Damage Control: Common Errors in Contractually Limiting Damages

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We've all heard the proverb, "Prepare for the worst, but hope for the best." Nowhere is that advice more fitting than in drafting a contract. Of course, the main focus of any negotiation will be the terms of the deal itself – who is doing what, when should it be done, and how much it will cost. But it's equally important to consider what will happen if the relationship goes south. How can you protect yourself and your organization from liability?

Contractual provisions for liquidated damages, indemnification, or other limitations on liability are a few of the most commonly used "damage control" tools. In too many cases, however, drafting errors transform the very provisions intended to provide for clear-cut remedies, or clear-cut limitations on remedies, into sources of prolonged and expensive litigation. Here are three of the most common pitfalls you'll want to avoid the next time you include one of these "damage control" provisions in your contract.

Liquidated vs. Actual Damages

Liquidated damages are a fixed amount of damages designated by the parties during the formation of the contract as the remedy for one or more breaches. Typically, liquidated damages are enforceable only when actual damages would be difficult to calculate with precision, and when the liquidated sum is a reasonable estimate of the actual damages flowing from a breach. In other words, because liquidated damages are a substitute for actual damages, you can't have both. Otherwise, the liquidated damages become an unenforceable penalty. (They could also be deemed a penalty if they are not a reasonable approximation of actual damages.) Yet, inclusion of both liquidated damages and actual damages in a contract is a common error. And it's easy to see why. After all, who wouldn't want to receive a predetermined sum of cash as recompense for any breach, *plus* whatever actual damages resulted from the breach? That sort of double dipping, however, is not permitted by the courts, as many companies discover for the first time only after litigation has begun. In fact, it's likely that when faced with a contract that provides for both liquidated damages and actual damages, a court will find the liquidated damages provision to be an unenforceable penalty, leaving the parties to litigate the question of actual damages. So, when it comes to actual versus liquidated damages, you can't have your cake and eat it, too.

Indemnity Clauses

Requiring the other party to a contract to indemnify you is usually a prudent step. As with many legal concepts, however, the devil is in the details, and defining the scope of the indemnification obligation is key. For instance, it is not uncommon for a contract to provide that each party will indemnify the other from liability flowing from "any and all" claims. But that language arguably applies not only to third-party claims, but also claims between the contracting parties themselves (which could potentially render any lawsuit by the indemnifying party against the indemnified party an exercise in futility). If it's not your intent to have the indemnification provision apply to direct claims between the contracting parties, then consider expressly limiting the provision to third-party claims.

In addition to the threshold issue of which claims are within the scope of the indemnity obligation, there is also the question of exactly what monies the indemnifying party is agreeing to pay. For example, does the indemnification obligation apply only to judgments rendered against the indemnified party? What about civil fines or penalties? Or punitive damages? Is the party who bears the burden of indemnity also obligated to assume the cost of defending the indemnified party in any litigation? If so, who gets to choose defense counsel? Does the indemnification obligation apply to disputes that are resolved outside of litigation? What if the indemnified party reaches a settlement through informal negotiation of a claim subject to the indemnity obligation; will the indemnifying party be responsible for paying that settlement? Will it have any say in the negotiations? Contract drafters are well advised to bear these questions in mind and to tailor the indemnity provision to the circumstances as closely as possible. Failure to do so may end up sowing the seeds of litigation and leaving your company unprotected.

Conspicuous Limitations

That parties are free to contract as they choose is a fundamental principle of law—so much so that the law will even permit one party to waive its remedies for a breach of contract. But for those of you in Georgia, there's a catch. In *Imaging Systems International, Inc. v. Magnetic Resonance Plus, Inc.*, 227 Ga. App. 641 (1997), the Georgia Court of Appeals held that contractual provisions severely restricting remedies should be explicit, prominent, clear, and unambiguous. In other words, burying your limitation on liability in the fine print jeopardizes your ability to enforce that provision. In *Imaging Systems*, the Court of Appeals found that a limitation of liability (also called an "exculpatory clause") was sufficiently conspicuous when it was set off in its own paragraph with the heading "LIMITATION OF LIABILITY," and with all key language capitalized.

In sum, these "damage control" provisions are not one-size-fits-all. While form agreements can be a good starting point, provisions limiting, or even eliminating, contractual damages must be considered on a case-by-case basis, and tailored to the terms of your particular deal.

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