Negotiating a One-Sided Limitation of Liability

When clients come to me asking for an evaluation of their remedies because their tech deal has gone sour, the single worst remedy and lawsuit killer I often find in existing tech contracts is the “standard” limitation of liability clause. It never ceases to amaze me how people do not pay attention to these provisions as they blithely sign-off on a one-sided agreement. It’s just one little clause and yet it can cause so much damage.

Here is an example of the type of a limitation of liability provision that you will find in tech agreements—this one is from a software as a service agreement:

Vendor shall have no liability with respect to Vendor’s obligations under this agreement or otherwise for consequential, exemplary, special, incidental, or punitive damages even if Vendor has been advised of the possibility of such damages. In any event, the liability of Vendor to Customer for any reason and upon any cause of action shall be limited to the lesser of the amount paid to Vendor under this Agreement or $_____. This limitation applies to all causes of action in the aggregate, including without limitation to breach of contract, breach of warranty, negligence, strict liability, misrepresentations, and other torts.

NO TRICKS UP MY SLEEVE

Now, if your client signed-off on a provision like that because they figured that you would find some technicality to overcome it if necessary, I think they have made a serious mistake. As a generalization, limitation of liability provisions mean what they say and say what they mean. Judges can read, and a judge would more than likely enforce it as written in a contract between two sophisticated parties. I think courts correctly read these provisions as allocation of risk provisions that the court should enforce as written.

While the sample provision above was clearly one-sided, courts are not in the business of rewriting deals to make them fairer. Simply put, that is the purpose of the negotiation. If your client failed to negotiate a more balanced limitation of liability provision, they will almost certainly have to live with the consequences of their failure if there is a dispute down the road.

IT’S THE NORM

When you negotiate your client’s agreement and tell the vendor that the limit of liability has to go, you are likely to get a blank look. You know, it is the same one you get from your kids when you remind them that they have not given you your change.

I know what I say because when I represent the seller of tech services I say things like: “Limits of liability are the norm.” “Everybody uses them.” “We have never done a deal without one.” “We would have to increase the price dramatically because of the additional risk we would be assuming.”

Ironically, all of this is true. So, we are done, right? Wrong. A skilled and experienced negotiator can make all the difference here. This is where you as the lawyer on the deal can make a meaningful difference. (A difference your client may not appreciate, but that is a different discussion.)

While it is the norm to see limits of liability in deals like software as a service, cloud computing, licensing, telecom and outsourcing...
deals it is not necessarily true that they are all as onerous as my example. While getting the other side to remove a limit of liability completely may be like climbing Everest and wholly unrealistic, making it fairer is not necessarily so hard if you ask for the right things.

**The Negotiation**

If the vendor will not eliminate the limit of liability provision, which no well-represented and solvent tech, telecom, or outsourcing company would, you have to start pecking at the provision to put a chink their armor. So let us go back to my example where the vendor’s liability is “limited to the lesser of the amount paid to Vendor under this Agreement or $_____” (emphasis added) and look at some ways to start pecking at it.

Let us say your client has a five-million dollar deal cooking, which calls for five equal payments over five months as work progresses. Let us say that after the first month it becomes clear that the work the vendor is doing is causing more harm than good, so your client rightly refuses to make your second one-million dollar payment. Finally, let us say that the vendor has somehow caused your client damages valued at two-million dollars. Your client might naïvely think that you could easily obtain a judgment for their two-million dollars. However, you are not likely to achieve what your client might think is the fair result because the limitation of liability provision limited their recovery to the amount they paid - i.e. a refund. Therefore, as written, no matter what the vendor does and no bad how bad it is, the most your client gets is a refund of the one-million dollar payment. The vendor risked nothing!

My first attempt to chink their armor would be to ask them to agree to a limit of liability of an amount equal to the total value of the contract to them (five-million dollars) and not the amount paid to date. Failing that, I might ask for some multiple of the amount paid to date.

As an aside, in the world of service deals like software as a service, a typical limitation of liability is equal to the fees paid by your client to the vendor over some relatively short period. In my experience, vendors typically start with three to six months of fees as their limitation of liability. I can usually get that up to 12 to 18 months, but my goal every time is at least 24 months.

When your contract bases the limitation of liability provision on fees over a certain period, you must be sure to draft the provision to deal with the situation of a breach occurring before the contract has been in place for as long as that certain period.

So for example, if your contract bases the limitation of liability on the fees paid over the last 24 months and the breach occurs in the fifth month, your contract should include the concept that if the breach occurs before the 24th month of the contract term, then the limitation of liability would be the average monthly fee up until the time of the breach times 24 months.

Another approach to chinking the vendor’s armor is “reciprocity.” In fact, I would say that no single word is more important in moving a one-sided agreement toward the middle than reciprocity. What is good for the vendor is good for your client. Do not be embarrassed to ask. They certainly were not embarrassed to make the provision one-sided to their advantage.

The idea is that the most that the vendor could ever recover from your client is equal to the most your client could recover from the vendor. Why should the vendor have a protective limit, but not your client? The vendor will not like that, but it is hard to argue against the proposal’s inherent fairness.

Yet another approach would be to carve out an exception if the vendor infringes the intellectual property rights of a third party. In the example as written, if they “created” software for your client and your client is sued for millions for infringing some third party’s copyright, your...
client could end up with millions in liability. Still, your client could only recover up to the amount of the limitation of liability from the vendor as the party who really caused the infringement. Again, the provision is simply not fair nor is it a fair allocation of risk. Therefore, my position is that liability for indemnification arising from the infringement of intellectual property should be excluded from the limitation of liability.

Then, I go farther on all third-party indemnification issues and take the position that vendor should be fully responsible for all third-party damages of every kind and nature including third party’s property damage and bodily injury claims. As with the copyright situation, it seems inherently unfair that your client should pay unlimited amounts of money to a third party because of something your vendor did.

A few other items that I want excluded from a limitation of liability include willful or intentional torts, claims arising from the vendor’s breach of a confidentiality provision, a claim arising from the vendor’s improper use of personal identifiable information, any claim for indemnification other than for IP which we discussed above, claims arising from the vendor’s failure to comply with the law, and vendor’s intentional breach of contract.

It is almost a waste of time to put effort into negotiating a contract to have it emasculated by a one-sided limitation of liability provision. Do not let that happen to your client. While it may be true that these types of provisions are “normal,” do not assume that the one in the vendor’s proposed agreement has dropped from the heavens as the only way it can be.

For more information on the topic discussed, contact Mark Grossman at grossman@thsh.com.

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