Contractual Limitations of Liability (a/k/a "LOLs," or Why the Other Party Is Laughing Out Loud)

by Marc T. Shivers and André J. Brunel

Limitations of liability (LOL) provisions are nothing new in the world of commercial contracts.[1] Even though LOLs are one of the most important standard provisions in commercial contracts, they are also one of the least understood by executives. Indemnity obligations run a close second, but that is another article. Too often in our law practices, we have seen executives negotiating a contract completely defer to their attorneys in negotiating LOLs even though there are a number of fundamental business issues embedded in any LOL. Importantly, LOLs typically exclude certain types of damages, such as indirect, punitive, or consequential damages from any recovery in breach of contract lawsuits (qualitative LOLs). These damages often account for much of the potential damage recovery in a typical breach of contract claim. In addition, LOL clauses often include a monetary cap on the parties' liability for the damages that are recoverable (quantitative LOLs). These two basic types of limitations on a party's potential liability under a contract can save (or put at risk) significant amounts of money for the party and greatly increase (or decrease) its leverage in the event the contractual relationship sours.

Executives tend to defer to legal counsel in connection with LOLs for a number of reasons. For one, LOLs are typically buried in the back half of the contract along with other provisions that executives believe contain only legal issues for the lawyers. Accordingly, executives tend to give only cursory review to these provisions when pressed for time. In addition, despite the fact that LOLs are often written in all capital letters[2] to draw the reader's attention, the legalese they contain will cause even the most diligent executive's eyes to glaze over. Finally, many lawyers simply don't take the time and effort to explain to their clients the significance of the LOL and walk them through the indecipherable legalese it contains. As a result, not much thought or effort is put into the drafting and negotiation of LOLs in many commercial contracts.

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As the fallout from the sharp downdraft in the technology sector has recently demonstrated, however, the fundamental business issues that make up the core of these provisions are of great interest to business executives. LOLs can and do play a crucial role in the allocation of risk among contracting parties and should always be carefully examined, even for small deals. In addition, LOLs can in some cases function effectively as termination for convenience (for a fee) clauses in those states that allow a party to intentionally terminate an agreement based on financial self-interest, with the fee being the amount of the remaining quantitative LOL cap.

Generally speaking, in the absence of controlling public policy, courts have held that contracting parties can limit their respective liabilities in damages to specified amounts and exclude certain types of damages pursuant to LOLs.[3] Section 2-719 of the Uniform Commercial Code (UCC), a version of which has been adopted in most states, expressly provides that an agreement for the sale of goods[4] may limit or alter the measure of damages recoverable, provide exclusive remedies

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for breaches and, absent unconscionability, limit or exclude the recovery of consequential damages.[5] Some states' courts have held, however, that although the basis for the enforcement of LOLs is the strong public policy favoring freedom of contract, LOL clauses are disfavored and must be strictly construed against the benefiting party.[6] As a result, the parties to a contract need to carefully consider and draft contractual LOLs.

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LOLs are common in almost all industries and contractual relationships (*e.g.*, commercial real estate sales and leases, asset purchase agreements, commercial lending transactions, etc.). To help explain LOLs in a concrete manner, this article uses as an example vendors and non-consumer customers[7] involved in software licensing, software development, outsourcing, and similar information technology transactions. This article is intended as a guide on LOLs and will address most of the issues that show up in large deals (*i.e.*, deals valued in excess of $100 million). While most medium and small-size deals will not have all of the LOL bells and whistles described in this article, the LOLs in these deals will contain a subset of these issues. This article also briefly discusses other common contractual provisions that can limit liability under a contract.

The Temptation to Breach

The downturn in the economy highlights the need to have well drafted LOLs. When a party realizes that a deal no longer makes economic sense, it often looks for a way out of the contract. Bargaining between the two parties (*i.e.*, the customer and vendor) typically ensues. For obvious reasons, vendors are loath to renegotiate prices. For equally obvious reasons, customers are equally insistent to renegotiate prices. As a result, the customer often completely stops paying under the contract to increase its leverage and to get the attention of the vendor's senior management in order to work out a compromise. Prior to committing a clear breach of contract by stopping all payments, however, customer executives reasonably want to determine the extent of their liability under the contract. The LOL often specifically addresses this question.

The result is sometimes surprising. If the LOL has a cap that limits the amounts of recoverable damages to the "amounts paid" by a party (which is typically the customer) and the LOL cap is applicable to both parties,[8] the customer considering stopping all future payments may have an additional legal reason to do so. If the customer stops making all payments immediately, its liability will be less than if it continues to make payments while seeking to negotiate a termination. Although this interpretation of this language is unlikely to be what the parties intended, it is often what the parties actually agreed to in writing. As a result, the customer's desire to increase its leverage by immediately stopping all payments also has the added benefit of possibly minimizing its potential exposure under the contract. This incentive structure is certainly not what the vendor intended. When the customer discovers this interesting wrinkle with LOLs, especially if it involves the vendor's form language, there may be more than a little laughing out loud (LOL in Internet speak) by the customer.

Varying Complexity of LOLs

LOL provisions come in many shapes, sizes, and levels of complexity, depending both on the degree of participation by the various parties in the activities covered by the contract and on, no surprise, the dollar value of the contract. A basic software license agreement's LOL is probably no longer than a few sentences (and most often limits only the liability of the vendor; but more on that later). A software development agreement with both parties actively involved in the development of the software may have an LOL with some additional levels of complexity and will most likely be mutual. A large, multifaceted agreement, such as an information technology services outsourcing agreement, is likely to have fairly complex LOL provisions that will probably be one of the final deal points during the negotiation of the contract. In large deals, it is difficult to finalize an LOL until most of the other risk-related provisions (*i.e.*, indemnity, risk of loss, insurance requirements) have been fully negotiated. At least from a legal risk perspective, all roads in a contract ultimately lead to the LOL.

Mutuality of LOLs

Many LOLs start out being one way because, generally speaking, vendors originate most commercial contracts. Vendors want to make sure that they are not

"insuring" the successful operations of their customers in the event, for example, the services or software the vendor provides to the customer fails to measure up to expectations (or fails completely for that matter). From the vendor's perspective, for example, the failure of the vendor's software should not subject the vendor to liability to the customer for consequential damages, such as lost profits, or for other types of damages that greatly exceed the amounts the vendor is being paid for the software. For example, a $10,000 software license should not expose the vendor to a million dollars in liability, even if the software turns out to be totally worthless.

A well-drafted LOL will encompass all potential types of claims that may arise from the parties' relationship.

In many cases, the one-way nature of LOLs limiting only the vendor's liability under the contract may not be offensive to the customer. If, for example, in the basic software license scenario, the primary obligation of the customer is to make periodic license payments to the vendor, the customer will probably not be adamant about having an LOL cap on its liability to the vendor. In these situations, there is minimal risk exposure for the customer because there really is nothing the customer can do that would cause damages to the vendor other than not paying for the license. If, on the other hand, the customer is responsible for providing certain software or personnel in connection with a software development agreement with a vendor, the customer should be more concerned about making sure the LOL is mutual.

Notwithstanding the greater need generally for vendors rather than customers to have LOL caps, most LOLs in negotiated contracts, even the simpler software license agreements, will likely become mutual during the contract negotiation process. For a simple software license agreement, the vendor may agree to mutuality of an LOL as an easy point to concede out of fairness. As already mentioned, the customer is not likely in a position to cause the vendor to incur damages greater than the cap. For medium to large deals, however, substantive analysis by the customer of its obligations under the agreement may lead to the conclusion that there is a real need for the customer to have an LOL on its potential liability to the vendor. As a result of an LOL becoming mutual, each party needs to examine the LOL issues from both sides (*i.e.*, both as the party whose liability is limited and as a party whose potential recovery from the other party is limited). As we will discuss in greater detail later in this article, while there may be sound reasons for certain provisions of an LOL benefiting just one of the parties, oftentimes because of a variety of reasons (convenience, bargaining positions, imprecise drafting) these provisions are made applicable to both parties with unexpected ramifications at times for one or both parties.

An Issue of Leverage

As is the case with most provisions in contracts that are negotiated, the relative leverage of each party in the pre-contract signing stage will have a significant effect on the contours of the LOL provisions. A vendor that really wants a particular customer, either because of the "quality" of the customer or the sheer size of the potential revenues from the customer, may be willing to accept more risk than usual to close the deal with that customer. A customer, on the other hand, may be comfortable with the reputation of the vendor or may be enamored with a particular vendor's services or software and thus willing to accept greater risk in order to hire a particular vendor.

The relative leverage of the parties to a contract, however, may flip once a deal goes into the ditch based on the nuances of the LOL. If, for example, the vendor was overly focused during the contract negotiation process on limiting its liability to the customer, it may have agreed to a mutual LOL cap equal to the amounts paid by the customer to the vendor. As described earlier regarding an amounts paid LOL, the vendor most likely will find that it has lost some of its bargaining leverage in the renegotiation discussions because the customer has little incentive to continue paying the vendor until the renegotiations have been finalized.

Whether this literal interpretation of an amounts paid LOL cap would ultimately survive a court challenge is an open question, especially in an extreme case in which the customer refuses to pay and is engaged in other behavior flaunting the loophole it discovered. At some point, public policy concerns become relevant. An extensive legal analysis of the enforceability of an amounts paid LOL cap under the appropriate state's law is likely to produce an ambiguous answer from an executive's perspective. Nevertheless, for the overwhelming number of disputes, this textual hook or "gotcha" is a

significant additional bit of leverage that will help the customer. In addition, if the vendor is particularly unlucky, its form contract not only had an amounts paid LOL cap but the deal included equity as part of the payments to the vendor. Solid, knock-them-down, drag-them-out fights can be had over whether equity should be included or excluded from the phrase "the sum of the amounts paid" and how to value the equity for purposes of the LOL. One would suspect that the courts would not have a lot of sympathy for vendors in these circumstances, especially if the vendor drafted the LOL and arguably had the superior bargaining power during the original contract negotiations.

Covering All Types of Claims

While the focus of LOLs in commercial contracts is on limiting claims based on breach of contract by the parties, a well-drafted LOL will encompass all potential types of claims that may arise from the parties' relationship that is the subject of the contract. Accordingly, an LOL should include language stating that the LOL covers claims based on:

> CONTRACT, EQUITY, NEGLIGENCE, INTENDED CONDUCT, TORT, OR OTHERWISE (INCLUDING BREACH OF WARRANTY, NEGLIGENCE, AND STRICT LIABILITY IN TORT).

Language like this greatly limits the creative lawyering that can be engaged in by the parties after a dispute arises in order to avoid the LOL. Executives are free to defer to their attorneys in crafting this part of the LOL.

Qualitative LOLs

Most contractual LOL provisions will exclude certain types of damages that may be recovered by one party from the other based on claims related to the contract. Typical qualitative LOL language may include an exclusion of:

> INDIRECT, INCIDENTAL, CONSEQUENTIAL, EXEMPLARY, PUNITIVE, OR SPECIAL DAMAGES OR LOSS OF INCOME, PROFIT, OR SAVINGS OF ANY PARTY, INCLUDING THIRD PARTIES.

Although some of these descriptive types of damages may overlap or seem to be redundant, the careful drafter is mindful that different jurisdictions treat the variety of potential damages recoverable under a contract differently. In some states, for example, the exclusion for consequential damages clearly bars recovery of most lost profits; in other jurisdictions such a reading is less clear. The overall theme with these limits on the types of damages is to restrict the recovery of damages under the contract to "direct" damages.

Another important phrase in the language quoted previously is the reference to third parties. In some contracts, one or both of the parties is required to indemnify the other party with respect to third-party claims based on the indemnifying party's acts or omissions. A portion of a third party's recovery against the indemnified party may consist of the types of damages that the contracting parties attempted to exclude (*e.g.*, consequential damages). These damages are in fact direct damages to the indemnified party as the damages were out-of-pocket amounts that have been paid or are due to the third party. Absent third-party language similar to that quoted previously, it is unlikely that the indemnifying party could avoid reimbursing the indemnified party for these damages. With mutual LOLs, this limitation on the types of third-party damages cuts both ways and needs to be examined carefully. In transactions in which a customer's primary obligation is to pay the vendor for the goods or services provided, the customer may not want to agree (at least without getting something in return) to extend the qualitative LOL to cover third-party damage recoveries that are subject to indemnification since this extension benefits only the vendor.

In the past few years, many parties in commercial transactions, particularly customers, have realized that an outright exclusion of consequential damages will effectively cut off most of the party's damage claims in the event of a breach of the agreement. In many cases, limiting recovery of a party's damages to direct damages is inadequate. As a result, the parties may agree that certain foreseeable consequential damages are recoverable. One example for a customer is the lost revenue damages resulting from the failure of a computer system caused by defective software supplied by the vendor that the system requires to operate.

Although most of the attention in negotiating qualitative LOL provisions is focused on the types of damages that are not recoverable, some thought needs to be given to the types of damages that may in fact be recoverable (if adequately proven by the party seeking the damages). While some of the negotiations on ensuring that certain types of damages are recoverable can be done in connection with the drafting of the "carve outs" from the LOLs (discussed later in this article), on

occasion, the parties, particularly customers, may want the contract to expressly set out certain types of damages that are not captured in the LOL limiting the types of damages recoverable. This concern is largely one that arises in large deals, but there is no reason the issue cannot be raised for negotiation purposes by the customer in medium-sized deals. It is probably inappropriate to raise this concern in smaller deals—you may be accused of overlawyering. An LOL provision addressing this issue may provide:

> THE FOLLOWING SHALL BE CONSIDERED DIRECT DAMAGES AND NEITHER PARTY SHALL ASSERT THAT THEY ARE INDIRECT, INCIDENTAL, COLLATERAL, CONSEQUENTIAL, OR SPECIAL DAMAGES OR LOST PROFITS TO THE EXTENT THEY RESULT DIRECTLY FROM EITHER PARTY'S FAILURE TO PERFORM IN ACCORDANCE WITH THIS AGREEMENT:
>
> - Reasonable costs and expenses of recreating or reloading any lost, stolen, or damaged customer data;
> - Reasonable costs and expenses of implementing a work-around to a failure to perform in accordance with this agreement;
> - Reasonable costs and expenses of replacing lost, stolen, or damaged equipment or software;
> - Reasonable costs and expenses incurred to procure the services from an alternate source as a result of vendor's breach of this agreement, to the extent in excess of vendor's charges under this agreement;
> - Straight time, overtime, or related expenses incurred by either party, including overhead allocations for employees, wages and salaries of additional employees, travel expenses, overtime expenses, telecommunication charges, and similar charges, due to a breach of this agreement; and
> - Payments or penalties imposed by a governmental body or regulatory agency for failure to comply with requirements or deadlines.

Quantitative LOLs

Different types of quantitative caps on liability for direct damages can be used in commercial contracts. A very common cap is based on some function of the amount of money paid by the customer under the contract.

Amounts Paid/Payable

As previously mentioned, a typical amounts paid LOL cap might read as follows:

> IN NO EVENT SHALL THE CUMULATIVE LIABILITY OF EITHER PARTY RELATING TO THIS AGREEMENT EXCEED THE SUM OF THE AMOUNTS PAID BY CUSTOMER TO VENDOR HEREUNDER.[9]

Many vendors are willing to peg the limits of their liability on the amounts that they have been paid by a customer based on the rough rule of thumb that the potential money paid out in damages should not exceed the money received by the vendor. As discussed previously, absent a "carve out" for payment obligations for goods already delivered and services already rendered, an amounts paid cap that is mutual may lead to unintended consequences for a vendor when its customer decides to stop paying during contract renegotiations.

A simple way to avoid this particular problem is to have the cap based on the sum of the amounts paid and payable for goods already delivered and services already rendered under the contract or the sum of the amounts billed to the customer or similar language that does not give the customer an incentive to withhold payments to limit subsequent liability. By doing this, however, the vendor's liability cap is increased even though the vendor has not in fact received some of the invoiced amounts.

Under either of these quantitative caps, the amount of the LOL will presumably grow during the life of the contract and by the end of the contract the LOL cap could equal the full amount of all payments by (or due from) the customer to the vendor. For a large, long-term deal, this amount could be more than the vendor realistically contemplated.

One way to base the LOL on some function of the amounts paid or payable by the customer under the contract without having the LOL grow to some unreasonably large number is to limit the period of time during which the amounts paid or payable are calculated. For example, the LOL might state that the total aggregate liability of either party for claims shall be limited to the total charges to the customer for the six months preceding the last act or omission giving rise to the liability. This type of provision allows the LOL to expand

and contract over time based on the amount of goods or services the customer has recently purchased, thereby aligning the vendor's liability more with the current economic benefit received by the vendor.

Under any amounts paid or payable under the LOL cap, the parties, particularly the customer, should also consider the amount of the cap during the first few months of the agreement. During this period the payments may be quite small and thus lead to a rather low LOL. In that event, the customer's recovery for a serious breach by the vendor may be unreasonably limited merely because the amounts invoiced are so low. Accordingly, the customer may want to consider having the cap during the first few months of the contract be the sum of the amounts invoiced plus some estimated amount of fees for an additional period of time.

Flat Dollar Amount

Alternatively, a quantitative LOL cap might simply be a flat dollar figure:

> THE TOTAL AGGREGATE LIABILITY OF EITHER PARTY FOR CLAIMS SHALL BE LIMITED TO $_______________.

A flat dollar figure, with appropriate "carve outs" (*i.e.*, for the customer's obligation to pay for goods or services already delivered), gives the parties more certainty in evaluating their respective potential liabilities to the other party under a contract. The dollar amount agreed on by the parties during contract negotiations, however, may not fit the deal over time, especially if, for example, the amount of services provided greatly increases or decreases over time.

Lesser /Greater of Variation

Another variation on the amount of the dollar cap seen in some large transactions is to have the cap be the lesser or greater of a flat dollar amount and the charges paid or payable over a retrospective period of time. Appropriate contract language may read as follows:

> THE TOTAL AGGREGATE LIABILITY OF EITHER PARTY FOR CLAIMS ASSERTED BY THE OTHER PARTY SHALL BE LIMITED TO THE LESSER OF (I) $______ AND (II) THE AMOUNTS PAID OR PAYABLE BY CUSTOMER UNDER THIS AGREEMENT DURING THE MOST RECENT SIX (6) MONTH PERIOD PRECEDING THE EVENTS GIVING RISE TO SUCH LIABILITY.

Refresh Concept

Over time the parties may find that one of them is consistently having to pay amounts to the other party for various items that, while not individually large, are counting against the party's quantitative liability cap. After awhile, the amount left in the cap may be quite low and the other party may start having some concern that the party that has been making all of these payments may lose its incentive to adequately perform under the contract because the downside for doing so is greatly reduced (since the party has almost exhausted its LOL cap). Enter the concept of the LOL cap "refresh." These provisions typically give a party the right to terminate the contract without penalty in the event the other party's quantitative LOL cap nears exhaustion unless the other party agrees to "zero out" or otherwise modify the LOL cap. Refresh language may read as follows:

> In the event (I) either party in aggregate incurs liability to the other party which equals or exceeds ninety (90) percent of the liability cap specified previously and does not fall within an exception to such liability cap and (II) such incurring party does not waive such liability cap or agree to increase it by a mutually agreeable amount within thirty (30) days of its receipt of written notice from the other party, then the other party may immediately terminate the agreement.

Subcaps and Multiple Caps

In large, multifaceted deals, one-size LOL caps may not fit all claims. Accordingly, an LOL may have different size caps for different types of claims. Some or all of these different caps may in turn fall under a larger umbrella cap. Alternatively, the parties may agree that a particular type of claim should be subject to a smaller cap (but the claim also counts toward the larger general cap on all claims). The parties may also agree to daily, monthly, or yearly caps for certain types of damages.

Carve Outs from LOLs

Except perhaps for the simplest transactions, most LOLs contain certain carve outs to the LOL. Carve outs are exceptions to the limitations on the types or amount of damages recoverable (*i.e.*, the amounts collected for these claims do not count toward the LOL cap). The parties thus are subject to potentially unlimited liability for the claims that are carved out.

In drafting the LOL carve outs, the parties need to take care that, when appropriate, the carve outs are applicable to both the qualitative LOL on the type of damages recoverable and the quantitative LOL on the amount of damages recoverable. Otherwise, for example, a vendor may run into a problem even if the amounts paid or payable to a vendor for services rendered by the vendor are carved out of the quantitative LOL cap on the amounts of damages recoverable. The component of these amounts that represent the vendor's profits may not be recoverable if the amounts are not also carved out of the qualitative LOL on the type of damages that are recoverable (and the LOL excludes recovery for lost profits).

Common LOL carve outs include:

- Amounts due for goods delivered and services rendered
- Certain indemnities
- Malicious/willful/intentional misconduct
- Personal injury and property damage claims
- Breach of confidentiality provisions
- Losses from vendor's failure to provide services
- Liquidated damages (service level credits)
- Termination fees
- Breach of certain representations and warranties

Amounts Due for Goods Delivered and Services Rendered

This carve out seems like a pretty obvious one, but, surprisingly, is not that common, especially in the one-way LOLs drafted by vendors for basic service or software license agreements that are made mutual in the negotiation process. This oversight may be due largely from what is perhaps a common sense, but incorrect, belief that the LOL is not meant to even cover these amounts since they are already due in a set amount. If the LOL is drafted broadly, however, the vendor may find that the customer's liability for past due amounts may very well be included in the LOL. The prudent measure for vendors is to have an explicit carve out from both the qualitative and quantitative LOLs for these amounts.

Certain Indemnities

It is also fairly common to have a number of carve outs for amounts due pursuant to certain indemnity obligations for third-party claims that the parties have agreed to elsewhere in the contract. Most technology-related agreements will typically have one or both parties indemnifying the other party for intellectual property right infringement claims resulting from the indemnifying party's intellectual property. Money damages paid to third parties by the indemnified party are a common carve out from the LOL since the indemnified party is often an innocent party in the dispute and assuming this risk is generally not part of the expectation of the deal.

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Other indemnities that are sometimes carved out from the LOL are those relating to confidentiality claims by third parties (*e.g.*, the customer handles confidential information of third parties that is compromised by vendor's software or actions) and personal injury or property damage claims by third parties (*e.g.*, the vendor destroys property owned by a third party while performing work for the customer). The latter types of damages are often covered by the parties' insurance and thus may not result in that much real exposure to the parties.

Malicious/Willful/Intentional Misconduct

Damages arising from malicious/willful/intentional misconduct, intentional tortious conduct, or gross negligence are, collectively, another common carve out from an LOL. These damages may already be carved out as a matter of common law or statutory law in many states,[10] but the parties often like to have all of the carve outs set forth in the contract. Imprecisely setting out a carve out for this type of conduct, however, may lead to some interesting questions as to what type of behavior is covered by the carve out. For example, is a party's intentional, wrongful termination of an agreement in order to get out of a bad deal the type of intentional conduct that is meant to be carved out?[11]

Personal Injury and Property Damage Claims

As is the case for the indemnity for third-party personal injury and property damage claims, an LOL carve out for a party's own personal injury (including employee claims) and property damage claims is also fairly common. As previously mentioned, these risks are

typically covered in large part by the parties' insurance policies.

Breach of Confidentiality Provisions

Another type of claim that may be carved out from the LOL is a claim resulting from the breach of the agreement's confidentiality provisions, especially when one or both of the parties is giving the other party access to highly confidential information, the release of which would cause the party serious damage by compromising its competitive advantage. The release or loss of confidential information is generally going to primarily result in consequential damages. If the parties want to allow the recovery of these damages, they will need to be carved out of at least the qualitative LOL.

A party whose confidential information is not really at risk may, during contract negotiations, take the position that this is an inappropriate carve out from the LOL since the other party can still recover certain direct damages from the breach of a confidentiality provision, such as the cost to recreate the competitive advantage from the confidential information. The other party may counter that it is impossible in practice to recreate such a competitive advantage for technical, market, or personnel reasons. Finally, whether such damages are also carved out of the quantitative LOL is primarily a question of negotiation leverage.

Losses from Vendor's Failure to Provide Required Services

When a vendor is providing a mission critical service to a customer that is difficult to obtain quickly from another vendor, the customer will often want to carve out from the LOL the damages that arise if the vendor refuses to provide the service when the vendor is able, and obligated, to do so. In addition to providing a disincentive to the vendor's taking action that may jeopardize a customer's business, this carve out prevents the vendor from gaining an unfair advantage in any contract renegotiation and helps make sure the vendor assists in the transition to the new vendor at the contract's expiration or termination.

Liquidated Damages (Service Level Credits)

In the medium to complex commercial agreements, the parties often agree to the vendor's payment of certain amounts (or agree to credit certain amounts against the amounts payable by the customer) as liquidated damages in the event the vendor's quality of service is not up to certain specified levels of service. For example, in a technology outsourcing deal, the agreement may provide that the vendor's computer network must be available to the customer during 99.95 percent of the customer's business hours during a 30-day period. These amounts probably need to be excluded from the qualitative LOL cap because it may be difficult for the customer to prove that these amounts do not at least in part consist of consequential, indirect, punitive, or other damages that are not direct damages. In addition, the customer may request that these amounts also be carved out of the quantitative LOL cap. The vendor has a stronger position arguing against this carve out from the quantitative LOL cap than it does with respect to the carve out from the qualitative LOL. These liquidated damages are just another form of monetary damages that probably should count against any monetary cap.

Termination Fees

Oftentimes in large, long-term contracts, in particular those in which the vendor has to invest a lot of resources up-front to provide services to the customer (*e.g.*, build a new facility or hire a lot of new personnel), the customer may be given the right to terminate the contract prior to the end of the stated term for a number of reasons. In order to do so, however, the customer must pay a specified termination fee to, in part, reimburse the vendor for certain of these sunk costs. These termination fees may be quite large early in the contract, but typically are less in the later years of the contract as the sunk costs are gradually reimbursed by the contract payments. Termination fees are typically carved out of both the qualitative and quantitative LOLs as the parties usually would not intend these payments to be subject to the LOLs.

Breach of Certain Representations and Warranties

There are a number of misrepresentation claims or breach of warranty claims that one or both parties may feel particularly strong about and request that recovery for the resulting damages be carved out from the LOL. Representations or warranties regarding corporate authority to execute and carry out the obligations of the contract, the absence of improper inducements made to employees and agents of the other party to enter into the agreement, and similar representations and warranties that address the fundamental integrity of the contract are some common carve outs of this type.[12]

Final Words on Carve Outs

Overall, it is completely up to the parties, and the relative strength of their negotiating positions, to determine what types of claims, if any, should or should not be carved out from the qualitative and quantitative LOLs in a commercial contract. There really are no common law or statutory limits on private parties subjecting themselves to unlimited liability.

Other Contractual Provisions Limiting Liability

A party may use a number of other contract terms to limit its liability.

Specifying an Exclusive Remedy/Damage Award

Another way for a party to limit its liability under a contract, especially with respect to a specifically identified breach, is to set out an exclusive remedy for the breach.[13] One common example in commercial agreements that involve the use of a party's intellectual property, such as a computer software application, is for the contract to set out the remedy for claims of infringement or misappropriation. Typically these remedies require the party supplying the product[14] to: (1) secure the other party's right to continue using the product; (2) modify the product to make it non-infringing; or (3) replace the product with a non-infringing functional equivalent. While these remedies are often the exclusive remedy for the other party for its own claims, they are usually in addition to the obligation to indemnify the other party from third-party intellectual property rights infringement claims.

As previously discussed, the parties in a large contract may specify certain liquidated damages in the event of certain contract breaches by the vendor. Liquidated damage awards are typically the customer's exclusive remedy against the vendor for these breaches. Importantly, Section 2.718(1) of the UCC, which as previously discussed governs the sale of goods, expressly provides:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Another fairly common use of an exclusive remedy is in connection with a contractual obligation with which one party is not very comfortable or for which there is no obvious way to measure the damages resulting from its breach. The parties in these situations may simply specify that if one party breaches its obligations, then the other party may terminate the agreement without penalty or payment of termination fees that would otherwise be due.

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When drafting an exclusive remedy, the remedy should be clearly identified as being the exclusive remedy for that breach (and all breaches for which the remedy is exclusive should be clearly identified). The courts generally will not infer exclusivity, especially since Section 2.719(1)(b) of the UCC provides that "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."

Contractual Statute of Limitations

Yet another dimension to limitations of liability is time. The parties to a contract, for example, may want to put some kind of time limitations as to when a party may assert a claim against the other party for an alleged breach of the contract. These contractual statutes of limitations supplement the statutory statutes of limitations that exist under state law, which generally impose a time deadline for filing a lawsuit based on various types of claims. The benefit of having a contractual statute of limitation is obviously to shorten what might be perceived as overly long statute of limitations periods in a particular state. Another benefit is to ensure that a particular time limitation for bringing claims is uniform for all types of claims, regardless of which state's statute of limitation laws are held to govern the contract. The following is an example of a contractual statute of limitations:

> No claim, demand for mediation or arbitration, or cause of action which arose out of an event or events that occurred more than two years prior to

the filing of a demand for mediation or arbitration or suit alleging a claim or cause of action may be asserted by either party against the other.

Contractual Obligation to Mitigate Damages

Although most, if not all, states have some common law (or perhaps statutory) obligation for a damaged party to attempt to mitigate its damages, it may still be wise to include an express contractual obligation on each party to mitigate damages that may be recoverable under the contract. A contractual mitigation provision may provide:

> Each party has a duty to mitigate the damages that would otherwise be recoverable from the other pursuant to this agreement by taking appropriate and reasonable actions to reduce or limit the amount of such damages.

Having an express contractual provision to mitigate damages at a minimum puts a contractual burden on the party seeking the damages to establish that it acted appropriately and reasonably to mitigate its damages.

Summary

Overall, the statutes and common law of most states in this country give contracting parties in business transactions wide freedom in crafting LOL provisions. One of the few limits to this freedom is the inability of contracting parties to exculpate themselves from certain intentional conduct and their gross negligence. Typically, however, parties to a contract with roughly equal bargaining power will find that they can be quite creative in custom designing contractual LOLs to allocate the economic risks between the parties in light of each party's business objectives. Business executives need to overcome the tendency to defer completely to their attorneys on LOLs because a significant business issue is at stake: The extent of the legal exposure of the executive's company under the contract. Executives' understanding of LOLs will measurably improve terms during contract negotiations and thus likely increase the leverage of the company after the contract is signed. Finally, all parties should take care in drafting the LOL provisions, as not only will many courts strictly construe the LOL against the benefiting party and read it as narrowly as possible, but the LOL may have unexpected consequences if each party does not fully think through all of each provision's ramifications. Otherwise, one party may find the other party laughing out loud when the LOL backfires.

Notes

1. *See, e.g.,* Hibbard v. Western Union Telegraph Co., 33 Wis. 558 (Wis. 1873) (in which the Wisconsin Supreme Court held that Western Union's printed regulations that limited its liability in connection with sending certain messages to the amount paid for sending the message was unreasonable and void, as against public policy, to the extent it undertook to protect the company from liability for the negligence or fraud of its agents).
2. Best practices suggest, and some courts have required, that the exculpatory language be written in all capital letters, in bolded text, or otherwise conspicuously set out from the surrounding text in a manner that draws attention to the text. The exceptions, or carve outs, to the LOL, however, probably do not need to be conspicuously set out.
3. *See, e.g.,* Vallance & Co. v. De Anda, 595 S.W.2d 587, 590 (Tex. Civ. App.—San Antonio 1980, no writ) ("In absence of a controlling public policy to the contrary, contracting parties can limit their liability in damages to specified amount."); Florida Power & Light Co. v. McGraw Edison Co., 696 F. Supp. 617, 620–621 (S.D. Fla. 1988), *affirmed,* 875 F.2d 873 (11th Cir. 1989) (holding that under Pennsylvania law, a contract provision that prohibited special, indirect, or consequential damages, and limited seller's liability to cost of equipment sold, was valid, even if such limitation was not expressly negotiated); Harper Tax Services, Inc. v. Quick Tax Ltd., 686 F. Supp. 109, 112–113 (D. Md. 1988) (holding that consequential damages exclusion in written licensing agreement for computer software was not prima facie unconscionable, even though the agreement may have been nonnegotiable adhesion contract since there was no allegation of undue influence, force, or threats). *But see,* Helena Chemical Co. v. Wilkins, 18 S.W.3d 744, 758 (Tex. App.—San Antonio 2000, no writ) ("A contractual limitation on damages is not effective to statutorily created rights, such as a right to recover for deceptive acts.").
4. This article deals with both the sale of goods, the sale of services, and hybrid sales of both goods and services. When the sale of goods is involved, the starting point for analyzing the LOL should be the applicable state's version of Article 2 of the Uniform Commercial Code (UCC) and the case law construing such statutes. The sales of services generally will not be subject to Article 2 of the UCC although the courts in some states seem to rely heavily on Article 2 when dealing with service contracts, albeit by analogy. For hybrid agreements involving both goods and services, most states employ an "essence of the transaction" or "predominant factor" test to determine if Article 2 will be applicable. If the sale of goods is the predominant factor or essence of the transaction, then Article 2 will apply.
5. Section 2.719 of the UCC reads in full as follows:

   § 2-719. Contractual Modification or Limitation of Remedy.

   (1) Subject to the provisions of subsections (2) and (3) of this section and of the preceding section on liquidation and limitation of damages,

(a) the agreement may provide for remedies in addition to or in substitution for those provided in this Article and may limit or alter the measure of damages recoverable under this Article, as by limiting 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; 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 this Act.

(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.

6. *See, e.g.,* Computrol, Inc. v. Newtrend, L.P., 203 F.3d 1064, 1070 (8th Cir. 2000) (applying Illinois law and *citing* Rayner Covering Sys., Inc. v. Danvers Farmers Elevator Co., 226 Ill. App. 3d 507, 168 Ill. Dec. 634, 589 N.E.2d 1034, 1036, and Liccardi v. Stolt Terminals, Inc., 178 Ill. 2d 540, 227 Ill. Dec. 486, 687 N.E.2d 968, 972–973 (1997)); Nahra v. Honeywell, Inc., 892 F. Supp. 962 (N.D. Ohio 1995) ("While viewed critically by the courts, limitation of liability clauses, including exculpatory clauses, may be freely bargained for in Ohio.").

7. This article focuses on business-to-business contracts and is not necessarily applicable to consumer contracts for which the rules of engagement for LOLs can be quite different.

8. Such an LOL might read as follows: "IN NO EVENT SHALL THE CUMULATIVE LIABILITY OF EITHER PARTY RELATING TO THIS AGREEMENT EXCEED THE SUM OF THE AMOUNTS PAID BY CUSTOMER TO VENDOR HEREUNDER."

9. A recent US Court of Appeals case, Computrol, Inc. v. Newtrend, L.P., 203 F.3d 1064 (8th Cir. 2000), in fact involved similar language that read as follows: "Except as otherwise expressly stated in this Alliance Agreement, each party's liability to the other for any cause whatsoever and regardless of the form of action and whether in contract or tort, or at law or equity shall in no event exceed the amounts actually paid to the other under this Alliance Agreement."

10. *See, e.g.,* AGIP Petroleum Co., Inc. v. Gulf Island Fabrication, Inc., 920 F. Supp. 1330, 1343 (S.D. Tex. 1996) ("[U]nder Louisiana law, contractual provisions limiting liability, with the exception of gross negligence and intentional conduct, are valid."); NMP Corp. v. Parametric Technology Corp., 958 F. Supp. 1536, 1543 (N.D. Okla. 1997) (*noting* that under Oklahoma law, a party may contractually limit damages on claims arising from its own negligence, but cannot contractually limit damages incurred as a result of its own gross negligence or fraud).

11. Interestingly, Louisiana recognizes a cause of action for willful or deliberate disregard of contractual duty for which liability may not be limited. *See* AGIP Petroleum Co., Inc. v. Gulf Island Fabrication, Inc., 920 F. Supp. 1330, 1343 (S.D. Tex. 1996). *But see* Metropolitan Life Insurance Co. v. Noble Lowndes International, Inc., 84 N.Y.2d 430, 438, 643 N.E.2d 504, 508, 618 N.Y.S.2d 882, 886 (N.Y. 1994) ("In excepting willful acts from defendant's general immunity from liability for consequential damages under [S]ection 7 of the Agreement, we think the parties intended to narrowly exclude from protection truly culpable, harmful conduct, not merely intentional nonperformance of the Agreement motivated by financial self-interest.").

12. The laws of some states may also restrict the ability to limit the damages resulting from such actions. *See, e.g.,* Arthur D. Little International, Inc. v. Dooyang Corp., 928 F. Supp. 1189, 1205 (D. Mass. 1996) ("Under Massachusetts law, a damage limitation clause in a contract does not bar recovery for intentional misrepresentation in the inducement of a contract.").

13. *See, e.g.,* Sun Microsystems, Inc. v. Microsoft Corp., 999 F. Supp. 1301, 1306 (N.D. Cal. 1998) (*noting* that under California law, a "clear and unambiguous contractual provision providing for an exclusive remedy for breach will be enforced"); Johnson v. Orkin Exterminating Co., Inc., 746 F. Supp. 627, 630–632 (E.D. La. 1990) (holding that exterminator was not required to repair damages to property caused by infestation of subterranean termites since under express and unambiguous terms of parties' contract, exterminator's liability was limited to re-treatment only).

14. Such a provision may also be applicable to certain services, especially with respect to the services provided by application service providers (ASP) that offer customers access over the Internet to software applications and related services that would otherwise have to be located in the customers' own personal or enterprise computers.