

Clashing Policies or Confusing Precedents: The "Gross Negligence" Exception to Consequential Damages Disclaimers

Michael Pillow

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CLASHING POLICIES OR CONFUSING PRECEDENTS:
THE “GROSS NEGLIGENCE” EXCEPTION TO
CONSEQUENTIAL DAMAGES DISCLAIMERS

MICHAEL PILLOW*

ABSTRACT

Consequential damages can easily amount to millions of dollars. Commercial parties often disclaim consequential damages in their contracts. This Article posits that such disclaimers between commercial parties under the Uniform Commercial Code (UCC) should not be found unenforceable based on gross negligence. Article 2 of the UCC promotes the policy of freedom of contract. Consistent with that policy, section 2-719 of the UCC provides that contractual consequential damages disclaimers should be enforceable absent a finding of unconscionability. This Article analyzes the interplay among UCC section 2-719, “public policy” exceptions to enforcing limitations of liability, and the law of gross negligence. This Article concludes that but for those rare circumstances in which a commercial buyer may invoke unconscionability, courts should uphold consequential damages disclaimers absent a clear showing of willful misconduct. This standard provides a more discernible “bright-line” that comports with the general treatment of economic losses under the UCC.

* Visiting Instructor, College of Law, Florida A&M University. He received his J.D. from the University of Pittsburgh School of Law and a B.A. from the University of Virginia. The author teaches Sales, Contracts Drafting, and Civil Procedure courses. He also has worked in the power generation industry for more than twenty years. The author especially wishes to acknowledge the gracious support, masterful critique, and invaluable editing performed by Attorney David H. Abrams of Longwood, Florida. The author also thanks Professor John Duncan of FAMU College of Law and Chris Flynn, corporate counsel at Siemens Energy, Inc., for their helpful comments and insights.

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INTRODUCTION

There are several points that have attained clarity regarding the enforceability of limitations of liability under the Uniform Commercial Code (UCC). Most importantly, agreed risk allocations under section 2-719 between sophisticated business entities are generally upheld. One notable exception to this point stems from “public policy” considerations, essentially arising from a seller’s alleged willful misconduct, gross negligence, or similar wrongful acts.¹ A second clear point is that courts may apply the unconscionability doctrine to overturn grossly unfair contract terms, including consequential damages disclaimers or other liability limitations.² This doctrine is largely restricted to the consumer or unsophisticated buyer context. A third point attaining clarity is that case decisions dealing specifically with sales of goods under Article 2 differ only somewhat from cases applying the common law.

At least two points remain unsettled. A split of authority still exists regarding whether a limited remedy that “fails of its essential purpose” also invalidates a consequential damages disclaimer or other monetary limitation on damages.³ Further, this Article posits that court decisions reflect dissonance, if not outright confusion, on what types of “bad acts” can negate an otherwise valid limitation on public policy grounds. One principal problem concerns the legal line of demarcation between gross negligence and intentional misconduct. Some courts use gross negligence or any conduct greater than ordinary negligence.⁴ Others employ such terms as recklessness, reckless disregard, or bad faith.⁵

Refusing to enforce commercial limitations of liability based on a nebulous concept of gross negligence clearly appears to conflict with the ascendant policy of freedom of contract.⁶ Such refusals are also inconsistent with both the text and purpose of section 2-719 and associated UCC provisions.⁷

This Article explores the primary impediments to enforcing a seller’s contractual limitations of liability in the commercial setting. It focuses on consequential damage disclaimers under the UCC. This Article suggests

¹ See generally RESTATEMENT (SECOND) OF CONTRACTS § 195 (1979).

² See U.C.C. § 2-719 (2012).

³ See *Fiorito Bros. v. Fruehauf Corp.*, 747 F.2d 1309, 1314 (9th Cir. 1984).

⁴ See *NMP Corp. v. Parametric Tech. Corp.*, 958 F. Supp. 1536, 1546 (N.D. Okla. 1997).

⁵ See *Marriott Corp. v. Chesapeake & Potomac Tel. Co.*, 723 A.2d 454, 462 (Md. Ct. Spec. App. 1998).

⁶ See *Colnaghi, U.S.A., Ltd. v. Jewelers Prot. Servs., Ltd.*, 611 N.E.2d 282, 283–84 (N.Y. 1993).

⁷ See U.C.C. § 2-719.

that, except in those rare circumstances in which a buyer may invoke unconscionability, courts should uphold consequential damages disclaimers per the contract terms, absent a clear showing of willful misconduct, that is, intentional “bad acts” by the seller. This standard provides a much more discernible “bright-line” test for courts to apply. Numerous federal and state cases demonstrate beyond cavil that the law affords no consistent conception of gross negligence.⁸ Unenforceability based on gross negligence also runs counter to established precedents limiting recovery of economic losses in tort. The analysis recommended here also accords with the better-reasoned cases’ conclusion that a failure of essential purpose does not automatically invalidate a consequential damages disclaimer.

To illustrate the importance of this issue, imagine the following realistic scenario. Two large, sophisticated companies negotiate a multimillion-dollar contract for supplying complex equipment and ancillary installation services.⁹ The contract includes a limitation of liability consistent with the particular industry’s standards. During negotiations, the buyer seeks to include an exclusion or exception to the limitation for any situation involving the seller’s gross negligence. Seller begrudgingly assents only if the parties could agree on a definition for gross negligence. The seller’s counsel drafts a definition essentially requiring “intentional” acts, which the buyer declines. Ultimately, the parties consciously leave out any reference regarding gross negligence in the liability limitation. During the course of seller’s performance, the seller’s product malfunctions numerous times. The seller responds to buyer’s warranty claims, and is finally able to make the product work after many months and several repairs. Meanwhile, the buyer suffers lost profits, business interruption, and other economic losses far exceeding the contract price. It seeks to avoid all limitations, particularly the consequential damages disclaimers, based on seller’s gross negligence in manufacturing and equipment installation. Under current law in most United States jurisdictions, the buyer might prevail.

I. LIMITATIONS OF LIABILITY UNDER THE UCC

UCC section 2-719 expressly allows parties to agree on contractual limitations to the remedies otherwise afforded to the parties under the respective

⁸ See *Smith v. Wade*, 461 U.S. 30, 72 (1983) (Rehnquist, J., dissenting).

⁹ Contracts involving both goods and services are considered “hybrid” contracts that are analyzed as to whether the UCC applies under either the “predominant purpose” test (majority rule) or the “gravamen of the action” test (minority approach). See JAMES J. WHITE & ROBERT S. SUMMERS, *PRINCIPLES OF SALES LAW* § 2-1, at 32–33 (2009) [hereinafter *WHITE & SUMMERS, PRINCIPLES*].

UCC provisions.¹⁰ Such limitations can take various forms, including use of liquidated damages in certain instances.¹¹ Probably the two most common means for a seller to limit its liability in commercial contracts consist of limitations on the total amount of recoverable damages (commonly referred to as “caps”) and “consequential damages disclaimers.”¹² A somewhat simplified sample limitation may be drafted along the following lines:

Seller is not liable to Buyer, whether as a result of breach of contract, warranty, indemnity, tort (including negligence), strict liability or otherwise for

(a) lost profits or revenues, business loss or interruption, claims of Buyer’s customers, or for any special, consequential, incidental, indirect or punitive damages, or

(b) any amounts in excess of the contract price paid to Seller.

The foregoing limitations of liability do not apply in the case of liabilities arising from Seller’s willful misconduct or fraud.

A few points about this language should be noted. First, the limitation attempts to shield the Seller from liability under some specific legal bases

¹⁰ U.C.C. § 2-719 provides as follows:

§ 2-719. Contractual Modification or Limitation of Remedy.

Subject to the provisions of subsections (2) and (3) of this section and of the preceding section on liquidation and limitation of damages, 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 recoverable under this Article, 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 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.

Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act.

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

U.C.C. § 2-719 (2012).

¹¹ *See id.*

¹² *See id.* Liability limits are much more relevant to a seller. First, sellers cannot normally seek consequential damages under section 2-715. WHITE & SUMMERS, PRINCIPLES, *supra* note 9, § 8-16, at 457. Second, a buyer’s “performance” will primarily consist of payment. Buyers may sometimes have additional obligations, such as transportation of goods, providing access to their factory or affording certain technical assistance. In these instances, buyers may seek “reciprocal” limitations of liability. These pose additional challenges, since they could be applied to the payment obligations as well.

as well as “otherwise.” The latter term may serve as shorthand for “any other legal theory.” Courts tend to interpret limitations of liability strictly, and at least require that the limiting language cover the specific claims raised in a lawsuit brought by a disgruntled buyer.¹³ For example, to enhance enforceability, if a buyer sues based on a negligence theory, a seller’s limitation should contain that word in the disclaimer.

Second, the disclaimer mentions specific categories of damages (typically those relevant to the particular product, contract, or industry) along with general categories. Fundamentally, the disclaimer intends to restrict a buyer to what one may consider “direct” damages. It also covers more than “consequential” damages. General damages terms may be interpreted in various ways. For example, the dividing line between “incidental” and “consequential” is not always clear.¹⁴ Even “lost profits” may be considered “direct” rather than “consequential” in certain circumstances.¹⁵

Third, the limitation of liability carves out fraud and willful misconduct. Such actions by a seller may render the limitation unenforceable in court as discussed below.¹⁶ Sellers and their counsel perhaps reasonably conclude that a court will more likely enforce the limitation if such recognized exceptions have been explicitly accepted.

A buyer challenging a consequential damages disclaimer must first establish that consequential damages may be claimed.¹⁷ Although the UCC uses different language for consequential damages than the basic common law “foreseeability” test, courts have generally employed the familiar test under the Code nonetheless.¹⁸ In the large majority of business disputes

¹³ See, e.g., *New Light Co. v. Wells Fargo Alarm Servs.*, 525 N.W.2d 25, 31 (Neb. 1994); *Great N. Ins. Co. v. ADT Sec. Servs., Inc.*, 517 F. Supp. 2d 723, 752 (W.D. Pa. 2007).

¹⁴ See *Firwood Mfg. Co. v. Gen. Tire, Inc.*, 96 F.3d 163, 173 (6th Cir. 1996) (interest charges).

¹⁵ See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 10-2, at 375–76 (5th ed. 2006); *Penncro Assocs., Inc. v. Sprint Spectrum, L.P.*, 499 F.3d 1151, 1156 (10th Cir. 2007). The *Penncro* court cited an example of a services contract where a party expected a profit as part of the benefit of its bargain. *Id.* One may also consider breaches of confidentiality or intellectual property agreements as involving more direct claims for lost profits.

¹⁶ See *infra* notes 53–71 and accompanying text.

¹⁷ See Thomas Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to Hadley v. Baxendale*, 63 *FORDHAM L. REV.* 665, 667–69 (1994).

¹⁸ See *id.* at 670–71. The authors of *Consequential Damages Alternative* address concerns with the ambiguous and inflexible standard of *Hadley v. Baxendale*. They propose a trifurcated approach to consequential damages claims, taking into account various policy considerations and the level of a seller’s knowledge of the consequences of breach. This would serve as a “default” approach when the parties have not contractually allocated the risk of consequential damages. Hence, their recommendations do not seem inconsistent with the primary tenets of this Article.

between sophisticated entities, a buyer should readily overcome this initial hurdle inasmuch as a seller would presumably recognize such implications of a breach.

A buyer may then dispute a limitation on the basis that it is unconscionable. Under UCC section 2-719, “[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable.”¹⁹ Unconscionability is measured at the time of contracting under section 2-302.²⁰ As one commentator has suggested, “[a] principled application of unconscionability must strike a balance between the need for fairness and the need for certainty.”²¹ The most widely accepted test for unconscionability involves both procedural and substantive aspects: “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”²²

Sample language along the lines shown above may exist in a seller’s standard terms or may result from negotiations. Unquestionably, a seller stands a better chance at enforcing negotiated terms rather than boilerplate terms, even putting aside battle of forms scenarios.²³ With standard terms, a buyer may concoct stronger arguments based on lack of meaningful choice and unreasonable contract terms. In commercial cases, this doctrine has been applied sparingly as courts rationalize that parties have relatively equal bargaining power.²⁴

Public Service Co. of New Hampshire v. Westinghouse Electric Corp. (*PSNH*) exemplifies the courts’ reluctance to find limitations of liability unconscionable in a commercial setting.²⁵ In *PSNH*, the buyer asserted that “standard” contractual limitations were unconscionable because such terms were “forced” on it due to disparity in bargaining positions, owed in part to the “duopolistic” nature of the industry at that time.²⁶ The federal district court rejected this contention, initially questioning the doctrine’s applicability in a commercial contract involving millions of dollars.²⁷ It indicated that

¹⁹ U.C.C. § 2-719 (2012).

²⁰ *Id.* § 2-302.

²¹ Jane P. Mallor, *Unconscionability in Contracts Between Merchants*, 40 Sw. L.J. 1065, 1085 (1986).

²² *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965).

²³ See Jonathan A. Eddy, *On the “Essential” Purposes of Limited Remedies: The Metaphysics of UCC Section 2-719(2)*, 65 CALIF. L. REV. 28, 80 n.179 (1977).

²⁴ See, e.g., *K & C, Inc. v. Westinghouse Elec. Corp.*, 263 A.2d 390, 393 (Pa. 1970); WHITE & SUMMERS, *PRINCIPLES*, *supra* note 9, § 13-11, at 710.

²⁵ *Pub. Serv. Co. of N.H. v. Westinghouse Elec. Corp.*, 685 F. Supp. 1281, 1288–89 (D.N.H. 1988).

²⁶ *Id.* at 1288.

²⁷ *Id.*

standard terms could be used without rendering them invalid.²⁸ Moreover, the court found that both parties were sizable business entities, who had arrived at contract terms after months of negotiations.²⁹ As another court found in rejecting unconscionability defenses, “the buyer was hardly the sheep keeping company with wolves that it would have us believe.”³⁰

Thus, it appears that an argument against limitations of liability based directly on unconscionability will most likely be dead on arrival, absent unique circumstances. An indirect approach to avoiding consequential damages disclaimers has been derived from the section 2-719 language dealing with failure of essential purpose.³¹

II. STRIKING DISCLAIMERS BASED ON FAILURE OF ESSENTIAL PURPOSE

Although the UCC generally allows limited remedies, exclusivity may not apply to the extent that “circumstances cause an exclusive or limited remedy to fail of its essential purpose.”³² Courts construe this language to operate when either party has been deprived of the substantial value of its bargain.³³ The most common scenarios involve a seller’s inability or unwillingness to effect warranty repairs within a reasonable time.³⁴ The seller’s negligence or bad faith is not considered relevant to this aspect of the issue.³⁵

Case law reflects greater discord on the further question of whether a finding of “failure of essential purpose” also negates the consequential damages disclaimer.³⁶ In simple terms, buyers argue that a failure of essential purpose entitles them to all Article 2 remedies, one of which is consequential damages.³⁷ The counterargument is that these provisions are

²⁸ *Id.*

²⁹ *Id.*

³⁰ *K & C, Inc. v. Westinghouse Elec. Corp.*, 263 A.2d 390, 393 (Pa. 1970).

³¹ U.C.C. § 2-719 (2012).

³² *Id.*

³³ *See, e.g., Transp. Corp. of Am., Inc. v. Int’l Bus. Mach. Corp.*, 30 F.3d 953, 959 (8th Cir. 1994); *see also Eddy, supra* note 23, at 38; John E. Murray, Jr., *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1, 46 (1969). *See generally* Roy Ryden Anderson, *Failure of Essential Purpose and Essential Failure on Purpose: A Look at Section 2-719 of the Uniform Commercial Code*, 31 SW. L.J. 759, 766 (1977).

³⁴ *See Transp. Corp. of Am.*, 30 F.3d at 959; *Eddy, supra* note 23, at 29; *Murray, supra* note 33, at 51; *Anderson, supra* note 33, at 768; *Beal v. Gen. Motors Corp.*, 354 F. Supp. 423, 425 (D. Del. 1973).

³⁵ *See Chatlos Sys., Inc. v. Nat’l Cash Register Corp.*, 635 F.2d 1081, 1085 (3d Cir. 1980); *S. M. Wilson & Co. v. Smith Int’l, Inc.*, 587 F.2d 1363, 1374–75 (9th Cir. 1978).

³⁶ *See Fiorito Bros. v. Fruehauf Corp.*, 747 F.2d 1309, 1314 (9th Cir. 1984).

³⁷ *See id.* at 1315; *Soo Line R.R. v. Fruehauf Corp.*, 547 F.2d 1365, 1373 (8th Cir. 1977).

independent and should be construed separately.³⁸ A third approach relies on a case-by-case assessment.³⁹

One commentator recently conducted an extensive analysis of the UCC language and case law.⁴⁰ He suggests that “[c]onsequential damages should be available when a limited or exclusive remedy fails of its essential purpose (1) only if the parties have not waived them for breach of warranty and/or breach of contract and (2) only as of the date the essential purpose of the limited remedy fails.”⁴¹ This proposal clearly merits consideration because it would provide a potential means for reconciling the disparate approaches while promoting freedom of contract. It appears that no court has yet adopted this approach.⁴² Pending such a development, results will vary depending on the jurisdiction and factual setting, with much of the case law arising in the federal courts.⁴³

This Article posits that courts that view sections 2-719(2) and (3) independently proffer the best analysis consistent with freedom of contract. As the Third Circuit Court of Appeals stated:

The limited remedy of repair and a consequential damages exclusion are two discrete ways of attempting to limit recovery for breach of warranty.... The Code, moreover, tests each by a different standard. The former survives unless it fails of its essential purpose, while the latter is valid unless it is unconscionable.... We therefore see no reason to hold, as a general proposition, that the failure of the limited remedy provided in the contract, without more, invalidates a wholly distinct term in the agreement excluding consequential damages. The two are not mutually exclusive.⁴⁴

The court then analyzed the circumstances surrounding the discrete provisions and concluded that there was nothing unconscionable about enforcing the parties’ agreed risk allocation disclaiming consequential damages.⁴⁵ Unfortunately, the court left an opening during its analysis by stating that

³⁸ See *Chatlos Sys.*, 635 F.2d at 1086.

³⁹ See *Cole Energy Dev. Co. v. Ingersoll-Rand Co.*, 678 F. Supp. 208, 211 (C.D. Ill. 1988).

⁴⁰ See Robert J. Williams, *Getting What You Bargained For: How Courts Might Provide a Coherent Basis for Damages That Arise When Remedies Fail of Their Essential Purpose*, 5 VA. L. & BUS. REV. 131, 134 (2010).

⁴¹ *Id.* at 136.

⁴² Research has disclosed no cases citing Williams’ article.

⁴³ See Williams, *supra* note 40, at 135. One explanation for the preponderance of federal court decisions might be that commercial litigators prefer federal courts over state courts. Cases originally commenced in state courts can of course be removed to a cognizant federal court under 42 U.S.C. § 1441 et seq. (2012).

⁴⁴ *Chatlos Sys., Inc. v. Nat’l Cash Register Corp.*, 635 F.2d 1081, 1086 (3d Cir. 1980).

⁴⁵ See *id.* at 1087.

it was “not a case where the seller acted unreasonably or in bad faith.”⁴⁶ Some later courts have seized upon this language and suggested that a bad faith exception may apply.⁴⁷ If so, this would effectively require the case-by-case approach adopted by some courts as mentioned above. Other courts have dismissed this contention on the basis that the question of “good faith” or “bad faith” constitutes an entirely separate question under the UCC.⁴⁸ Therefore, the uncertain role that “bad faith” may play further clouds the enforceability of consequential damages disclaimers.

The conclusion that a consequential damages disclaimer may survive a “failure of essential purpose” does not necessarily extend to other liability limitations. Section 2-719(3) only mentions consequential damages.⁴⁹ In a typical situation, such as our initial scenario, a seller undertakes warranty repairs at its cost. A seller may incur repair costs, which would probably be considered “direct” rather than consequential in nature.⁵⁰ If a court finds that a warranty has failed of its essential purpose, a seller may not be able to invoke its “cap” on liability for such direct costs and could therefore have unlimited liability to effect repairs.⁵¹ In short, the second part of the sample limitation above would not be enforced.

This resolution—allowing a buyer unlimited repair costs but no lost profits or other consequential damages—may not fully compensate a buyer, especially one whose product is never fixed. However, in situations entailing significant technical, technological, or commercial risks, the parties remain free to tailor their contracts to the situation.⁵² A seller spending inordinate sums effecting repairs will have ample incentives to make accommodations. In some circumstances, a seller must also recognize that public policy may still limit its limitations.

III. THE “PUBLIC POLICY” EXCEPTION FOR LIMITATIONS OF LIABILITY

The common law refuses to enforce exculpatory clauses in contracts in which enforcement would violate public policy.⁵³ As expressed by the

⁴⁶ *Id.*

⁴⁷ *See* Canal Elec. Co. v. Westinghouse Elec. Corp., 548 N.E.2d 182, 187 n.6 (Mass. 1990).

⁴⁸ *See* Bray Int’l, Inc. v. Computer Assocs. Int’l, Inc., No. CIV H-02-0098, 2005 WL 3371875, at *4 (S.D. Tex. 2005).

⁴⁹ *See* U.C.C. § 2-719 (2012).

⁵⁰ *See, e.g.*, Am. Elec. Power Co. v. Westinghouse Elec. Corp., 418 F. Supp. 435, 459–60 (S.D.N.Y. 1976).

⁵¹ *See id.*

⁵² *See, e.g.*, Chatlos Sys., Inc. v. Nat’l Cash Register Corp., 635 F.2d 1081, 1087 (3d Cir. 1980).

⁵³ *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 195 (1979).

New York Court of Appeals, “an exculpatory agreement, no matter how flat and unqualified its terms, will not exonerate a party from liability under all circumstances. Under announced public policy, it will not apply to exemption of willful or grossly negligent acts.”⁵⁴ Other courts have added an additional, related exception for contracts that are intrinsically tied to the public interest.⁵⁵ This “public policy” concept has been extended to contracts containing limitations of liability for a breach or other fault, as opposed to exempting or exculpating another party from any liability.⁵⁶

Courts have struggled with the public policy exception in several ways. As one court aptly summarized the fundamental tension, “[f]earing the disruptive effect that invocation of the highly elusive public policy principle would likely exert on the stability of commercial and contractual relations, Maryland courts have been hesitant to strike down voluntary bargains on public policy grounds.”⁵⁷ Further, courts sometimes confuse precedents discussing exculpatory clauses with those addressing liability limitations. This is evidenced in part by cases citing section 195 of the Restatement of Contracts that addresses only exemptions from liability, which in reality equate to exculpatory clauses.⁵⁸ Some courts fortunately recognize the distinction. “[W]hereas exculpatory clauses are generally disfavored by courts and subject to strict construction standards, limitation of liability clauses are not disfavored and are construed under the general rules applying to contract interpretation.”⁵⁹

As always, context matters. Much of the case law on exculpatory clauses developed outside the commercial sphere. In some consumer contexts, one cannot legally achieve complete exoneration, even for ordinary negligence.⁶⁰ It is relatively easier to understand a broad reluctance with pure exculpatory clauses, than any hesitation associated with limitations on remedies. Exculpatory clauses seek to shield a company from any liability.⁶¹

⁵⁴ *Kalisch-Jarcho v. City of New York*, 448 N.E.2d 413, 416 (N.Y. 1983).

⁵⁵ *See Md. Nat’l Capital Park & Planning Comm’n v. Wash. Nat’l Arena*, 386 A.2d 1216, 1229 (Md. 1978); *Wolf v. Ford*, 644 A.2d 522, 525 (Md. 1994).

⁵⁶ *See Sommer v. Fed. Signal Corp.*, 593 N.E.2d 1365, 1370–71 (N.Y. 1992).

⁵⁷ *Md. Nat’l Capital Park*, 386 A.2d at 1228.

⁵⁸ RESTATEMENT (SECOND) OF CONTRACTS § 195.

⁵⁹ *Royal Indem. Co. v. Sec. Guards, Inc.*, 255 F. Supp. 2d 497, 502 (E.D. Pa. 2003); *see also Great N. Ins. Co. v. ADT Sec. Servs., Inc.*, 517 F. Supp. 2d 723, 752 n.29 (W.D. Pa. 2007). Many of the decisions involving interpretations of limitation of liability provisions use the term “exculpatory” when referring to limitation of liability clauses. As noted above, this is a distinction with a very real difference, and has resulted in confusion and inconsistent results in the state appellate and federal district courts.

⁶⁰ *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 195 cmt. a.

⁶¹ *See, e.g., Roopchan v. ADT Sec. Sys., Inc.*, 781 F. Supp. 2d 636, 642 (E.D. Tenn. 2011); *Platt v. Gateway Int’l Motorsports Corp.*, 813 N.E.2d 279, 283 (Ill. App. Ct. 2004).

Limitations of liability, on the other hand, seek to do precisely what the term suggests: limit rather than exempt a company from liability.⁶² Many commercial contracts contain interrelated provisions concerning warranty limitations and exclusive remedies, in addition to liability limitations.⁶³ Although one may contend that the net collective effect of these provisions accomplishes much the same thing as an exculpatory clause, the two concepts cannot be considered equal.⁶⁴

When analyzing limitations of liability between sophisticated parties, courts focus on the conscious risk allocations.⁶⁵ Much of the case law developed from disputes in industries such as energy and power generation, computer systems, and building alarm systems.⁶⁶ One may often find a discernible, if not universally accepted, industry practice underpinning the express terms.⁶⁷

The UCC clearly allows limitations on the quantum of remedies, provided “that at least minimum adequate remedies [remain] available.”⁶⁸ Neither section 2-719(3) nor its associated comments mention public policy as a further constraint on consequential damages disclaimers.⁶⁹ Buyers, moreover, retain the right to claim non-consequential damages up to the limit contained in the contract.⁷⁰ Such damages may not satisfy a buyer that sustains significant economic harm. In response, buyers and their counsel have accordingly devised other theories to overcome contractual limitations, primarily by asserting tort claims.⁷¹

⁶² See generally WHITE & SUMMERS, PRINCIPLES, *supra* note 9, § 13-11, at 708.

⁶³ See *id.*

⁶⁴ *Great N. Ins. Co.*, 517 F. Supp. 2d at 749.

⁶⁵ For example, in *Canal Electric*, the court found that consequential damages disclaimers such as that used by Westinghouse constituted a norm in the power generation industry and represented “a reasonable accommodation between two commercially sophisticated parties.” *Canal Elec. Co. v. Westinghouse Elec. Corp.* 548 N.E.2d 182, 185 (Mass. 1990).

⁶⁶ With respect to the power generation industry, see *Arkwright-Boston Mfrs. Mut. Ins. Co. v. Westinghouse Elec. Corp.*, 844 F.2d 1174 (5th Cir. 1988); *Pub. Serv. Co. of N.H. v. Westinghouse Elec. Corp.*, 685 F. Supp. 1281 (D.N.H. 1981); *Am. Elec. Power Co. v. Westinghouse Elec. Corp.*, 418 F. Supp. 435 (S.D.N.Y. 1976); *Canal Elec.*, 548 N.E.2d at 182; *N.Y. State Elec. & Gas Corp. v. Westinghouse Elec. Corp.*, 564 A.2d 919 (Pa. Super. Ct. 1989). With respect to alarm systems, see *Am. Auto. Ins. Co. v. Rest Assured Alarm Sys., Inc.*, 786 F. Supp. 2d 798, 798, 802 (S.D.N.Y. 2011); *Great N. Ins. Co.*, 517 F. Supp. 2d at 723, 729, 735; *Synnex Corp. v. ADT Sec. Servs., Inc.*, 928 A.2d 37, 45 (N.J. Super. Ct. App. Div. 2007). See generally Marjorie A. Shields, *Validity, Construction, and Application of Exculpatory and Limitation of Liability Clauses in Burglary, Fire, and Other Home and Business Monitoring Service Contracts*, 36 A.L.R. 6TH 305 (2008).

⁶⁷ See *Southland Farms, Inc. v. Ciba-Geigy Corp.*, 575 So. 2d 1077, 1077–79 (Ala. 1991); *Canal Elec.*, 548 N.E.2d at 185–86.

⁶⁸ U.C.C. § 2-719 (2012).

⁶⁹ See *id.* § 2-719(3).

⁷⁰ See, e.g., *Canal Elec.*, 548 N.E.2d at 186.

⁷¹ See cases cited in *supra* note 66. In virtually all of these cases, tort claims were asserted.

IV. RESTRICTING ECONOMIC LOSS IN TORT

Against the backdrop of evolving products liability law nationwide, particularly strict liability under section 402A of the Restatement (Second) of Torts, courts confronted commercial claims arising out of contracts yet sounding in tort.⁷² Two watershed cases, the early California Supreme Court case of *Seely v. White Motor Co.*,⁷³ and the United States Supreme Court case *East River Steamship Corp. v. Transamerica Delaval, Inc.*,⁷⁴ addressed this duality and restricted contracting parties' capabilities of asserting claims for economic losses in tort.⁷⁵

Seely involved a rather straightforward claim for damages for repair costs, purchase price payments, and lost profits stemming from an accident involving a truck used for plaintiff's business.⁷⁶ The court upheld the trial court's ruling that the defendant manufacturer was liable for all but the repair costs based on a breach of express warranty.⁷⁷ The court declined to disturb the trial court's finding that the plaintiff had not proven that the product defect caused the physical damage.⁷⁸ More importantly, in arguable dicta, the court refused to apply strict liability, rather than UCC warranty law, to the plaintiff's claims, eloquently stating:

The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products. He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands. A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not match his economic expectations unless the manufacturer agrees that it will.⁷⁹

⁷² See *Seely v. White Motor Co.*, 403 P.2d 145, 147–48 (Cal. 1965); *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 859 (1986).

⁷³ See *Seely*, 403 P.2d 145.

⁷⁴ See *East River S.S. Corp.*, 476 U.S. 858.

⁷⁵ See *id.* at 868–69; *Seely*, 403 P.2d at 151.

⁷⁶ See *Seely*, 403 P.2d at 147–49.

⁷⁷ See *id.* at 152.

⁷⁸ See *id.*

⁷⁹ *Id.* at 151.

In *East River Steamship*, the United States Supreme Court applied what it termed the “majority land-based approach” represented by *Seely* to an admiralty claim for damage to a ship’s turbine.⁸⁰ The Supreme Court held “that a manufacturer in a commercial relationship has no duty under either a negligence or strict products-liability theory to prevent a product from injuring itself.”⁸¹ The Court rationalized that “[t]he increased cost to the public that would result from holding a manufacturer liable in tort ... is not justified.”⁸² *East River Steamship* strongly influenced subsequent decisions and solidified the use of the “economic loss” rule, with some variations among jurisdictions, to stem the tide of parties pursuing tort claims for economic losses, at least absent personal injury or property damage.⁸³

The trend is well represented by the Florida Supreme Court’s decision in *Florida Power & Light Co. v. Westinghouse Electric Corp.*⁸⁴:

We agree and find no reason to intrude into the parties’ allocation of risk by imposing a tort duty and corresponding cost burden on the public. We hold contract principles more appropriate than tort principles for resolving economic loss without an accompanying physical injury or property damage. The lack of a tort remedy does not mean that the purchaser is unable to protect himself from loss. We note the Uniform Commercial Code contains statutory remedies for dealing with economic losses under warranty law, which, to a large extent, would have limited application if we adopted the minority view. Further, the purchaser, particularly in a large commercial transaction like the instant case, can protect his interests by negotiation and contractual bargaining or insurance. The purchaser has the choice to forego warranty protection in order to obtain a lower price. We conclude that we should refrain from injecting the judiciary into this type of economic decision-making.⁸⁵

The “economic loss” rule acts as a trade-off in products liability claims. In exchange for the somewhat easier tort route afforded by strict liability and

⁸⁰ See *East River S.S. Corp.* 476 U.S. at 868, 870.

⁸¹ *Id.* at 871.

⁸² *Id.*

⁸³ See, e.g., *Jones v. Childers & Talent Servs., Inc.*, 18 F.3d 899, 904 (11th Cir. 1994); *Purvis v. Consol. Energy Prods. Co.*, 674 F.2d 217, 220 (4th Cir. 1982); *Jones & Laughlin Steel Corp. v. Johns-Manville Sales Corp.*, 626 F.2d 280, 287 (3d Cir. 1980); *Fla. Power & Light v. Westinghouse Elec. Corp.*, 510 So. 2d 899, 900, 902 (Fla. 1987); *Moorman Mfg. Co. v. Nat’l Tank Co.*, 435 N.E.2d 443, 446 (Ill. 1982); *Neibarger v. Universal Coops., Inc.*, 486 N.W.2d 612, 624–25 (Mich. 1992). For an excellent overall discussion of the “economic loss” doctrine, see Ralph A. Anzivino, *The False Dilemma of the Economic Loss Doctrine*, 93 MARQ. L. REV. 1121 (2010).

⁸⁴ *Fla. Power & Light*, 510 So. 2d at 901–02.

⁸⁵ *Id.* at 902. In *Tiara Condo. Ass’n v. Marsh & McLennan Cos.*, No. SC10-1022, 2013 WL 828003 (March 7, 2013), the Florida Supreme Court held that Florida’s economic loss rule applied only in the products liability context.

negligence for personal injuries and property damage, claimants with purely economic losses are relegated to warranty and other contract claims.⁸⁶ Courts have since wrestled with the types of tort claims barred from assertion in contract. Coverage for simple negligence is clear, at least absent property damage or “a substantial and unreasonable risk of death or personal injury.”⁸⁷ Other cases have found that misrepresentations, even if characterized as fraudulent, fall within the ambit of the “economic loss” rule at least insofar as they simply re-cast basic contract claims as opposed to alleging fraud in the inducement.⁸⁸ The outcome may hinge on whether or not the allegations amount to a separate and distinct tort.⁸⁹ Using the approach most courts follow, if intentional torts are covered, this Article maintains that ipso facto gross negligence claims should also be swept under the “economic loss” umbrella.

One commentator proposed adopting a “contract-first” approach to resolving conflicting tort and contract claims for economic loss, especially the “other property” exception.⁹⁰ This would arguably enhance the economic loss rule’s cardinal principles: “(1) to maintain the fundamental distinction between tort law and contract law; (2) to protect commercial parties’ freedom to allocate economic risk by contract; and (3) to encourage the party best situated to assess the risk [of] economic loss, the commercial [buyer], to assume, allocate, or insure against that risk.”⁹¹

Clearly, both these principles and the proposed solution appear laudable and fully consistent with UCC tenets.⁹² The commentator enumerates the safeguards justifying this approach.⁹³ These otherwise viable safeguards include ongoing protection against a seller’s gross negligence.⁹⁴ In contrast, this Article posits that gross negligence should not prevent enforceability of a consequential damages disclaimer.

⁸⁶ See *East River S.S. Corp.*, 476 U.S. at 871–76.

⁸⁷ *Potomac Constructors v. EFCO Corp.*, 530 F. Supp. 2d 731, 737 (D. Md. 2008) (quoting *Council of Co-Owners Atlantis Condo., Inc. v. Whiting-Turner Contracting Co.*, 517 A.2d 336, 345 (Md. 1986)); see also cases cited *supra* note 37.

⁸⁸ See *Imaging Fin. Servs., Inc. v. Lettergraphics/Detroit, Inc.*, 178 F.3d 1294, at *2 (6th Cir. 1999) (unpublished table decision); *Allmand Assocs., Inc. v. Hercules Inc.*, 960 F. Supp. 1216, 1216 (E.D. Mich. 1997).

⁸⁹ See *Action Orthopedics, Inc. v. Techmedica, Inc.*, 759 F. Supp. 1566, 1570 (M.D. Fla. 1991).

⁹⁰ See Anzivino, *supra* note 83, at 1128–30.

⁹¹ *Id.* at 1142 (quoting *Daanen & Janssen, Inc. v. Cedarapids, Inc.*, 573 N.W.2d 842, 846 (Wis. 1998)).

⁹² See *id.* at 1133.

⁹³ See *id.* at 1133–42.

⁹⁴ See *id.* at 1141–42. The article does not elaborate on the essential difference between exculpatory clauses and disclaimers or attempt to reconcile this view with the language of the UCC.

V. GROSS NEGLIGENCE AS A LIABILITY STANDARD

Gross negligence was originally conceived as involving either a great amount of negligence or a lack of even slight care.⁹⁵ The term may simply be described as “very careless.”⁹⁶ According to one commentator, some courts

have construed gross negligence as requiring willful, wanton, or reckless misconduct, or such utter lack of all care as will be evidence thereof But it is still true that most courts consider that “gross negligence” falls short of a reckless disregard of the consequences, and differs from ordinary negligence only in degree, and not in kind.⁹⁷

Indeed, many formulations equate gross negligence with some form of recklessness or conscious disregard.⁹⁸ Under North Carolina law for example, gross negligence “has the same basic elements as negligence, but requires either ‘intentional wrongdoing or deliberate misconduct affecting the safety of others,’ such as ‘when the act is done purposely and with knowledge that such act is a breach of duty to others.’”⁹⁹ Under Massachusetts law, gross negligence “falls short of being equivalent to a willful and intentional wrong.”¹⁰⁰ Louisiana’s related concept of “gross fault” has been equated with fraud.¹⁰¹

The United States Supreme Court discussed various liability standards for upholding punitive damages in a section 1983 action based on a showing of reckless disregard or indifference to a claimant’s federally protected rights.¹⁰² The Court noted the historical variation among the states in determining the proper liability standard for punitive damages, “exacerbated by the ambiguity and slipperiness of such common terms as ‘malice’ and ‘gross negligence.’”¹⁰³ The Court reviewed the standard articulated in prior cases since

⁹⁵ See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 34, at 211 (5th ed. 1984).

⁹⁶ See *Smith v. Wade*, 461 U.S. 30, 61, 73 (1983) (Rehnquist, J., dissenting).

⁹⁷ KEETON ET AL., *supra* note 95, § 34, at 212.

⁹⁸ See, e.g., *Marriott Corp. v. Chesapeake & Potomac Tel. Co.*, 723 A.2d 454, 462 (Md. Ct. Spec. App. 1998); *Metro. Life Ins. Co. v. Noble Lowndes Int’l, Inc.*, 643 N.E.2d 504, 506, 508 (N.Y. 1994).

⁹⁹ *Boykin Anchor Co. v. AT&T Corp.*, 825 F. Supp. 2d 706, 712 n.6 (E.D.N.C. 2011).

¹⁰⁰ *Lumbermens Mut. Cas. Co. v. Grinnell Corp.*, 477 F. Supp. 2d 327, 334 (D. Mass. 2007) (citing *Altman v. Aronson*, 231 Mass. 588, 591–92 (1919)).

¹⁰¹ See *Occidental Chem. Corp. v. Elliott Turbomachinery Co.*, 84 F.3d 172, 177 (5th Cir. 1996). Here the court found limitations of liability in a warranty clause invalid under a Louisiana statute and relied in large measure on a law review article that provided much of the basis for drafting the statute. See Saul Litvinoff, *Stipulations as to Liability and as to Damages*, 52 TUL. L. REV. 258, 279 (1978).

¹⁰² See *Smith v. Wade*, 461 U.S. 30, 33 (1983).

¹⁰³ *Id.* at 39.

those cases conflicted as to whether the vague term “gross negligence” could serve as the basis for punitive damages.¹⁰⁴ Chief Justice Rehnquist’s strong dissenting opinion urged a requirement of “wrongful intent” to resolve the conflict; gross negligence, however defined, set too amorphous a standard for courts to apply.¹⁰⁵

To resolve concerns such as those of Chief Justice Rehnquist, a few states have enacted statutory definitions. Texas law requires both an extreme degree of risk and an actual, subjective awareness by the actor.¹⁰⁶ Michigan applies a simpler formulation to support governmental tort immunity: “conduct so reckless as to demonstrate a substantial lack of concern for whether an injury results.”¹⁰⁷ Oklahoma’s statutory scheme provides a general definition for gross negligence: that it “consists ... in the want of slight care and diligence.”¹⁰⁸

The Oklahoma Supreme Court cited and quoted the Oklahoma statute in a case involving allegations of gross negligence, elaborating that

[t]he intentional failure to perform a manifest duty in reckless disregard of the consequences or in callous indifference to the life, liberty or property of another, may result in such a gross want of care for the rights of others and of the public that the finding of a willful, wanton, deliberate act is justified.¹⁰⁹

A subsequent federal court decision characterized this statement as an “expounding” of the definition, concluding, “gross negligence is the same as

¹⁰⁴ *See id.*

¹⁰⁵ *See id.* at 57 (Rehnquist, J., dissenting).

¹⁰⁶ *See* TEX. CIV. PRAC. & REM. CODE ANN. § 41.001 (West 2003). This statute provides in pertinent part:

- (11) “Gross negligence” means an act or omission:
- (A) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and
 - (B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others.

Id.

¹⁰⁷ MICH. COMP. LAWS § 691.1407 (2012). This statute provides in pertinent part:

- (7) As used in this section:
- (a) “Gross negligence” means conduct so reckless as to demonstrate a substantial lack of concern for whether an injury results.

Id.

¹⁰⁸ OKLA. STAT. tit. 25, § 6 (2012).

¹⁰⁹ *Fox v. Okla. Mem’l Hosp.*, 774 P.2d 459, 461 (Okla. 1989).

[an ordinary] negligence claim, differing only as to the degree.”¹¹⁰ Although the latter phrase certainly meshes with the statutory definition, the language in these cases blurs the distinction between negligent acts and intentional, deliberate, or willful actions, contrary to fundamental tort precepts.

Two Oklahoma cases involving oil well locations illustrate how courts apply Oklahoma law to alleged gross negligence actions.¹¹¹ In one case, the court found that drilling a well within defined boundaries without notifying the other party did not constitute gross negligence although such action could constitute ordinary negligence.¹¹² The court distinguished a prior case where a driller relocated a well staked at a specific location without giving notice and later attempted to hide its actions.¹¹³ The later court differentiated between apparent inadvertence and a seemingly intentional act.¹¹⁴

Although gross negligence can serve as a basis for tort liability, its status as a separate cause of action varies among the states.¹¹⁵ In some instances, the concept of “gross negligence” has been abandoned in connection with adoption of a comparative negligence scheme.¹¹⁶ A majority of states have passed comparative negligence statutes, potentially obviating the need for a separately available gross negligence claim.¹¹⁷

Many cases involving gross negligence involve alarm systems. Plaintiffs often allege gross negligence in order to overcome a contractual limitation of liability excluding gross negligence.¹¹⁸ New York courts articulated a more stringent standard in the limitation of liability context, where “[g]ross negligence ... is defined as conduct that evinces a reckless disregard for the rights of others or smacks of intentional wrongdoing. To constitute gross negligence, the act or omission must be of an aggravated character, as distinguished from the failure to exercise ordinary care.”¹¹⁹ Under this heightened standard, allegations such as inappropriate installation, inspection failures, and inadequate responses represent nothing more than ordinary negligence.¹²⁰

¹¹⁰ *NMP Corp. v. Parametric Tech. Corp.*, 958 F. Supp. 1536, 1546 (N.D. Okla. 1997).

¹¹¹ *See Palace Exploration Co. v. Petroleum Dev. Co.*, 374 F.3d 951, 951 (10th Cir. 2004); *Hamilton v. Tex. Oil & Gas Corp.*, 648 S.W.2d 316, 316 (Tex. App. 1982).

¹¹² *See Palace Exploration*, 374 F.3d at 954.

¹¹³ *See Hamilton*, 648 S.W.2d at 323–24.

¹¹⁴ *See Palace Exploration*, 374 F.3d at 954–55.

¹¹⁵ *See, e.g., Hanks v. Powder Ridge Rest. Corp.*, 885 A.2d 734, 747–48 (Conn. 2005).

¹¹⁶ *See, e.g., Biegas v. Quickway Carriers, Inc.*, 573 F.3d 365, 372 (6th Cir. 2009).

¹¹⁷ *See, e.g., id.; Hanks*, 885 A.2d at 747–48.

¹¹⁸ *See Shields*, *supra* note 66, § 2.

¹¹⁹ *Am. Auto. Ins. Co. v. Rest Assured Alarm Sys., Inc.*, 786 F. Supp. 2d 798, 807 (S.D.N.Y. 2011) (quoting *Travelers Indem. Co. of Conn. v. Losco Grp., Inc.*, 204 F. Supp. 2d 639, 644 (S.D.N.Y. 2002) (internal quotations & citations omitted)).

¹²⁰ *See id.* at 807–08.

Application of the heightened standard sometimes results in summary judgment based on the limitation of liability clause.¹²¹ Where the plaintiff claimed that a burglar alarm company's failure to wire a skylight properly constituted gross negligence, the New York court upheld summary judgment, indicating that such failure, "while perhaps suggestive of negligence or even 'gross negligence' as used elsewhere, does not evince the recklessness necessary to abrogate [an] agreement to absolve [the alarm company] from negligence claims."¹²² Likewise, the New York Court of Appeals upheld a broad limitation of liability that excluded gross negligence.¹²³ The court concluded that the defendant's actions were motivated by economic self-interest, which was insufficient to support the reckless disregard "smack[ing] of intentional wrongdoing" standard necessary to vitiate the limitation of liability.¹²⁴ In other words, facts that might otherwise warrant a finding of "gross negligence" will not suffice to overturn a negotiated limitation of liability. This stricter standard has not been consistently applied, however, even in New York.¹²⁵

Suffice it to say, based on the examples provided above, there is no clearly established definition of "gross negligence." Court cases do not even suggest "you know it when you see it" in all situations.¹²⁶ Whether particular conduct supports a finding of gross negligence is normally a question of fact.¹²⁷ Leaving a decision as to the enforceability of such a provision as critical as consequential damages disclaimers to case-by-case analysis hardly creates the level of certainty sought by contracting parties.

¹²¹ See, e.g., *id.* at 808.

¹²² *Colnaghi, U.S.A., Ltd. v. Jewelers Prot. Servs., Ltd.*, 611 N.E.2d 282, 284 (N.Y. 1993).

¹²³ See *Metro. Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 643 N.E.2d 504, 505–06 (N.Y. 1994).

¹²⁴ See *id.* at 509.

¹²⁵ See *Net2Globe Int'l, Inc. v. Time Warner Telecom of N.Y.*, 273 F. Supp. 2d 436, 450 (S.D.N.Y. 2003); *Metro. Life Ins. Co.*, 643 N.E.2d at 509; *cf. Apache Bohai Corp. v. Texaco China BV*, 480 F.3d 397 (5th Cir. 2007); *Sommer v. Fed. Signal Corp.*, 593 N.E.2d 1365, 1370–71 (N.Y. 1992). The *Apache Bohai* court upheld an arbitration award where the "arbitrator found that clause unenforceable as against public policy because Apache (1) acted with reckless disregard for Texaco's rights; (2) intentionally abandoned the contract; and (3) breached a fundamental obligation of the contract." 480 F.3d at 406. The key to this case may have been the limited review of an arbitrator's decision confirmed by a district court.

¹²⁶ *Cf. Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring). Justice Stewart declined to define the limits of hardcore pornography, famously saying "I know it when I see it." *Id.*

¹²⁷ See *Net2Globe*, 283 F. Supp. 2d at 450.

VI. TOWARD FREEDOM OF CONTRACT,
CONSISTENCY, AND A BRIGHTER LINE

Undoubtedly, freedom of contract represents a vital underpinning of both our legal and commercial systems.¹²⁸ Consequential damages can easily reach millions of dollars.¹²⁹ A plant or business that suffers significant downtime, business interruption, or lost profits, especially over an extended period of time, can often justifiably claim exorbitant amounts.¹³⁰ A seller may reasonably foresee this quantum of damages, but most sellers are not likely positioned to absorb them.¹³¹ Therefore, consequential damages limitations clearly form a material part of a company's risk analysis. Should a company be able to rely on the negotiated waiver language unless it has intentionally caused the complained harm? This Article argues that it should, for the reasons that follow.

Based on an examination of section 2-719's text, one would not be inclined to surmise that gross negligence, or even intentional acts, should defeat a properly negotiated limitation of liability. The section plainly states, "[c]onsequential damages may be limited or excluded unless the limitation or exclusion is unconscionable."¹³² Comment 3 buttresses the conclusion that unconscionability constitutes the only statutory test, since "such terms are merely an allocation of unknown or undeterminable risks."¹³³ As established earlier in this Article, unconscionability findings remain "rare" in the commercial setting, and such claims should be subjected to a "hard-headed analysis."¹³⁴

¹²⁸ The United States Supreme Court has underscored this principle's importance by suggesting that the due process clause retains vitality to protect contract rights. *See* *Washington v. Glucksberg*, 521 U.S. 702, 760 (1997) (Souter, J., concurring) (quoting *Allgeyer v. Louisiana*, 165 U.S. 578, 589 (1897)); *Bd. of Regents of State Colls. v. Roth*, 408 U.S. 564, 576–77 (1972); *see also* Steven W. Feldman, *Autonomy and Accountability in the Law of Contracts: A Response to Professor Shiffrin*, 58 *DRAKE L. REV.* 177, 222 n.220 (2009).

¹²⁹ *See* *N.Y. State Elec. & Gas v. Westinghouse Elec. Corp.*, 564 A.2d 919, 922–23 (Pa. Super. Ct. 1989) (the plaintiff alleging that losses from a generator forced to be off-line for over three months caused damages in excess of eight million dollars).

¹³⁰ *See id.*

¹³¹ *See* *Metro. Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 643 N.E.2d 504, 508 (N.Y. 1994) (noting that the seller "would be under inordinate economic pressure to complete performance, being at risk of incurring liability for consequential damages in sums ... many times greater than the gross contract price" without a clause limiting liability).

¹³² U.C.C. § 2-719(3) (2012); *see* *Posttape Assocs. v. Eastman Kodak Co.*, 537 F.2d 751, 756–57 (3d Cir. 1976).

¹³³ U.C.C. § 2-719 cmt. 3.

¹³⁴ WHITE & SUMMERS, *PRINCIPLES*, *supra* note 9, § 13-11, at 710.

Various cases support such a strict textual reading, by adopting an “independent approach” when evaluating “failure of essential purpose.”¹³⁵ The courts reason that warranty repair remedies and consequential damage waivers represent discrete means of handling risks, as measured by different standards.¹³⁶ In other words, the consequential damages waiver stands on its own merits for evaluations based on unconscionability.¹³⁷ No equivalent standard exists for caps. Because commercial disputes typically involve performance or warranty issues, it may make sense that a company must spend amounts over the cap in order to make a product work.

What then provides the basis for courts to overturn consequential damages disclaimers based on public policy? One answer stems from the UCC’s preservation of supplemental principles of law, including contract law, “[u]nless displaced by the particular provision[s].”¹³⁸ Nevertheless, some courts have explicitly or implicitly found that section 2-719 displaces the common law regarding the enforceability of limitation of liability clauses.¹³⁹ If so, courts should not maintain a “public policy” exception to enforceability, which is unsupported by the UCC language, especially insofar as such a policy fails to distinguish between exculpatory clauses and liability limitations.

Several cases applying Pennsylvania law support the analyses recommended in this Article.¹⁴⁰ The Pennsylvania Superior Court upheld consequential damages limitations in *New York State Electric & Gas Corp. v. Westinghouse Electric Corp. (NYSEG)*.¹⁴¹ In *NYSEG*, the plaintiff sought to recover lost profits and replacement power costs on various theories, including negligence, allegedly caused by a defective Westinghouse turbine generator.¹⁴² The court upheld the trial court’s ruling that the claims for these consequential damages were barred due to the express contractual limitation of liability as well as the economic loss rule.¹⁴³ The court provided a simple

¹³⁵ *Chatlos Sys., Inc. v. Nat’l Cash Register Corp.*, 635 F.2d 1081, 1086 (3d Cir. 1980); see also *Williams*, *supra* note 40, at 135.

¹³⁶ See *Chatlos Sys.*, 635 F.2d at 1086; see also *Williams*, *supra* note 40, at 135.

¹³⁷ See *Chatlos Sys.*, 635 F.2d at 1086.

¹³⁸ U.C.C. § 1-103(b) (2012). As the comments discuss, this section was amended to clear up some confusion concerning the relationship between the UCC and the common law of contracts.

¹³⁹ See *McNally Wellman Co. v. N.Y. State Elec. & Gas Corp.*, 63 F.3d 1188, 1196 (2d Cir. 1995); *N.Y. State Elec. & Gas Corp. v. Westinghouse Elec. Corp.*, 564 A.2d 919, 929 (Pa. Super. Ct. 1989).

¹⁴⁰ See, e.g., *Great N. Ins. Co. v. ADT Sec. Servs., Inc.*, 517 F. Supp. 2d 723, 753 (W.D. Pa. 2007); *Valeo v. Pocono Int’l Raceway, Inc.*, 500 A.2d 492, 493 (Pa. Super. Ct. 1985).

¹⁴¹ *N.Y. State Elec.*, 564 A.2d at 920, 930.

¹⁴² See *id.* at 923.

¹⁴³ See *id.* at 926.

and straightforward analysis: “[T]he parties specifically allocated the risks of uncertain events and consequences, including the risk that the generator would be out of service for some time, by agreeing to a limitation on Westinghouse’s liability.”¹⁴⁴

Courts have also expressly confronted the significant difference between exculpatory clauses and liability limitations.¹⁴⁵ Rejecting a buyer’s attempt to impose strict scrutiny, an appellate court was

persuaded that limitation of liability clauses are not disfavored under Pennsylvania law; especially when contained in contracts between informed business entities dealing at arm’s length, and there has been no injury to person or property. Furthermore, such clauses are not subjected to the same stringent standards applied to exculpatory and indemnity clauses.¹⁴⁶

As the subsequent federal case *Great Northern Insurance Co. v. ADT Security Services, Inc.*¹⁴⁷ confirmed, Pennsylvania courts evaluate each limitation of liability based on a three part test to determine whether the clause: “(1) does not violate public policy; (2) is part of a contract between private parties and relates solely to their private affairs; and (3) is not a contract of adhesion.”¹⁴⁸

Great Northern engaged in the well-reasoned analysis advocated by this author, albeit under the common law rather than the UCC.¹⁴⁹ After finding the limitation of liability generally enforceable, it addressed the plaintiff’s contention that the clause’s limitation—restricting the plaintiff to \$1000—should *not* apply to situations involving gross negligence.¹⁵⁰ The court distinguished various precedents either dealing with exculpatory clauses or analyzing limitations of liability as exculpatory clauses.¹⁵¹ The court concluded that Pennsylvania courts would uphold liability limitations in the face of alleged gross negligence, and found as a matter of law that the limitation applied.¹⁵²

The contract language in *Great Northern* limited liability for “negligence, active or otherwise.”¹⁵³ The court found this language sufficiently

¹⁴⁴ *Id.* at 925.

¹⁴⁵ *See, e.g.,* Valhal Corp. v. Sullivan Assoc., 44 F.3d 195, 204 (3d Cir. 1995); *Great N. Ins. Co.*, 517 F. Supp. 2d at 749.

¹⁴⁶ *Valhal Corp.*, 44 F.3d at 203–04.

¹⁴⁷ *Great N. Ins. Co.*, 517 F. Supp. 2d at 728.

¹⁴⁸ *Id.* at 747 (citing Emp’rs Liab. Assurance Corp. v. Greenville Bus. Men’s Ass’n, 224 A.2d 620, 623 (Pa. 1966)).

¹⁴⁹ *See id.* at 749.

¹⁵⁰ *See id.* at 751.

¹⁵¹ *See id.* at 753.

¹⁵² *Great N. Ins. Co.*, 517 F. Supp. 2d at 753.

¹⁵³ *Id.* at 751.

broad and clear as to encompass gross negligence.¹⁵⁴ By so doing, the court relied in part on a Pennsylvania appellate court decision upholding a true exculpatory clause disclaiming liability for “negligence or otherwise” as covering gross negligence.¹⁵⁵ Pennsylvania, like many jurisdictions, has somewhat confusing precedents concerning the impact of degrees of negligence.¹⁵⁶

Cases from other jurisdictions reach disparate results, often in the guise of evaluating, or relying on precedents involving, actual or supposed exculpatory clauses.¹⁵⁷ These cases perpetuate the use of gross negligence, as well as intentional wrongdoing, or lesser standards such as recklessness, as a means of overcoming limitations of liability.¹⁵⁸ As Justice Rehnquist summarized the common law, “‘gross negligence’ is ‘a relative term,’ and ‘a word of description, and not of definition.’”¹⁵⁹ “This distinction between acts that are intentionally harmful and those that are very negligent, or unreasonable, involves a basic difference of kind, not just a variation of degree.”¹⁶⁰ The bottom line is that the term imparts too uncertain a standard for judging something as important as contractual limitations of liability.

Gross negligence exclusions also undercut the “economic loss in tort” theory. Consequential damages represent a quintessential example of economic or commercial losses.¹⁶¹ If consequential damages cannot be disclaimed for gross negligence, then logic suggests that such tort claims for “economic losses” would presumably be permitted. Thus, one cannot reconcile adoption of the economic loss in tort principle with maintenance of gross negligence as an exception. At least one court has indeed barred tort claims founded on gross negligence because there were no duties outside of the written agreement.¹⁶²

¹⁵⁴ See *id.* at 751–52.

¹⁵⁵ *Valeo v. Pocono Int’l Raceway, Inc.*, 500 A.2d 492, 493 (Pa. Super. Ct. 1985).

¹⁵⁶ *Great N. Ins. Co.*, 517 F. Supp. 2d at 753.

¹⁵⁷ See, e.g., *Houghland v. Sec. Alarms & Servs., Inc.*, 755 S.W.2d 769, 771 (Tenn. 1988); *Adams v. Roark*, 686 S.W.2d 73, 75 (Tenn. 1985). See generally *Shields*, *supra* note 66, § 1.

¹⁵⁸ See, e.g., *Houghland*, 755 S.W.2d at 773; *Adams*, 686 S.W.2d at 75.

¹⁵⁹ *Smith v. Wade*, 461 U.S. 30, 72 (1983) (Rehnquist, J., dissenting) (quoting *Milwaukee & St. Paul Ry. Co. v. Arms*, 91 U.S. 489, 493 (1875)).

¹⁶⁰ *Id.* at 62–63.

¹⁶¹ See Anzivino, *supra* note 83, at 1123–24. As Professor Anzivino suggests, citing *All-Tech Telecom, Inc. v. Amway Corp.*, 174 F.3d 862, 865 (7th Cir. 1999), the “economic loss” doctrine could be considered the “commercial loss” doctrine. Despite whatever mysteries might otherwise surround the term “consequential damages,” there is no dispute among the cases and authorities that such damages are economic in nature. *Id.*; see also *Diamond & Foss*, *supra* note 17, at 672.

¹⁶² See *NMP Corp. v. Parametric Tech. Corp.*, 958 F. Supp. 1536, 1547 (N.D. Okla. 1997). The *NMP Corp.* court did not directly apply the economic loss rule since it was not clear whether the rule had been adopted in Oklahoma, but the court reached the same result. *Id.*

“Public policy” exceptions should be limited to intentional wrongdoing rather than any degree of negligence, this Article suggests. New York courts embrace, even if they do not always employ, the “smack[ing] of intentional wrongdoing” standard.¹⁶³ Commentators analyzing consequential damages suggest that it is “important to limit expansive liability to those [intentional and willful] breaches that are most readily capable of being deterred.”¹⁶⁴

A potential contractual standard to exclude or except limitations of liability may be framed, as in the wording at the beginning of this Article, as “willful misconduct.”¹⁶⁵ Although used in a wide variety of statutes and conventions, this phrase may not be susceptible to a single precise meaning.¹⁶⁶ Indeed, the use of “willfulness” as a standard applied to breach of contract actions has been criticized by a prominent contracts scholar as indicating “a childlike faith in the existence of a plain and obvious line between the good and the bad, between unfortunate virtue and unforgivable sin.”¹⁶⁷ The term “willful” when coupled with “misconduct” certainly connotes actual or equivalent knowledge, combined with a repugnant intent or action.¹⁶⁸ The term appears to bear close similarity to “reckless disregard” in some contexts, but should still require a degree of awareness almost akin to scienter requirements under criminal law.¹⁶⁹ In any case, the term should impart conduct greater than gross negligence.¹⁷⁰ Flaunting of a legal duty could suffice, for example.¹⁷¹ Although companies may not be able to control their employees’ intentional acts any more than they can control grossly negligent actions, contracting parties can more adequately gauge those acts that represent intentional or willful conduct versus acts that fall below the

¹⁶³ See *Sommer v. Fed. Signal Corp.*, 593 N.E.2d 1365, 1371 (N.Y. 1992).

¹⁶⁴ *Diamond & Foss*, *supra* note 17, at 681.

¹⁶⁵ See, e.g., *Digital Envoy, Inc. v. Google, Inc.*, No. 5:04-CV-1497RS, 2005 WL 2999364, at *2 (N.D. Cal. Nov. 8, 2005). It should be noted that exceptions or exclusions may apply only to a “cap” on liability rather than to the consequential damages disclaimer as well.

¹⁶⁶ Compare *Wells v. Polland*, 708 A.2d 34, 44 (Md. Ct. Spec. App. 1998) (noting a difference between reckless disregard and willful misconduct), with *Saba v. Compagnie Nationale Air France*, 78 F.3d 664, 667 (D.C. Cir. 1996) (noting that reckless disregard is an equivalent to willful misconduct).

¹⁶⁷ 5A CORBIN, CONTRACTS § 1123 (2012).

¹⁶⁸ See, e.g., *Wells*, 708 A.2d at 44 (discussing actual knowledge and conscious failure to avoid injury).

¹⁶⁹ See *Saba*, 78 F.3d at 667.

¹⁷⁰ See *id.*; see also *Dazo v. Globe Airport Sec. Servs.*, 295 F.3d 934, 941 (9th Cir. 2002); *Arch Chems., Inc. v. Radiator Specialty Co.*, 653 F. Supp. 2d 1099, 1103 (D. Or. 2009).

¹⁷¹ See *Sierra Club v. Franklin Cnty. Power of Ill., LLC*, 546 F.3d 918, 935–36 (7th Cir. 2008). Intentional breach or abandonment of a contract, without tortious acts, should not suffice. See, e.g., *Metro. Life Ins. Co. v. Noble Lowndes Int’l, Inc.*, 643 N.E.2d 504 (N.Y. 1994).

standard.¹⁷² To the extent sellers' contracts so provide, the sellers should take responsibility for corporate acts such as a conscious management decision to take or forego certain critical remedial actions or withhold essential information. For example, suppose a company learns that its products contain a latent defect with a high probability of product failure, which as a result would cause serious economic harm to a prospective plaintiff.¹⁷³ The company makes an informed decision not to notify a customer of the defect due to its remedial costs. Several months later, the product indeed malfunctions and explodes, causing a fire at the customer's factory and millions of dollars of property damage. Such a conscious decision may "smack of intentional wrongdoing" and justify holding the company liable for consequential damages, if the contract allows such liability.

Contrast the above scenario with a situation where a fully trained employee performs work on a buyer's product. The employee fails to follow industry standards or simply takes a short cut, causing the type of explosion and damages described above. How can a company or a court determine whether such actions amount to ordinary versus gross negligence? Under what circumstances should a company be held liable? The concern with uncertainty is compounded since the existence of gross negligence is normally considered a question of fact.¹⁷⁴

Accepting the proposition that contract language should be enforced, courts must still ascertain the parties' intent to determine what conduct has been excluded.¹⁷⁵ Certainly, courts must determine that the contract language is written so as to cover gross negligence, as in *Great Northern*.¹⁷⁶ An exclusion of "negligence" should suffice, without the need to distinguish gross negligence, as at least some courts have held.¹⁷⁷ The sample language at the beginning of this Article therefore works, inasmuch as it shows a clear intent to exclude or limit claims on any legal theory other than contract.

¹⁷² See *Wells*, 708 A.2d at 45 (discussing willful misconduct in terms of a land owner's liability for injury to a trespasser, noting that "liability for injury to trespassers is imposed only in those cases in which the land owner has engaged in conduct calculated to or reasonably expected to lead to injury"). Conduct calculated to cause injury is likely more easily identified than mere negligent conduct.

¹⁷³ This may give rise to a duty to warn under various state and federal laws if personal injuries or death may ensue.

¹⁷⁴ See, e.g., *Great N. Ins. Co. v. ADT Sec. Servs., Inc.*, 517 F. Supp. 2d 723, 751 n.27 (W.D. Pa. 2007), and cases cited therein.

¹⁷⁵ See *id.* at 752 n.28.

¹⁷⁶ See *id.* at 753.

¹⁷⁷ See *id.* at 752; *Valeo v. Pocono Int'l Raceway, Inc.*, 500 A.2d 492, 493 (Pa. Super. Ct. 1985). But see *Hanks v. Powder Ridge Rest. Corp.*, 885 A.2d 734, 747 (Conn. 2005) and cases cited in that opinion.

If the parties wish to retain the right to unlimited liability or a lesser standard, such as for gross negligence, that right can be incorporated into the contract.¹⁷⁸ Indeed, many contract provisions do incorporate such language.¹⁷⁹ There must also remain room for finding unconscionability in those rare instances where the circumstances warrant it. Otherwise, courts should not disturb a conscious risk allocation using the vagary of gross negligence, especially for a provision having as much impact as a consequential damages disclaimer.

In viewing conscious allocations of risk, several factors lurk in the background, including risk mitigation and the contracting parties' relationships. Companies typically obtain insurance to protect themselves from major contractual or project risks.¹⁸⁰ Parties take on insurance costs and burdens based in part on their ability to control the underlying risks, and in part on their rights or property interests in the damaged property.¹⁸¹ Insurance never provides a complete solution, since coverage may not be clear, premiums may increase to reflect payouts, and insurance companies may pursue subrogation claims against the other contracting party based on fault.¹⁸²

The extent of the parties' relationship also matters. Course of performance, course of dealing, and trade usage must be considered.¹⁸³ Often these circumstances arise between companies who have conducted business in the past. How the companies have handled issues may help determine their respective intentions and influence contract interpretation. Even more likely, standards develop in particular industries or trades.¹⁸⁴ In the power generation industry, for example, it has long been common for companies to limit their liability, often in relation to the purchase price for the particular contract, and to disclaim consequential, indirect, and similar damages.¹⁸⁵ Willful misconduct is often excluded from such limitations, while gross negligence less often appears as an express exception or exclusion.¹⁸⁶

¹⁷⁸ See *Valeo*, 500 A.2d at 493.

¹⁷⁹ See generally Shields, *supra* note 66.

¹⁸⁰ See *Great N. Ins. Co.*, 517 F. Supp. 2d at 744.

¹⁸¹ See *id.* at 726.

¹⁸² For an example of a case brought by insurers via subrogation, see *Great N. Ins. Co.*, 517 F. Supp. 2d at 723. Although insurers as subrogors stand in the shoes of their insureds, for purposes of interpreting contract provisions, this presents a curious situation where a stranger to the original contract negotiations urges certain contract interpretations.

¹⁸³ See generally Michael Pillow, *International Commercial Sales and Service Contracts—Negotiation and Enforceability of Limitations of Liability*, 21 No. 6 ACCA DOCKET 62, at *71 (June 2003).

¹⁸⁴ See, e.g., *Southland Farms, Inc. v. Ciba-Geigy Corp.*, 575 So. 2d 1077, 1081 (Ala. 1991).

¹⁸⁵ John L. Rudy, *Limitation of Liability Clauses in Public Utility Tariffs: Is the Rationale for State-Sponsored Indemnity Still Valid?*, 52 BUFF. L. REV. 1379, 1379–80 (2004).

¹⁸⁶ See generally Pillow, *supra* note 183, at *67–68.

CONCLUSION

Returning to the scenario raised in the introduction, a seller's status under current law must be characterized as uncertain, even though the parties' intent seems clear enough. The law should follow the analyses employed by the *NYSEG* and *Great Northern* courts. Where commercial parties have negotiated contractual terms, and agreed to disclaim consequential damages, their bargain should be upheld. The only exceptions that should potentially be countenanced are:

1. Willful misconduct or similar intentional actions;
2. Those rare instances where unconscionability truly applies; and
3. Any other exceptions or exclusions expressly agreed to by the parties.

In all of these cases, interpretations should be made based on the parties' contract, and as a matter of law. If the contract language leaves doubt as to the intentions of the parties, that matter may require a threshold resolution. Where the language is clear, or the parties' intentions may be readily discerned, courts should not disturb the deal.