Contracting with Suppliers – A Balanced Approach to Indemnities and Limitations of Liability

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The General Theme – One Pushes and the Other Pulls

- On the whole, indemnities seek to increase liability beyond the law of damages.
- On the other hand, limitations of liability seek to reduce (and in some cases eliminate) liability under (i) the law of damages and (ii) indemnities (except to the extent which the agreement is drafted so that indemnities are not subject to the limitations on liability).
- Indemnities and limitations of liability are often contained in different sections of an agreement but they should always be reviewed in tandem. One should always consider the extent to which one or more limitations of liability should apply to an indemnity.
- In other words, as each provision in an indemnity is considered, the following question should be asked: "Does it make sense to limit the indemnity by a limitation of liability provision and, if so, to what extent?"
- Before we consider negotiation of indemnities and limitations of liability, we will begin with a review of some of the fundamental principles of the law of damages and indemnities.
- One is much better equipped to engage in meaningful and efficient negotiations if one appreciates the balance between the law of damages, indemnities and limitations of liability, and has a toolbox of creative solutions.

Brief Summary of the Law of Damages

- When a breach of contract occurs, the law of contract provides to the innocent party the remedy of damages as compensation for the losses suffered as a result of the breach.
- A breach of contract may also constitute a tort, and the most common occurrences are negligence, negligent misrepresentation and fraudulent misrepresentation. Damages are also available under the law of torts.
- The goal of damages for breach of contract is to put the innocent party in the economic position in which it would have been if the contract had been performed. The expectation interest of the injured party is protected. The innocent party is also entitled to compensation for consequential losses that would not have occurred but for the breach of the contract.

- However, the expectation interest of the injured party is subject to limitations. The losses must have been caused by the breach, they must have been reasonably foreseeable at the time of contracting, they must be proven with sufficient certainty, and they must be unavoidable (which is known as the duty of mitigation).
- The principle of remoteness is probably the most important principle because it limits the extent of compensation to damages within the reasonable contemplation of the parties at the time of contracting.
- This principle is associated with the classic case of *Hadley v. Baxendale*, which establishes that losses which are compensable in damages are restricted to those that would arise in the usual or natural course from a breach of the particular contract and thus would or should be foreseen by a contracting party and also for losses that are specifically identified as possible at the time of contracting the particular contract. In other words, the losses must be reasonably foreseeable.
- Damages for a tort differ from contract damages but some of the principles overlap. In tort, the injured party is compensated for losses actually suffered as a result of the misconduct, which differs from putting the innocent party in the economic position in which it would have been had a contract been performed. Tort damages must be caused by the tort misconduct.
- In addition to causation, there are once again limiting factors. Tort recovery is limited to losses which are reasonably foreseeable (as is the case with contract claims). The injured party must mitigate, and the injured party must prove his or her loss with reasonable certainty.
- Generally speaking, the objective of civil law is to provide compensation to the injured party, and it is usually the role of criminal law to punish wrongdoing. Case law establishes that punitive or exemplary damages are awarded in a civil claim only in exceptional cases where the defendant's conduct is malicious, oppressive, high-handed, and offensive to the court's sense of decency. Punitive damages are especially rare for breach of contract.

How do Consequential Damages fit into the Picture?

- Consequential damages, indirect damages and incidental damages are essentially synonyms.
- Direct damages are damages which flow directly, naturally and immediately from the breach whereas consequential damages are one step removed from the actual breach.
- Indeed, one court may regard as consequential what another regards as direct damages. The cases suggest that the line between direct damages and consequential damages can be very grey.
- Consequential damages are recoverable under the principles of *Hadley v. Baxendale* if they would arise in the usual or natural course from a breach of the contract and thus

would or should be foreseen by a contracting party. The availability of consequential damages depends substantially upon the special knowledge of the parties in a particular case.

- The jurisprudence suggests that direct damages are always recoverable by the innocent party but consequential damages are recoverable if they are foreseeable.
- Each case is fact specific. For example, depending on the circumstances of a particular case, lost profits suffered by an innocent party may constitute (i) direct damages (ii) consequential damages which are foreseeable or (iii) consequential damages which are not foreseeable. Recovery would typically be available under (i) and (ii) but not (iii).
- In light of the uncertainties associated with the question of whether a certain loss is recoverable in light of principles of direct damages, consequential damages and foreseeability, the best route, if the loss is to be excluded, is to specifically exclude the type of loss – for example, “loss of profits” or “loss of data”. Reliance upon merely excluding “consequential damages” may invite murkiness.

Let’s Have a Look at the Types of Indemnities

- On the whole, indemnities shift risk to expand liability from what might be the case simply under the law of contract or of tort.
- Indemnities may be divided into two broad categories:

  (i) indemnities for losses and damages (including third party claims) arising out of the failure of the other party to comply with its obligations under the contract (which may include the tort of negligence regarding performance under the contract), and

  (ii) indemnities for losses and damages arising out of third-party claims (e.g., intellectual property infringement claims, claims from regulatory authorities due to failure of the other party to comply with applicable laws, or third-party tort claims for personal injury or death, or damage to property).

- The question of the extent to which an indemnity increases risk beyond the law of damages is a question of contract interpretation under the particular circumstances (other provisions in the contract besides the indemnities may be relevant).
- Sometimes a supply agreement will provide a representation and warranty that “The Deliverables do not infringe the intellectual property rights of any person."
- By way of contrast, a supply agreement may provide indemnification for “all claims, damages, losses, liabilities, demands, suits, judgments, causes of action, legal proceedings, penalties or other sanctions which may directly or indirectly arise from any allegation or claim that the Deliverables infringe the intellectual property rights of any person”.

- If the foregoing representation and warranty is breached, the remedies of the innocent party will be subject to the principles outlined above regarding the law of damages, including principles of foreseeability. On the other hand, the rights of the innocent party under the indemnity are not determined in accordance with the law of damages but in accordance with the interpretation of the indemnity as a matter of contract law.
- A court would, in all likelihood, hold that the indemnification language provides a wider remedy to the innocent party and more exposure to the party which is responsible for the breach of third-party intellectual property rights.
- As a matter of freedom of contract, contracting parties are generally able to expand or reduce the extent of liability for third-party claims, breach of contract or for tort liability through indemnities, and exclusions and limitations of liability.

Discussion of Sample Indemnities

- Of course, indemnities take on many different forms and an "ideal indemnity" does not exist (each indemnity should be drafted to fit particular circumstances).
- The sample indemnities which follow illustrate different approaches to indemnities:

> *[A] hereby agrees to defend, indemnify and save [B], its directors, officers, employees, and agents, harmless from and against any and all claims, damages, losses, liabilities, demands, suits, judgments, causes of action, legal proceedings, penalties or other sanctions, including all direct, indirect, consequential and incidental damages, and any and all costs and expenses arising in connection therewith, including legal fees and disbursements on a solicitor and his own client basis, which may, directly or indirectly in any way result from or arise out of or be in relation to (i) the Products or Services; (ii) the negligence of [A] or any of its employees or anyone else for whom it is responsible in law (whether in relation to the Products or Services or otherwise); and (iii) any breach by [A] or by any of its employees or anyone else for whom it is responsible at law, of any of the provisions of this Agreement (save and except to the extent of the negligence of [B] or by any of its employees or anyone else for whom it is responsible in law).*

- For our purposes, the foregoing indemnity will be referred to as the "**Contractual Indemnity**" and the indemnity which follows will be referred to as the "**Third-Party Claim Indemnity**":

> *[A] shall indemnify, defend and hold harmless [B], its Distributors and its and their End Users, and their respective officers, directors, employees, parent, subsidiaries, affiliates and related companies, successors and permitted assigns, from and against any and all losses, liabilities, damages, costs or expenses, including reasonable legal fees and disbursements and costs of investigation, litigation, settlement, judgment, interest and penalties, arising from or relating to third party claims, demands or actions (collectively, "Claims") arising from or relating to: (a) any breach by [A] or its agents, employees or subcontractors of any of the warranties set forth in Section 10, including any warranties pertaining to the Software and Documentation that are passed through to End Users; (b) any injury to any person, including death, illness or bodily injury, or damage to real or tangible personal property, resulting from (i) the Software, Documentation or any other Deliverables furnished by [A] or (ii) any act or omission of [A] or its agents, employees or*

subcontractors; and (c) without limiting paragraph (a) above, any alleged or actual infringement, violation or misappropriation of any Intellectual Property Rights of any third party by [A] or its agents, employees or subcontractors or any Software, Documentation or other Deliverables furnished by [A] to [B] hereunder.

- Both indemnities expand liability to include compensation for losses suffered by persons who are not parties to the contract and with whom there might not be a relationship giving rise to liability in tort. Thus, certain directors, officers, employees and agents are covered by both of them.
- Both indemnities cover all losses, liabilities, damages, etc., and therefore they seek to expand liability beyond the test of foreseeability which would normally cover tort and contract claims. Indeed, the Contractual Indemnity states that the indemnities apply to all direct, indirect, consequential and incidental damages, and therefore these express provisions make it perfectly clear that a line should not be drawn between direct and other types of damages.
- Also, the use of the words "directly or indirectly" in the Contractual Indemnity help express the intention that all damages are covered by the indemnity.
- The major difference between the Contractual Indemnity and the Third-Party Claim Indemnity is that the Contractual Indemnity provides indemnification for third-party claims and also for losses and damages arising out of the matters covered by the indemnity such as breach of contract, even if there is not any third-party claim. On the other hand, the Third-Party Claim Indemnity is restricted to third-party claims.
- The Contractual Indemnity seeks indemnification for legal fees on a solicitor-and-client basis, whereas the Third-Party Claim Indemnity covers reasonable legal fees.
- It is suggested that it is often easier to negotiate indemnities which are restricted to third-party claims (such as the Third-Party Claim Indemnity) than broader indemnities which provide for indemnification, even if a third-party claim does not occur (such as the Contractual Indemnity). Negotiations may get extremely difficult when indemnities beyond third-party claims are requested.
- Broader indemnities can also invite negotiation of mutuality of indemnities which can further complicate negotiations.
- Before a party insists on an indemnity beyond third-party claims as a "deal breaker", the party should ask itself whether the law of damages would be sufficient under the circumstances. It may be that very little may be gained through a broad indemnity under the circumstances of a particular case.
- The Third-Party Claim Indemnity provides that indemnification covers all losses, liabilities, etc., arising out of third-party claims. By doing so, the indemnifying party may be exposed to a claim for indemnification beyond the out-of-pocket costs of litigation, and any settlement amount or award of damages; the claim for indemnification could extend to loss of profits if the third-party claim affects sales of the innocent party. One

tool to help reduce exposure is to limit the indemnified items to out-of-pocket costs associated with the litigation and the amount of any settlement or award of damages.

- Indemnities are lengthy and complex. In order to negotiate them effectively, the parties should try to separate those items which are "important" versus those items which "look nice on paper". The effect of exclusions and limitations of liability on each of the indemnities must be kept in mind at all times.
- It is a balancing act. A party may agree to give broad indemnities if there is sufficient comfort in the exclusions and limitations of liability which appear elsewhere in the contract. It is important to put "everything on a scale" rather than get tied up regarding points of principle which, under the circumstances of a particular case, may pose a highly theoretical concern and not a practical business concern or a material legal risk.

Let's Have a Look at Types of Exclusions and Limitations

- A sample of exclusion and limitation of liability provision is as follows (once again, an ideal provision does not exist as each provision must be suitable for the particular circumstances):

> NEITHER PARTY SHALL BE LIABLE TO THE OTHER FOR ANY INDIRECT, CONSEQUENTIAL, INCIDENTAL, EXEMPLARY, SPECIAL OR PUNITIVE DAMAGES (INCLUDING LOST PROFITS AND LOST BUSINESS), ARISING OUT OF OR RELATED TO THIS AGREEMENT, EVEN IF IT HAS BEEN ADVISED OR IS AWARE OF THE POSSIBILITY OF SUCH DAMAGES, AND REGARDLESS OF WHETHER ARISING IN TORT (INCLUDING NEGLIGENCE), CONTRACT, OR OTHER LEGAL THEORY. IN ANY EVENT, THE LIABILITY OF ONE PARTY TO THE OTHER FOR ANY REASON AND UPON ANY CAUSE OF ACTION SHALL BE LIMITED TO AN AMOUNT EQUAL TO THE GREATER OF: (A) $500,000.00; OR (B) THE TOTAL AMOUNT OF FEES PAID TO [A] DURING THE TWELVE (12)-MONTH PERIOD IMMEDIATELY PRECEDING THE EVENT GIVING RISE TO SUCH CLAIM. THIS LIMITATION APPLIES TO ALL CAUSES OF ACTION IN THE AGGREGATE. NOTWITHSTANDING ANYTHING TO THE CONTRARY CONTAINED HEREIN, THE EXCLUSIONS AND LIMITATIONS OF LIABILITY CONTAINED IN THIS SECTION SHALL NOT APPLY TO: (I) [B]'S FAILURE TO PAY FEES DUE AND OWING HEREUNDER; (II) LOSSES ARISING OUT OF OR RELATING TO A PARTY'S FAILURE TO COMPLY WITH ITS CONFIDENTIALITY AND OTHER OBLIGATIONS UNDER SECTION 5 OF THIS AGREEMENT; (III) [A]'S OR [B]'S INDEMNIFICATION OBLIGATIONS UNDER THIS AGREEMENT INCLUDING THE OBLIGATIONS IN SECTIONS 8 AND 9; (IV) PERSONAL INJURY, INCLUDING DEATH, AND DAMAGE TO TANGIBLE PERSONAL PROPERTY CAUSED BY THE NEGLIGENT, WILFUL OR INTENTIONAL ACTS OF A PARTY OR ITS EMPLOYEES, AGENTS OR SUBCONTRACTORS (V) LOSSES SUFFERED BY A PARTY ARISING OUT OF ACTS OR OMISSIONS OF THE OTHER PARTY THAT ARE COMMITTED OR OMITTED BY THE OTHER PARTY VOLUNTARILY NOTWITHSTANDING THAT THE OTHER PARTY KNOWS OR OUGHT TO HAVE KNOWN THAT SUCH ACTS OR OMISSIONS WILL RESULT IN DAMAGES INCLUDING, IN THE CASE OF [A], CESSATION OF THE SERVICES.

- Although the foregoing limitations are mutual, they may also be drafted solely for the benefit of a single party. It is usually more in the interests of the supplier of goods and services to insert limitations of liability than for the recipient. The recipient's obligation is

typically fundamentally one of paying money and therefore the recipient is usually less exposed to liabilities beyond non-payment of the fees and amounts under the contract.

- The foregoing limitation of liability provisions contain three important aspects:

  (i) certain types of damages, such as consequential damages, are excluded (we'll call this an "**exclusion of liability**")

  (ii) a general monetary limit of liability applies to damages which are not excluded under (i) (we'll call this a "**limitation of liability**"), and

  (iii) certain liabilities are not affected by the exclusions and limitations in (i) and (ii) (we'll call this a "**carve-out**").

- Let us look at each of items (i), (ii) and (iii).

Exclusion of Liability

- The sample provision contains fairly "typical" provisions which exclude "indirect, consequential, incidental, exemplary, special or punitive damages". As discussed above, it is very difficult to predict the sorts of losses which, in a particular case, will qualify as such excluded damages. It may be difficult for lawyers to engage in negotiations regarding these general exclusions because the jurisprudence suggests that the implications of this language may not be clear.
- The more concrete provisions are the express exclusions for "lost profits and lost business" because these provisions make it perfectly clear that such losses are excluded.
- If certain areas of potential exposure are particularly sensitive to a supplier, the specific types of losses should be identified as ones which are excluded.
- One could expand the express exclusions of liability beyond "lost profits" and "lost business" to items such as "loss of data", "loss of use", "interruption of communications", "interruption of business", "loss of savings" and "loss of financing, business and reputation".
- It is possible to be creative. For example, a supplier may insist that "loss of profits" be excluded but the parties may negotiate the provision to read "loss of profits except anticipated profit arising directly from the Work". Such an approach is adopted by the American Institute of Architects in its *General Conditions of the Contract for Construction* (AIA Document A201 - 1997). Although this approach may invite debate about its interpretation, it may be acceptable to both parties by way of compromise.
- Another typical provision in this sample is that the exclusions apply even if a party has been advised or is aware of the possibility of consequential and other similar damages. By doing so, it is made perfectly clear that the principles in *Hadley v. Baxendale* are subject to the express exclusion of liability – in other words, the exclusion applies even if

the consequential damages are foreseeable (as discussed above in the section entitled "*How do Consequential Damages get into the Picture*?", consequential damages may be awarded if they are reasonably foreseeable based upon the knowledge of the parties in a particular case).

- The sample exclusion of liability also contains a common provision that it applies regardless of whether the damages arise in tort (including negligence), contract or other legal theory. By doing so, it is expressly agreed that any consequential damages arising under tort theories, such as negligence, are covered by the exclusion of liability.
- The exclusions for consequential damages and other items in the sample are tied to the limitations of liability which "cap" damages by a monetary amount. The more that a party feels comfortable with the risk associated with the monetary limitation of liability, the more likely that the party will be less concerned about protection in the form of the exclusion of liability.
- By the same token, the more that a party feels comfortable with the risk associated with the monetary limitation of liability, the more likely that the party will be less concerned about exposure under the indemnities (assuming, of course, that the indemnities are not a carve-out to the limitation of liability).

Limitation of Liability

- The limitation of liability in the sample provision limits liability to the greater of $500,000 or the total amount of fees paid during the preceding 12-month period.
- This sample provision demonstrates the "greater of" technique which can be used to balance the interests of both parties (it ensures that a limitation of liability tied solely to fees is not unreasonably low).
- The sample provision refers to fees paid for the 12-month period but such a limitation is most appropriate if fees are paid monthly on a continuing basis. If a contract provides for fees to be paid over a relatively short period of time, such a provision may not be acceptable to the recipient of services if the breach occurs early. In other words, it might be appropriate to negotiate the limitation on the basis of the aggregate contract price as opposed to fees paid.
- If fees are paid on a monthly basis and, for example, the limitation of liability limits liability to fees paid during the previous 12-month period, it may be appropriate to insert pro-rating provisions so that if a breach occurs three months into the contract, liability will be limited to the average fees paid per month for the three-month period multiplied by 12.
- Another tool to help resolve limitations of liability is to negotiate different monetary "caps" depending upon the nature of the losses. For example, a service supplier may not be willing to accept all of the risk of damages if confidentiality provisions are breached because a third-party "hacker" gains illegal access to personal information, but a "super

cap" may be inserted which limits liability to an amount which is above the amount for other breaches of contract.

- Master Services Agreements with Statements of Work are becoming more popular, but any limitation of liability in such an Agreement should be considered in the context of each Statement of Work. It may be appropriate to provide for limitations of liability on the basis of each Statement of Work with perhaps an overall aggregate limitation of liability regarding all liabilities under the Agreement and all Statements of Work.
- The limitation of liability may be the most important provision in a contract with respect to allocation of risk. Although indemnities and exclusions of liability shift risk, in most situations the "buck stops" with the limitation of liability (except, of course, to the extent that carve-outs are inserted).

Carve-Outs

- Carve-outs regarding exclusions and limitations of liability can be used creatively to find solutions during difficult negotiations.
- Indeed, the carve-outs for the exclusion of liability may differ from the carve-outs in the limitation of liability. One may agree that the exclusion of liability does not apply to confidentiality provisions in order that consequential damages not be excluded, but that the monetary limitation of liability nonetheless applies.
- The sample provision contains five carve-outs which probably go beyond the ones which are "typical" in a single contract. Of course, other carve-outs may be negotiated (for example, a carve-out may apply to one party breaching the intellectual property rights of the other party or one party breaching the exclusivity provisions which benefit the other party).
- It is critical that the parties advert to whether indemnification obligations are subject to a limitation of liability and, if so, whether a carve-out is appropriate.
- One of the carve-outs in the sample provision states that the limitation of liability does not apply to the failure of the party to pay fees. If the recipient of fees has agreed to a limitation of liability which might be less than the amount of the fees, this carve-out may be important.
- Another carve-out in the sample is that the limitation of liability does not apply to personal injury, including death, and damage to tangible personal property caused by the negligent, wilful or intentional acts of a party. This carve-out deals largely with tort liability. It is often considered that liability for behaviour that results in these types of damages should not be limited.
- The sample provision also carves out acts or omissions constituting voluntary behaviour that the party knows or ought to know will cause damages. The purpose of this carve-out is to protect a party in the event that the other party's behaviour is so bad that the other party ought not to be shielded by the exclusion and limitation of liability. Abandonment of

a project without cause would typically be subject to this carve-out. Even if the bargaining strength of a party is relatively poor, the other party can often agree to such a "wilful default" carve-out.

- Under the sample provision, the limitation of liability applies to the aggregate of all claims under the contract. If such a provision is not inserted, a limitation of liability may be interpreted to apply to each event that gives rise to a cause of action.
- One of the best ways to resolve any impasse which may arise in connection with the indemnities and limitations and exclusions of liability is to insert meaningful (and in some cases creative) carve-outs. The carve-outs will depend upon the circumstances of each case. The carve-outs can help restore "balance".

The Big Picture

- Of course, it is often difficult to effectively negotiate indemnities and exclusions and limitations of liability without producing frustration for the business team. Many of the relevant concepts are complex and difficult to grasp by someone who has no legal training.
- However, a monetary limitation of liability is a concept which usually can be grasped quite easily by business personnel. In many cases, the monetary limitation of liability is more important than the indemnities or exclusion of liability. If the parties can reach an understanding regarding the limitation of liability early in the process as opposed to later, it can add focus to negotiation of the indemnities and exclusions of liability.
- Ultimately it is a "balancing act" between all of the relevant provisions, but dealing with the fundamental concept of the monetary limitation of liability (plus any carve-outs) early in the negotiation process can help ease potential frustration and make indemnities easier to negotiate.

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