an LoL clause that carefully defines the types of losses that your company will be liable for and excludes business-interruption damage claims. The form contract is sent to a number of potential customers who are enthused by your PaaS offering, but the contracts all come back with a sea of redlining on — surprise, surprise — the LoL clause. Your company’s entry into the exciting world of cloud contracting comes to a grinding halt as to you try to reach some acceptable middle ground with each customer.

The majority of the in-house counsel’s time and attention spent on contracts (whether on the next asset purchase agreement with your closest competitor or the renewal of the company’s cafeteria contractor) is often spent on the wording of the LoL clause and its close relatives, the indemnity and warranty clauses. Other topics such as contract term, pricing and even confidentiality often take a back seat. The significance of the LoL clause could not be greater in the brave new world of big data, data breaches, outsourcing of key company data and systems to the cloud and patent trolls’ continued assault on technology companies.

Much has been written on workarounds, and middle ground compromises, when businesses reach an impasse on the wording of LoL clauses. A good example is “Distributors: Tracking the IP Indemnity Squeeze in the Supply Channel” by Rich English in the October 2012 issue of this magazine. Bargaining power often plays a large role in the haggling over LoL clauses.

But even when you have the bargaining power to secure advantageous LoL language for your company, the words you choose may not give you the protection you think. LoL clauses cannot secure ironclad protection from all risks, but they need not be leaky sieves.

This article will review recent developments in the area of LoL clause interpretation and suggest appropriate drafting tips. Just to be clear, it will focus exclusively on the LoL clause in the context of commercial (B2B) contracts. The treatment of the clause in the consumer contracting context is an entirely different animal due to a host of statutory restrictions.

Some basics

Any good analysis of LoL clauses in a commercial context starts with the Uniform Commercial Code (UCC). While the UCC applies by its terms to the sale of goods, it also informs the law on the sale of software and other services because similar principles apply.

UCC Section 2-719 governs contractually agreed limitations of liability and sets forth the following four principles:

1. It permits buyers and sellers to limit or alter by agreement the measure of damages otherwise available under the UCC, including consequential damages. For example, the parties may agree to limit "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."
2. It treats a contract's designation of a remedy as optional unless the remedy is "expressly agreed to be exclusive," in which case it is the sole remedy.
3. It provides that where circumstances cause an agreed-on remedy to "fail of its essential purpose," the standard remedies under the UCC (including consequential damages) are available. The most common scenario in which a designated remedy "fails of its essential purpose" occurs when the remedy involves the repair or replacement of goods, and the seller is unable to repair or replace the goods (such as computer hardware or a software system) in a way that conforms to the contractual requirements.
4. It permits the parties to agree to limit or exclude consequential damages "unless the limitation or exclusion is unconscionable." Unlike the disfavored treatment of such limitations relating to consumer contracts and personal injury, a limitation on consequential damages for commercial losses between contracting business entities is not "prima facie unconscionable."

In short, the UCC allows parties to broadly limit their damages by agreement, especially in transactions involving commercial goods and sophisticated parties, where LoL clauses are rarely found to be unconscionable. However, as seen below, the courts do not always enforce LoL clauses in the ways that sellers may have expected.

LoL clauses do not exist in a vacuum, and there is often interplay between the LoL and indemnity and warranty clauses. An LoL clause can limit recovery under an indemnification clause unless otherwise stated in the LoL clause. The wording of LoL clauses may often provide a separate dollar-value cap for indemnification claims or even exclude them altogether. Similarly, warranty clauses may provide an exclusive remedy for a breach of warranty, but, as will be discussed below, if the seller cannot correct the defect, a "repair or replace" LoL clause may be invalidated.

The "arising under or related to the agreement" challenge

The standard LoL clause will generally seek to limit damages for all claims "related to or arising out of " the agreement and also provide that the LoL clause will survive the termination of the agreement so as to protect against post-termination claims. These are not always broadly enforced by the courts, which can be quite metaphysical about construing language such as terms "related to and arising out of the agreement." It is a struggle to glean any bright lines from court decisions.

Two recent cases illustrate this problem. In *MyPlayCity, Inc. v. Conduit Limited*, 2013 WL 150157 (S.D.N.Y. 2013), MyPlayCity (a maker of online games) and Conduit (a developer of "toolbars" facilitating such games) entered into agreements that allowed MyPlayCity to create toolbars using its trademarks that customers could download from Conduit's online platform. The toolbars provided access to MyPlayCity's games. Conduit eventually terminated the agreement but allegedly continued to distribute the toolbars containing MyPlayCity's trademark, triggering a trademark-infringement action by MyPlayCity.

The LoL clause provided that in no event would Conduit's "aggregate liability for any claim *arising out of or relating to this Agreement*, [or] the use of or the inability to use the Toolbar and/or Environment … exceed $5,000" (emphasis added). The court held that because the trademark infringement occurred after termination of the contract, it did not "arise out of " the agreement. The "relates to" language presented a closer question, but the court ruled that because the agreement concerned the

authorized use of MyPlayCity's trademarks, Conduit's continued use of them post-termination was *unauthorized* and did not "relate to" the agreement. The court also found that the agreement was ambiguous as to whether the limitation on liability for claims involving the "use of or inability to use" the toolbar applied to trademark infringement claims. A trial was required to resolve that issue.

Compare *MyPlayCity*, however, to *JJCK, LLC v. Project Lifesaver Int'l*, 2011 WL 2610371 (D. Del. 2011). In JJCK, the defendant, Project Lifesaver (PLI), had contracted with the plaintiff, doing business as EmFinders, to distribute and promote EmFinders' tracking devices in a specified territory, and PLI had further agreed not to distribute or promote products of EmFinders' competitors. EmFinders eventually sued PLI for breach of contract and tortious interference with existing and prospective contractual relationships, asserting that PLI failed to promote EmFinders' product and actively disparaged it to potential customers. EmFinders terminated the agreement shortly before it sued PLI.

The LoL clause in the agreement applied to damages "arising out of or relating to this agreement," and the agreement expressly stated that the LoL clause survived termination of the agreement. At issue was whether the alleged disparagement of EmFinders to customers taking place post-termination "related to" the underlying agreement. Even though the PLI conduct may have occurred post-termination and was not authorized by the earlier agreement, the court held that the conduct "related to" the agreement and thus came within the LoL clause. This ruling is inconsistent with the result in *MyPlayCity*.

Most courts will construe LoL clauses narrowly, so clear drafting is vital.

Practice tip 1: The issue of what "arises out of " or "relates" to agreements will unavoidably provoke disputes without the benefit of brightline tests. If there are specific fact patterns or conduct that you want to subject to the LoL clause, even post-termination, you should spell them out explicitly in connection with the "arising out of or relating to" language and indicate that those examples are "without limitation" to the clause's broader language.

Such language listing specific types of claims should be accompanied by broad language not keyed to the "agreement." For example, an LoL clause might state that it applies to "all claims related in any way to the seller's goods, services or rights, as well as those arising under or related the parties' agreement."

Handling simple negligence in the LoL clause

LoL clauses limiting damages for simple negligence generally fare well in the courts. But the precise choice of wording matters, as some states may not read LoL clauses to apply to negligence claims unless the clause explicitly mentions negligence. A good example is provided by a recent California decision, *Peregrine Pharmaceuticals, Inc. v. Clinical Supplies Management, Inc.,* Case No. SACV 12-1608, 2014 U.S. Dist. LEXIS 105756 (C.D. Cal. July 30, 2014). There the LoL clause contained the standard language disclaiming liability for "consequential, incidental, special or indirect damages" and capped the seller's overall liability for direct damages at the sum of payments made by the buyer to the seller. The clause did not expressly state that it applied to negligence claims. The federal court, interpreting California law, imposed no limit on liability for any genus of damages for "active" negligence claims. It held that, absent an express reference to "negligence" in a LoL clause, the clause limits only claims for "passive" negligence. According to the court, passive negligence involves "nonfeasance," such as failure to discover a dangerous condition, as opposed to active negligence involving an affirmative act, knowledge of or acquiescence in negligent conduct or failure

to perform specific duties.

Practice tip 2: An LoL clause, subject to California law, that disclaims liability for "consequential, incidental, special or indirect damages" and/or caps damages for direct damages should add the phrase "including, but not limited to, negligence claims." Such language is generally recommended in other states as well.

The impact of gross negligence or reckless conduct on the LoL clause

The general rule is that courts will not enforce LoL clauses that limit a contracting party's liability for gross negligence, but there are state-by-state exceptions. An example of this is *Great Northern Insurance Co. v. ADT Security Services, Inc.*, 517 F. Supp. 2d 723 (W.D. Pa. 2007). There the federal district applied Pennsylvania law and concluded that an LoL clause permissibly limited damages for gross negligence. The following clause was at issue, with the capitalization in the original:

> [Buyer] AGREES THAT ADT SHALL BE EXEMPT FROM LIABILITY FOR LOSS, DAMAGE OR INJURY DUE DIRECTLY OR INDIRECTLY TO OCCURRENCES, OR CONSEQUENCES THEREFROM, WHICH THE SERVICE OR SYSTEM IS DESIGNED TO DETECT OR AVERT; THAT IF ADT SHOULD BE FOUND LIABLE FOR LOSS, DAMAGE OR INJURY DUE TO A FAILURE OF SERVICE OR EQUIPMENT IN ANY RESPECT, ITS LIABILITY SHALL BE LIMITED TO A SUM EQUAL TO 10% OF THE AGGREGATE PRICE REFLECTED ON THE FRONT HEREOF OR $1,000, WHICHEVER IS GREATER, AS THE AGREED UPON DAMAGES AND NOT AS A PENALTY, AS THE EXCLUSIVE REMEDY; AND THAT THE PROVISIONS OF THIS PARAGRAPH SHALL APPLY IF LOSS, DAMAGE, OR INJURY IRRESPECTIVE OF CAUSE OR ORIGIN, RESULTS DIRECTLY OR INDIRECTLY TO PERSON OR PROPERTY FROM PERFORMANCE OR NONPERFORMANCE OF OBLIGATIONS IMPOSED BY THIS CONTRACT OR FROM *NEGLIGENCE, ACTIVE OR OTHERWISE*, STRICT LIABILITY, VIOLATION OF ANY APPLICABLE CONSUMER PROTECTION LAW OR ANY OTHER ALLEGED FAULT ON THE PART OF ADT … . (Emphasis added.)

The court concluded that the clause's reference to negligence, "active or otherwise," indicated a clear intention to apply the LoL to all types of negligence, including gross negligence, and that this was not contrary to Pennsylvania public policy.

The *Great Northern* case and similar cases dealing with limitations on certain causes of action involve the nuanced difference between (a) clauses exempting or excluding a party from all liability for certain types of wrongdoing (called "exculpatory clauses") and (b) clauses limiting the amount of recovery for various types of wrongdoing (*i.e.*, LoL clauses). Although courts may strictly construe LoL clauses, the cases indicate that exculpatory clauses are even more disfavored by the courts and will receive more severe treatment.

A contrary example of how a broad LoL clause has been found insufficient to limit damages for "gross negligence" is provided by *Baidu, Inc. v. Register.com*, 760 F. Supp. 2d 312 (S.D.N.Y. 2010), decided under New York law. Baidu, a large Chinese Internet search engine service, had its website hacked after the staff of the defendant (an Internet domain name registrar) allegedly acted with "gross negligence" to release account and password information to the hacker without following the defendant's own security protocols. The parties' contract precluded liability for such security

breaches and also limited remedies to the greater of the amounts paid to defendant or $500.

Despite the contractual disclaimers and limitations, the court allowed claims of gross negligence and breach of contract to proceed without any limitation on the available damages. The defendant argued that it had contractually disclaimed any legal duty to provide website security and therefore could not be found liable for gross negligence. The court rejected this argument because the defendant had in fact undertaken to provide website security and had established security protocols. Therefore, the court reasoned, the defendant was subject to liability under the principle that one who "voluntarily assumes a duty can be held liable for negligence in the performance of that duty."

This holding poses a Catch-22 for sellers: They might take no voluntary measure to protect buyers, with the hope of avoiding the creation of any duty of care, but the lack of any protective measures could lend even greater support to allegations of a gross negligence claim. On balance, because courts generally do not enforce LoL clauses against claims of gross negligence, it is likely more prudent to take voluntary protective measures.

Practice tip 3: Choice of law matters when it comes to LoL clauses. If you want your LoL clause to be effective in limiting the damages recoverable for gross negligence claims, in your governing law clause pick the law of a state with a reasonable relationship to the parties or transaction where LoL clauses may permissibly limit damages for gross negligence claims. Also, in your wording of the LoL clause, be sure to include a specific limitation of damages for both simple negligence and gross negligence.

Practice tip 4: If the governing-law provision in a contract lists a state that does not enforce LoLs against claims of gross negligence, you should consider language to discourage frivolous end runs around the LoL through plaintiffs' assertion of gross negligence claims. For example, if you don't have a general attorneys' fee-shifting provision in your standard contract, you should consider including language stating that "any party who unsuccessfully seeks to avoid this contract's limitations on liability through claims of gross negligence, or otherwise, shall be liable to the seller for the reasonable attorneys' fees and expenses incurred in defending such claims."

The impact of intentional misconduct on the LoL clause

A fundamental principle is that LoL clauses will not limit liability for intentional misconduct such as fraud even where they purport to do so. This principle was extended in the recent Peregrine Pharmaceuticals, Inc. case discussed earlier to claims of constructive fraud involving negligent misrepresentations.

Practice tip 5: Don't waste your time by attempting to limit damages for intentional fraud or other intentional misconduct in your LoL clause. However, remember that LoL clauses limiting damages for negligent misrepresentation (which is a form of negligence) may be enforced in many states.

Characterization of consequential damages and the ability to limit them through the LoL clause

UCC Section 2-715(1) defines consequential damages as including (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." To be recoverable as

consequential damages, the type of damage suffered by the buyer must have been reasonably foreseeable at the time of sale.

It is often assumed that a LoL clause that bars the recovery of consequential damages will serve to avoid claims for a party's lost profits. That assumption may prove incorrect depending on the definition of "consequential damages" under the applicable state's laws.

For example, in a recent ruling applying Montana law, the 9th Circuit ruled that a contract clause barring recovery of consequential damages did not limit the plaintiff 's ability to recover lost profits involving lost annual license maintenance fees caused by the defendant's failure to promote the plaintiff 's software. *Education Logistics, Inc. v. Laidlaw Transit, Inc.*, No. 13-35264, 2014 U.S. App. LEXIS 13347 (9th Cir. July 14, 2014), *cert. petition filed* (Nov. 20, 2014). The court relied on the definition of "general damages" under Montana law, which included all damages that flow from "the natural, necessary and logical consequences of the wrong or breach."

An earlier example arose in *Valve Corp. v. Sierra Entertainment Inc.*, 431 F. Supp. 2d 1091 (W.D. Wash. 2004), where the plaintiff (a computer-game manufacturer) sued a publisher for lost profits and loss of goodwill resulting from the unauthorized distribution of the games to cybercafes. A LoL clause barred the recovery of consequential damages, but the court (applying Washington state law) found that "[l]ost profits are considered to be general or direct damages in a breach of contract case, while they are considered to be special or indirect damages in a tort case." Thus, lost-profit damages were allowed in the plaintiff 's contract claim.

Practice tip 6: Once again, the choice of state law matters. Know how your chosen governing law set forth in the contract defines consequential damages, and adjust your LoL wording so as to effectuate the parties' intent on the issue. In practice, this means that a LoL clause should not only state that no consequential, incidental or indirect damages are recoverable but should go on to expressly limit the recovery of lost profits, business interruption losses, loss of goodwill, etc.

The "unconscionability" challenge to the LoL clause

A contracting party who later seeks to negate the LoL clause that it originally accepted may object that the clause is (a) "procedurally" unconscionable (i.e., where that party did not know or understand what it was agreeing to) or (b) "substantively" unconscionable (*i.e.*, where the clause is inordinately one-sided in a party's favor). Courts may consider both aspects of unconscionability in determining whether to enforce a LoL clause.

It is unusual for LoL clauses in a commercial contract to be found "unconscionable" and thus unenforceable. However, contracting parties should not assume that every B2B transaction is immune from challenge on this basis. Such challenges can occur, and be successful, where there is great disparity between the size or sophistication of the contracting parties.

A recent example occurred in *Manchin v. QS/1 Data Systems*, Civ. No. 7:13-cv-02188, 2014 U.S. Dist. LEXIS 89126 (D.S.C. July 1, 2014). The plaintiff owned two pharmacies in West Virginia that purchased pharmacy management software from the defendant. The software allegedly provided inaccurate pricing information, leading the plaintiff to assert a sizable claim for lost revenue. The defendant contended that a contract clause absolved it from responsibility for losses resulting from inaccurate pricing information.

The court found the contract clause to be "unconscionable" based on several factors: (a) The buyer

had no meaningful choice because all providers of similar software services used a similar clause; (b) no reasonable person would agree to such a clause; (c) the disclaimer language was not capitalized or prominent but instead was in small print that was “nearly illegible”; (d) there was a great disparity in bargaining power between a “family pharmacy in a small town in West Virginia” and the defendant, a “much larger business with revenue many times larger than [plaintiff ’s] revenue on a yearly basis”; and (e) there was no actual negotiation over the contract clause. These circumstances likely exist in numerous transactions between large and small businesses.

Practice tip 7: On the procedural side, parties should ensure that the LoL clause appears in a conspicuous manner (such as through capitalized letters or bold print as is required in many jurisdictions) to better avoid claims of procedural unconscionability. On the substantive side, parties may also seek to strengthen their ability to defend claims of substantive unconscionability by adding language in the LoL clause reciting that the clause was factored into the price and was the subject of bargaining and reviewed by counsel.

The “failure of its essential purpose” challenge to the LoL clause

A clause limiting remedies exclusively to the repair or replacement of a product may fail of its “essential purpose,” and therefore be held unenforceable, if the seller is unable to repair the product or replace it with a functioning product within a reasonable period of time. In such cases, a seller may unintentionally open the door to claims for large consequential damages.

Sellers may wish to avoid unlimited exposure to damages by adding an exclusive backup LoL clause to their contracts, which would apply only if the primary exclusive remedy is found to have failed its essential purpose. For example, a contract clause might read: “Seller’s liability for any breach of contract or warranty shall be limited exclusively to repair or replacement of the product, and if Seller cannot provide repair or replacement after making good-faith efforts, then the Buyer’s exclusive remedy shall be a refund of all amounts paid to the Seller.” In a recent 1st Circuit case, a court found that such a clause limiting remedies to a credit was enforceable when repair or replacement could not be accomplished. *BAE Systems Information and Electronics Systems Integration, Inc. v. Spacekey Components, Inc.,* 752 F.3d 72, 76-79 (1st Cir. 2014). In essence, the credit remedy was a satisfactory backup remedy.

Practice tip 8: In addition to including a backup remedy in your LoL clause, it is vital to label a limited remedy as “exclusive.” Otherwise, a court is apt to treat such a remedy as optional without precluding claims for any type of damage normally recoverable under the law. For example, in one case involving an electronic voting system, the Third Circuit (following UCC Section 2-719(a)(2)) allowed the plaintiff-buyer to pursue all remedies because it found that the contracting parties “did not expressly agree that repair and replacement would be the exclusive remedy.” *Montgomery County v. Microvote Corp.*, 320 F.3d 440, 449 (3d Cir. 2003).

The interplay between the “sole remedy” and “no consequential damages” language in an LoL clause

Contracts often provide that a designated remedy, such as repair or replacement of a faulty product, is the “sole” or “exclusive” remedy and then proceed to add that in no case shall the buyer be permitted to recover consequential, special or incidental damages or lost profits. When an exclusive repair or replace LoL remedy is found to fail its essential purpose, will courts enforce the separate language limiting consequential and similar damages?

A majority of courts hold that the failure of the sole remedy does not automatically invalidate LoL clause language limiting consequential damages, which will be evaluated *independently* to determine whether the elimination of consequential damages is itself unconscionable. A significant minority of courts, however, finds that a LoL clause precluding consequential damages is *dependent* on a sole remedy clause and is invalid if the sole remedy clause is invalidated.

One of the early cases addressing this issue is *American Electric Power Co. v. Westinghouse Electric Corp.*, 418 F. Supp. 435 (S.D.N.Y. 1976), where the seller of an electric turbine generator included an LoL clause in the sales contract that (a) specified that repair or replacement would be the exclusive remedy for defective equipment and (b) precluded consequential damages. The court found "no reason to disturb the consensual allocation of business risk" in the parties' contract and followed the rule that "where an exclusive remedy (such as warranty to repair or replace) fails of its essential purpose, it may be ignored, and other clauses in the contract which limit remedies for breach may be left to stand or fall independently of the stricken clause." Because there was no evidence that the bar on consequential damages was unconscionable, the court precluded such damages.

This point takes on special importance in technology-related contracts in the only two states, Virginia and Maryland, that have adopted the Uniform Computer Information Transactions Act (UCITA). UCITA is applicable to agreements to "create, modify, transfer, or license computer information or informational rights in computer information."

Under UCITA Section 22-803(c), the failure or unconscionability of an "exclusive . . . remedy makes a term disclaiming or limiting consequential or incidental damages unenforceable unless the agreement expressly makes the disclaimer or limitation independent of the agreed remedy."

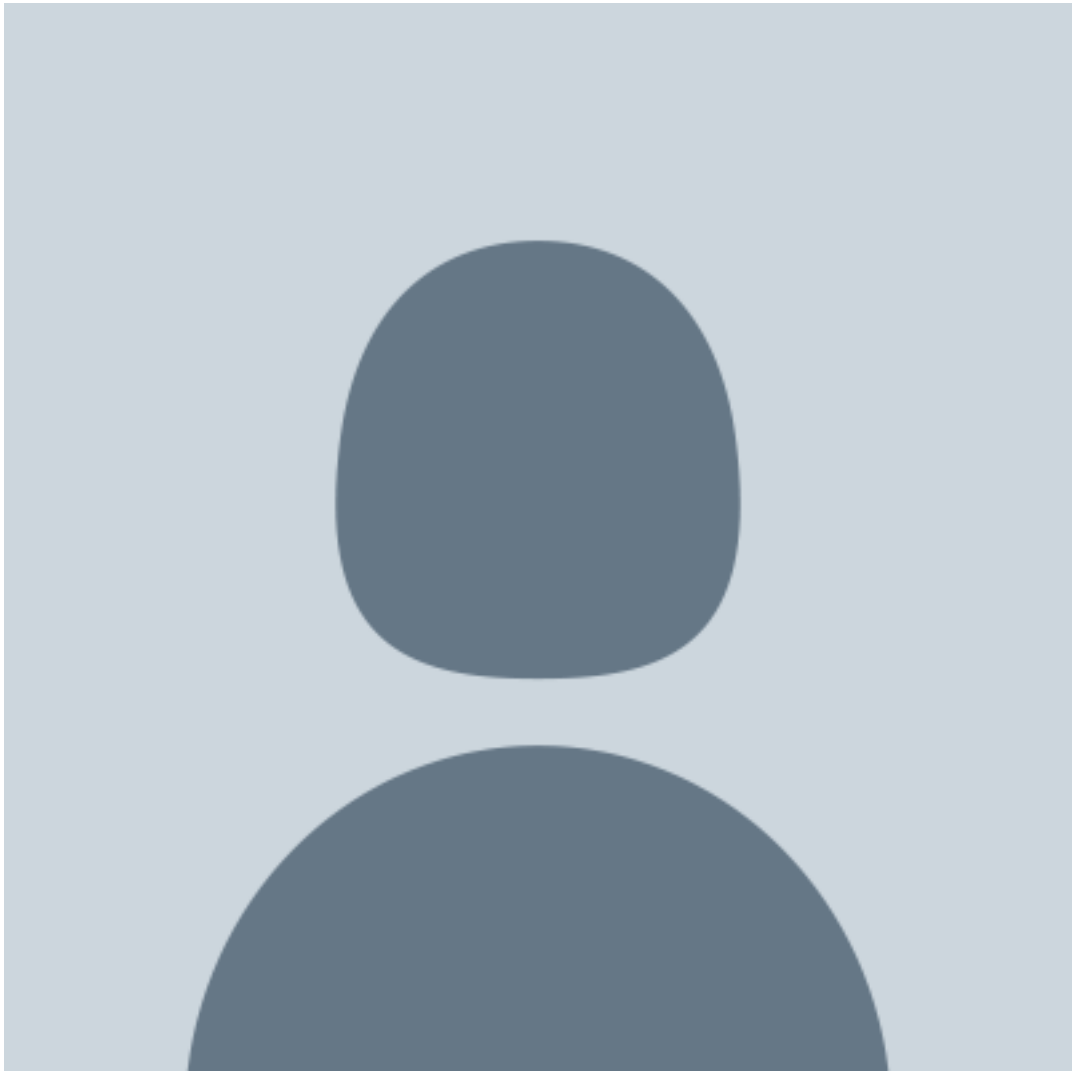
Practice tip 9: To avoid invalidation of your LoL clause, you should include language expressly stating that the LoL clause barring consequential or other types of damages is "independent of any other limitation of liability and reflects a separate allocation of risk from provisions specifying or limiting a party's remedies." Again, choice of law matters. If the contract is technology related, choice of Maryland or Virginia law (and thus the UCITA) will make the language on the LoL's independence even more important.

Conclusion and a final practice tip

As recent cases have shown, words (or their absence) matter in contract drafting, perhaps no more so than in drafting LoL clauses. Not only do words matter, but so too does the choice of law. A LoL that shuts off liability in one state may utterly fail to do so in a neighboring state.

Practice tip 10: Show this article to your risk manager. Together, make sure that your company's insurance coverage is aligned with the gaps in the enforceability of any LoL clause and the range of risks presented by noncontracting parties whose claims will usually not be affected at all by LoL clauses.

Robert M. Lindquist



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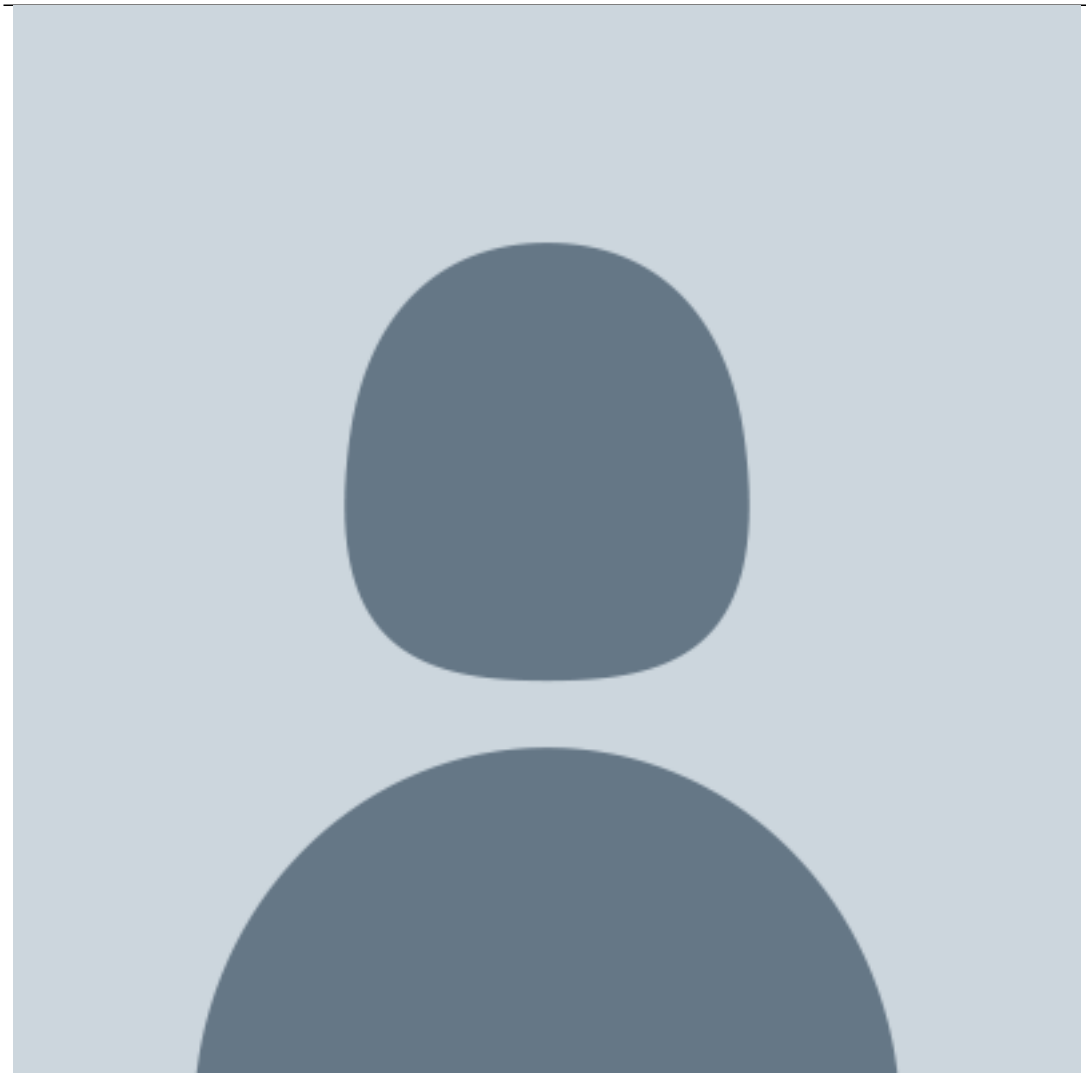

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