Know the Limits of Liability When Drafting IT Contracts

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In information technology agreements, vendors typically try to limit the amount of recoverable damages to the price of the product or, in the case of a long term agreement to acquire services, to the amount paid during some portion of the contract (e.g., 12 months of fees). Vendors also typically try to limit their liability to the buyer's direct damages. In other words, consequential, incidental and other damages are excluded. Often each of these limitations includes a list of exceptions, some of which are fairly easily agreed upon and others that are more controversial.

Vendors impose these limitations on the buyer's right to recover because they are not willing to act as an insurer for all of the buyer's potential risks associated with the products and/or services, nor can they afford to do so for all of their customers. Vendors are more willing, however, to agree to unlimited (or at least greater) liability for risks over which they have greater control.

In this article, we will examine limitations on recovery of direct and indirect damages and common exceptions to each, as well as the benefits of defining direct damages. Both parties should carefully examine the impact of these issues and tailor the liability provisions to protect themselves against the risks of their transaction, rather than relying on form agreements.

Mutual Limitations

First, and perhaps the most easily overlooked issue, is whether a vendor's proposed agreement limits only the vendor's liability. While many vendor forms limit only the vendor's liability, almost all vendors will, upon request, agree to make the limitations of liability mutual.

General Monetary Cap

Next, buyers should examine the general monetary cap. We frequently see information technology vendors propose a cap on damages of the last twelve months of fees paid by the buyer under the agreement, and sometimes as little as the last three or six months of fees paid (for vendors selling equipment, the cap is often limited to the amount paid for the equipment at issue). A much better arrangement for buyers is to make the monetary cap the greater of (i) a multiplier of fees paid or payable over a specified portion of the contract term; and (ii) a specified dollar amount (which in effect becomes the "floor" of recoverable damages).

Including any amounts payable over the time period specified in the cap protects the buyer if there have been any payment issues or the buyer has not yet paid the specified fees. To establish both the correct cap and the floor, counsel need to understand the potential damages, the payment schedule and their client's leverage. The "floor" protects buyers in the early stages of the transaction when the risk can be great, such as during transition, but little money has been paid or is payable.

Exclusions

Certain types of damages are excluded from the general monetary cap because the resulting damages are likely to exceed the general monetary cap and, as between the parties, the party responsible for the damage should be the party footing the bill. Buyers should consider an exclusion from the general monetary cap of the vendor's indemnification obligations, as well as damages caused by certain acts or omissions of the vendor, such as a breach of its confidentiality or data security obligations; gross negligence, willful misconduct or fraud; a violation of law; and personal injury and property damage. Vendors will generally require that these exclusions to be mutual in order to agree to them.

While not all types of indemnification obligations are always excluded, types of indemnification obligations commonly excluded include the vendor's obligation to indemnify the buyer for intellectual property infringement; either party's breach of its confidentiality or data security obligations; gross negligence, willful misconduct or fraud; a party's violation of law; and personal injury and property damage. As with other liability-related considerations, the parties must consider which indemnification obligations are appropriate for the transaction at issue.

Due to the potential for extremely high damages in the privacy arena, we have recently seen more vendors refuse to agree to unlimited liability for breach of their data security obligations, with a compromise frequently being a higher liability cap than the general direct damages cap, otherwise referred to as a "super cap." If industry-specific vendor confidentiality or security obligations apply your transaction and are not addressed in the general confidentiality or data security provisions (for example, those contained in a separate business associate agreement, if the buyer is in the health care industry), the buyer should consider specifically excluding damages for the vendor's breach of those obligations. Keep in mind that vendors are also typically providing buyers with information the vendor wishes to keep confidential, so vendors will expect that any exclusion for damages due to breach of confidentiality obligations be mutual.

Other commonly requested exclusions include claims arising from gross negligence, willful misconduct or fraud; violations of law; and personal injury and property damage. In certain transactions, the potential harm to the buyer can be exceptionally high based on certain vendor conduct so the buyer may want to exclude additional types of claims from the cap on damages, such as damages arising from: (a) the vendor's refusal to perform services (abandonment); or (b) the vendor's breach of its obligations relating to business continuity and disaster recovery.

Vendors usually will not agree to be liable for indirect, incidental, consequential, special or exemplary damages, but often will agree to accept liability for these damages in the same circumstances they will agree to unlimited direct damages.

In all cases, the parties must carefully consider how they may be damaged by the other party's conduct and tailor the exclusions to address those concerns.

Defined Direct Damages

When there has been an alleged breach and the parties begin to contemplate the damages available to a party, one of the most critical questions is what damages qualify as a "direct damage." Business clients are frequently surprised to learn how narrow recoverable "direct damages" are compared to the total economic harm they've suffered. Where a buyer has sufficient leverage, to avoid a potential dispute about whether certain damages are considered direct or indirect, the buyer should consider identifying certain damages as "direct damages."

The particular list of agreed upon direct damages will vary based on the nature of the agreement. Buyers must consider how they may be harmed and whether the resulting damages are likely to be classified as direct or indirect damages, as well as whether the contemplated damages already fall within an agreed upon exception to the bar on recovery of indirect damages. Some of the common types of damages we see enumerated include:

(a) costs and expenses incurred by the buyer to perform a work around, or alternative method to achieve the desired outcome;

(b) costs and expenses incurred by the buyer to correct any errors or deficiencies in the services;

(c) costs and expenses incurred by the buyer to transition the services from the vendor back to the buyer or to an another provider;

(d) costs and expenses incurred by the buyer to notify individuals of a data breach and provide credit monitoring services;

(e) fines, penalties and interest assessed against buyer; and

(f) performance credits or other similar payments owed by the vendor to the buyer.

Other Considerations

If a buyer is planning to enter into multiple related but separate agreements with a vendor, such as a software license agreement and a professional services agreement for implementation of the software, the buyer should keep in mind how the limitations of liability apply between the related agreements. For example, if the buyer pays the initial license fee and then under a separate professional services agreement, the vendor fails to implement the software, the amount the buyer can recover should be tied to the fees paid for the license plus the implementation fees paid. A similar situation arises when the maintenance and support agreement is separate from the license agreement.

For each transaction, both parties should carefully consider the ways in which the other party, and the services or products being provided, may expose it to risk or liability, including the types of and amount of damages, and the level of risk the party is willing to tolerate.

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