Contract Corner: Limitations of Liability—Exceptions and Caps

Monday, March 16, 2015

We recently discussed the enforceability and exclusion of different types of damages in contractual limitation-of-liability provisions. In this Contract Corner post, we focus on caps on liability and exceptions to such limitations of liability.

Do contracts typically include an upper limit (or cap) on liability?

Parties commonly negotiate for an aggregate upper limit on liability for direct damages that arise out of their contracts to get comfort and certainty with the potential risk of the transaction relative to the expected commercial benefits. This cap on liability can be a specific dollar amount, but many contracts tie the cap in some way to amounts paid for products or services.

The latter approach automatically provides flexibility and proportionality, in case the commercial relationship significantly grows or shrinks over time. However, an aggrieved party may find itself with little or no remedy if a breach occurs early in the relationship before substantial amounts of products or services have been purchased. Therefore, some contracts combine these two approaches and use the specific dollar amount as a minimum floor for the cap on liability.

A key issue to address is how these contractual caps apply, such as whether the cap is an aggregate cap for all claims that arise during a contract’s term or claims that arise during a particular period (such as an annual cap).

What are common exceptions to limitations of liability?

Another key issue is whether there are any exceptions to the cap—are there any claims or liabilities that arise under the contract to which the cap does not apply? Although an aggregate limit on liability, on its face, sounds comforting to both parties, contracts typically carve out certain risks that the parties deem appropriate for one party to bear without limitation. These exceptions are sometimes also carved out of the other limitations of liability in the contract, including the disclaimer of indirect and special damages.

Examples of exceptions to limitations of liability to consider include the following:

- Indemnification obligations of a party for third-party claims brought against the other party, including intellectual property infringement claims
- Liabilities of a party that arise from a breach of its confidentiality or data security obligations
- Liabilities of a party that arise from a breach of its obligations to comply with laws
- Liabilities of a service provider that arise from its refusal to perform the required services (whether intent is required may need to be clarified)
- Liabilities of a party that arise from its fraud
- Liabilities of a party that arise from its willful misconduct and gross negligence (both of which may need to be defined to reduce uncertainty due to inconsistent determinations by courts)
Do parties have unlimited exposure because of exceptions to limitations of liability?

With respect to each exception, parties should address in the contract whether the liable party is exposed to unlimited liability or to a higher capped amount and whether the other party may seek to recover direct damages only or any type of damages.

Higher or separate secondary caps on liability are increasingly being used to provide boundaries on damages that are carved out from limitations of liability while still giving customers a higher level of protection than the generally applicable direct damage cap. For example, liabilities for data security or confidentiality breaches that involve personal information are often limited by a secondary cap. Secondary caps can be creatively constructed to suit parties’ preferences, including subcaps for certain types of indirect or special damages. The contract should address whether the secondary cap is a separate cap available for the subject liabilities or an additional layer that is “on top” of the generally applicable cap and available for the subject liabilities.

This post is part of our recurring “Contract Corner” series, which provides analysis of specific contract terms and clauses that may raise particular issues or problems. Check out our prior Contract Corner posts for more on contracts, and be on the lookout for future posts in the series.

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