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## DAMAGE AWARDS – HOW TO REDUCE THEM

### I. Introduction

The large amounts US juries sometimes award plaintiffs are often discussed abroad and even scare off foreign direct investors. This article offers a brief overview of some of these damages and practical steps companies can take to reduce them.

Generally speaking, damages are the amount of money necessary to put the injured party in the position it would be in financially had the other party performed as promised. US law favors having a party make financial payments over making that party comply with the contract as written ("specific performance"). Specific performance is a remedy reserved for limited situations, such as trade secrets, non-competition agreements and the sale of unique goods.

With few exceptions, jury awards for personal injuries cannot be controlled by contract provisions. Reducing the risk of such awards will require extensive legislation at the federal level. US lawmakers are not interested in the chilling effect these awards have on foreign direct investment, despite the resulting loss of American jobs.

This article focuses instead on commercial loss claims between business partners and on contractual provisions that can limit remedies for these losses.

### II. Types of Damages Not Controlled by Contract

#### A. Damages for Personal Injury

Personal injury claims can by their nature not be limited by contract. The producer of the product seldom has a direct contractual relationship with the injured party. Under U.S. principles of product liability, even if the producer does have a contract, public policy will not permit it to limit those damages. (There are exceptions to every rule, such as damage waivers signed by drug study participants.) The relative power of the two parties makes any resulting contract too one-sided.

#### B. Damages to End Consumer Other Than for Personal Injury

Damages other than for personal injury can be limited, but these are the subject of special consumer legislation (the Magnuson-Moss Federal Warranty Act) not covered here. Briefly summarized, defenses against these types of product liability claims include (a) special attention to product quality, design, safety features (including ones needed by users without special qualifications), warning labels, user training and manuals; (b) third party testing – such as UL and TUV; (c) insurance; (d) customer and public relations; (e) quick and practical dispute resolution; (f) ties to the local community; and even (g) a good corporate citizen policy. Keep in mind that the U.S. public is not the same as the

German public, either in training (practical or academic) or willingness to accept injury. The simple translation of a German product manual into English is utterly inadequate. Furthermore, litigation deterrents in the German legal system, such as costs tied to the amount of the claim and payment of the winner's legal fees, are unknown in the American system.

### C. Punitive Damages

The other types of damages – not covered in detail here – include punitive damages. Briefly stated, punitive damages are damages intended to deter the tortfeasor and others from engaging in reckless or intentional bad behavior. The award is intended take away any economic incentive to engage in the behavior. The theory behind punitive damages goes even further: it assumes that the instant injury is only one of many that go unreported. And, the theory continues, other similar actors should be deterred by seeing what happens to the defendant who gets caught. For these reasons punitive damage awards are quite high. The problem with punitive damages is not the theory behind them but their implementation. For a more detailed discussion of punitive damages and defenses against them, see Houck, "Punitive Damages – How Juries Decide," *German American Trade* Vol. 15, No. 10, 14-20.

## IL Limiting Damages by Contract

### A. Sources of Law Applicable to Any Contractual Limitation of Damages

There are three basic sources of law to be considered: statutes, court decisions and the contract itself

Remedies and damages for the sale of defective goods are covered in large part by the Uniform Commercial Code (UCC), as adopted with some relatively minor variations in 49 of the 50 States (Louisiana being the sole exception). The courts of each of these states interpret the UCC as adopted in the state, leading to further differences. As is always the case, if a claim arises, the parties have to determine which state's law applies and how the statutes and case law of that state are likely to apply in that particular case. Often a contract provision will specify which state's law applies. This "choice of law" provision will not, of course, apply to a person or entity that is not a party to the contract. The UCC sections discussed apply only to the sale of goods, so this discussion does not apply to services.

The general rule is that businesspersons are free to bargain for and regulate the remedies and damages available to them. The UCC recognizes this freedom, within broad limits. The greater the differences between the two contracting parties, the greater the possibility that a court will show sympathy for the weaker party. This discussion assumes that both parties to the contract are sophisticated businesses, each with access to legal representation.

When considering remedies, note that the parties must look to *both* the contract and the UCC. Remedies are cumulative unless specifically agreed to be exclusive. So providing remedies in a contract without making them exclusive only expands a buyer's rights; it does not limit them.

B. Contract Formation

A key factor in determining remedies for breach of contract is which writings between the parties in fact constitute a binding contract. The so-called statute of frauds requires that most contracts for the sale of goods be in writing, but the writing may not be the particular writing that the seller intended. For example, absent a writing between the parties limiting damages and remedies that is signed by buyer, buyer can safely be assumed to be entitled to *all* remedies and claims for damages resulting from the non-performance of the other party or its goods. If the parties have both signed the same document and it contains provisions limiting remedies and damages, those provisions are likely to regulate their relationship. But often the parties exchange documents, letters and printed forms but never both sign the same piece of paper. This "battle of the forms" scenario leads to great uncertainty, which is likely to be resolved in buyer's favor. Limitations on damages and remedies contained in seller's general terms and conditions of sale, order confirmation or invoice are unlikely to be respected by the court. Their effect is mostly psychological. Thus, if seller is serious about limiting buyer's remedies and damage claims, it should insist on a document to this effect signed by buyer.

C. Consequential and Incidental Damages

Turning to "normal" commercial damages, these are usually ones which arise between two businesses due to failure of a product to perform or to be delivered as promised. In contrast to the damages touched on above, these damages *can* be controlled by a thoughtful seller. Bear in mind the difference between remedies and damages: remedies focus on the *process* of correcting a problem, while damages refer to the *quantification* of compensation to be paid. This is a distinction with a difference under U.S. law.

What are the normal damages the injured buyer can claim? Section 2-712 spells out the normal reaction of a disappointed buyer: it buys the equivalent product in the market ("covers") and claims damages from the seller. The UCC divides these damages into consequential and incidental damages, but there are more names for them, including direct, indirect, compensatory, actual, direct, indirect, exemplary and special. UCC 2-715(2) defines "consequential damages" as follows.

> Consequential damages include (a) any loss resulting from general or particular requirements and needs of ***which the seller at the time of contracting had <u>reason to know;</u>*** and (b) injury to *person or property* proximately resulting from any breach of warranty.

(Emphases added.)

The "reason to know" language in UCC 2-715 is important to seller. If buyer intended to resell the product seller failed to deliver or delivered in defective condition, seller may be liable for normal profits that buyer lost. If buyer had an especially lucrative contract for resale of the product which seller had no reason to know about, those extra profits are *not* a proper part of buyer's recovery. Likewise, unless otherwise agreed, failure of seller to deliver a replacement part by an agreed upon date could leave seller liable for profits that the broken machine would have earned. This assumes that seller knew or had reason to know about the importance of its part. Seller should be wary of circumstances surrounding a sale that warns him that buyer has a special use for the goods. Besides special resale circumstances, seller may know that its product will play a small but important role in buyer's product. A typical horror scenario is the failure of a stabilizer seller sells to the manufacturer of seals for office tower windows. Replacement of the windows due to failure of the seals and resultant foggy windows is readily foreseeable.

Under UCC 2-715(1), ***incidental damages*** include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

These damages are usually insignificant when compared to consequential damages. Although winning lawyers have tried to collect their fees from the loser as incidental or consequential damages, they are normally excluded from recovery.

## D. Limitation of Remedies and Damages

This brings seller to the key provision of the UCC regarding remedies generally, Section 2-719. It states in relevant part:

> (1) Subject to the provisions of subsection (2) and (3) [below] and of the ... section on liquidation ... of damages [also below],
>
> (a) the agreement may provide for remedies in addition to or ***in substitution for*** those provided in this Article and may ***limit or alter*** the measure of damages ..., as by limiting the buyer's remedies to ***return** of **the goods and repayment** of **the price or to repair and replacement of non-conforming goods or parts;*** and
>
> (b) resort to a remedy as provided is ***optional*** unless the remedy is ***expressly agreed to be exclusive,*** in which case it is the sole remedy.
>
> (2) Where the circumstances cause an exclusive or limited remedy to *fail of* ***its essential purpose,*** [the full] remedy [is available].....

> (3) Consequential <u>damages</u> ***may be limited or excluded*** unless the limitation or exclusion is unconscionable. Limitation of consequential <u>damages</u> for injury to the ***person in the case*** *of* ***consumer goods*** is prima facie unconscionable but limitation of <u>damages</u> where the loss is ***commercial*** is not.

(Emphases added.)

Parts of UCC 2-719 are simple and require little comment. The reader should focus on the difference between remedies and damages. Seller can bargain with buyer for limitations on damages and remedies, regardless of the injury buyer is likely to suffer or in fact suffers. The extent of possible damages awarded is clearly a risk, one which seller should take into account when setting the price of its goods. It can be seen as an insurance policy sold with the goods; a policy with high limits costs more than one with low ones. Seller may go so far as to limit buyer's remedies to <u>repayment of the purchase price or repair or replacement of the goods</u>, thereby excluding any responsibility for buyer's lost profits, factory downtime, product recall, and the like. Seller can reasonably argue that the price of the goods would have been higher if these risks were its own. Which of buyer and seller may elect repayment or repair or replacement is another subject of possible negotiation.

The drafter of the contract must be careful that the limited remedies provided in the contract are the *exclusive* remedies available to the parties. Otherwise, the parties have the remedies provided in the contract <u>and</u> the remedies provided in the Uniform Commercial Code, including consequential damages. This result can be an unpleasant shock for seller, who thinks he has protected itself

As noted, buyer's remedy can be limited to the repair or replacement of the part. In implementing such a limited remedy, seller must take care that it provide this remedy quickly and fully. Lengthy delay, delivery of new but defective goods, or repeated but failed attempts to repair the defective goods can constitute "failure of the essential purpose" of the remedy. If this occurs, buyer will have the full set of remedies.

Regarding limitation of damages, damages are commonly limited to the amount of the sales price received from buyer. The parties may also negotiate another amount, having nothing to do with the sales price.

Regarding the "unconscionability" of excluding consequential damages, as between experienced businesspeople represented by attorneys this limitation is not normally questioned. Such businesspeople are permitted broad freedom to regulate their relationship.

If the remedy does "fail of its essential purpose," does this failure also remove the restriction on consequential damages? Court decisions are split, but some important states seem to indicate that the two sections (remedies and damages) are separate. So a limitation on damages would still apply even if the remedy fails. To increase the likelihood of this result, the two provisions should be in separate sections of the contract, and the restriction on damages should explicitly survive any failure of the remedy. Still, the best course is to supply the remedy quickly and effectively.

### E. No Penalties Allowed: Liquidated Damages

Germans often try to insert a "penalty" for non-performance in their American contracts. U.S. law will not enforce a penalty. As an alternative, ***liquidated damages*** may be permissible. "Liquidated" damages are simply damages the amount of which has been settled. UCC Section 2-718(1) contains the relevant provision:

> Damages for breach by either party may be ***liquidated*** in the agreement but only at an amount which is ***reasonable in the light*** *of* ***the anticipated or actual harm*** caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining and adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

American lawyers have devised standard language to conform to this Section. But the amount must still be reasonable, at least at the time the parties agreed on it. Note that, while there is some uncertainty, it is likely that liquidated damages will be the sole measure of damages. This means that the injured party cannot waive its claim to liquidated damages and try to prove it suffered an even greater amount. Whether a clever draftsperson can craft the right of election between actual damages and liquidate seems to be uncharted territory and cause for expensive litigation.

### F. Other Protections

In addition to these provisions covered by the UCC, standard methods seller uses to limit its risks with a commercial buyer include the following contract provisions:

- A limited warranty, excluding implied warranties of merchantability and fitness for a particular purpose. Seller might also that seller's recommendations are only that and not warranties. Furthermore, the contract typically provides that seller's employees and agents have no right to change these warranties.
- The obligation of buyer to inspect the goods for conformity to seller's specifications, both for readily visible defects and, using lab instruments, for others. Note, however, that unreasonable obligations may cause the remedy to "fail of its essential purpose."
- The obligation of buyer to test the product in small batches.
- The obligation to share third party damages claims in accordance with their responsibility for the defect.
- The irrevocable waiver of the parties' rights to trial by jury.
- The obligation of the loser to reimburse the winner's legal fees.

• Specifically stating which state law applies to the contract.

Not all these provisions will necessarily be honored by the courts. For example, some states restrict pre-dispute waiver of jury trials. But if seller does not insert them, the court will certainly not.

Note the essential lack of equilibrium between buyer and seller: if buyer does not perform, seller's remedy consists only of a claim for payment of the purchase price and possibly interest. So there is an easily determined maximum amount of the claim. In contrast, if not effectively limited, buyer may have a claim substantially in excess of the purchase price of the goods, such as for lost profits, damage to its reputation, failure of a factory to function, etc. Hence, seller has a real interest in inserting these protections.

Finally, although these comments are focused on the sale of products by a company to customers, probably over several years, they also apply to the sale of a company or line of business structured as an asset sale.

## G. Conclusion

The consequences of these provisions? Seller should consider whether it can protect itself against large jury awards or even awards imposed by a judge for breach of contract by entering a written contract signed by both seller and buyer, not just exchanging forms. Often the profits to be gained from the sale will be eaten up by the cost of negotiating a set of general terms of purchase and sale. Salespeople operating on a commission basis will fight against the extra transaction burdens and risks of losing the sale. But these sorts of awards foreign businesspeople do fear can effectively be foreclosed or limited by the right documentation. Businesspeople must balance the risk of large claims versus the risk of losing the sale.

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