

## Top Ten Considerations for Contract Provisions that Manage Business Risks

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Many types of contract provisions address the allocation of business risk, including that duo of provisions often relegated to the lawyers—the limitation of liability and the indemnity. This "top ten" list focuses on these two provisions but you should also consider addressing risk through termination rights, change of control and assignment provisions, covenants, warranties, waivers, and releases, and other provisions

### 1. Identify the risks you want to manage.

Begin by identifying the risks you'll need to address. You can't fashion the right remedies or allocate risks if you haven't identified them. Distinguish between risks related to the contracting parties and risks related to third parties.

Risks associated with contracting parties depend on the circumstances. Consider these traditional break-up risks:

- I don't love you anymore – It just isn't working out; we have different priorities; I found someone better than you, etc. ("economic breach")
- You didn't do what you said you'd do – Your product or service doesn't do what I hoped; you don't provide support; you missed a deadline; you didn't pay me when you said you would; you told my secret to someone else; ("material breach")
- You found someone else – You partnered with my competitor; a competitor bought you or invested in you

Exemplar risks involving third parties include:

- A third party sues one of the parties for intellectual property infringement
- A customer experiences a data breach
- One party didn't pay a vendor and now the vendor is threatening to sue the second party

You will most likely need the business team to help identify the risks.

### 2. Understand how a limitation of liability and an indemnity differ.

Generally, a limitation of liability is designed to allocate the risks between the parties and serves as a mechanism to exclude or include available damages in a dispute between the contracting parties. Unless it is an intended third party beneficiary, a third party generally will not be beholden to the limitation of liability agreed upon by the parties to a contract. In contrast, indemnification

provisions allow you to address risks between the parties and third parties—with the indemnifying party typically agreeing to defend or otherwise indemnify the indemnified party against third party claims.

### **3. Appreciate the limitations of a limitation of liability.**

Courts will usually afford contracting parties the right to allocate liability as between them. But courts will not uphold a limit that is contrary to public policy or statutory prohibitions. For example, as a general rule, exculpatory provisions for gross negligence have not been upheld in many state courts, including in California and New York.

### **4. Clearly exclude or include certain liabilities in the limitation of liability provisions.**

Consider whether you want to include or exclude certain categories of damages in your limitation of liability. It is common to disclaim indirect, special, consequential, incidental, enhanced, and punitive damages. These provisions are not "boilerplate" however and you should carefully consider what should and should not be included. For example, you may want to be able to recover enhanced damages or may want to expressly disclaim certain direct damages for lost profits, loss of revenue, and loss of data.

Some courts have traditionally treated lost profits as **consequential damages** but other courts have held lost profits to be **general damages**. See *Biotronik A.G. v. Conor Medsystems Ireland*, 986 N.Y.S.2d 437 (2014). In *Biotronik*, the distribution agreement in question disclaimed "indirect, special, consequential, incidental, or punitive damages." Following its acquisition by Johnson & Johnson, the manufacturer terminated development of a product that was competitive with a Johnson & Johnson product. The New York court confirmed that lost profits may be recoverable as general damages in that case but rejected adopting a bright line rule. The takeaway: be specific as to whether lost profits are general damages or not.

### **5. Consider whether your proposed cap on damages makes business sense.**

It's not uncommon to include a cap on direct damages in the limitation of liability provision. First order of business: Consider whether a cap makes sense for your situation. If you are negotiating for a customer, you may not want your vendor to cap its damages at all. Next question: Does the cap make sense in the context of the business deal? For example, if you represent the party receiving fees, it may not make sense for the cap to be lower than the fees payable. In that case, consider excluding from the agreed upon cap the fees payable under the agreement. Another consideration: Does the cap cover each claim or does it reflect the aggregate cap on damages for the lifetime of the contract? Be clear regarding how the cap is calculated. Don't forget: Should certain types of breaches be excluded from the cap or subject to a higher cap, e.g. indemnification, breach of confidentiality, etc.? Warning: If you say the cap on direct damages is zero, in some circumstances courts may not enforce the "cap."

### **6. Consider specific remedies that you want to include.**

Is it sufficient to have the right to sue the other party for breach of contract? Is it enough for the other party to defend you and pay your damages if a third party sues you? Where appropriate, consider specific remedies tailored to specific breaches of contract such as **liquidated damages**, the right to seek injunctive relief (without having to post a bond), rights to terminate, credits for breach of service levels, audit rights or most favored pricing, release of materials from escrow, breach notification reimbursement, recovery of special damages for epidemic failure, etc. Make sure the limitation of liability addresses these specific remedies.

Also, are there remedies or litigation costs you would prefer to exclude or reduce? In addition to limiting specific damages from the limitation of liability, consider limiting the statute of limitations for claims, requiring waiver of the right to a jury trial, limiting remedies for implied or express warranties, choosing a lower-cost forum for dispute resolution, and attorney fees and cost shifting.

### **7. Choose the "style" of the indemnity.**

Indemnities come in many flavors but often take two typical structures: (1) a "defend and pay" indemnity under which the indemnifying party defends or pays the cost of defense of the indemnified party and pays awarded damages, reasonable settlement amounts, and sometimes other costs related to third party claims, and (2) an "insurance-style" indemnity where the indemnifying party defends, indemnifies, and holds the indemnified party harmless from all liabilities associated with the claim (which if not limited to third party claims could include claims as between the parties). The second type of provision is akin to "insurance" in that it makes the indemnified party whole in the event of a breach or occurrence of indemnified claims.

Unless you are certain that you won't have to indemnify the other party as the negotiations progress, consider offering a reasonable

indemnity or variation of a "defend and pay" indemnity and don't automatically opt for a one-sided indemnity. You don't want to throw in a kitchen-sink indemnity from the other side only to discover you now have to grant a mutual indemnity. And decide whether you want to include a process for indemnity claims, including for making demands, providing notices, approving settlements and judgments and the like.

#### **8. Address the right to defend in an indemnity provision.**

If you want to be able to control litigation, be sure to address directly the right to defend. Absent such express language, an agreement to indemnify may not include the right to control the defense. See, for example, Section 2778 of the California Civil Code, which states "The person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity, but the person indemnified has the right to conduct such defense, if he chooses to do so." If you want to conduct the defense, it is best to say as much in the contract itself.

#### **9. Think through reasonable exceptions to the indemnity.**

Depending on the circumstances, some liability may not be fairly borne by the indemnifying party, such as:

- unauthorized use of a service, product, or technology
- certain licensee modifications or combinations
- failure to implement required updates
- implementation by a vendor of certain customer requirements or specifications
- claims made against the indemnified party by its own affiliates
- unreasonable settlement agreements that the indemnified party hasn't approved
- the indemnified party's own breach of the agreement

Consider carve-outs to address specific situations depending on the nature of the agreement.

#### **10. Address the interaction between indemnity and limitation of liability.**

Consider whether you want to expressly carve out liabilities and costs related to the indemnity from the cap on damages or include a higher cap on the indemnity obligations. One way to address this concern is to be specific regarding the extent of a party's indemnity obligations, including the amount of defense costs that must be expended or reimbursed.

Once you've identified the business risks you want to manage in your contract and the liabilities you cannot (or do not want to) limit, you will be much better prepared to style the appropriate limitations on liability and indemnities. But always keep in mind that if you are seeking specific remedies or penalties or want to limit liability for specific identified risks, then you may want to spell out each party's rights and obligations rather than rely on general provisions.

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