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A Primer on
Limitations of Liability and Indemnification
in Contract Negotiations

Limitations of liability and indemnification clauses are important, technical provisions of most commercial contracts. It is customary to find these two provisions around the middle or near the end of many agreements, sometimes with the limitations of liability offset in all-caps, boldface or underline. This article discusses what these provisions are, why they are important and how they may interact with each other. Understanding these issues will help you better negotiate the terms of contracts that are important to you.

Many commercial contracts follow a customary outline, starting with recitals, turning to descriptions of performance, consideration and pricing, representations and warranties, and then limitations of liability, indemnity, termination, jurisdiction and venue, dispute resolution, force majeure, contact details for notice, and boiler plate language which may be under a section named "miscellaneous" or may be broken out, to address assignment rights, the scope of the agreement (which may be referenced as the "entire agreement" provision), amendments, and finally signature blocks, perhaps followed by exhibits. The precise order may vary, but if you are not an attorney and are trying to wade through a commercial agreement alone, your eyes may start to roll to the back of your head by the time you hit representations and warranties, and you may be worn down by the time you reach the limitations of liability and indemnity clauses. That would be unfortunate.

The limitation of liability provision of a contract is like a circuit-breaker, which if applicable, limits the ultimate amount of damage for which a party may be liable, for harm arising under or related to performance of the contract. These provisions are also often referred to simply as "liability caps" because they fix the total amount of liability one or more of the parties to a contract may face, if applicable. It is important to bear in mind the conditional term "if applicable" because liability caps generally apply as between two parties or as between the parties to the agreement, but will usually not apply to a third-party's claims. For example, Acme Inc. and Widget Corp. may sign an agreement stating that neither can be liable to each other for more than $100 in connection with their sales of doodads. But if Joe Smith buys a doodad and is harmed by a defect in the product, Joe may well sue both Acme and Widget for more than $100, and each of them may be liable to Joe notwithstanding the limitations of liability clause in the sales agreement between Acme and Widget.

Broadly, liability cap provisions may be bifurcated, or in some instances, a liability cap may address only one of the following two issues: indirect damages and direct damages. Indirect or special damages are liabilities, costs, expenses or harm that are difficult to anticipate and quantify. Concepts such as "lost profits" (i.e., on sales which may have never occurred) are an excellent example of indirect damages. Predictable, quantifiable damages suffered by one party as a result of the action or inaction by another party in the performance or breach of the relevant agreement, constitute direct damages. The limitation of liability may be drafted in a unilateral manner to protect only one party (or set of parties) to an agreement, or may be drafted to mutually cover both or all parties to the agreement. Many contracts disclaim any liability for indirect or special damages as between the parties, because by definition, such damages are remote and difficult to accurately calculate, especially in advance. Because the performance and risk of each party may be different, it

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may be reasonable to apply different limitations of liability to different parties with respect to direct damages. The limitation of liability may be a sum certain or may be an amount arrived at by formula. The formula may, for example, be tied to one or more party's insurance limits (or success in collecting insurance), or a so-called "look back" period, such as the six, twelve, twenty-four, etc. months immediately preceding the date on which the liability arose.

An indemnification provision is related to the liability cap because it too addresses and clarifies allocation of risk among the parties. Generally, an indemnity provision of an agreement sets forth in detail the compensation one party provides another party (or multiple parties) for expenses or liability incurred as a result of breach of the agreement by the compensating party. The indemnity provision may include or exclude claims brought by one party against another, as well as claims brought by a third-party against a party, in connection with performance of the agreement. Referring again to the prior doodad sales agreement between Acme and Widget, they may have an indemnity clause, for example, that only applies to third-party claims, reasoning that claims by one party against the other should be resolved informally. Thus, if Joe sues both Acme and Widget for sale of defective doodads, and following investigation, it is discovered that Acme's quality control process was at fault in failing to screen out the defective doodad that harmed Joe, the indemnity may materially help Widget. If Joe wins a court judgment against Widget for $500, Widget may be able to demand Acme reimburse Widget for this $500 expense. The liability cap of $100 likely would not apply since the claim was originally brought by Joe – a third party. The indemnity would likely apply for the same reason, though the devil is in the details of how the clause is drafted and what (further) conditions, if any, must be met. Direct liability Acme may have to Joe may not be material or relevant to the operation of the indemnity clause. Because they are contractual clauses, they can be qualified and conditioned however the parties agree. This is why it is so important to read and understand the terms and conditions; you need to confirm they are drafted in a manner that is reasonable and consistent with current market terms. If you are not sure what is reasonable under the circumstances or what current market terms are, you are not the best choice in negotiating that portion of the agreement.

Indemnification is useful in the event of litigation, in helping quantify damages. In general, commercial litigation consists of two phases, each of which is time consuming and expensive. The first phase is assessing whether a claim is sustained or rejected. If a claim is rejected, there is no second phase; but if a claim is sustained, then the court must calculate the damages which arise. This can amount to a second trial. Having an indemnity provision, in which the parties allocate costs and risks in the contract itself, can materially shorten or eliminate the second phase of commercial litigation.

The indemnity clause usually incorporates one or more of the representations and warranties set forth by the parties earlier in the contract, as the benchmark for assessing whether a breach has occurred. As the in case of the limitation of liability, because the performance of parties may differ, and consequently, the risks of the parties may differ, the indemnity clause may not be identical as between the parties. And like the liability cap provision, the indemnity clause may be unilateral or mutual in the manner in which it is drafted, meaning, it may address only compensation by one party, or by both (or all) parties to the agreement.

Finally, keep an eye out for a limitation of liability provision that carves the indemnity out of the liability cap. It may state something along the lines of, "except for liability arising under the indemnification provision hereof, the aggregate liability of any party arising under this agreement shall not exceed" the sum certain or formula set forth in the liability cap. So what does this mean for you? It depends. You need to assess which party is more likely to breach the agreement. Often, in a commercial services agreement, the customer's primary obligation is to pay for a service; their greatest risk is narrow: inability to pay. Meanwhile, the service provider takes on all the risk of performing the service for which it is being paid. If you are the customer, a limitation of liability provision that carves any indemnifiable liability out of the liability cap may be perfectly acceptable, or indeed, preferable. It means that if a liability ripens which is subject to indemnity, there is no applicable liability cap, i.e., such liability is theoretically infinite. Sounds acceptable if you know your only risk is that you need to pay your bill, you have a sense of what the bill will be, and you are confident in your ability to make payments over the contract term. What may be great for the customer, however, may not be so great for the service provider. From the service provider's standpoint, that carve-out may constitute the exception that swallows the rule. What good is the liability cap to a service provider who is looking at trip-wires of a dozen representations and warranties, any one of which if breached, will trigger its uncapped liability under the indemnity clause? The point of the liability cap, after all, is to provide some certainty – and presumably comfort – to each party to the agreement. A carve-out that effectively nullifies the value of the liability cap to one of the parties, is going to be a source of controversy during the contract negotiations, so long as each of the parties reads and understand the contract.

If you enter into commercial contacts regularly and wonder whether they contain a limitation of liability clause or indemnification provision, here is the answer: many of them do contain these provisions. And if you are wondering whether they are mutual or unilateral to your disadvantage, here is the answer: many of them are unilateral and to your disadvantage. These provisions tend to be like home insurance: a waste of money and time to pay for, think about and argue over; unless you have fire, water or other insurable damage to your home. So if you are reviewing an important contract by yourself, towards the end of the work day, and you just want to get the deal done, fight the urge to sign it because you are tired, and you know the other party and think you can trust or reason with them if a problem arises. Put the agreement down for the day and review it with fresh eyes later; what constitutes "reasonable behavior" or "a reasonable position" may vary significantly before you sign an agreement, and after you sign it, depending on how the terms and conditions in the agreement are drafted.

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