

Limiting Licensor's Liability

U.S. courts will enforce contractual provisions limiting licensor's liability, but language must be unequivocal

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A question sometimes overlooked or ignored in technology license agreements is the licensor's liability for indirect or consequential damages in the event of a failure.

A license agreement for technology grants certain rights under the patents, engineering design, know-how and trade secrets of the licensor in return for a royalty. The capital investment on the part of the licensee in utilizing the technology is usually disproportionately large relative to the royalties. For example, the licensee may construct a multimillion-dollar plant to use technology for a royalty that is a small fraction of its total investment.

In some instances, the agreement provides that the technology is guaranteed to meet certain performance standards established by the licensor. Such standards may include, for example, conversion rates, yield, cycle life, ultimate life, temperature and pressure conditions, etc. If the technology fails in one or more aspects to meet performance standards, damages to the licensee may include loss of its capital investment or a substantial portion thereof, loss of profits and other indirect or consequential damages. Quite naturally, the licensee being the aggrieved party will look to the licensor for at least some portion of its damages.

What contract provision will give the licensor the maximum protection if a claim for damages is asserted by the licensee? The licensor may seek protection by providing in the agreement that a process failure limits licensor's liability to damages commensurate to the royalties. Is a clause of this type valid and enforceable, and does this clause afford to the licensor the maximum protection against a claim for damages?

At the time the agreement is being negotiated, the licensee's underlying interest is in acquiring a process. Consequently, the licensor's offer to forego at least a portion of the royalties in the event of failure satisfies that interest. Will the licensee's underlying interests shift once its plant is commissioned and there is a performance failure? In such event its viewpoint becomes myopic. The licensee had not anticipated the possibility that it purchased defective technology, and its position now becomes that the intended bargain was to buy a process that performs.

The licensee's investment has its genesis in the

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technology furnished by the licensor who purports to have the skill, judgment and expertise required for the design and operation of the process. While it is true that the licensee exercised certain judgments prior to making the investment, it relied heavily on the licensor as the developer and seller of the process. Based on this reliance coupled with a performance guarantee, which tends to enlarge the responsibility of the licensor, the licensee undertook a substantial investment. Can the licensor induce another to act and simultaneously limit its liability to a proportion only of the royalties recited in the contract?

Licensor View

The licensor realizes that its investment and possible loss is small relative to that of the licensee. In the event of failure, the technology may have suffered a loss in credibility, or the licensor may lose some portion of its royalties, but the licensor earnestly intends that damages commensurate to royalty payments be the limit of its liability, which gives partial satisfaction to the licensee.

Contracts for technology licensing frequently guarantee the process and provide for damages if there is a failure based on licensee's obligation for payments under the agreement. The licensor quite naturally wants to protect itself against a claim for other damages. The validity of such a clause appears reasonable and valid, but can a failure evolutionize the licensee's thinking?

Let us address these questions and offer a provision that may afford maximum protection to the licensor.

United States courts generally have recognized as valid and enforceable a contract provision limiting a party's liability, provided such a clause is not violative of public policy and no inequality of bargaining power exists.¹ These exceptions to the general principle are not apt to arise between sophisticated parties acting on the advice of counsel, and, therefore, will not be treated in this article. This principle is firmly established in the sale of goods, and although certain parallels may exist between this law and technology licensing, there are important distinctions which preclude drawing a meaningful or acceptable analogy. There is no precedent for technology licensing agreements which accepts or refutes this general principle or which suggests other standards should apply to technology licensing agreements.

A contract clause limiting liability to a specified sum manifests a substantial disparity between this limitation and damages to the licensee resulting from a process failure. The licensor is the expert and possesses controlling knowledge. Its offer of a process guarantee manifests this control as well as confidence in its technology and, therefore, enlarges its responsibility.

Prior successful operations of the licensed process by others helps promote the process, thereby expanding the reliance placed upon the licensor by the licensee. Under the circumstances, one might assert that a liability limitation, which is at best nominal relative to the licensee's loss, renders the contract illusory and should not be enforced.

In most, if not all, situations where a licensee is making a substantial investment, the licensee is relying heavily on his own judgments and recognizes an allocation of risks. The licensee is willing to make a large investment because of the profit potential, and this profit potential takes into account the royalty credit, which frequently is a minuscule portion of the balance sheet. On the other hand, the royalty is based solely on the value of the process, which invariably is small relative to the licensee's investment, and the licensor's profit from the royalty income is small as compared to that of the licensee. Therefore, in the event of a failure, the liability limitation of a specified sum constitutes a substantial penalty to the licensor commensurate with its royalty income and profit.

Yardstick

The yardstick by which to measure the true import of such a limitation is the degree to which it penalizes the licensor, and not whether the limitation is nominal relative to the licensee's loss. By this standard, one can determine whether the limitation was meaningful and, therefore, enforceable or nominal (unreasonable) and, therefore, illusory.

70 This question of nominal liability was touched upon by Williston, wherein he states that "if the agreed amount to which liability is limited is something more than a mere nominal sum, the validity of the provision has long been recognized."² No case was cited by Williston, however, which refused to enforce such a provision solely on this ground. An interesting case which bears on this point deftly expressed by the dissent is *Widner v. Fidelity Security Systems, Inc.*² Here, the plaintiff furrier had a contract with the defendant to provide plaintiff's store with a burglar alarm system. A burglary did occur resulting in a loss of merchandise valued at \$38,862 and a further loss due to a temporary closing to replenish the stock of \$7,318. The contract provided that defendant's liability shall be limited to the yearly service charge, and the trial judge found for the plaintiff in that express amount (i.e. \$312). This ruling was upheld on appeal wherein the affirming opinion found the clause as a limitation on liability arrived at in a private arrangement between two parties and as not unconscionable. In a strong dissenting opinion, the judge stated that he would not enforce such a limitation "where unreasonable and bearing no relation to the loss that would result from defendant's failure to fulfill the terms of its contract."³

Might not one contend that a holding expressed by the dissent would substitute a burglar alarm system for insurance? Certainly the parties must have recognized that the alarm was useful only as a deterrent and as a means to alert the police. In light of the limitation clause, failure with the alarm should limit the security company to the annual service charge and

not subject the company to consequential damages. Their income from this particular client was small, and their profit likewise small. Damages assumed by the security company consumed this income and eliminated its profits. Hence, when liability is measured in relation to the income of the party assuming the damages, the limitation was reasonable and meaningful.

There is an apparent parallel between this rationale and technology licensing. The licensor is the security company and the licensee is the furrier. The investment on the part of each is of differing magnitudes, and consequently the damages suffered by each are in relation to its own investment or income and not to the other. Therefore, if the licensor's limitation is significant in relation to the royalties it receives, it appears unlikely that a court would hold such an amount to be nominal or unreasonable and refuse to enforce such a limitation clause.

Does not the dissent in *Widner* strike closer to home where it discussed the bargained-for performance? The opinion states, at page 434, with reference to the limitation clause that:

"[it] deprives plaintiff of the bargain of his contract. As construed in the affirming opinion, the clause in effect works a rescission of the contract, completely, freeing defendant from proper performance of its terms and requiring only a return of the service charge when defendant has failed to properly perform thereunder. The contract thus becomes, in effect, an illusory one with defendant not being bound to perform and plaintiff not being entitled to performance by defendant.

In technology licensing, does not the licensee bargain for a process that performs? If the licensor has the option of paying damages limited to some portion of the royalty income and is thereby released from all obligations, where is the bargained-for performance? With a limitation clause, the licensee may not realize its bargain, and the licensor is freed from proper performance. One can assert, however, in technology licensing, that the parties are sophisticated, that the parties are fully cognizant of the investments of each, and that the parties accept an allocation of risks. Therefore, any principle of law which nullifies a limitation clause, even though it is reasonable relative to the licensor's position, would defeat the very purpose of this clause having long-standing acceptance and, in fact, have a sweeping effect on the very rudiment of contract law permitting the parties to bargain in good faith.

Construction

It appears, therefore, that the validity or enforceability of a provision limiting a party's liability to a specified maximum amount is not apt to be a significant problem in a normal transaction involving technology licensing. The principal question is more apt to be one of construction, i.e. did the parties intend the provision to apply in the particular circumstances? The circumstances may suggest that it would be unfair to impose the nearly complete burden of loss on the licensee who in good faith expended substantial sums in reliance upon the technology supplied by the licensor. This reliance may be compounded by guarantees or success with other licensees. Therefore, it is ad-

visible and beneficial to insert a provision in the contract which negates such an inference. That is, the purpose of such a provision is to make clear that the parties intended the liability limitation to apply under all circumstances.⁵

No provision can be drafted in the abstract which would be adequate and effective for all contracts, but certain guidelines are adaptable for most circumstances. The applicable clause should state clearly that the licensor made no representations or warranties except to the extent of the recited guarantees, and that the licensee knowingly assumed all risks with the understanding that the technology might not perform as originally contemplated. If there are specific guarantees, the agreement should describe the conditions under which the guarantees will be measured and licensee's obligations as a prerequisite to establishing the guarantees.⁶ Further, the limiting liability provision should extend to all breaches of the agreement and may be reinforced with a specific disclaimer by the licensee of the right to recover any damages in excess of the stipulated maximum amount, whether direct, indirect, consequential, incidental, or otherwise. If such provisions are omitted from the contract, or if included but in an emasculated version, the licensor is running a severe risk that the licensee will be able to avoid or nullify the normal impact of the liability provision.

If we follow these guidelines, a provision such as set forth below might be utilized:

The liability of the licensor for any and all breaches of this agreement and for any and all failures to meet the process guarantees set forth in this agreement shall, in the aggregate, be limited to [insert the \$ amount or refer to a formula for calculating the same] and the licensee hereby waives and disclaims the right to recover any damages in excess of such amount for any and all such breaches and for any and all such failures irrespective of whether such damages are direct, indirect, consequential, incidental or any other type of damages and irrespective of whether based upon loss of investment, loss of production, lost profits, interest on investment, interruption of business or any other loss of any character whatsoever, and agrees that its sole and exclusive remedy for any and all such breaches and any and all such failures shall be to recover damages actually sustained up to, but not in excess of, such amount.

While it is generally assumed that the licensor under a technology agreement does not make an implied warranty that the technology will perform, it may nevertheless be appropriate in certain circumstances to include a provision in the agreement disclaiming the existence of any implied warranties. The provision could be coupled with a provision disclaiming the making or continued existence of any express warranties made during the course of the negotiations leading up to the agreement. A provision to this effect might be extremely important if the agreement was preceded by the licensor furnishing substantial data to the licensee and engaging in numerous discussions and transmitting correspondence explaining the use of the technology. Such a provision might be worded as follows:

The agreement sets forth the entire agreement between the parties hereto relating to the subject matter hereof and supersedes all previous communications, negotiations, representations, warranties, or

agreements, whether oral or written, express or implied, with respect to such subject matter. Without limiting the foregoing, the licensor hereby specifically disclaims any express or implied warranties with respect to the performance of the technology licensed hereunder or any other aspect of the subject matter of this agreement (except to the extent of the express warranties or process guarantees contained in Paragraph _____ hereof).

If the agreement contemplates that the licensed technology will be used in a new application or on a larger scale or otherwise in a manner outside the scope of the experience of the licensee and for the foregoing reasons or any other reason the licensor has any significant doubts as to the performance of the technology, the licensor should consider including a specific provision to the effect that the licensee was apprised of such risks and knowingly assumed them. Such a provision would be extremely helpful in convincing a court to enforce the provision limiting the licensor's liability to the maximum specified amount.

Liquidated Damages

It is important to distinguish between a "liquidated damages" provision and a provision limiting liability to a maximum amount.⁷ A "liquidated damages" provision is enforceable only if the specified amount of damages represents reasonable compensation for actual damages which are incapable or very difficult of accurate estimation. If the specified amount is excessive, the "liquidated damages" provision will be considered a penalty and unenforceable. A provision limiting liability to a maximum amount does not purport to provide reasonable compensation for actual damages. Since it is intended to limit a party's liability to a maximum amount, it necessarily contemplates that the actual damages may be substantially in excess of such amount. There is often confusion between these concepts, and therefore the agreement should not employ the term "liquidated damages" or use other terms associated with this concept when a provision limiting liability to a maximum amount is intended.

The erroneous use of the term "liquidated damages" or associated terms could result in confusion as to what the parties intended and might lead a court to determine the enforceability of a provision intended to limit liability to a maximum amount by using criteria which are applicable to liquidated damages provisions and possibly result in a holding of unenforceability because the provision does not represent a reasonable approximation of actual damages.

From the foregoing, we can conclude that in normal circumstances involving technology licensing, United States courts and probably those of many other nations will enforce a contractual provision in the agreement limiting the licensor's maximum liability to a specified amount. The provision should be unequivocal and may be reinforced by other provisions which make it clear that the parties intended the former provision to apply in all circumstances to preclude a court from construing the former provision narrowly in favor of the licensee.

The other accompanying provisions may be in the

form of clauses whereby the licensor specifically disclaims any representations or warranties as to the performance of the licensed technology and whereby the licensee specifically acknowledges that it is assuming any risks with respect to such performance or in the form of any other clauses indicating such intention of the parties which are appropriate in the circumstances.

The provision limiting the licensor's liability to a specified amount should avoid use of the term "liquidated damages" or terms associated with such term to prevent confusion between these two distinguishable concepts. Quite obviously, this paper advocates the use of an unambiguous provision limiting the licensor's liability.

NOTES

1. See *Moreira Construction Co., Inc. v. Monetrench Corp.*, 97 N.J. Super.391, 235 A.2d 211, 213 (App. Div. 1967), *aff'd*, 51 N.J. 405, 241 A.2d 236 (1968) where the contract limited liability of the lessor of a pump to the lessee to free replacement of any defective part or parts of the equipment furnished under the agreement. The court stated:

"Parties to a contract may agree to limit their liability as long as the limitation is not violative of public

policy. *Silvestri v. South Orange Storage Corp.*, 14 N.J. Super. 205, 81 A.2d 502 (App. Div. 1951); 5 Williston,

- Contracts (3d ed. 1961), §781A, pp. 709-710 . . ."
Accord, RESTATEMENT OF CONTRACTS §339, comment g at 554 (1932); 5 WILLISTON ON CONTRACTS §781A, pp. 709-710 (3d ed. 1961); *Arrow Petroleum Co. v. Johnston*, 162 F.2d 269 (7th Cir. 1947)
2. WILLISTON ON CONTRACTS, §781A, pp. 709-710 (3 ed. 1961), citing cases.
 3. 228 Pa. Super.67, 307 A2d 429 (1973).
 4. *Id.* at 433.
 5. Fraud and negligence are additional factual elements that may influence the outcome. These factors, however, are not dealt with in this paper except to state generally that the typical limited liability provision would not apply in either of these situations and the licensor would be liable for the full amount of damages.
 6. Such conditions might include, for example, temperature, pressure, time, feed specifications, etc.; and examples of licensee's obligations might include utilities, feed stock quantities, supplies, qualified personnel, etc.
 7. RESTATEMENT OF CONTRACTS §339, comment g at 554 (1932) reads:

"An agreement limiting the amount of damages recoverable for breach is not an agreement to pay either liquidated damages or a penalty. Except in the case of certain public service contracts, the contracting parties can by agreement limit their liability in damages to a specified amount, either at the time of making their principal contract, or subsequently thereto. Such a contract does not purport to make an estimate of the harm caused by a breach; nor is its purpose to operate in *terrorem* to induce performance."