Contracts 101: Limitation of Liability Clauses

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Porzio Business Law Update

Contracts and their terms serve several functions. Two critical functions are managing and allocating risk—two distinct concepts influenced by the leverage a contracting party has or brings to the negotiations. One of the most important provisions that should not be overlooked is the limitation of liability clause, a clause that allocates and manages risk for contracting.

Why include a limitation of liability clause in a contract?

A limitation of liability clause is essential in a contract because it provides certainty and acts as a safety net, clearly outlining what you are liable for in the event of a breach of contract. It allows the negotiating parties to understand the potential quantum of damages for breach by limiting, restricting, or capping them. The clause, if drafted appropriately, can eliminate a party's right to certain types of damages. When negotiating a contract and drafting these clauses, it helps to understand first what damages might flow directly and indirectly from a breach of the contract to protect your business.

Direct and Indirect Damages

Damages flowing from a breach of contract can be broken down into two categories, direct and indirect. To recover damages, the damages caused by a breach must be reasonably foreseeable at the time of contracting, meaning that at the time the contract is breached, the non-breaching party's loss could be reasonably predicted.

Direct Damages

Direct damages logically flow from a party's non-performance, *e.g.* the costs the non-breaching party must pay to a third-party for goods the breaching party failed to deliver or defectively manufactured.

Indirect Damages

Indirect damages (also called special damages) are those the parties, with their intimate knowledge of the deal, would expect the non-breaching party to incur.

Examples of indirect damages fall into two categories, incidental and consequential damages. Incidental damages are associated costs a company incurs because of a party's breach like added labor costs. Consequential damages result from the breach and are often unique to the business circumstances of the non-breaching party—for example, lost profits and delay damages. Because these damages are not as reasonably foreseeable when the parties contracted as direct damages, they are most times excluded in limitations provisions. Incidental, especially consequential damages, can be speculative, requiring the drafting party to consider excluding them in the limitation of liability clause.

Why exclude indirect and consequential damages from the clause?

Limitation of liability clauses generally exclude recovery for indirect or consequential damages for delay, lost profit, expenses, rents, insurance premium payments, and attorneys' fees because they are speculative, and, difficult to quantify

at contracting. Further, lost profit and attorneys' fees can be substantial. To avoid defending the costly lawsuit seeking lost profits, the limitation of liability clause should exclude them.

Key Drafting Considerations

When drafting the clause, consider the extent of the clause, and if you should exclude all potential damages. *Remember*, the purpose of contracting is to contract and agree with another on terms, and limitations on clauses can be a hurdle to contracting. So, if the total value of the contract is not material, say $100,000, do you consider capping potential damages consistent with the value of the contract? Further, in supply agreements, consider excluding certain causes of action for product liability, personal injury, wrongful death, and tangible property damage from the clause. These causes are inherent to the deal and the supplier should not be permitted to avoid paying damages when the product it manufactures and sells fails. Allowing your contracting partner some opportunity to sue, even if for a limited amount of money, might get the deal over the finish line.

The drafter can manage risk by drafting these clauses, but their effectiveness is only as good as their enforceability. Commercial contract limitation of liability clauses are enforceable almost as a matter of law as the parties are presumed to be sophisticated and represented by counsel.

If a limitation of liability clause is contained in a consumer contract, make sure:

- The clause is easy to find (conspicuous);
- Easy to read (bold and large print);
- Easy to understand; and
- Plain language is always used.

A court may refuse to enforce a limitation of liability clause if some or most of these factors are not met.

In conclusion, nearly every contract contains limitation(s) of liability clauses and no commercial contract should be lacking such a clause as they are essential to mitigate and prevent exposure to significant damages. Too often parties fail to read and understand their scope and effect. When parties fail to do so, they lose the opportunity to negotiate a less restrictive clause that might allow them to recover damages if the contract is breached.