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Legislation and Compliance

Limitation of Liability Clauses: Getting It Right

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Biography

Tom Bolam is a commercial litigation solicitor who joined Fladgate (www.fladgate.com) in 2011 after training at a major international law firm, and focuses on Shareholder, partnership and joint-venture disputes; Insolvency litigation, both acting for liquidators and defending claims brought by liquidators; Claims relating to breach of directors' duties and directors' disqualification proceedings; Civil fraud; Commercial breach of contract; Commercial agency disputes; and International arbitration.

Advising clients across a wide range of industry sectors including manufacturing, retail, sport, professional services, media and finance, around 50% of Tom's cases have an international element and Tom has extensive experience of enforcing foreign judgments in England.

Tom is regularly involved in applications for injunctive relief including freezing injunctions.

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Paper type Opinion

Abstract

Most commercial agreements contain clauses that limit liability for breach. Often these clauses produce unintended and unfair results. In this article, the author explains a common misunderstanding about the operation of limitation of liability clauses and suggests ways for contractual parties to avoid being left exposed.

Introduction

Unlike in many jurisdictions, most English lawyers confine themselves to narrow specialisms. Lawyers responsible for drafting commercial contracts are rarely the same people involved when a dispute arises. Often, lawyers responsible for drafting commercial contracts have no practical experience of dealing with the fallout from a breach of contract. This means that commercial contracts often include clauses designed to set out the consequences of a breach of contract that have unfair or unintended consequences.

This problem is commonly seen in the area of limitation of liability clauses. These types of clauses seek to limit the scope of damages that a party may recover following a breach of contract. Understandably, parties to a contract are concerned to ensure that they understand the possible consequences if they fail to perform in accordance with its terms. However, the best intentions of parties can be undermined by the drafting of such clauses.

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Take the following limitation of liability clause in a software development contract:

> "*The Developer shall not be liable for any indirect loss or loss of profit as a consequence of its failure to meet the development milestones at Schedule 1 to this Agreement for whatever reason.*"

This is a fairly typical limitation of liability clause. Some parties may understand the full implications of such a clause but, often, the intention of the counterparties and the draftsperson was at odds with the legal meaning of such a clause. There is often a perception that indirect loss and loss of profit are interchangeable. This is incorrect. Loss of profit may be indirect but, often, it will represent a direct loss.

Take the example of a software developer engaged by a start-up to produce a bespoke online platform that allows people to trade unwanted Christmas presents. The development contract contains a limitation of liability clause in the form set out above. At a late stage in the development, just before Christmas, the software developer informs the start-up that it is reallocating its entire staff to a more lucrative project for a period. The start-up is unable to identify an alternative developer in time to get its platform up and running for the Christmas season. Another start-up company, offering a similar online platform, launches that Christmas to huge publicity and trades profitably.

In this scenario, the start-up may only have limited recourse against the developer. The developer deliberately failed to perform under the agreement because it obtained a more lucrative offer. This has left the start-up in the lurch, allowing a competitor to enter the market unopposed, make huge profits and secure market share. However, the contract between the parties excludes the developer's liability for loss of profit. In all likelihood, the only claim the start-up has against the developer is for wasted development costs. The development costs may be relatively small and much less significant than the profits the start-up would have made had it gone live in time for Christmas. In this scenario, the developer may be able to hold the start-up to ransom by demanding higher fees in return for complying with its contractual obligations.

Poorly drafted clauses

Litigation lawyers regularly see unfair and obviously unintended consequences stemming from poorly drafted limitation of liability clauses. The law in England on recoverable loss following a breach of contract is intended to be predictable and fair. It is often the attempt by parties to achieve greater predictability that causes unintended, unpredictable and unfair outcomes.

Unless a great deal of time and thought is applied to the possible consequences of breach, a sensible mantra for any principal is to agree to limit liability by reference to value rather than agreeing to excluding liability for a specific type of loss. Alternatively, a principal should insist that any limitation of liability clause states that it does not limit liability for deliberate breaches. This restricts the ability of parties to take advantage of limitation of liability clauses. Clauses that impose a blanket restriction on the recoverability of damages for loss of profit should, unless you are the only party that will benefit from such a clause, be avoided.