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The Public Policy Exception To The Enforceability Of Damage Waiver Clauses

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It has become routine for sophisticated contracting parties to limit, in advance, their liability to each other for consequential, special or punitive damages arising from a subsequent breach.[1] In deference to the freedom of contract, New York courts generally enforce these agreements.[2] As the New York Court of Appeals stated in *Met. Life Ins. Co. v. Noble Lowndes Int'l*, "[a] limitation on liability provision in a contract represents the parties' Agreement on the allocation of the risk of economic loss in the event that the contemplated transaction is not fully executed, which the courts should honor."[3] The Court elaborated by quoting Professor Corbin:

> With certain exceptions, the courts see no harm in express agreements limiting the damages to be recovered for breach of contract. Public policy may forbid the enforcement of penalties against a defendant; but it does not forbid the enforcement of a limitation in his favor. Parties sometimes make agreements and expressly provide that they shall not be enforceable at all, by any remedy legal or equitable. They may later regret their assumption of the risks of non-performance in this manner; but the courts let them lie on the bed they made.[4]

There are, however, limits on such enforcement. For one, the scope of exculpatory clauses will be strictly construed against the party seeking to avoid liability.[5] More significantly, New York courts will not enforce exculpatory clauses where to do so would violate public policy.[6]

The Public Policy Exception

New York courts have routinely refused to enforce exculpatory clauses when faced with "willful or grossly negligent acts," as to do so would violate public policy.[7] As the New York Court of Appeals has explained:

> [T]he policy which condemns such conduct is so firm that even when, in the context of the circumstances surrounding the framing of a particular exculpatory clause, it is determined, as it was by one of the interrogatories here, that the conduct sought to be exculpated was within the contemplation of the parties, it will be unenforceable.[8]

A recent decision by the Appellate Division, First Department provides an excellent overview of the principles involved. In *Banc of Am. Sec. LLC v. Solow Building Co.*,[9] the plaintiff-tenant leased office space from the defendant-landlord. The lease required the tenant to obtain the landlord's consent before undertaking any alterations, and provided that the landlord could not unreasonably withhold its consent to non-structural changes. The lease further obligated the landlord to approve or disapprove proposed alterations within 10 business days of submission, and obligated the tenant to pay the reasonable expenses incurred by the landlord.

In response to the tenant's request for consent to proposed alterations, the landlord made a written demand for the payment of $6 million allegedly owed to the landlord in connection with its review of previously submitted renovation plans. When the tenant balked, a default notice was served and a lawsuit ensued. The tenant alleged that because the landlord's failure to consent disabled the tenant from making the alterations, the tenant suffered consequential damages in the form of loss of business income, loss of use of the premises and additional expenses.

The landlord moved for partial summary judgment seeking dismissal of the tenant's claim for consequential damages. The landlord relied on the lease provision by which the tenant waived any damage claim based on the landlord's unreasonable withholding or delay of giving consent, and further agreed that, in that event, the tenant's sole remedy was to seek specific performance. The trial court found that, given the facts, the exculpatory clause might not be enforceable. However, the court denied the motion, finding the presence of factual issues with respect to whether the landlord had acted in bad faith or maliciously. The landlord appealed.

In affirming, the Appellate Division carefully analyzed the public policy exception to the enforceability of exculpatory clauses. The court summarized:

> The common business practice of limiting liability by restricting or barring recovery by means of an exculpatory provision, although disfavored by the law and closely scrutinized by the courts is accorded judicial recognition where it does not offend public policy; however, that policy does not extend to acts that are

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either willful or grossly negligent. Enforcement of such a provision is precluded when the misconduct for which it would grant immunity smacks of intentional wrongdoing, where it is willful, as when it is fraudulent, malicious or prompted by the sinister intention of one acting in bad faith. Or, when, as is gross negligence, it betokens reckless indifference to the rights of others.[10]

The court found that to limit the tenant's remedy to specific performance, as set forth in the lease, would permit the landlord "to willfully breach the lease with impunity in order to exact unreasonable concessions from its tenant in clear violation of the implied covenant of good faith and fair dealing."[11]

When Is A Breach Willful?

An issue of some tension in this area of New York case law is whether an exculpatory clause is unenforceable where the breach was caused by an act that, while intentional, was not undertaken with malice. The Court of Appeals grappled with this issue in *Met. Life Ins. Co. v. Noble Lowndes Int'l.*[12] There, the defendant contracted to supply plaintiff with software for processing insurance claims along with customized enhancements suited to plaintiff's particular needs. The cost of providing those enhancements proved greater than anticipated, causing the defendant to demand payment in excess of the contract amount. When plaintiff refused, the defendant withdrew from the project. The plaintiff sued for breach of contract, and the defendant invoked a limitation of liability clause that absolved the defendant of liability for consequential damages other than those caused by "intentional misrepresentations, willful acts and gross negligence."[13]

The plaintiff urged that consequential damages should not be precluded because, defendant's decision to withdraw from the project being intentional, the breach arose from a "willful act." The Court of Appeals disagreed. The Court held that the exculpatory clause was "intended to narrowly exclude from protection truly culpable, harmful conduct, not merely intentional nonperformance of the Agreement motivated by financial self-interest," and that enforcing such a clause in this context did not offend public policy.[14] In essence, the Court found the term "willful act" to require something more than an intentional breach of contract.

Subsequent decisions have sought to clarify the line drawn in *Noble Lowndes* between "truly culpable" and "merely intentional" non-performance, with questionable success. In *Banc of Am. Sec. LLC v. Solow Bldg. Co.*, the defendant-landlord argued that its refusal to perform its lease obligation fell within the analysis of *Noble Lowndes* in that, although intentional, it was motivated by the landlord's financial self-interest.[15] In distinguishing *Noble Lowndes*, the Appellate Division – over two dissents – observed that, in that case, there was insufficient proof that the defendant intended to inflict harm on the plaintiff. Rather, the defendant's repudiation in *Noble Lowndes* "was motivated exclusively by its own economic self-interest in divesting itself of a highly unprofitable business undertaking in order to promote the sale of its computer software division to a competitor company."[16] Although the Court of Appeals in *Noble Lowndes* had found an exculpatory clause enforceable where the defendant had engaged in "intentional nonperformance of the Agreement motivated by financial self-interest," the Appellate Division held that this economic self-interest test should not be broadly applied "to excuse all manner of misconduct," noting that economic self-interest is what motivates fraud, self-dealing, and breach of fiduciary duty, all of which "smack of intentional wrongdoing."[17] The court further distinguished *Noble Lowndes* observing that the defendant there did not breach to derive an additional benefit from the plaintiff, whereas in *Banc of Am. Sec. LLC*, the landlord "has engaged in a blatant attempt to compel additional exorbitant payment for services it was obligated to provide."[18] The court concluded that the pertinent question was whether the fee demanded by the landlord was a "matter of [its] *legitimate* economic self-interest or, alternatively, whether it evinces the intent to inflict economic harm on [the tenant]."[19]

Ordinary v. Gross Negligence

Another area of some uncertainty is the line between gross negligence and ordinary negligence. While exculpatory clauses are enforceable to preclude the recovery of consequential damages for negligence, they will not be enforced for gross negligence. The Court of Appeals explained this distinction on the grounds that gross negligence "differs in kind, not only degree" from ordinary negligence, because it involves "conduct that evinces a reckless disregard for the rights of others or smacks of intentional wrongdoing."[20]

When does conduct "evince a reckless disregard for the rights of others" such that it is considered gross, rather than ordinary, negligence? The boundary between gross and ordinary negligence, like the boundary between truly culpable and merely intentional breach, is imprecise. For example, in *Satterwhite v. Image Bank, Inc.*,[21] a photographer alleged breach of contract where a stock agency, acting as an agent for the sale or lease of his images, lost 33,000 of those images. The parties' contract contained a limitation of liability provision that purported to exculpate the stock agency from any liability for images lost through "normal usage."[22] Because the stock agency "submitted affidavits showing a systematic method for retrieving photos and returning them to photographers," the court held that "the exculpatory clause in the contract precludes liability as a matter of law."[23] The loss of more than a third of the photographer's 96,000 images was, without more, insufficient to constitute the gross negligence needed to defeat enforcement of the exculpatory clause.

In *Ombreski v. Image Bank, Inc.*,[24] another photographer alleged breach of contract when the stock agency lost 16,000 of his images. The photographer argued that the agency's actions constituted gross negligence, and therefore the exculpatory provision in the parties' contract should not apply. The court rejected this contention, finding that the agency's conduct "amounted to no more than ordinary negligence at most," despite the photographer's allegations that the agency "terminated hundreds of photographers over a relatively short period of time; closed some of its offices, thereby greatly backlogging unprocessed slides; and failed to hire sufficient staff to handle this glut of images."[25]

In disputes between security companies and their burglarized customers, the New York courts have generally held that "[d]elayed or inadequate response to an alarm signal, without more, is not gross negligence."[26] But, where security companies have engaged in "more outrageous acts of folly," the courts have found an issue of fact with respect to gross negli-

gence.[27] For example, in *Green v. Holmes Protection of New York, Inc.*,[28] the court found that where a burglar alarm company "allow[ed] robbers who gave an incorrect name access to plaintiffs' store at 4 a.m., by divulging over the phone at that hour the security codes that disengaged the alarm," its conduct "clearly met the standard of … gross negligence," thereby making the exculpatory clause in the parties' contract unenforceable.[29] And, in *Hanover Ins. Co. v. D & W Station Alarm Co.*,[30] the court found a triable issue of fact with respect to the security company's gross negligence where its employee responded to the second alarm signal at plaintiff's building, could not gain entry, and was subsequently told to "forget that assignment and go on another guard run."[31]

Conclusion

A damage limitation clause can be an important term in complex business transactions. However, as contracting parties are presumed to act in good faith towards each other, well developed New York law makes clear that exculpatory clauses will not be enforced in the face of willful or grossly negligent conduct. Uncertainty creeps into the analysis, however, when trying to draw the line between truly culpable and merely intentional non-performance, as well as between gross negligence and negligence. In light of this uncertainty, contracting practices would be wise to consider that an exculpatory provision may not be there to protect them in the event they decide to breach an unprofitable contract intentionally.

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[1] See Banc of Am. Sec. LLC v. Solow Bldg. Co., *847 N.Y.S.2d 49, 53 (1st Dep't 2007).*

[2] See *Corbin, Contracts § 79.4, at 20-21 (2003).*

[3] Met. Life Ins. Co. v. Noble Lowndes Int'l, *84 N.Y.2d 430, 436, 643 N.E.2d 504, 507, 618 N.Y.S.2d 882, 885 (1994).*

[4] Id. *(quoting Corbin, Contracts § 1068 at 334 (2003)).*

[5] See Terminal Cent., Inc. v. Henry Modell & Co., *212 A.D.2d 213, 218-19, 628 N.Y.S.2d 56, 59-60 (1st Dep't 1995);* see also Banc of Am. Sec. LLC, *847 N.Y.S.2d at 53;* Valuable Holding Corp. v. Midtown Vault Corp., *120 A.D.2d 356, 502 N.Y.S.2d 8, 9 (1st Dep't 1986).*

[6] See Banc of Am. Sec. LLC, *847 N.Y.S.2d at 53.*

[7] See Banc of Am. Sec. LLC, *847 N.Y.S.2d at 53 (quoting* Kalisch-Jarcho Inc. v. City of New York, *58 N.Y.2d 377, 384-85, 448 N.E.2d 413, 416, 461 N.Y.S.2d 746, 749-50 (1983)).*

[8] Kalisch-Jarcho Inc., *58 N.Y.2d at 385, 448 N.E.2d at 417, 461 N.Y.S.2d at 750.*

[9] Banc of Am. Sec. LLC*, 847 N.Y.S.2d 49.*

[10] Id. *at 53 (internal quotation marks and citations omitted).*

[11] Id. *at 54.*

[12] See Noble Lowndes Int'l, 84 *N.Y.2d 430, 643 N.E.2d 504, 618 N.Y.S.2d 882.*

[13] Id., 84 *N.Y.2d at 438, 643 N.E.2d at 509, 618 N.Y.S.2d at 887.*

[14] See id., *84 N.Y.2d at 438, 643 N.E.2d at 508-509, 618 N.Y.S.2d at 886-87. However, the Court did not hold that all contracts prohibiting liability except in the case of "intentional misrepresentations, willful acts and gross negligence" should be construed, as a matter of law, to exculpate parties for merely intentional non-performance. See Con Edison v. N.E. Utils., 249 F. Supp. 2d 387, 414-15 (S.D.N.Y. 2003) (concluding that "the definition of willful acts in [Noble Lowndes] is of little use in determining what constitutes a 'willful and material breach' under [the contract at issue in the instant case]" because the Court of Appeals was interpreting the terms of the particular contract at issue, not defining the term "willful" as a matter of contract law).*

[15] See Banc of Am. Sec. LLC., *847 N.Y.S.2d at 51.*

[16] See id. *at 55.*

[17] See id.

[18] See id. *at 57.*

[19] See id. *(emphasis in original).*

[20] Colnaghi, U.S.A., Ltd. v. Jewelers Protection Servs., Ltd., *81 N.Y.2d 821, 823-24, 611 N.E.2d 282, 284, 595 N.Y.S.2d 381, 383 (1993) (quotation marks omitted).*

[21] *Satterwhite v. Image Bank, Inc.*, No. 01 Civ. 7097, 2007 U.S. Dist. LEXIS 55104 (S.D.N.Y. July 20, 2007).

[22] *See id.*, 2007 U.S. Dist. LEXIS 55104, at *2.

[23] *See id.*, 2007 U.S. Dist. LEXIS 55104, at *4.

[24] *See Ombreski v. Image Bank, Inc.*, 30 A.D.3d 1141, 816 N.Y.S.2d 448 (1st Dep't 2006).

[25] *See id.*, 30 A.D.3d at 1142, 816 N.Y.S.2d at 450.

[26] *See Hartford Ins. Co. v. Holmes Protection Group*, 250 A.D.2d 526, 528, 673 N.Y.S.2d 132, 133 (1st Dep't 1998); s*ee also Net2Globe Int'l v. Time Warner Telecom of N.Y.*, 273 F. Supp. 2d 436, 453-56 (S.D.N.Y. 2003) (comparing a series of cases involving allegations of gross negligence, exculpatory clauses, and security companies).

[27] *See id.*, 250 A.D.2d at 528, 673 N.Y.S.2d at 134.

[28] *Green v. Holmes Protection of New York, Inc.*, 216 A.D.2d 178, 629 N.Y.S.2d 13 (1st Dep't 1995).

[29] *See id.*, 216 A.D.2d at 179.

[30] *Hanover Ins. Co. v. D & W Ctr.*

[31] *See id., 164 A.D.2d at 113-114, 560 N.Y.S.2d at 294.*