

Limitations on Liability Exceptions – Interplay between Contract Terms and Legal Principles

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Announcer

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Julian Dibbell

Hello and welcome to Tech Talks. Our topic today is exceptions to contractual limitations on liability. A topic with implications far beyond the world of tech, of course, but one that comes up in nearly every technology transaction agreement. More specifically we're going to be talking about the interplay between contract terms and legal principles and what that means for contract negotiations. I'm your host, Julian Dibbell. I'm a senior associate in Mayer Brown's Technology Transactions practice. I'm joined today by Linda Rhodes, Anja Watt and Chris Houpt. Linda is a Technology Transactions partner in our Washington DC office. Anja is an associate in the Litigation & Dispute Resolution practice based in our New York office. Chris is co-chair of Mayer Brown's Banking & Finance Litigation group in New York. All right, let's jump right in. Linda, you first [wrote an article](#) on the topic of limitations on liability exceptions for gross negligence and willful misconduct back in 2013, and it is still getting hits on the Mayer Brown website to this day. I think even more hits than most articles on the website. Why is this issue still relevant?

Linda Rhodes

Thank you, Julian and hello, everyone. So, the issue of limitations on liability is negotiated in virtually every deal. Limits on liability and damages are a common way of allocating and managing risk and contractual relationships, including not only tech transactions, as you mentioned such as outsourcing SAS agreements, software data and digital, but also in other types of agreements, including financing.

Julian Dibbell

Okay. Could you provide some clarity on what you mean by limitations on liability?

Linda Rhodes

Sure. When I refer to limitations on liability, I am referring to several types of limitations. First, there are certain types of damages or acts that might be excluded entirely. For example, it is quite common for a contract to provide that neither party is liable for consequential, incidental, punitive or other indirect damages. Thus, if party A breaches the contract and party B brings a claim against party A, party A will be responsible for party B's direct damages, but not any of these consequential damages such as lost profits. Alternatively, a contract might provide that party A will have no liability for actions taken in good faith based upon the directions of party B. Thus, in this example, as long as party A takes action in good faith based upon party B's direction, party A will not have any liability to party B for any damages party B may suffer as a result thereof, and regardless of whether the resulting damages are indirect, direct consequential or otherwise.

Secondly, when you talk about limitations of liability, it also includes parties agreeing to cap their damages. So, for example, it might mean if party A were to breach the contract and it causes party B damages, party B is then able to recover its damages, but up to a limitation, and any damages that party B may suffer above that cap would be borne by party B. And then finally, I'd also like to mention that limitations of liability may also take the form of limited remedies for a breach, and I think a common example in the tech trans world is a SAS provider that might try to limit its liability for SLA failures by saying that SLA credits are the sole and exclusive remedy. So in that case, if there were a failure to meet service levels, a customer could get the credits but couldn't recover for any additional damages that it might suffer. Another example might be repair or replacement as an exclusive remedy for a warranty breach.

However, what is even often more heavily negotiated than what the limitations of liability are, are what the exceptions to those limitations are. The exceptions to both the excluded damages, meaning, you can't recover consequential or punitive, etc., as well as the exceptions to the liability cap when you can recover them as above the cap. They're often the same but they don't necessarily need to be the same. There could also be exceptions to the sole and exclusive remedy provisions. While the parties pretty much readily agree to exceptions for willful misconduct, gross negligence is more often a topic of negotiation in large part due to the lack of clear understanding as to what conduct actually constitutes gross negligence. Further, the determination of whether or not conduct constituted gross negligence depends highly on the facts of each case.

Julian Dibbell

All right. Okay. So let's get into that. These are contract terms that we've been talking about here, and the parties will have their own understandings of what those mean, but then if push comes to shove, so to speak, and a court has to apply those contract terms to the facts of an actual case, how does that play out? And I want to clarify here, for our listeners, that we'll be talking about legal principles based on New York law. Mainly, so that we can be as precise as possible about what the law actually says but also because so many commercial contracts are governed by New York law. So, having said that, again, what is the interplay between contract terms and legal principles once a contract case gets into court?

Linda Rhodes

Thanks, Julian. I think you summed that up nicely. So you know the extent to which a party to a contract can limit their liability is not only a question of what the contract terms and conditions say, but it is also a question of whether a court will enforce the limitations. While limitation on liability clauses usually are enforceable under New York law, there are exceptions regardless of what the contract says. Anja and Chris will go into further detail as to how New York courts have dealt with this issue of enforceability of limitations on liability and contracts.

Julian Dibbell

Okay, then. Well. Let's turn to Chris and Anja. Starting with you Anja, can you give us an overview of New York law on limits of liability?

Anja Watt

Sure. Hi, Julian. Hi, everyone. Generally, these clauses are enforceable. Parties can generally exclude their liability for certain acts or types of damages, as Linda explained. Parties can also generally limit the amount of damages for which they are liable, limiting the other party's recovery to either specific amounts or recovery based upon a certain formula. So, for example, contracting parties typically limit their liability to an amount equal to the fees paid or payable under the contract over a specified period of time. However, courts will not uphold these clauses when they attempt to completely shield the party from liability for conduct that rises to the level of either gross negligence or willful misconduct. But as we'll discuss later in the podcast, the law on whether liability for gross negligence can be capped or otherwise limited is evolving.

Julian Dibbell

Okay. So why won't courts generally uphold limitations of liability for gross negligence and willful misconduct?

Anja Watt

So this comes from New York's public policy and, at a more fundamental level, basic principles of contract in tort law. As explained in the restatement second of contracts, a party cannot completely exempt themselves from liability for harm that is caused either intentionally or recklessly. Animating this policy is the concern that allowing parties to exempt themselves from liability for this type of conduct increases the risk that the general public will be harmed. And similar to complete exclusions of liability, the same public policy principles I just mentioned also historically apply to capping liability for gross negligence and multiple misconduct. But like I said, recent cases in New York courts have indicated that caps of liability for gross negligence may be enforceable provided that the cap is meaningful. This is the same rule courts will apply to indemnities. In general, indemnities for the indemnified party's gross negligence or willful misconduct are unenforceable.

Julian Dibbell

Could you help us understand the practical effect of contractual and legal prohibitions on limiting liability for these categories: willful misconduct and gross negligence?

Anja Watt

Sure. So, given the relatively high bar a party needs to clear to prove either willful misconduct or gross negligence, in practice, this exception is quite narrow and, as Linda mentioned, is often fact-specific. New York courts have interpreted willful misconduct to require things like intentional acts for failures to act, knowing that the party's conduct will probably result in injury or damage. Acts in so reckless in manner or failures to act in circumstances where an act is clearly required so as to indicate disregard of the party's action or inaction. Or, intentional acts of unreasonable character performed in disregard of a known or obvious risk so great as to make it highly probable that harm would result. Now, gross negligence is a bit of a confusing term because it sounds like it just means very negligent but, under New York law, it's more akin to willful misconduct. Gross negligence generally requires reckless indifference to the rights of others or a failure to use even slight care or conduct that is so careless as to show complete disregard for the rights and safety of others. Thus, a deviation from a standard of care—even a major deviation—isn't enough to constitute gross negligence.

Julian Dibbell

All right. So, Chris, Anja mentioned recent developments in cases examining the enforceability of limitations of liability. Could you give us an update?

Chris Hought

The most recent important development was a decision by the New York Court of Appeals, which is New York's highest court, in a case involving mortgage-backed securities and that decision addressed some broader questions of the enforceability of limits on liability, including caps on liability and damages and limits on remedies. The case is called, "*In re Part 60 Putback Litigation*", and just to give you a little bit about the claim, the way a mortgage securitization works is that a sponsor bank puts loans into a trust for the benefit of investors and they make representations and warranties to the trustee about the quality of the loans and the underwriting standards. And a typical provision in these contracts is that if a representation is breached as to a particular loan, the trustee can sell that loan back to the sponsor at its outstanding principal balance. So that's called a "put-back."

Julian Dibbell

Okay. So why was gross negligence even an issue there? Was there a limit on liability?

Chris Hought

Well, the case wasn't about an explicit limit on liability or damages. It was about what's called "the sole remedy" clause. The contract said that the trustee's right to put the loan back to the sponsor is the sole remedy for a breach of a representation. And that case is a little bit unusual in this context because I think that the real reason that the plaintiff wanted to challenge the sole remedy clause was just that it made litigation so much more expensive. It required that they approve a breach of a representation on a loan-by-loan basis, so they had to go through the underwriting file for each loan and have an expert testify that the underwriting standards were breached on each loan, and it's just a very tedious and time-consuming and expensive process. So what the trustee plaintiff did instead was argue that the sponsor had just reached so many representations on so many loans that its conduct amounted to gross negligence so that the sole remedy clause was not enforceable. If it had succeeded, what they were trying to do was to

just recover general damages to the trust as a whole based on pervasive evidence of breaches rather than having to go through loan by loan.

Julian Dibbell

Okay. So what did the court in fact hold?

Chris Houpt

The court found in favor of the defendant. It said that the sole remedy clause was enforceable and the test that it applied was pretty straightforward. It said that the sole remedy clause was not an exculpation of the sponsor's conduct. It didn't say the sponsor shall not be liable for something. Nor did it cap damages at what the court called a nominal level and it said unless it falls into one of those two categories, it'll be enforceable even in the face of gross negligence. The court reasoned that the parties had just decided on a particular remedy for a breach of representation, but it wasn't the limit on the recovery, and especially among sophisticated commercial parties, the court said we're not going to interfere with those voluntary decisions.

Julian Dibbell

Okay. So Anja, what do we learn from that? Does the *Part 60* decision provide real clarity in the law?

Anja Watt

So yes, and no. The court in *Part 60* did not reach the issue of whether the specific allegations in that case constituted gross negligence, but it did clarify that more broadly speaking clauses seeking to limit a party's liability will not become enforceable just because there are allegations of gross negligence unless the clause is either an absolute bar on liability or a limit to just nominal damages. But the facts of the case do leave some questions open. So, for one thing, the put-back remedy was a sole remedy provision. It didn't limit the amount of damages the other party could recover, and it did not absolve the sponsor or for liability for its conduct. Rather, it limited the types of remedies that were available in the event of a breach. In some ways the put-back remedy was more favorable to the parties than normal contract damages. Upon proof of any breach of representation, the sponsor was required to buy back the loan at full face value, essentially taking on 100% of any loss. Without this contractual remedy, the plaintiff would have had to prove that the breach caused the damages and would have to prove the amount of damages arising from that breach in order to recover those damages from the defendant. So while establishing a breach of a warranty required significant effort by the trustee, once that breach was established, the put-back remedy provided a potentially greater or more certain recovery than straight contract damages would have provided. The decision also left open a question regarding remedy provisions that turn out to be illusory. While the court addressed the argument that the provision at issue may be illusory and possibly unenforceable, it found that the provision was not actually illusory based upon the facts of that case. So this leaves open the question of whether a court would enforce a sole remedy clause that meaningfully limited a plaintiff's recovery and at what point a limit on the plaintiff's ability to recover is meaningful enough to prevent a court from striking down that limitations clause. Finally, the court also left open the question of how the holding would apply to sole and exclusive remedies in light of allegations of intentional misconduct. However, since the "*In re Part 60*" decision, cases that

have come out interpreting that case have found the decision does not apply for allegations of willful misconduct.

Julian Dibbell

Well, a lot to think about, there. Interesting developments. Linda, what are some of the practical takeaways for contracting parties here?

Linda Rhodes

Listening to the details of the *Part 60* decision highlights how important it is to carefully consider the liability and remedy terms included in agreements.

Although a court may strike down limitations on liability for gross negligence or willful misconduct, it appears New York leaves open the possibility that liability for, at least gross negligence, could be subject to a cap or limited by exclusive remedies, as long as the plaintiff's ability to recover damages is meaningful. Therefore, for example, a customer under an technology services contract will want to expressly exclude gross negligence from the limitations on liability, as well as exclusive remedy provisions.

If a customer wants to ensure that a specific type of misconduct by a service provider falls outside of the limitation of liability clause, the customer should specifically describe such misconduct in the agreement. For example, excluding the service provider's refusal to provide services from the limitation of liability, breach of customer policies, violation of laws, breach of confidentiality, etc. and the like would provide clearer standards for the customer to prove, rather than relying on the exception for gross negligence. In other words, give thought up front to what behaviors you want to drive and incentivize – or more appropriately in the case of exclusions to limitations on liability – dis-incentivize that conduct.

Since the limitation of liability provision has a significant impact on the allocation of risk between parties to tech transactions and other agreements, customers should ensure that any specific losses or misconduct that should not be subject to contractual limitations on liability are clearly and sufficiently identified as exclusions to the limitation of liability provisions.

Julian Dibbell

Well, very helpful, Linda, thank you so much. And thank you, Anja and Chris, for filling us in on the details of the law and the latest developments. Listeners, if you have any questions about today's episode or an idea for an episode you'd like to hear about anything related to technology transactions and the law, please email us at techtransactions@mayerbrown.com. Thank you for listening

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