Published on *The National Law Review* https://natlawreview.com

Contract Corner: Limitations of Liability—Structure and Enforceability

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Throughout the contract drafting and negotiation process, the parties allocate responsibility and risk for certain issues and circumstances that may arise. There comes a point, however, when it's easier to establish general limitations of liability instead of conjuring up and squabbling over a laundry list of potential injuries and remedies. In addition, contractual limitations on liability are customary in technology and other commercial transactions because they enable a licensor, service provider, or supplier to provide a service or product that they might not otherwise provide if they were exposed to unlimited liability. These limitations therefore make a transaction simpler to assess from a commercial perspective. Below we discuss the structure and enforceability of limitations of liability. In future posts in this series, we will discuss different types of damages, exclusions, and caps.

How are limitation-of-liability provisions structured?

Contracts for technology and commercial transactions commonly include an aggregate limit on a party's liability for direct damages under the agreement, typically referred to as a "direct damage cap." Certain matters are usually excluded from the cap, such as the obligation of the licensor, service provider, or supplier to defend and indemnify the licensee or customer from claims by third parties that the software, service, or product infringes the third party's intellectual property rights. These exceptions cover circumstances where the allocation of risk between the parties under the agreement is such that the risk is properly placed on the licensor, service provider, or supplier that, therefore, does not get the benefit of the protection provided by the cap. The answer to allocating risk does not have to be black or white—either covered by the direct damage cap or not. With respect to liability of the licensor, service provider, or supplier for certain risks (for example, liability for breach of data security obligations), the parties may agree to a separate direct damage cap or an extra layer of liability for direct damages above the direct damage cap.

These contracts typically also include a separate section that disclaims consequential and other indirect damages that don't result directly and naturally from a breach of the agreement. As we will describe in greater detail in a future post, such provisions regularly list specifically excluded damages, such as lost profits, to avoid liability for injuries that are distinctive to the nonbreaching party or that arise from remote consequences flowing from the breach.

Are limitation-of-liability provisions enforceable?

In general, contractual limitations on a party's liability in an agreement between sophisticated parties are enforceable, regardless of whether the contract is for services or goods. But limitations of liability may be deemed unenforceable—even in contracts between sophisticated parties—under certain circumstances, including the following:

- When the party otherwise shielded from liability caused the harm intentionally or by engaging in willful misconduct or gross negligence, which is a relatively high standard of misconduct
- When the bargaining power of the parties is grossly unequal
- When the transaction involves public interest

Under most circumstances that involve negotiated contracts between businesses, however, these provisions are treated as binding limitations of liability.

This post is part of our recurring "Contract Corner" series, which provides analysis of specific contract terms and clauses that may raise particular issues or problems. Check out our prior Contract Corner posts for more on contracts, and be on the lookout for future posts in the series.

National Law Review, Volume V, Number 68